Skadden

2024 Compensation Committee Handbook

Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates

2024 Compensation Committee Handbook

Skadden Executive Compensation and Benefits Group*

Erica Schohn

Page W. Griffin

Shalom D. Huber

Joseph M. Penko

Joseph M. Yaffe

Michael A. Wiseman

Louise Batty

Kristin M. Davis

Berit R. Freeman

Evgueni Gokhmark

Jeffrey A. Lieberman

Timothy F. Nelson

Young M. Park

Laura Westfall

Stephanie Birndorf

* The group thanks Edward B. Micheletti, Katherine D. Ashley, Kenneth B. Schwartz, Peyton V. Carper, James Rapp and F. Joseph Ciani-Dausch for their additional contributions.

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Preface

The duties imposed on compensation committees of publicly traded companies have evolved and grown over time. This tenth edition of the *Compensation Committee Handbook* from the lawyers of the Executive Compensation and Benefits Group at Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates is intended to help compensation committee members understand and comply with the duties imposed upon them. We have also undertaken to describe in some detail the concepts underlying a variety of areas within the bailiwick of compensation committees (for instance, the types of equity awards that are commonly granted and their respective tax treatment) and to provide our perspective on some of the many decisions that compensation committees must make (for instance, the pros and cons of hiring a compensation consultant and the factors that go into that hiring decision).

In short, we hope that this handbook will help compensation committee members understand their responsibilities and how best to discharge them.

We deliberately wrote this handbook in a nontechnical manner. We intend it to be something to read, not something to parse — more of a "how to" guide than a reference source for arcane rules. With that said, some of the chapters deal with technical rules, and at some length, where we think it is essential for compensation committee members to appreciate them.

Precisely because so many of the applicable rules are technical and complex and because the circumstances addressed by compensation committees are often nuanced to begin with, it is important to recognize that this handbook has limitations, in part again due to our nontechnical approach to writing it. As such, compensation committee members should not expect this handbook to be an exhaustive compliance manual.

Indeed, in some places, this handbook may even raise questions, not answer them. We hope so, because that means we achieved what we set out to do — to help compensation committee members think in a fresh way about what they are charged with doing and why.

This handbook focuses on considerations for publicly traded companies and specifically those listed on the New York Stock Exchange (NYSE) or Nasdaq. Many of the principles discussed have broader application, however.

We discuss the developments over the past year to executive and director compensation practices and related trends, particularly with respect to implementation of the SEC's clawback rule in connection with the Dodd-Frank Act (discussed principally in Chapter 2) and pay-versus-performance disclosure requirements (discussed principally in Chapter 4).

We expect that this handbook will continue to evolve further over time to address the seemingly never-ending developments in the legal and commercial landscape applicable to compensation committee responsibilities. In the meantime, we welcome any questions you might have.

Chapter 1

Overview of Committee Member Responsibilities

Compensation committee (Committee) members' duties and responsibilities generally are outlined in the Committee's organizational charter approved by the board of directors (board) of the applicable company, which should reflect requirements imposed by the securities exchanges, some of which are the result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank), applicable Securities Exchange Commission (SEC) regulations and other legal limitations. All of those obligations are discussed in greater detail later in this handbook.

The Committee is responsible for establishing and overseeing an executive compensation program for the company. The Committee should make executive compensation decisions within the context of its members' executive compensation philosophies and the corporate governance standards applicable to directors generally.

This chapter provides an overview of the most important considerations that relate to the proper discharge of the Committee's responsibilities, including the role of advisers to the Committee. The remaining chapters address those considerations in more detail.

Overview of Committee Member Responsibilities

Adopting and Implementing a Compensation Philosophy

The Committee is responsible for establishing or recommending to the board the various components of compensation for the company's senior executives, which typically consist of some of the following components, among others: base salary, annual bonuses (which are usually paid in cash), long-term incentives (which may consist of cash or equity-based awards, or a combination), executive benefit plans (for instance nonqualified deferred compensation plans, including supplemental pension and savings plans) and perquisites. The Committee often will need to make compensation decisions on an ad-hoc basis, for example to provide specialized incentives for particular circumstances (such as a corporate transaction or special performance initiatives) that were not contemplated in the ordinary course.

> The most common philosophy surely has been and remains "pay for performance."

The Committee's overarching compensation philosophy should enable it to assess the suitability of various compensation program components in a rigorous way. The most common philosophy in more recent years surely has been and remains "pay for performance" — though that of course begs the question of what type of performance is rewarded and how. For most companies, stock price performance is one natural measure of success; that is not necessarily the case for all companies, however, and the Committee should be sure to consider whether other measures are appropriate. The recent implementation of the pay-versus-performance disclosure requirements underscores the importance of the Committee's careful analysis of the relationship between pay and performance, especially concerning the relationships between named executive officer (NEO) pay and (i) total shareholder return, (ii) net income and (iii) the financial performance measure selected by the company under the pay-versus-performance requirements. Pay versus performance is discussed in detail in Chapter 4.

One consideration in implementing a compensation philosophy is determining how much potential pay should be fixed (typically in the form of salary and benefits) and how much should be "at-risk" (typically in the form of cash bonuses or equity incentive compensation).

- The implementation of the philosophy may differ depending on the level of the affected executive. For example, more senior executives often have more pay "at-risk" than lower-level executives do.
- Another important consideration for the at-risk component of compensation is whether the incentive should be short-term (typically annual) or longer-term in nature.

In recent years, a much-discussed trend has developed toward a greater portion of pay being at-risk in the form of long-term compensation based on performance rather than time-based vesting criteria, a trend that shareholders seemed to receive well.

Corporate Governance Standards — Business Judgment Rule

Most directors are familiar with the so-called business judgment rule that applies in respect of Delaware companies and that has analogs in most other states. The business judgment rule was developed as a complement to a director's two fundamental fiduciary duties under Delaware corporation law, first, the duty of loyalty, which requires a director to act without self-interest and in a manner that the director honestly believes is in the best interests of the company and its shareholders and, second, the duty of care, which requires the director to act prudently and with diligence.

The business judgment rule creates a rebuttable presumption that in making a business decision, directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company and its shareholders. The protection of the business judgment rule is not absolute. It can be rebutted if a plaintiff can present facts sufficient to support a claimed breach of duty.

In assessing a claim of breach of the duty of care, the courts place emphasis on process and look for objective evidence that directors undertook a careful, educated decision-making process. Accordingly, when making a decision, directors should:

- Become familiar with all material information reasonably available to make an informed decision.
- Secure independent expert advice (for instance from legal counsel or a compensation consultant) where appropriate and fully understand the expert's findings and the basis underlying such findings.
- Actively participate in discussions and ask questions of officers, employees and outside experts, rather than passively accept information presented.
- Understand and weigh alternative courses of conduct that may be available and the impact of such alternatives on the company and its shareholders.
- Take appropriate time to make an informed decision.

These considerations apply equally to Committee members when making determinations regarding compensation matters.

Where compensation decisions involve directors paying themselves, Delaware courts are particularly cognizant of the need for scrutiny. Self-interested compensation decisions made without independent protections are subject to the same entire fairness review as any other interested transaction. The compensation of directors is discussed further in Chapter 13.

Special considerations apply in the case of tender offers and in the mergers and acquisitions (M&A) context generally. These considerations are discussed in Chapter 12.

Communicating the Executive Compensation Program to Shareholders

Compensation Discussion and Analysis

One of the most visible roles of the Committee is to discuss with management the Compensation Discussion and Analysis (CD&A) that is included in the company's annual SEC filings and to recommend to the board that the CD&A be included in the filings. As discussed in greater detail in Chapter 4, the members of the Committee must sign a Compensation Committee Report attesting that it has discharged that obligation.

While preparation of the CD&A is the responsibility of management, it is important that the Committee be involved at all stages. Ultimately the CD&A is describing the compensation philosophy and programs that the Committee has approved for the company's executive officers, and the Committee is effectively confirming it agrees with the contents by recommending inclusion of the CD&A in the company's SEC filings.

It is not enough that the CD&A be accurate, however, because the CD&A can greatly influence the outcome of the say-on-pay shareholder vote discussed in greater detail in Chapter 4. It also should be a persuasive advocacy piece for why the compensation philosophy and programs are appropriate for the company. Moreover, in some cases — typically where the company received a low favorable say-on-pay vote in the prior year — the pay practices described in the CD&A may cause proxy advisory firms (such as Institutional Shareholder Services (ISS) and Glass Lewis) to recommend voting against a Committee member's reelection, which of course is unwelcome attention.

While preparation of the CD&A is the responsibility of management, it is important that the Committee be involved at all stages.

Where shareholder support for the say-on-pay vote is low, it can often make sense to meet with significant shareholders to explain the Committee's decisions and permit them to ask questions and raise concerns. While such meetings are sometimes arranged and attended by management rather than Committee members, in many cases direct involvement by Committee members can be helpful in addressing specific shareholder concerns.

Internal Controls/Risk

Item 402(s) of Regulation S-K (discussed in greater detail in Chapter 4) requires that the company disclose in its SEC filings its policies and practices for compensating employees, including nonexecutive officers, as they relate to risk management practices and risk-taking incentives to the extent that the risks arising from those policies and practices are reasonably likely to have a material adverse effect on the company.

- Companies typically conclude that their policies and practices do not create risks that are reasonably likely to have a material adverse effect.
- While the responsibility for making that determination is not expressly imposed on the Committee, the determination typically is made by the Committee based upon a management presentation, a result that is of course not surprising given the Committee's role in establishing those policies and practices.
- In making its determination, the Committee should also consider whether the company has internal controls in place that are reasonably designed to ensure that the compensation policies and practices are properly administered and that they are not subject to manipulation and further to ensure that the information required to generate proxy disclosure of that compensation is accurately captured.

In short, it is rare, but possible, for a company to conclude that its compensation policies and practices are reasonably likely to have a material adverse effect on the company. If that is the case, the Committee would likely seek to mitigate those risks. Accordingly, as noted above, most disclosure that implicates Item 402(s) simply recites that the company has determined that there is no such risk.

Input From Compensation Consultants/Management

The Committee may give considerable weight to the views of management and its advisers in establishing its compensation philosophy and making compensation decisions under it, but ultimately the company's executive compensation programs are the responsibility of the Committee, not management or the Committee's advisers.

Committees often retain compensation consultants to help guide their view on the appropriate compensation for executive officers and particularly how the company's programs compare to those at other peer companies. Such reliance can help the Committee substantiate that it has complied with the conditions underlying the protections offered by the business judgment rule as discussed above. However, the Committee must be sure not to substitute the judgment of its consultant for its own, as ultimate responsibility for the compensation philosophy and programs lies with the Committee.

Chapter 3 addresses particular concerns regarding the retention of advisers by the Committee, including independence assessment requirements imposed under the Dodd-Frank Act and the related stock exchange rules.

Recent Legislative/Regulatory/Political Developments

A burst of notable executive compensation rulemaking occurred in late 2022 and continues to be implemented.

On August 25, 2022, the SEC adopted final rules implementing the pay-versus-performance disclosure requirements mandated by Dodd-Frank. The final rules require public companies to disclose the relationship between the executive compensation actually paid to the company's NEOs and the company's financial performance, as discussed below (in Chapter 4). Calendar-year public companies included pay-versus-performance disclosures for the first time in their proxy statements filed in 2023.

Additionally, on October 26, 2022, the SEC adopted final rules implementing the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Act. The final rules directed the securities exchanges to establish listing standards requiring listed companies to develop and implement a policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers and to satisfy related disclosure obligations, as discussed below (in Chapter 2). The NYSE and Nasdaq established corresponding clawback listing standards that took effect in October 2023, and listed companies were each required to adopt a compliant clawback policy by December 1, 2023. For 2024 and beyond, the regulatory focus will shift to implementing clawback policies and satisfying disclosure requirements if a clawback is triggered.

In December 2022, the SEC adopted a new disclosure requirement under Regulation S-K Item 402(x). The new regulation (discussed in greater detail in Chapter 10) requires an issuer to disclose on its Form 10-K or in its annual meeting proxy statement its policies and practices regarding the timing of awards of options in relation to the disclosure of material nonpublic information.

Chapter 2

Stock Exchange and Committee Charter Requirements

Committees are subject to requirements from a variety of sources, including the stock exchanges (only the NYSE and Nasdaq requirements are discussed in this chapter), the charter that governs the Committee's operations and various statutory/regulatory requirements.

Stock Exchange and Committee Charter Requirements

Exchange Requirements

NYSE Obligations

NYSE-listed companies are required to have a Committee that is composed entirely of independent directors and subject to a written charter, which must be posted on the company's website. The requirement to have an independent compensation committee does not apply to controlled companies, limited partnerships, companies in bankruptcy proceedings, management investment companies registered under the Investment Company Act, passive investment organizations in the form of trusts, listed derivatives and special purpose securities, and foreign private issuers.

NYSE imposes certain responsibilities on the Committee. These responsibilities may be delegated to subcommittees, but any subcommittee must be composed entirely of independent directors and have a charter (which likewise must be posted on the company's website).

Under the NYSE rules, the charter must address the Committee's purpose and responsibilities, which must include responsibility to:

- Review and approve goals and objectives relevant to chief executive officer's (CEO's) compensation, evaluate the CEO's performance in light of such goals and objectives and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation based upon this evaluation.
  - » In determining the long-term incentive component of CEO compensation, NYSE commentary recommends, but does not require, that the Committee consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the company's CEO in past years.
  - » The Committee is not precluded from discussing CEO compensation with the board generally.
- Recommend non-CEO executive officer compensation to the board for approval together with any incentive and equity-based compensation plans that are subject to board approval.
- Prepare the Compensation Committee Report required under Regulation S-K.
- Provide for an annual performance evaluation of the Committee.

The rules also recommend (but do not require) that the charter address:

- Committee member qualification, appointment and removal.
- Committee structure and operations.
- Committee reporting to the board (including authority to delegate to subcommittees).

Under NYSE rules adopted in response to a mandate under the Dodd-Frank Act, the Committee may, in its sole discretion, retain or otherwise obtain the advice of compensation consultant, independent legal counsel or other adviser, and is directly responsible for the appointment, compensation and oversight of that adviser's work. These rules are discussed in greater detail in Chapter 3.

Nasdaq Obligations

Nasdaq-listed companies, pursuant to a mandate under the Dodd-Frank Act, are required to have a Committee consisting of at least two independent directors. The requirement to have an independent compensation committee does not apply to controlled companies, limited partnerships, management investment companies registered under the Investment Company Act of 1940, asset-backed issuers and other passive issuers, cooperatives, and foreign private issuers.

Under exceptional and limited circumstances (as determined by the board), and provided the Committee comprises at least three members, one nonindependent director may be appointed to the Committee. A member appointed under this exception may not serve longer than two years and the company must disclose either on its website or in its proxy statement the nature of the director's relationship with the company and the reasons why the director was appointed notwithstanding such relationship.

Under the Nasdaq rules, the company must adopt a written compensation committee charter, which must be reviewed at least annually by the Committee and should be posted on the company's website (or included as a proxy statement appendix once every three years or in any year in which the charter was materially amended). The charter must specify:

- The scope of the Committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements.
- That the Committee will determine or recommend to the board the compensation of the CEO and all other executive officers.
- That the CEO may not be present during voting or deliberations on the CEO's own compensation (no similar limitation exists for other executive officers).

As a result of the same Dodd-Frank Act mandate that gave rise to the NYSE rules (and as discussed further in Chapter 3), Nasdaq rules also provide that the Committee may, in its sole discretion, retain or otherwise obtain the advice of a compensation consultant, independent legal counsel or other adviser.

Charter Obligations

Companies should endeavor to create a compensation committee charter that best reflects their current circumstances and avoid a "one size fits all" approach. Below are some topics that companies should consider when creating or updating the charter:

- **Purpose.** The charter should include a description of the Committee's purpose, including for example overseeing the company's compensation and employee benefit plans and practices, including its executive compensation plans, and its incentive compensation and equity-based plans.
- **Composition.** The charter should establish the minimum Committee size and address appointment, removal, resignation and replacement of Committee members.
- **Meetings and minutes.** The charter should establish a targeted minimum number of annual meetings and any notice/quorum requirements. The charter should address procedures for maintaining minutes and records and reporting to the board.

- **Duties and responsibilities.** The charter should address the Committee's duties and responsibilities regarding:
  - The company's executive compensation plans.
  - CEO and non-CEO executive officer compensation.
  - Director compensation (unless addressed by a separate committee or the board as a whole).
  - Consideration of the most recent advisory say-on-pay vote.
  - Review and discussion of the CD&A with management, and recommending inclusion of the CD&A in the company's annual proxy statement or annual report on Form 10-K.
  - Preparation and inclusion of the Compensation Committee Report in the company's annual proxy statement or annual report on Form 10-K.
  - Evaluation of whether incentive and other forms of pay encourage unnecessary or excessive risk-taking.

  The charter also should address the Committee's duties and responsibilities in respect of general compensation and employee benefit plans, including incentive-compensation plans and any pension or equity-based plans.

> Companies should endeavor to create a compensation committee charter that best reflects their current circumstances and avoid a "one size fits all" approach.

- **Delegation of authority.** The charter should address the Committee's ability to delegate its duties to subcommittees or others. Companies should ensure that, if desired, any delegation complies with Rule 16b-3 under the Securities Exchange Act of 1934 (Exchange Act), which is discussed in greater detail in Chapter 9.
- **Evaluation of the committee.** The charter should provide that the Committee will conduct an annual self-evaluation of its performance and review of the charter.
- **Consultants and advisers.** The charter should address the Committee's rights and responsibilities under the applicable NYSE and Nasdaq listing rules, as described above under "Exchange Requirements."

Dodd-Frank Clawback Rules

On October 26, 2022, the SEC adopted final rules implementing the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Act. The NYSE and Nasdaq established corresponding clawback listing standards that took effect on October 2, 2023, requiring listed companies to adopt a compliant clawback policy by December 1, 2023. To meet these requirements, some companies adopted an entirely new clawback policy, while others amended their existing clawback policies to meet the listing standard requirements. Each such policy, to the extent it is designed to meet the listing standard requirements, is referred to as a "Dodd-Frank Clawback Policy" in this handbook. Some Dodd-Frank Clawback Policies contain more expansive clawback provisions that extend beyond the requirements of the listing standards, such as requiring recovery from individuals below the executive officer level if they contribute to a fault-based accounting restatement. Such optional provisions are disregarded in this section of our handbook.

Clawback Policy Requirements: Committees are likely familiar with the core elements of the clawback policies that they adopted to meet the listing standard requirements, which are summarized in this section. Such policies provide for the recovery of incentive-based compensation erroneously received by current or former executive officers during the three completed fiscal years immediately preceding the year in which the company is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements. Erroneous payments must be recovered even if there was no misconduct or failure of oversight on the part an individual executive officer, subject to limited exceptions where recovery would be impracticable.

Covered Executive Officers: Dodd-Frank Clawback Policies apply to all current and former officers subject to Section 16 of the Securities Exchange Act of 1934 (Section 16). These executive officers are subject to the clawback requirements without regard to any individual knowledge or responsibility related to the restatement or the mistaken payments. However, Dodd-Frank Clawback Policies do not require recovery of incentive-based compensation in circumstances where (i) the compensation was received by a person before beginning service as an executive officer or (ii) that person did not serve as an executive officer at any time during the three-year lookback period to which the clawback rules apply.

Covered Accounting Restatements: Both "Big R" and "little r" restatements can trigger enforcement of Dodd-Frank Clawback Policies. A "Big R" restatement occurs when a company is required to prepare an accounting restatement that corrects an error in previously issued financial statements that is material to the previously issued financial statements. By contrast, a "little r" restatement corrects an error that would result in a material misstatement if the error was not corrected in the current period or was corrected in the current period and generally does not require Form 8-K filing.

Restrictions on Indemnification and Insurance: Listed companies are prohibited from indemnifying or reimbursing any current or former executive officer against the recovery of erroneously awarded incentive-based compensation under their Dodd-Frank Clawback Policies.

Companies are further prohibited from paying the premiums on an insurance policy that would cover an executive officer's potential clawback obligations.

Enforcing Dodd-Frank Clawback Policies: For Committees, action will be required when a "Big R" or "little r" restatement occurs that may impact a financial reporting measure underlying executive officer incentive-based compensation paid during an applicable three-year lookback period.

Committees or their delegates will be required to determine the amount of erroneously received incentive-based compensation to recover, if any, which will require especially close attention when total shareholder return (TSR) or stock price was an input to the amount of incentive-based compensation received. The Committee or its delegate may be required to determine the amount of erroneously received incentive-based compensation based on a reasonable estimate of the effect of the restatement on the stock price or TSR if direct mathematical calculation is not possible and also be required to maintain and provide documentation of such determination to the applicable stock exchange. If such circumstances arise, the Committee should consider consulting with outside advisers to carefully quantify the amount of erroneously received incentive-based compensation.

Once the amount of erroneously received incentive-based compensation to recover has been determined, Committees will need to assess how they plan to recover it, including the means and timing of recovery, and to communicate any repayment obligation to their executive officers. Committees should keep in mind that certain states, such as California, have laws that generally prohibit the recovery of wages that have already been paid. While the Dodd-Frank clawback rules are currently expected to preempt conflicting state law, litigation activity may be on the horizon to definitively confirm this.

New Disclosure Requirements: A listed company must disclose its Dodd-Frank Clawback Policy as an exhibit to its Form 10-K filings and, as applicable, disclose the aggregate excess incentive-based compensation attributable to a financial restatement (and certain other related information) in its annual proxy (under Item 402(w) of Regulation S-K).

Specifically, under Item 402(w), if during or after the last completed fiscal year the listed company was required to prepare a restatement that required recovery of erroneously awarded incentive-based compensation under the listed company's Dodd-Frank Clawback Policy, or there was an outstanding balance as of fiscal year-end of erroneously awarded incentive-based compensation to be recovered from a previous application of the policy, the listed company generally will be required to disclose: (a) the date it was required to prepare the restatement; (b) the aggregate dollar amount of erroneously awarded incentive-based compensation, including an analysis of how the amount was calculated (with enhanced disclosure for certain financial measures); and (c) the aggregate dollar amount of erroneously awarded incentive-based compensation that remains outstanding at the end of the last completed fiscal year (subject to alternative disclosure if the dollar amount has not yet been determined).

If, as of the end of the last completed fiscal year, erroneously awarded incentive-based compensation remained outstanding for 180 days or longer since the date the listed company determined the amount owed, the company should disclose the dollar amount of outstanding erroneously awarded incentive-based compensation due from each applicable current and former NEO.

Additionally, if recovery would be impracticable in accordance with the narrow exceptions in the Dodd-Frank clawback rules, listed companies are required to briefly disclose why recovery was not pursued and the amount of recovery foregone.

If the listed company was required to prepare a restatement during or after its last completed fiscal year and concluded that recovery of erroneously awarded incentive-based compensation was not required under the Dodd-Frank Clawback Policy, the company is required to briefly disclose the reasoning behind such conclusion.

Compensation reported in a company's Summary Compensation Table should also be adjusted to disclose the effect of any recovered amount under the Dodd-Frank Clawback Policy.

Effect on Existing Clawback Rules: CEOs and chief financial officers (CFOs) remain subject to the clawback provisions of the Sarbanes-Oxley Act of 2002 (SOX), which provide that if a company is required to prepare an accounting restatement because of "misconduct," the CEO and CFO are required to reimburse the company for any incentive or equity-based compensation and profits from selling company securities received during the year following issuance of the inaccurate financial statements. To the extent that a Dodd-Frank Clawback Policy and SOX cover the same recoverable compensation, the CEO or CFO would not be subject to duplicative reimbursement. Recovery under the Dodd-Frank Clawback Policy will not preclude recovery under SOX to the extent any applicable amounts have not been reimbursed to the issuer.

Other Statutory/Regulatory Requirements

There are various additional statutory and regulatory requirements that govern the administration of executive compensation programs, most notably those imposed under SEC and IRS regulations. These requirements are discussed in greater detail in the remaining chapters, principally in Chapters 4, 8, 9 and 11.

Chapter 3

The Use of Advisers by the Compensation Committee

As Committees grapple with the heightened complexity of the compensation setting process — including the technical details of various forms of compensation and the increased transparency and potential for close scrutiny through public disclosures — it is common for them to seek assistance from external advisers and consultants. In particular, many Committees engage and seek the advice of compensation consultants, legal counsel or other advisers such as proxy solicitation firms. In fact, the NYSE and Nasdaq listing standards both provide that a Committee's charter must address the Committee's authority to retain advisers and require the Committee to provide for funding of any such advisers.

The Use of Advisers by the Compensation Committee

The Pros and Cons of Using an Adviser

Pros

- **Access to peer company and other executive compensation data.** As part of setting or reviewing compensation for the company's executive officers, the Committee often will take into consideration the compensation data disclosed by peer or other companies and may actively use that data to make adjustments to compensation levels or awards for the company's executive officers. Consultants can assist with the collection, organization and analysis of compensation data, often tailored to provide useful comparisons to the company's actual executive officers' positions and roles.

- **Expert advice regarding compensation trends and design of compensation programs.** Consultants may assist with identifying trends in public company executive compensation, including changes within the company's peer group in terms of design of compensation arrangements, forms of compensation awards and allocations of overall compensation into different types of compensation awards (*e.g.*, the allocation of performance-based compensation compared to compensation that is not at-risk).

- **Expert advice regarding potential investor perception of and reaction to compensation arrangements.** Consultants may advise on the potential reaction to levels or elements of compensation by investors or shareholder advisory services such as ISS or Glass Lewis. This understanding can be critical to understanding the impact of compensation decisions on say-on-pay voting or the likelihood of approval of other proxy proposals such as equity compensation plan approvals.

- **Assistance with and analysis of technical/legal compliance.** Legal advisers can assist with compliance with the myriad legal and regulatory requirements that must be satisfied in connection with any compensation decision. From disclosure obligations and consequences to understanding of tax consequences under Sections 409A, 162(m) or 280G of the Code (discussed in greater detail in Chapter 8), individual compensation decisions may have dramatic and adverse legal consequences.

- **Additional protection against litigation relating to director compensation.** As discussed in Chapter 13, recent years have seen an increase in shareholder claims relating to director compensation, in particular regarding the level of judicial review courts will apply to directors' decisions relating to their own compensation. Reliance on (and disclosure of the advice received from) a compensation consultant and legal advisers can help mitigate the risk of such suits.

- **Third-party assessment and opinions regarding compensation decisions.** While the adviser need not be "independent" under any specific statutory or regulatory guidelines, input and analysis from an adviser retained by the Committee can be a relevant and useful data point for consideration by the Committee.

Cons

- **Expense.** The retention and use of an adviser may add significant expense to the compensation decision-making process.

- **Time.** Inclusion of an adviser in the compensation decision-making process may result in additional time required to adequately assess and process the adviser's contributions. However, this may be managed through efficient use of, and instructions to, the adviser.

- **Inappropriate reliance on the adviser.** While an adviser may be helpful in providing advice to the Committee, the Committee must be mindful of its duties and obligations and take care to not let an adviser's philosophy or recommendations supplant its own. An adviser should be a tool for the Committee to avail itself of as it makes its decisions, not a replacement for the Committee's own analysis and conclusions.

Types of Advisers Commonly Used

External compensation consultants. The Committee may retain directly the services of one of the many compensation consulting firms. Typically, the consultant is retained directly by, and reports to, the Committee.

Management-retained compensation consultants. In some circumstances, company management may retain a compensation consultant to assist management with the review and formulation of compensation proposals for recommendation to the Committee. Under this approach, the consultant is retained by and reports to management, not the Committee.

Company legal counsel. Often, the company has retained and management then works with legal counsel. Under this common approach, legal counsel is retained by company management to assist with executive compensation legal issues and provides advice to the company on which the Committee then relies.

External legal counsel. The Committee may find it desirable to retain legal counsel with expertise in executive compensation issues to provide advice directly to the Committee.

Proxy solicitation firms. With the advent of say-on-pay votes, influence of shareholder advisory firms such as ISS and Glass Lewis and increased shareholder activism and proxy-related litigation, Committees have found it helpful to enlist the services of firms specializing in proxy-solicitation analysis and advice. Typically, such firms are retained by the company, but their advice may be provided directly or indirectly to the Committee for its consideration as part of the compensation decision-making process.

Retention of the Adviser — Practical Considerations

It is common for a Committee to retain compensation consultants or other advisers directly. Where the Committee engages an adviser directly, the Committee should detail the terms of the engagement in writing and, at a minimum, specify:

- The scope and role of the adviser's engagement.
- The Committee's expectations with respect to the adviser, including deliverables expected of the adviser and responsibilities to attend Committee meetings.
- Any limitations on the scope of what is expected of the adviser.

- The time period for the engagement (it is common for such engagements to be made on an annual basis, with the Committee engaging in an annual review of the adviser's performance and making a determination whether to renew the adviser's appointment).
- The person or persons to whom the adviser will report.
- The person or persons in whom the authority to terminate the relationship with the adviser resides.
- The fees, costs and bases on which the adviser will be compensated for its services.
- The adviser's commitment to provide the Committee with information necessary for the Committee to satisfy its independence analysis of the adviser, as discussed below.

The Committee can utilize the assistance of management in connection with its direct retention of an adviser. Management may assist in proposing advisers for retention, schedule and participate in interviews of proposed advisers as well as provide input as to the proposed scope of the adviser's role and responsibilities. However, care should be taken in connection with management's involvement in the adviser engagement processes to ensure the adviser is made cognizant of its role as adviser to the Committee (and not management), reporting to and subject to the Committee's direction.

In some circumstances, management may engage an adviser of its own, which then provides, directly or indirectly, advice to the Committee. A common example of this is external legal counsel retained by the company, whose advice is provided to the Committee and who may participate in Committee meetings and deliberations. In many circumstances, involvement by a management-retained adviser will be the most efficient means of providing robust analysis of compensation decisions, especially where advice is sought on a real-time basis in the midst of Committee deliberations, or where legal review is sought of a management proposal in advance of its presentation to the Committee. It is not uncommon for legal counsel retained by the company to work closely with a compensation consultant who has been retained by the Committee. As a practical matter, an adviser retained by management may work most effectively to implement the Committee's decisions as a result of more regular day-to-day interaction between the adviser and management.

In any event, the company must provide appropriate funding, as determined by the Committee, for payment of reasonable compensation to the adviser.

Retention of the Adviser — NYSE and Nasdaq Listing Standards

Independence Factors

Under the NYSE's and Nasdaq's current listing standards, *before* selecting or receiving advice from a compensation consultant or other adviser (whether in respect to executive compensation decisions or otherwise), the Committee must take into consideration the following factors:

- The provision of other services to the company by the adviser's employer.
- The amount of fees received from the company by the adviser's employer, as a percentage of the total revenue of the adviser's employer.

- The policies and procedures of the adviser's employer that are designed to prevent conflicts of interest.
- Any business or personal relationship of the adviser with a member of the Committee.
- Any stock of the company owned by the adviser.
- Any business or personal relationship of the adviser or the adviser's employer with an executive officer of the company.

In addition, the NYSE requires consideration of *all* factors relevant to an adviser's independence. Nasdaq does not have a similar catch-all requirement.

Importantly, neither the NYSE nor Nasdaq listing standards preclude the Committee from selecting or receiving advice from an adviser even where one or more of the factors set forth above evidence an actual or perceived conflict of interest. The listing standards simply require that the factors above be considered in advance of any selection or receipt of advice. However, the assessment that a conflict of interest with respect to a compensation consultant exists after consideration of these factors may result in additional disclosure obligations under Item 407(e) of Regulation S-K, as discussed below.

Typically, compensation consultants and other advisers provide upon request information responsive to the independence consideration factors set forth above. The Committee should take steps to reflect its consideration of those factors in meeting minutes or any other record of its proceedings. Further, the Committee should be prepared to reassess these factors on an ongoing basis, including in connection with any reapproval of a consultant's retention. The Committee should instruct its advisers to bring any changes in respect of these factors to its attention on a timely basis, and before the Committee receives additional advice from the adviser.

Consultants for Management: Special Considerations

One issue arising under NYSE and Nasdaq rules regarding independent advisers to a Committee is how and whether those rules are implicated where management retains an adviser on behalf of the company and not the Committee. In those circumstances, the Committee should determine whether advice from the management-retained adviser ultimately will be provided to and relied upon by the Committee. In many cases, the advice is sought by management from advisers retained by the company but the ultimate advice delivered to the Committee is provided to the Committee by the company's internal legal counsel or other management members following their review of the outside legal adviser's advice. In such circumstances, the Committee may not need to engage in any analysis of the independence of the adviser retained by management because the advice actually provided to the Committee is from a management member who is recognized *per se* by the Committee to not be independent.

In other circumstances, the role of an adviser retained by management may be different. For example, advisers may be relaying their advice directly to the Committee or the advice may be expressly presented by management as advice originating from the adviser. In those cases, the Committee may wish to have the management-retained adviser provide it with information sufficient to analyze the independence factors set forth above in advance of receiving such advice. In either circumstance, it is a best practice for the Committee to have an understanding of the source — and independence — of the advice on which it is relying, whether the advice comes from management, an adviser retained by management or an adviser retained directly by the Committee.

One issue arising under the NYSE and Nasdaq rules regarding independent advisers to a committee is how and whether those rules are implicated where management retains an adviser on behalf of the company and not the Committee.

Because it may not always be clear whether advice provided to management is ultimately provided to and relied upon by the Committee, or because an adviser who typically interfaces with management may be called unexpectedly and in short order to provide advice directly to the Committee, it may make sense for advisers to be assessed for independence on a prophylactic basis even where it is not presently expected that they will provide advice directly to the Committee.

Disclosure Obligations

The extent to which an adviser is involved in the compensation-setting process for executive officers must be disclosed by the company in the following circumstances:

First, the CD&A should include, if material, disclosure regarding the role a compensation consultant plays in the company's compensation-setting process.

Second, Item 407(e) of Regulation S-K requires additional disclosure regarding the use of compensation consultants in certain circumstances. Specifically, Item 407(e)(3)(iii) requires disclosure of the role of compensation consultants in determining or recommending the amount or form of executive and director compensation during the company's last fiscal year. The identity of the consultant should be included, together with a statement of whether the consultant was engaged directly by the Committee (or persons performing the equivalent functions) or any other person. The disclosure must describe the nature and scope of the consultant's assignment and the material elements of the instructions or directions given to the consultant with respect to the performance of its duties under the engagement. This disclosure obligation does not apply to any role of a compensation consultant that is limited to consulting on broad-based plans that do not discriminate in scope, terms or operation in favor of executive officers or directors of the company and that are available generally to all salaried employees, or is limited to providing information that is not customized for the company or that is customized based on parameters that are not developed by the compensation consultant and about which the compensation consultant does not provide advice.

Additional Fee Disclosure

Additional disclosure must be provided if a consultant provides services other than executive compensation advice to the Committee or management. Specifically, if a consultant was engaged by the Committee to provide advice or recommendations on the amount or form of executive or director compensation and the consultant and its affiliates also provided additional services to the company with a value in excess of $120,000 during the last fiscal year, then disclosure is required of the aggregate fees for determining the amount or form of executive and director compensation and the aggregate fees for the additional services. In addition, disclosure must be provided as to whether the decision to engage the consultant or its affiliates for the additional services was made, or recommended, by management, and whether the Committee or the board approved the additional services of the consultant or its affiliates.

Moreover, under Item 407(e)(3)(iii)(B) of Regulation S-K, if the Committee has not engaged a compensation consultant, but management has engaged a consultant to provide advice or recommendations on the amount or form of executive and director compensation for which disclosure is required under Item 407(e)(3)(iii) and the consultant or its affiliates has provided additional services to the company with a value in excess of $120,000 during the last fiscal year, then disclosure must be provided as to the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the consultant or its affiliates.

Conflicts of Interest

Item 407(e)(3)(iv) of Regulation S-K requires that, with regard to any compensation consultant whose work has raised any conflict of interest, disclosure must be included as to the nature of the conflict and how the conflict is being addressed. Instructions to Item 407(e)(3)(iv) indicate that the following six factors should be considered in determining whether a conflict of interest exists:

- The provision of other services to the company by the adviser’s employer.
- The amount of fees received from the company by the adviser’s employer as a percentage of the total revenue of the adviser’s employer.
- The policies and procedures of the adviser’s employer that are designed to prevent conflicts of interest.
- Any business or personal relationship of the adviser with a member of the Committee.
- Any stock of the company owned by the adviser.
- Any business or personal relationship of the adviser or the adviser’s employer with an executive officer of the company.

These are the same factors set forth above in connection with the independence assessment required of the Committee under the NYSE and Nasdaq listing standards.

As a result of these disclosure obligations, the Committee should expect that any use of an adviser in connection with its decision-making process may trigger public disclosure of the adviser’s role. The extent of and need for such disclosure should be reviewed with legal counsel.

Chapter 4

SEC Filings

The Committee assists with and supervises the company's compliance with its public disclosure requirements. This chapter provides an overview of two disclosure requirements that implicate Committee concerns:

- The executive compensation disclosure required under Item 402 of Regulation S-K (which usually is set forth in a company's annual proxy statement but can be required in certain other public filings).
- The requirement to disclose certain personnel and compensation matters on SEC Form 8-K.

SEC Filings

Special Note About Emerging Growth Companies

It is important to note that special rules apply to so-called emerging growth companies (EGCs), a category of company created under the Jumpstart Our Business Startups (JOBS) Act in 2012. For instance, the disclosure discussed below under Item 402 of Regulation S-K is greatly simplified for EGCs, in that fewer individuals are subject to the disclosure, no CD&A is required, and certain portions of the otherwise required tabular disclosure may be omitted. Members of the Committee of an EGC should seek special counsel focused on the company's status as an EGC.

An EGC is defined as an issuer that had total annual gross revenues of less than $1.235 billion during its most recently completed fiscal year (as adjusted for inflation from the original $1.0 billion). An issuer that is an EGC continues to be an EGC until the earliest of:

- The last day of the fiscal year during which it had total annual gross revenues of at least $1.235 billion.
- The last day of the fiscal year following the fifth anniversary of the initial public offering of its equity.
- The date on which it has, during the previous three-year period, issued more than $1 billion in nonconvertible debt.
- The date on which it is considered to be a "large accelerated filer" under the Exchange Act.

An issuer does not qualify as an EGC if it conducted an equity IPO on or before December 8, 2011.

Regulation S-K Item 402 Disclosure

CD&A (Item 402(b)(1))

General Considerations: The company must provide in narrative form a general overview of its executive compensation practices as they apply to the company's NEOs. The CD&A must cover compensation for the preceding fiscal year, but should also discuss NEO post-termination compensation arrangements that were in effect during that year (even if not triggered) and also, if they could affect a fair understanding of compensation for the preceding fiscal year, new compensation arrangements and policies (or arrangements or policies from earlier years).

The NEOs include for any fiscal year the company's CEO and CFO, the three most highly compensated employees other than the CEO and CFO serving as an executive officer at the end of the fiscal year and up to two additional individuals for whom disclosure would have been provided (*i.e.*, because they had higher compensation than one of the other additional three executives) except that the individuals were not serving as executive officers of the company at the end of the fiscal year.

The CD&A is designed in large part to facilitate an understanding of the detailed tabular presentation of compensation that follows it (as discussed further below). At a minimum, the company must discuss each element of the following:

- The material principles underlying the company's executive compensation policies and decisions.
- The objectives of the company's compensation programs.
- What the compensation programs are designed to reward.
- Each element of compensation.
- Why the company chooses to pay each element.
- How the company determines the amount (and, where applicable, the formula) for each element it pays.
- How each compensation element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements.

Other required disclosures will vary based on facts and circumstances, but the SEC has identified the following list of potential material information, which, among other factors, the company may need to discuss, if applicable:

- Policies for allocating between long-term and currently paid out compensation.
- Policies for allocating between cash and noncash compensation, and among different forms of noncash compensation.
- For long-term compensation, the basis for allocating compensation to each different form of award.
- How the determination is made as to when awards are granted, including awards of equity-based compensation.
- What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions.
- How specific elements of compensation are structured and implemented to reflect these items of the company's performance and the executive's individual performance.
- How specific forms of compensation are structured and implemented to reflect each NEO's individual performance and/or individual contribution to these items of the company's performance, describing the elements of individual performance and/or contribution that are taken into account.
- Policies and decisions regarding the adjustment or recovery of awards or payments if performance measures are restated or adjusted in a manner that would reduce the award or payment (*i.e.*, clawback policies).
- The factors considered in decisions to increase or decrease compensation materially.
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (*e.g.*, how gains from prior option or stock awards are considered in setting retirement benefits).
- With respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payments at, following, or in connection with any termination or change in control, the basis for selecting particular events as triggering payment.

- The impact of accounting and tax treatments of a particular form of compensation including the consequences under Section 409A and Section 162(m) of the Code, to the extent applicable, which are discussed in Chapter 8.
- The company's stock ownership requirements or guidelines and any policies regarding hedging the economic risk of such ownership.
- Whether the company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies).
- The role of executive officers in the compensation process.

Confidential Information: Award targets that contain confidential commercial or business information need not be disclosed in the CD&A. While the company is not required to formally seek confidential treatment for omitted information, the ability to omit information is subject to the same standards as when the company requests confidential treatment in other public filings. If targets are not disclosed, the company must describe how difficult it will be for the company (or executive, as the case may be) to achieve the undisclosed target.

The company is specifically required to analyze and discuss the methods it uses to select the terms of incentive compensation awards, such as the grant date and the exercise price of options.

Award Timing Considerations: The company is specifically required to analyze and discuss the methods it uses to select the terms of incentive compensation awards, such as the grant date and the exercise price of options. According to the SEC, the company should pay careful attention to the following:

- Does the company have a program, plan or practice to time option grants in coordination with the release of material nonpublic information (including for new executive officers)?
- How does the timing of option grants to executives fit in the context of option grants to employees generally?
- What is the Committee's role in approving such a program or practice? Did the board or Committee consider this information in determining when and in what amount to make such grants? Did the Committee delegate authority to administer the program to any other persons?
- What is the role (if any) of the executive officers in the timing of option grants?
- Does the company time the release of nonpublic information to affect the value of executive compensation?

If an option exercise price is not based on the stock's closing price on the actual grant date, the CD&A should describe how the exercise price is determined.

Discussion of Say-on-Pay Vote Results: The company must disclose whether it considered the results of the most recent say-on-pay vote in determining executive compensation policies and decisions and, if so, how that consideration affected those policies and decisions. Moreover, ISS has stated that if the company's say-on-pay proposal does not receive at least 70% support, ISS will closely scrutinize the company's responsiveness to shareholder concerns and, based on that review, will consider whether to recommend against the reelection of Committee members and against the company's next say-on-pay proposal. Similarly, Glass Lewis has indicated that it expects some evidence of engagement and responsiveness to shareholder concerns if a company's say-on-pay proposal does not receive more than 80% support, and Glass Lewis newly clarified in its 2024 U.S. Benchmark Policy Guidelines published in November 2023 that it counts both "against" and "abstain" votes as opposed for purposes of this analysis. The say-on-pay vote is discussed in more detail below in this chapter.

Executive Compensation Tables and Narrative Disclosure (Items 402(c) – (j))

In addition to the CD&A, the company must provide extensive quantitative information about the compensation paid to each NEO — generally in tabular form — including the Summary Compensation Table (which generally includes three years of historical compensation for each NEO) and more detailed information in respect of the most recent fiscal year regarding incentive compensation grants, outstanding equity awards, equity awards exercised or vested during the year, pension and deferred compensation benefits, and payments upon employment termination or a change in control of the company. Any table, or column in any table, can be omitted entirely if there is no information to disclose.

Director Compensation Table (Item 402(k))

Item 402(k) requires a Director Compensation Table covering compensation paid to directors for the preceding fiscal year, together with a narrative description of the compensation programs in effect for that year. The table is similar in many respects to the Summary Compensation Table required for NEOs, though it relates to the preceding fiscal year only, not the three preceding years, and it is not supplemented with the additional tabular disclosure provided for NEOs. Despite the relatively limited disclosure requirements of Item 402(k), for the past several years there has been an increasing trend toward including additional disclosure around director compensation, which may be attributable to the increased scrutiny of director compensation by shareholders, which is discussed in greater detail in Chapter 13.

In addition to Item 402(k), a Nasdaq rule requires listed companies to annually disclose information about compensation that the company's directors and director nominees receive from third parties. The disclosure must include the material terms of all arrangements between any director or nominee and any person or entity, other than the company, that relates to compensation or other payments in connection with that person's candidacy or service as a director of the company, other than (i) arrangements only for expense reimbursement, (ii) pre-existing arrangements (except that material compensation increases under such arrangements due to nomination or service must be disclosed) and (iii) arrangements already publicly disclosed (*e.g.*, pursuant to Item 402(k)). The disclosure must be located on the company's website (or accessible from the website) or included in its proxy or information statement for any shareholders' meeting at which directors are elected (or Form 10-K or Form 20-F, as applicable).

Risk of Compensation Programs (Item 402(s))

As discussed in Chapter 1, the SEC requires companies to disclose the relationship of the company's compensation policies and practices to risk management, but *only* if those compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. The company is not required to include an affirmative statement that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company, but many companies include this statement, as well as an explanation of the company's process for evaluating risks arising from compensation policies and practices, to address the concerns of shareholders and proxy advisors.

The SEC rule, in effect, ensures that the company monitors and reviews the risks associated with its executive and employee compensation programs at least once each year. The risk assessment process will vary from company to company, depending on a variety of factors, including company size, maturity, industry sector and compensation philosophy. Responsibility for the assessment also typically will vary from company to company. Typically, management leads the assessment (perhaps with a consultant) and provides the results to the board and/or the Committee. In other cases, the Committee (or less likely, the board), will oversee the assessment, using management to gather the necessary information and conduct the analysis.

CEO Pay Ratio (Item 402(u))

Under Item 402(u), which implements the "CEO pay ratio" disclosure requirements, the company must disclose (i) the median of the annual total compensation of all employees of the company other than the CEO, (ii) the annual total compensation of the CEO and (iii) the ratio of those two amounts. The comparison must be disclosed either as a ratio (*e.g.*, 50:1 or 50 to 1) or narratively in terms of the multiple. (For example, "The CEO's total compensation amount is 50 times that of the median of the annual total compensation of all employees.")

Companies need to identify a median employee only once every three years, unless the company has a change in the employee population or compensation arrangements that could significantly affect the pay ratio, requiring the company to assess annually whether their workforce composition or compensation arrangements have materially changed. Companies should review the year in which they last designated the median employee: If a new median employee was last designated for fiscal year 2021, the company will need to perform calculations to again identify a median employee for fiscal year 2024 because the three-year maximum will have been reached.

Certain non-U.S. employees may be excluded from the median employee calculation pursuant to a foreign data privacy law exemption and/or a 5% *de minimis* exemption; however, reliance on either exemption requires additional disclosure. Careful consideration is warranted each year concerning whether such exemptions remain applicable, especially if a company's workforce composition changed significantly over the year. For example, if a company conducted layoffs in the United States, certain jurisdictions that were formerly eligible to be excluded from the median employee calculation under the de minimis exception might newly make up a share of the company's total employee population that exceeds the threshold for such exception.

In addition to disclosing the pay ratio, the company is required to briefly describe the methodology used to identify the median employee, as well as any material assumptions, adjustments (including cost-of-living adjustments) or estimates used to determine the median employee or annual total compensation. To identify the median employee, companies may use a "consistently applied compensation measure," rather than calculating each employee's "annual total compensation" under Item 402(c).

The SEC has issued an interpretive release on the disclosure requirements, and the staff of the SEC's Division of Corporation Finance issued separate guidance regarding the use of statistical sampling in conducting the pay ratio analysis. This guidance affirmed that the SEC and its staff intend to provide companies with a wide range of flexibility in complying with the pay ratio rules.

The interpretive release generally provides significant flexibility to companies in identifying their median employee and calculating the median employee's total annual compensation and also expressly provides that as long as the company uses reasonable estimates, assumptions and methodologies, the pay ratio calculation and related disclosure will not provide the basis for an SEC enforcement action, unless the company lacked a reasonable basis for the disclosure or it was not made in good faith. Moreover, a company may use existing internal records that reasonably reflect employees' annual compensation to identify its median employee, even if those records do not include every element of compensation, such as equity awards widely distributed to employees.

The separate guidance issued by the SEC staff sets forth hypothetical examples to assist companies in determining how to use statistical sampling methodologies and other reasonable methods that may be appropriate for their specific circumstances. For instance, the staff identified various sampling techniques (*e.g.*, simple random sampling, stratified sampling, cluster sampling and systematic sampling) as well as potential situations under the pay ratio rules in which companies may use reasonable estimates, which may be appropriate depending on the company's particular circumstances.

EGCs, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirements. There are also transition periods for private companies that go public and companies engaging in business combinations or acquisitions.

Although, as described above, the SEC rules and guidance permit a fair degree of flexibility, most companies appear to keep the actual calculation as simple as possible. Notably, resulting ratios tended to correlate with specific industries, with certain industries generally having higher ratios than others. ISS and Glass Lewis, the two largest proxy advisory firms, have indicated that they continue to display CEO pay ratio as a data point for informational purposes in their research reports and Proxy Papers, respectively, but that the CEO pay ratio is not a determinative factor in their voting recommendations at this time.

Committees also should be aware that state and local governments are increasingly viewing pay ratios as a tax revenue-generating opportunity. For example, in San Francisco, an additional gross receipts tax or an administrative office tax applies to some companies engaging in business in San Francisco when a company's highest-paid managerial employee earns more than 100 times the median compensation paid to its employees based in San Francisco. Lawmakers in at least nine U.S. states — including California, Connecticut, Hawaii, Illinois, Massachusetts, Minnesota, New York, Rhode Island and Washington — and federal representatives have launched proposals relating to taxation based on CEO-worker pay ratios in the past several years.

Pay Versus Performance (Item 402(v))

In August 2022, the SEC adopted final rules requiring public companies to disclose the relationship between the executive compensation actually paid to the company's NEOs and the company's financial performance, adding Item 402(v) to Regulation S-K. Companies were required to incorporate these items into those proxy or information statements that include executive compensation disclosure for fiscal years ending on or after December 16, 2022, meaning that calendar-year companies needed to include this new disclosure for the first time in their proxy statements filed in 2023.

The final rules require companies to include in those proxy or applicable information statements a "Pay Versus Performance" table with the following information:

- The total compensation of the CEO and the average total compensation of the other NEOs, using the information required to be reported in the Summary Compensation Table.
- The compensation "actually paid" to the CEO and the average total compensation "actually paid" to the other NEOs, calculated in accordance with the final rules.
- The TSR of both the company and its peer group.
- The company's net income.
- A financial performance measure selected by the company that in the company's assessment represents the single most important financial measure that it used for the most recent fiscal year to link compensation actually paid to the company's NEOs to the company's performance.
- Footnoted disclosure to the table for any amounts deducted and added to total compensation of the NEOs to determine the amount of compensation "actually paid."

Covered Issuers and Time Period: Companies are required to disclose the applicable information for their five most recently completed fiscal years, provided that in the first proxy or information statement in which a company provided this disclosure, the company could disclose for three years instead of five years, adding another year of disclosure in each of the two subsequent annual filings. Therefore, looking ahead to the second proxy statement where the pay-versus-performance disclosure is required, companies will need to include four years of data in their Pay Versus Performance table, including the three years previously disclosed and data for the most recently completed fiscal year. Smaller reporting companies are subject to scaled disclosure requirements.

Listing of Important Financial Measures: Companies also must provide an unranked tabular list of at least three and up to seven financial performance measures (the "tabular list") that in each company's assessment represent the most important financial performance measures the company used for the most recent fiscal year to link compensation actually paid to the company's CEO and other NEOs to the company's performance. A company may include nonfinancial performance measures in this list if those measures are among the most important performance measures used by the company to link compensation actually paid to performance and the company has disclosed at least three financial performance measures (or fewer, if the company uses fewer than three).

Description of the Relationship Between Pay Versus Performance: Using values reflected in the Pay Versus Performance table, a company is required to describe (i) the relationship between (a) the executive compensation "actually paid" to the CEO and the average total compensation "actually paid" to the other NEOs and (b) the company's

TSR, its net income and the company-selected measure (CSM), and (ii) the relationship between the company's TSR and the TSR of its peer group. In addition, the company must describe the relationship between (a) the executive compensation actually paid to the CEO and the average total compensation actually paid to the other NEOs and (b) any supplemental measures voluntarily included in the Pay Versus Performance table.

Supplemental Disclosures: Companies are permitted to supplement the disclosure by providing pay-versus-performance disclosure (in tabular format or otherwise) based on other compensation measures such as "realized pay" or "realizable pay" if they believe such supplemental disclosures provide useful information about the relationship between the compensation paid and the company's financial performance. The supplemental disclosure, however, may not be misleading or presented more prominently than the required pay-versus-performance disclosure. In practice, supplemental disclosures were not common in the first year of pay-versus-performance disclosure.

Applicable Filings: The pay-versus-performance disclosure is required in any proxy or information statement that is required to include executive compensation disclosure, including those with respect to the election of directors. The disclosure is not required in annual reports on Form 10-K (other than with respect to the incorporation of proxy disclosure by reference), Securities Act registration statements or Exchange Act registration statements (*e.g.*, registration statements on Form S-1 for IPO companies).

First-Year Mistakes: SEC comment letters revealed the following common mistakes in the first year of pay-versus-performance disclosures:

- Failing to describe the relationship between (a) compensation "actually paid" and (b) TSR, net income and the CSM.
- Failing to include the tabular list.
- Including multiple CSMs or failing to include the CSM in the tabular list.
- Failing to provide a GAAP reconciliation for non-GAAP CSMs.
- Using a TSR peer group that does not match either the industry group in the company's 10-K performance graph or the compensation peer group disclosed in the CD&A.
- Failing to include or identify all NEOs who served each year.
- Using partial-year compensation (*e.g.*, including only compensation for the time served as an NEO during a given year).
- Valuing awards that vest during the year based on a "year-over-year" change, rather than valuing them as of the date of vesting.

Clawback Rules (Item 402(w))

As discussed in detail in Chapter 2, Item 402(w) implements the SEC's final rules regarding the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Act.

Option Award Timing (Item 402(x))

As discussed in detail in Chapter 10, Item 402(x) implements the SEC rules regarding disclosure of the timing of awards of options in relation to the disclosure of material nonpublic information.

Compensation Committee Report

As noted in Chapter 1, the Committee must discuss the CD&A with management and recommend to the board that the CD&A be included in the company's annual proxy or annual report on Form 10-K, and each member of the Committee must sign a Compensation Committee Report attesting that the Committee has discharged that obligation.

The Compensation Committee Report will not be deemed soliciting material under the proxy rules or "filed" with the SEC, and as such it will be subject to limited liability under the federal securities laws. Regardless, to help ensure the accuracy of the Compensation Committee Report, the Committee should review the CD&A carefully in advance of furnishing the CD&A.

Say-on-Pay Votes

Say on pay voting includes three separate nonbinding shareholder votes that must be held in varying circumstances:

- A vote on executive compensation (say on pay).
- A vote on whether future say on pay votes should take place every one, two or three years (say on frequency vote).
- A vote on certain M&A-related compensation arrangements (say on golden parachute vote).

An EGC is exempted from the requirement to hold say-on-pay votes.

Say on Pay

The say-on-pay resolution must indicate that the shareholders are voting to approve the compensation of the company's NEOs as disclosed "pursuant to Item 402 of Regulation S-K" or a plain English equivalent of those words. The proposal should also indicate that the vote is advisory and will not be binding on the company.

It has become common for companies to include, as part of the proposal, information that is designed to support a positive vote, for instance favorable information about the company's operational results and how payments under the company's compensation programs promote or are conditioned upon those results.

Say on Frequency

In addition to a say-on-pay vote, the company must allow shareholders to vote, at least once every six years, on how frequently to hold the say-on-pay vote, which is also a nonbinding advisory vote. Shareholders must be given the choice of one of the following times for holding the say-on-pay vote:

- Every year.
- Once every other year.
- Once every three years.
- Abstaining from the vote.

Because many companies first provided shareholders the opportunity to cast a say on frequency vote in 2011, many included the nonbinding advisory vote again in 2017 and 2023 proxy statements. At the overwhelming majority of companies, shareholders voted in favor of an annual say-on-pay vote, and that frequency remains by far the most common.

Moreover, although say on frequency is advisory in nature, Glass Lewis' recent guidance indicates that it considers failure to heed to the shareholder vote result akin to ignoring the clear will of shareholders. Therefore, Glass Lewis generally will recommend against all members of the Committee when the board adopts a frequency other than the frequency approved by a plurality of shareholders.

Say on Golden Parachute

In connection with most M&A and tender offer transactions, the say on golden parachute rules require the company to provide disclosure of the compensation and benefits that may be provided to target and acquiring company NEOs in connection with the transaction and generally afford shareholders a nonbinding advisory vote as to whether those benefits should be provided.

Companies must disclose (and separately identify as either "single trigger" or "double trigger") the following information:

- Cash severance amounts.
- The value of accelerated equity awards.
- Pension and deferred compensation benefit enhancements.
- Perquisites and health and welfare benefits.
- Tax gross-ups.
- Any other elements of compensation.

Additional narrative disclosure must describe any material conditions or obligations regarding the payment, such as noncompete or nonsolicitation obligations, specific circumstances triggering payments, the duration of payments and other material provisions of the agreement or arrangement providing for the M&A-related compensation.

The say on golden parachute vote is separate from the vote to approve the transaction and will not factor into whether the transaction has obtained the requisite shareholder approval. Although agreements or understandings between the acquiring company and the target company NEOs must be disclosed, they are not subject to the vote requirement. In that (not particularly unusual) case, the target company must provide a second disclosure table containing information for only those arrangements that are subject to the say on golden parachute vote.

Form 8-K

Overview

Form 8-K is a report filed by the company with the SEC to disclose a variety of circumstances on a current basis (typically within four business days of the event). A fairly wide variety of circumstances can trigger an 8-K filing. Those most relevant to the Committee are:

- The departure of a director or certain officers.
- The appointment of certain officers.
- The election of a director.
- The adoption or material amendment of a material compensation arrangement with an NEO.
- The occurrence of a blackout period under a company benefit plan.
- The results of certain shareholder votes.

The 8-K disclosure obligation is separate from the filing obligation that may also apply (*i.e.*, where a document must be filed as an exhibit to the company's next Form 10-Q or Form 10-K).

Departure of a Director as a Result of a Disagreement or Removal

Disclosure is required if a director resigns or refuses to stand for reelection because of a disagreement with the company regarding its operations, policies or practices or is removed for cause. In such a case, the company must describe:

- The date of resignation, refusal to stand for reelection or removal.
- Any committee memberships of the director.
- The disagreement that caused the director's resignation, refusal to seek reelection or removal.

If the director delivers any notice or letter to the company regarding the director's resignation, refusal or removal, the company must file the notice or letter.

Departure of Director for Other Reasons/Departure of Certain Officers

Disclosure is also required if a director departs for a reason other than a disagreement with the company or for cause (as described immediately above) or if any of the following officers retire, resign or are terminated:

- The CEO.
- The CFO.
- The president.
- An accounting officer.
- The COO.
- Any other person listed as an NEO in the company's most recent proxy statement.

In this case, the company must disclose the departure and the date it occurred.

Appointment of Certain Officers

Disclosure is required if the company appoints a new:

- CEO.
- CFO.
- President.

- Accounting officer.
- COO.

In this case, the company must describe:

- The name, age and position of the officer.
- The date of appointment.
- The officer's employment history for the previous five years.
- The material terms of any material arrangement with the new officer or any material amendment or any award or grant (or modification thereto) to the new officer under such arrangement.
- Any related party transactions under Item 404(a) of Regulation S-K between the new officer and the company (which generally includes any transaction in which the company was or is to be a participant where the amount involved exceeds $120,000 and in which the new officer had or will have a direct or indirect material interest).
- Any relationships between the new officer and other officers and directors.

If the company plans to issue a press release or make some other public announcement regarding the new appointment, the company may delay filing the Form 8-K until the date it issues the announcement. Note, however, that if the company is appointing the new officer to replace an officer whose departure must be disclosed, disclosure of the departure may not be delayed, which limits the utility of delaying disclosure of the appointment.

Election of a New Director

Disclosure is required if the company adds a new director other than by shareholder vote at a meeting. In this case, the company must describe:

- The name of the director.
- The date of appointment.
- Any committees on which the director will serve.
- Any arrangement under which the director was appointed.
- Any related party transactions between the new director and the company.
- Any relationships between the new director and other officers and directors.
- Any material compensation arrangements.

Compensatory Arrangements of Certain Officers

Disclosure is required if:

- The company adopts a new material compensation plan, agreement or arrangement — or materially amends an existing plan, agreement or arrangement — in which an NEO participates or to which the NEO is a party.

- A material grant or award under any such plan, agreement or arrangement to an NEO is made or materially modified.

Disclosure is not required of:

- A plan that does not favor executive officers and is generally available to all salaried employees, such as a typical broad-based severance plan.
- An award or agreement that is subject to shareholder approval (though no other contingency defeats the current obligation to disclose, and disclosure is required once shareholder approval is obtained).

An important exception to disclosure applies where a new award is consistent with the terms of a previously disclosed plan or agreement, such as a typical annual or long-term incentive award. Such an award is not subject to 8-K disclosure and instead merely must be disclosed as part of the regular executive compensation disclosure (typically in the annual proxy) as and when required.

Note that new awards or compensation programs for directors are not subject to 8-K disclosure (though, as noted above, material compensation arrangements for newly appointed directors must be summarized when their appointment is disclosed).

Delayed Compensation Information for NEOs

If the salary or bonus for any of the NEOs cannot be determined by the time the company must file compensation information in its Form 10-K or annual proxy statement, the company must file an 8-K to disclose the information once it is finally determined. Similarly, if the CEO's salary or bonus information cannot be determined by the time the company must file its Form 10-K or annual proxy statement and, as a result, the CEO Pay Ratio disclosure is not determinable at such time, the company must file an 8-K to disclose the CEO Pay Ratio information once it is finally determined.

Temporary Suspension of Trading Under the Company's Employee Benefit Plans

The company must file an 8-K if a "blackout period" arises under one of its employee benefit plans. A blackout period generally occurs when trading in the company's securities under the plan is prohibited (for instance, under a 401(k) plan that includes a company stock account), though the rule is subject to many and varied exceptions. Typically, blackout periods occur when the plan is changing its record-keeper or investment options or in a plan merger or spinoff scenario (including in the M&A context).

During any such blackout period, directors are generally prohibited by the SEC's Regulation Blackout Trading Restriction (so-called Regulation BTR) from purchasing, selling or otherwise acquiring or transferring any equity security of the company if the security was acquired in connection with their service as a director.

Submission of Matters to a Vote of Security Holders

After the company holds a shareholders meeting, it must file an 8-K to report the results of the votes presented to shareholders at that meeting. If the shareholders voted to elect directors, this information must be broken out by each director nominee.

Other Events

The company may voluntarily file an 8-K to report any other information whose disclosure is not otherwise required if it believes shareholders would find the information important, for example if the company reaches a settlement of outstanding material litigation.

Failure To File a Form 8-K

The failure to file a Form 8-K is a violation of the company's obligations under the Exchange Act and subjects the company to potential liability, which can include a loss of the company's right to use a Form S-3 for both primary and secondary offerings.

Form 10-K

In 2020, the SEC updated its Regulation S-K rules, which generally require companies to make certain human capital-related disclosures in their annual reports on Form 10-K. Further details about this human capital disclosure requirement are outlined in Chapter 10.

Chapter 5

Proxy Advisory Firms

Institutional shareholders typically maintain holdings in hundreds or even thousands of companies. During proxy season, these companies present various proposals, some of which are compensation-related, to their shareholders for voting purposes. Many shareholders, including the largest institutional shareholders, do not have the resources available to read, analyze and make independent determinations in connection with the proposals in such a short span of time. As a result, many institutional shareholders rely on guidance and voting recommendations from proxy advisory firms.

ISS is the largest proxy advisory firm by a considerable margin, with the next largest being Glass Lewis. Some ISS and Glass Lewis clients follow the voting recommendations without further review, while others do additional research and analysis to supplement the information from the firms.

Proxy Advisory Firms

The Significance of Proxy Advisory Firms

Until the 2011 proxy season, the influence of proxy advisory firms within the compensation world was largely limited to instances in which a company sought shareholder approval of a new equity compensation plan (or an increase in authorized shares under an existing plan). However, this changed dramatically when the SEC issued rules implementing the Dodd-Frank Act's say-on-pay vote requirement.

As discussed in more detail in Chapter 4, say on pay is an advisory vote to approve the compensation of the company's NEOs as disclosed pursuant to Item 402 of Regulation S-K (which includes the CD&A, the compensation tables and the other narrative executive compensation disclosure). A say-on-pay vote was first required at the 2011 annual meeting of shareholders and is held every one, two or three years thereafter, depending on the frequency chosen by the company's shareholders in the separate say on frequency vote. The most common frequency is annual.

The advisory firms review the company's annual proxy after it is filed and then make a recommendation either "for" or "against" the company's proposals, including the say-on-pay proposal. Proposals receiving an "against" recommendation typically receive significantly lower support from shareholders (often about 20-30% lower), and almost all companies with say-on-pay or equity plan-related proposals that ultimately fail have received an "against" recommendation from either or both of ISS and/or Glass Lewis.

Although the say-on-pay vote is nonbinding, a company that receives fewer than 70% of the shareholder votes and that does not proactively respond with shareholder outreach — and (potentially) program changes — runs the risk of having that perceived lack of responsiveness constitute additional, independent grounds for an "against" recommendation the following year. If a company receives fewer than 70% of the shareholder votes, ISS may also recommend "against" or "withhold" from reelection of Committee members, on a case by case basis, in a subsequent year. ISS views a company receiving fewer than 50% of the shareholder votes in respect of its say-on-pay proposal as warranting the highest degree of responsiveness.

Additionally, ISS may recommend "against" or "withhold" for all members of the Committee and potentially the full board in the absence of a say-on-pay proposal (*e.g.*, in a year where no say-on-pay proposal is required) or in egregious situations. Some of the situations identified by ISS that may result in a vote against or withhold for the entire Committee include:

- Significant misalignment between CEO pay and company performance.
- Maintenance of significant problematic pay practices.
- Poor communication and responsiveness to shareholders.

If ISS identifies a significant pay-for-performance misalignment that results in an adverse recommendation on the say-on-pay proposal or the election of Committee members, ISS also may recommend a vote against an equity plan proposal on the same ballot.

Additionally, ISS adopted a policy, first effective for shareholder meetings occurring on or after February 1, 2018, providing for adverse vote recommendations for board or Committee members who are responsible for approving or setting director compensation where there is a recurring pattern (two or more consecutive years) of excessive director pay without a compelling rationale or other mitigating factors. ISS' implementation of this policy first began impacting ISS vote recommendations in 2020.

Committee members must be mindful of the climate created by the say-on-pay requirement and the strong influence of proxy advisory firms not only during proxy season, but at each stage of the compensation process.

In September 2018, the SEC withdrew two of its previously issued interpretive letters, pursuant to which the SEC staff had determined that a proxy advisor's receipt of compensation from a company to which it provides advice on corporate governance issues would not affect the proxy advisor's independence from an investment advisor as long as the investment advisor made an assessment of the proxy advisor's ability to analyze proxy issues and make impartial recommendations in its clients' best interests. In August 2019, the SEC issued guidance intending to provide clarity to investment advisors regarding how to satisfy their proxy voting obligations under Rule 206(4)-6 of the Investment Advisers Act of 1940, as amended. Generally, the SEC advised that investment advisors who vote proxies for their clients must do so in a manner consistent with their fiduciary obligations, and if they rely on voting advice from proxy advisory firms, they must take reasonable steps to ensure the use of that advice is consistent with their fiduciary duties. Among other things, the SEC outlined factors an investment advisor should consider if it retains a proxy advisory firm factors to assist it in discharging its proxy voting duties, including identifying a proxy advisory firm's potential conflicts of interest.

Say on Pay — Actions for the Committee To Take at Each Stage of the Process

Committee members must be mindful of the climate created by the say-on-pay requirement and the strong influence of proxy advisory firms not only during proxy season, but at each stage of the compensation process. Committees should:

Analyze shareholders and prior reports. The Committee should carefully analyze the company's institutional shareholder base and determine the degree of influence that each of ISS and Glass Lewis will have on the manner in which its shareholders will vote. In addition, the Committee should carefully analyze the reports issued by ISS and Glass Lewis in respect of prior years so the Committee can focus on any specific concerns that may have been raised.

Conduct outreach. The advisory firms express a high level of concern when they feel that a company has not conducted adequate shareholder outreach efforts, particularly when they feel that the Committee has been disconnected from outreach efforts. The company should document and describe any shareholder outreach efforts in detail in the proxy, and it should emphasize the involvement of the Committee in those efforts, whether via direct interface with shareholders or through determination of the content and direction of those communications. The Committee should consider implementing year-round communication and proactive outreach to facilitate investors' understanding of the company's compensation arrangements instead of communicating only after there has been a negative recommendation. Effective outreach should solicit reactions to the company's existing executive compensation program, as well as views regarding any concerns raised by ISS and others, and could include making presentations via teleconference, providing written materials regarding the company's current program and proposed changes, and holding in-person meetings. For purposes of shareholder outreach communications, the company should consider implementing policies and procedures intended to avoid Regulation Fair Disclosure (Reg FD) violations, such as pre-clearing discussion topics or having company counsel participate in meetings.

Perform a "pay-for-performance" analysis. The Committee should review, on an annual basis, the degree to which there is a "pay-for-performance disconnect" between the compensation paid to the CEO and the company's performance, based on the advisory firms' models. This disconnect is the most common reason for a negative or "against" recommendation. It should be noted that this performance is measured on both an absolute and relative basis, with the latter measurement being performed based on a "peer group" comparison. Peer groups chosen by the advisory firms for purposes of the performance measurement may differ from company to company and from the peer group chosen by the Committee for purposes of setting executive compensation. In addition to a pay-for-performance disconnect being an independent basis on which the company may receive an "against" recommendation, if the analysis identifies any items of "medium" or "high" concern, ISS will perform a deeper analysis of the company's arrangements than would be the case if there was a "low" level of concern. A company finding itself in this position for the first time may thus find that compensation arrangements that were not flagged by the advisory firms as being problematic in past years are now, when viewed under a stronger microscope, a source of concern and potentially a negative recommendation.

Be aware and mindful of typical advisory firm concerns. The Committee should be aware in setting compensation of the factors that traditionally may cause advisory firms to issue an "against" recommendation, which, in addition to a pay-for-performance disconnect, include:

- "Golden parachute" excise tax gross-up provisions (inclusion of a gross-up can trigger an "against" recommendation even in the absence of other concerns) or other excessive tax reimbursements on executive perquisites or other payments.
- Equity award grants that are time-based rather than performance-based, particularly if such grants represent a substantial portion of the company's equity grant program or if the company is shifting the pay mix away from performance-based awards to time-based awards.
- Multiyear guaranteed salary increases, nonperformance-based bonuses or equity awards.
- Performance goals that are changed, canceled or replaced during the performance period without adequate explanation.

- Excessive or extraordinary perquisites.
- Severance payments that could (based on ISS calculations) result in compensation greater than three times an executive's annual compensation and liberal change-in-control definitions combined with any single-trigger benefits.
- "Good reason" definitions that present windfall risks, including definitions triggered by potential performance failures of the company (*e.g.*, bankruptcy or delisting).
- Dividends or divided equivalents paid on unvested performance awards.
- Outsized CEO pay in relation to the rest of the executive group.
- Abnormally large bonus or incentive plan payouts, including payments made despite failure to achieve preestablished performance criteria.
- Insufficient disclosure of executive compensation at "externally managed issuers," companies (for instance, many REITs) where management functions are performed by a management company in exchange for a management fee.
- Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options).
- Termination and severance payments to an outgoing executive, particularly in the case of a "friendly" termination (such as a termination characterized as a retirement or where the individual remains on the board).
- Signing or "mega" grants to newly hired CEOs that are deemed excessively large or insufficiently linked to performance.

Although ultimately the process of setting compensation is influenced by many factors, the company may want to consider these advisory firm concerns when designing its plans and programs. In addition, the Committee should consider adopting policies that the advisory firms view as exemplifying good corporate governance, including stock ownership requirements, a clawback policy that exceeds the Dodd-Frank Act's requirements and an anti-hedging policy. ISS' December 2023 U.S. Equity Compensation Plans FAQs provide that, to receive points for a clawback policy for equity plan scorecard purposes, a clawback policy should authorize compensation recovery upon a financial restatement and cover all or most NEO equity awards, including time- and performance-based awards. A policy that adopts the minimum requirements under Dodd-Frank will not receive ISS equity plan scorecard points because Dodd-Frank generally exempts time-based awards. When reviewing these conditions in the context of potential compensation decisions, the Committee should be aware that ISS Corporate Solutions, a subsidiary of ISS, will provide advice (for a fee), but cannot guarantee a positive recommendation from ISS.

Other Recent Proxy Advisory Firm Updates

In November 2023, Glass Lewis published its 2024 U.S. Benchmark Policy Guidelines, which provided the following key compensation updates:

- To be viewed positively by Glass Lewis, clawback policies should permit companies to recover variable incentive payments (whether time-based or performance-based) in circumstances that exceed the Dodd-Frank Act's requirements, including when there is evidence of problematic decisions or actions — such as material misconduct, a material reputational failure, material risk management failure or a material operational failure — that have not yet been reflected in incentive payments and where recovery is warranted.
- In connection with shareholder proposals approving individual equity grants where the recipient is a large shareholder whose vote may materially affect support for the proposal, Glass Lewis encourages the company to strongly consider the level of disinterested shareholder approval before making the grant. Companies may require interested shareholders to abstain from the vote to help mitigate such conflicts of interest.
- Glass Lewis may consider the "compensation actually paid" data disclosed in the Pay Versus Performance section of a company's proxy statement as part of its supplemental quantitative assessment supporting its primary pay-for-performance grade assessment.

In December 2023, ISS published its updated U.S. Compensation Policies and Compensation Policies FAQs, which contained few changes. Notable updates included the following:

- If companies take action to address pay-related concerns raised in a published ISS research report and disclose such action in a public filing, ISS newly clarified that it will generally be able to change its voting recommendation in response to the additional public filing only if the public filing is made at least five business days before the meeting date.
- ISS included a new FAQ on non-GAAP metrics, noting that if adjustments materially increase incentive payouts, companies should provide clear proxy statement disclosure concerning each adjustment, its impact (dollar or percentage) on payouts and the board's rationale for the adjustment. ISS highlighted that best practice is a line-item reconciliation to GAAP results in the proxy statement, and ISS cautions that the absence of such disclosure about non-GAAP metrics in the proxy statement will be viewed negatively by ISS, along with adjustments that blunt the impact of performance failures on executive compensation, particularly for companies with a quantitative pay-for-performance misalignment.
  - » Glass Lewis similarly expanded on its discussion of the importance of clear disclosure about non-GAAP incentive plan metrics in its 2024 U.S. Benchmark Policy Guidelines.
- ISS included a new FAQ clarifying that while it continues to view single-trigger change-in-control severance negatively, bona fide incentive awards payable upon a change in control, such as transaction bonuses linked to an acquisition premium, would be analyzed as change-in-control incentive awards and not as problematic single trigger severance. ISS will continue to evaluate change-in-control incentive awards qualitatively, and such awards may still raise ISS concern, depending on their magnitude, the rationale for them, disclosure about them and how they factor into the context of the company's severance entitlements.

Additionally, companies should:

Allow time for detailed proxy drafting. The company should begin the proxy drafting process months in advance by identifying those individuals who will need to provide input for the proxy, including individuals from the legal, human resources, finance, stock administration and other departments, as well as external legal counsel, compensation consultants and accounting firms. Each piece of the puzzle will need to be integrated into a document that ultimately "tells the story" of the company's executive compensation programs in a coherent and compelling manner. The company should consider using charts, graphs and an otherwise reader-friendly presentation to achieve maximum clarity for the company's message. This disclosure may extend well beyond what is required by SEC rules and include executive summaries and charts showing the amount of pay actually realized by executives (which may be less than the compensation included in the Summary Compensation Table). In addition to describing the company's programs and shareholder outreach efforts, the proxy should also address any specific concerns raised by the advisory firms and perhaps shareholders as well. Even if the company decides not to make changes in response to those concerns, it should note in the proxy that those concerns were reviewed and considered. If the company does make changes, it will be viewed favorably by ISS and other services if the changes are described in some detail and explicitly linked to the concerns that were raised.

Review the advisory report thoroughly. It is important to read the advisory firm reports carefully upon receipt, even if the recommendation is positive, to ensure that all of the company's plans and arrangements have been described accurately and to reach out to the firms with corrections as soon as possible. In recent proxy seasons, a number of companies have alleged that the shareholder advisory firms made mistakes of fact regarding the terms and parameters of compensation arrangements, particularly in the case of incentive compensation plans. While each situation has its own unique characteristics and context, the fact that this issue was raised by multiple companies is a reminder that when drafting proxy disclosure with respect to complex arrangements, it is critical to be exceptionally clear and to have the disclosure carefully reviewed by multiple parties to check for overall comprehensibility.

Be prepared to respond quickly. Advisory firm reports are typically issued a few weeks prior to the scheduled shareholder meeting, which provides little time for follow-up actions such as supplemental filings and the correction of factual errors.

Consider issuing a supplemental filing. Companies receiving a negative recommendation from ISS and/or Glass Lewis may consider issuing supplemental proxy materials to make their case directly to shareholders, although it is not clear that such supplemental filings have a substantial impact on vote results, and ISS recently clarified that such supplemental filings should be made at least five business days prior to the meeting for ISS to be able to factor them into its vote recommendations. Over the past several years, these filings have covered issues such as the following:

- One of the most frequently articulated concerns is the degree to which the peer groups chosen by ISS and Glass Lewis are different from the peer groups chosen by companies. While this concern has begun to decrease as the advisory firms have refined the methodology by which they choose peer groups, many companies still express concerns in their supplemental filings such as:

  - » The comparison with peer groups based solely on revenue, at times resulting in peer groups in which not a single peer is in the same market capitalization range.
  - » The exclusion of peers in the company's geographical area when that is the area within which the company competes for talent (and/or failure to take into account that the geographical area in question has an unusually high cost of living).
  - » The inclusion of many companies not in the company's industry.

- Some companies express frustration that ISS has not adequately acknowledged the unique circumstances of CEO transitions, during which an outgoing CEO might be paid a retention amount at a time when it is unclear how long a search for the CEO's successor will take, and a new CEO could be awarded signing and make-whole awards as part of the recruiting process.
- Some supplementary filings focus on the perception by companies that ISS has materially overstated CEO pay by focusing on the grant date value of awards. Companies have noted that the ISS methodology allocates to one year (the year of grant) a lump sum amount based on the award's grant value for accounting purposes, an amount that is both potentially vastly overstated relative to actual value delivery and allocated in a lump sum to a single year prior to the year (if any) that any value is or can be realized.
- ISS still considers total shareholder return 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 have argued strongly in supplemental filings against using a single measure in this manner. If the company believes that measures other than total shareholder return 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 also discuss this point in the CD&A to provide shareholders with that context. Notably, and likely in recognition of a trend away from company reliance on total shareholder return as an exclusive performance measure, ISS has begun using other measures of companies' performance to supplement relative total shareholder return, at least on a qualitative basis, including relative return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth and growth of cash flow from operations. Additionally, in 2018, ISS also began taking into consideration the rankings of CEO total pay and company financial performance relative to a peer group.
- Companies frequently express disagreement in supplemental filings with the ISS policy that stock options are not "performance-based compensation" (absent a performance-based vesting schedule), even though no value can be received with respect to a stock option unless the stock price increases.

Consider post-recommendation changes. The Committee should consider whether changes should be made to the company's programs following an "against" recommendation and prior to the annual meeting. Such changes have been known on rare occasions to cause ISS to alter its vote recommendation. An ISS recommendation change typically occurs when ISS identifies a particular problematic issue — for example, the company entering into a new agreement containing a "golden parachute" excise tax gross-up or granting a significant time-based equity award. In circumstances such as these, the company can (with the executive's consent) eliminate the gross-up or layer performance vesting conditions onto the award, and this has on occasion been sufficient to tip the balance and cause the advisory firms to change their recommendation. However, most post-recommendation changes do not have this effect (although they could potentially sway some shareholders, if coupled with an effective communication strategy).

Assess special golden parachute gross-up consideration. As noted above, provision of a golden parachute excise tax gross-up is viewed quite negatively by proxy advisory firms, and in recent years a pronounced trend has emerged to exclude such provisions. Interestingly, however, there have been numerous instances of the implementation of gross-up protection at target companies in connection with M&A transactions, typically where an executive might otherwise lose a substantial benefit if the benefit were limited to the executive's 280G limit or be subject to a significant excise tax (for instance, because the executive is a recent hire with resulting low historical compensation). While the advisory firms do not appear to view such circumstances any more sympathetically than otherwise, at least some companies are willing to risk a negative advisory firm recommendation at the time of the company sale.

ISS Guidance on Golden Parachute Votes

A FAQ released by ISS in December 2021 and retained in the December 2023 FAQs identifies pay practices that will likely trigger an adverse ISS say-on-golden-parachute vote recommendation.

Such practices include:

- Anticipated golden parachute excise tax gross-up payments (based on amounts reported in the golden parachute tables).
- Single-trigger cash severance payments that are triggered solely by the occurrence of a change in control without disclosure indicating that the applicable executive will incur a termination of employment or service in connection with the transaction.
- Single-trigger acceleration of performance-based awards at an above-target performance level in the absence of a disclosure with a compelling rationale for such treatment.

Equity Plan Approvals

As described in Chapter 6, when a public company proposes to adopt a new equity plan, or materially modify an existing equity plan (including reserving additional shares under an existing plan), the NYSE and Nasdaq require shareholder approval prior to the issuance of equity securities. For shareholders to make an informed decision regarding the proposal, shareholders must have an understanding of how the existence of the plan and the reservation of shares for employee grants will affect their own interests as shareholders. The role that advisory firms play in this process is to evaluate the plan based on their own particular models to determine whether to recommend that shareholders vote to approve the plan.

ISS' Approach

ISS' current policy, which the firm updates annually, is named the Equity Plan Scorecard (EPSC) and represents a holistic analysis based on the following factors, which generally are weighted as follows for companies in the S&P 500 and Russell 3000 effective for meetings on and after February 1, 2024:

- **Plan cost (43%)**, which measures "Shareholder Value Transfer" relative to peers (determined based on industry and market capitalization), calculated in two ways: first, based on the sum of new shares requested and shares remaining for future grants; and second, based on the sum of new shares requested, shares remaining for future grants, and outstanding unvested/ unexercised grants.
- **Plan features (22%)**, which evaluates the following plan features: quality of disclosure of award vesting on a change in control; discretionary vesting authority; liberal share recycling (*e.g.*, returning to the plan shares withheld on vesting to cover taxes); and minimum vesting periods for grants made under the plan; and payment of dividends prior to award vesting.
- **Grant practices (35%)**, which focuses on three-year average burn rate relative to peers; vesting requirements in the most recent CEO equity grants (based on a three-year lookback); estimated duration of the plan (based on the company's three-year average burn rate); proportion of the CEO's most recent equity grants subject to performance conditions (again, based on a three-year lookback); whether the company has a sufficient clawback policy; and whether the company has established post-exercise/vesting holding periods for the shares received.

The weightings set forth immediately above took effect for meetings on and after February 1, 2024, and were included in ISS' December 2023 U.S. Equity Compensation Plan FAQs, which made minor adjustments to the weightings, most notably by increasing the weighting of the plan features pillar and decreasing the weighting of the plan cost pillar and the grant practices pillar for the S&P 500 and Russell 3000.

Special scoring rules apply to non-Russell 3000 companies and S&P 500/Russell 3000 companies that fall into a "Special Cases" category (companies with less than three years of disclosed equity grant data, such as IPO companies and companies emerging from bankruptcy).

As of February 2023, ISS uses a value-adjusted burn rate (VABR) methodology to calculate and compare burn rates. The VABR methodology uses a formula that features actual stock price to quantify full-value awards and the Black-Scholes value for stock options (rather than ISS' former volatility multiplier). Benchmarks are calculated as the greater of:

i. An industry-specific threshold based on three-year burn rates within the company's Global Industry Classification Standard group segmented by S&P 500, Russell 3000 index (less the S&P 500), and non-Russell 3000 index.

ii. A de minimis threshold established separately for each of the S&P 500, the Russell 3000 index less the S&P 500, and the non-Russell 3000 index.

ISS has indicated that the EPSC methodology will not be used unless the proposal (i) includes a material request for additional shares, (ii) represents the first time shareholders have had an opportunity to opine on the plan, (iii) includes an extension of the plan's term, (iv) includes the addition of full-value awards as an award type when the current plan authorizes only option/SAR grants, (v) eliminates or increases a full-value award limit or (vi) eliminates a so-called "fungible share" ratio (under which full-value shares are counted as more than one share pursuant to a specified ratio). If the proposal involves none of these circumstances, ISS will make its recommendation based on a qualitative analysis of the overall impact of the amendment — *i.e.*, whether it is deemed to be "overall beneficial or contrary to shareholders' interests." The EPSC score typically will not determine ISS' recommendation based on such a qualitative analysis, though ISS' EPSC summary and scoring will be displayed in its report for informational purposes.

Unlike the prior series of pass/fail tests, under the EPSC approach a low score in one area can be offset by a high score in another. As such, a plan with a cost that is somewhat higher than that of peers could potentially still receive a "for" recommendation if plan feature and grant practice considerations are extremely positive. Conversely, a lower plan cost may not be sufficient to receive a "for" recommendation if the plan includes enough problematic provisions or if past grant practices raise concerns. Some "overriding" provisions (such as the ability to reprice options without shareholder approval, inclusion of an evergreen share-addition provision, the plan being determined to be excessively dilutive to shareholders or the presence of a liberal change-in-control definition that could result in awards vesting by any trigger other than "double trigger") are viewed by ISS as egregious and may result in an automatic negative recommendation and, in exceptional cases, ISS may recommend against approval of a plan despite a passing EPSC score if the proposed amendments as a whole represent a "substantial diminishment to shareholders' interests." In addition, if ISS identifies a significant pay-for-performance misalignment that results in an adverse recommendation on the say-on-pay proposal or the election of Committee members, it also may recommend a vote against an equity plan proposal on the same ballot based on certain considerations, including, but not limited to, the severity of the pay-for-performance misalignment, whether problematic equity grant practices are driving the misalignment and whether equity plan awards have been heavily concentrated to the CEO and/or other NEOs (as opposed to the plan being considered broad-based).

ISS sells a service through its consulting arm under which it provides assistance in determining whether a proposed plan is acceptable under its EPSC system.

Glass Lewis has its own analytical tools for determining whether to recommend that shareholders approve a new equity plan or an increase in the number of shares reserved for issuance under an existing plan. While Glass Lewis does not disclose the details of its models, the goal of the analysis is to determine whether the proposed plan is more than one standard deviation away from the average peer group plan with respect to various measures, and whether the proposed plan exceeds any absolute limits in the model.

Given the analytical complexity and the specificity of the advisory firm models, the Committee should engage early in the process with internal finance and equity specialists, as well as external legal counsel and compensation consultants, to confirm that the plan documentation and number of shares are appropriate and that the proposal is likely to receive a "for" recommendation from the advisory firms.

Chapter 6

Equity Compensation

Equity-based compensation is one of the most versatile and powerful executive compensation tools. As explained in greater detail in Chapters 8 and 9, equity compensation grants to executive officers are typically made by the Committee because of considerations applicable under Rule 16b-3 under the Exchange Act and, historically, Section 162(m) of the Code.

This chapter provides an overview of:

- The types of equity awards most commonly issued by employers.
- The tax consequences of equity awards for the grantee and the company.
- Key considerations for the development of an equity granting policy.
- The shareholder approval requirements of the NYSE and Nasdaq applicable to equity compensation plans.
- The securities law requirements that are applicable to equity grants (namely the requirement that they either be registered under the Securities Act of 1933, as amended (Securities Act), or be exempt from such registration).

Equity Compensation

Common Types of Equity Awards

Although the overarching objective of all executive compensation awards is essentially the same — incentivizing individual performance to maximize the company's short- and long-term value — no single compensation formula fits all companies. This is particularly true for equity compensation awards, where many different types of awards are used.

The table below identifies the most common types of equity-based compensation awards.

Type of Award	Description
Stock Options	• A stock option is a right to purchase a fixed number of shares within a fixed time period at a fixed price, typically following the satisfaction of service-based and/or performance-based vesting conditions. • Because of requirements that apply under Section 409A of the Code (as discussed in greater detail in Chapter 8), stock options generally must be granted with an exercise price that is not less than the fair market value of the underlying shares on the date of grant. Section 409A also effectively requires the grant to be made only in respect of common stock. • The two basic varieties of options are: i. Incentive stock options (ISOs), which offer certain favorable tax treatment for the grantee as described below. ii. Nonqualified stock options, which comprise any option that does not qualify as an ISO. Most companies that grant options grant nonqualified options though ISOs are typical in some industries. • To qualify as an ISO, among other requirements, the option must: » Be granted pursuant to a plan approved by shareholders that specifies the number of shares that may be made subject to the ISO and dictates that ISOs may be issued only to employees (not consultants or nonemployee board members). » Not exceed certain limits on the number of shares that may vest in any year (shares with a value, determined at the grant date, not in excess of $100,000). • While options are often designed to require the payment of an exercise price in exchange for delivery of the full number of shares subject to the option, cashless exercise (broker-assisted or via net settlement in shares or cash by the company) has become increasingly prevalent, particularly since financial accounting rule changes eliminated the unfavorable treatment that had previously applied to options with a net settlement feature. Note that under the cashless exercise approach, the company is deprived of the cash that otherwise would be paid upon exercise; depending on the magnitude of the grants and stock price, the lost cash flow can be substantial.

Type of Award	Description
Stock Appreciation Rights (SARs)	• SARs entitle the grantee to receive the appreciation on the underlying stock over the SAR's exercise price; they are essentially stock options with a mandatory net settlement feature. Like stock options, SARs generally must be granted with an exercise price of no less than fair market value of the underlying shares on the date of grant. • SARs can provide that they will be settled in either cash or stock (though the accounting treatment varies between the two).
Restricted Stock	• A restricted stock award is an award of actual shares of stock that is subject to forfeiture if vesting conditions, typically service-based and/or performance-based, are not satisfied over the vesting period or restricted period specified by the terms of the grant. • Because the award consists of actual outstanding shares, restricted stock is entitled to any voting and dividend rights appurtenant to the class of stock subject to the award. • The voting and dividend rights can be limited pursuant to particular award conditions. For example, sometimes dividends are accrued and paid only upon ultimate vesting of the underlying shares. • Restricted stock is often used in lieu of restricted stock units (discussed immediately below) where the company wants to provide executives with voting and current dividend rights.
Restricted Stock Units (RSUs)	• An RSU represents the right to receive a share of stock (or the cash value thereof) in the future, based on satisfaction of any applicable vesting conditions, typically service-based and/or performance-based conditions. • Until the unit is vested and the stock (if the unit is stock-settled) is delivered to the grantee, the grantee does not have any voting or dividend rights (because, in contrast to restricted stock, an RSU is a promise to deliver stock in the future after satisfaction of vesting conditions as opposed to an award of actual stock that is subject to forfeiture if the vesting conditions are not satisfied). • Typically, if RSUs are accompanied by dividend equivalent rights, dividend equivalents are subject to the vesting conditions that apply to the award of RSUs — *i.e.*, dividends accumulate during the vesting period and are paid upon settlement of the unit (in cash or in kind). • An additional critical distinction between restricted stock and RSUs is that settlement of the unit may be delayed until some specified time after vesting (subject to the requirements of Section 409A of the Code). Delayed settlement may result in beneficial tax consequences to the grantee because a unit is subject to income tax only upon actual or constructive receipt of the underlying cash or stock. Accordingly, while settlement is often made at the time of vesting, that is not always the case. For instance, the units may vest over a period of years, but the underlying shares might be delivered only upon a subsequent termination of employment. No such delay is possible with restricted stock since, as discussed below, income and employment taxes are imposed no later than immediately upon vesting.

Type of Award	Description
Bonus Shares	• As noted above, the entitlement to an award is typically made subject to the satisfaction of either a preestablished service- or performance-based vesting condition, though there is no legal requirement that any vesting conditions apply. • For example, an immediately exercisable option or fully vested and nonforfeitable shares might be awarded to an executive as additional compensation for exceptional prior service.

US Tax Treatment of Equity Awards

The table below provides a general summary of the United States federal tax rules applicable to each type of equity compensation award described above.

Type of Award	Tax Consequences to the Grantee	Tax Consequences to the Company
Nonqualified Stock Options	• No income is recognized at the time of grant or vesting. • Upon exercise, the employee recognizes ordinary wage income equal to the excess of the fair market value of the shares received over the exercise price (*i.e.*, the "spread"). • Upon exercise, income tax must be withheld and employment (*i.e.*, FICA/FUTA) tax is due.	• The company generally will be entitled to a tax deduction at the time that, and in the same amount as, the employee recognizes income (subject to any limitations under Section 162(m) of the Internal Revenue Code).

Type of Award	Tax Consequences to the Grantee	Tax Consequences to the Company
Incentive Stock Options (ISOs)	• No income is recognized at the time of grant, vesting or exercise. • No income tax must be withheld, and no employment tax is due, upon exercise of an ISO. • If the shares acquired upon exercise are held for at least two years from the date of grant and at least one year from the date of exercise, the employee recognizes capital gain or loss upon a subsequent sale of the shares equal to the difference between the sale price and the exercise price. » A disqualifying disposition thus essentially causes the ISO to be treated as a nonqualified stock option for income tax purposes (though the option still escapes the income tax withholding and employment tax payment requirements). • Generally the "spread" on the exercise date will be an item of adjustment for purposes of the alternative minimum tax.	• If the required holding periods are satisfied, no deduction is allowable to the company (as the income to the employee is capital gain rather than ordinary wage income). • Upon a "disqualifying disposition," the company is generally entitled to a deduction in the same amount as the employee recognizes in income (subject to any limitations under Section 162(m) of the Internal Revenue Code).
Stock Appreciation Rights	• Tax consequences are the same as those for nonqualified stock options.	• Tax consequences are the same as those for nonqualified stock options.
Restricted Stock (No 83(b) Election Is Made)	• No income is recognized at the time of grant. • The employee recognizes ordinary wage income when the shares vest (*i.e.*, when they are transferable or no longer subject to a "substantial risk of forfeiture," whichever occurs first). • Upon vesting, income tax must be withheld and employment tax is due.	• The company generally will be entitled to a tax deduction at the time that, and in the same amount as, the employee recognizes income (subject to any limitations under Section 162(m) of the Internal Revenue Code).

Type of Award	Tax Consequences to the Grantee	Tax Consequences to the Company
Restricted Stock (83(b) Election Is Made)	• Pursuant to a so-called 83(b) election (which references Section 83(b) of the Code), an employee may elect to recognize the value of the stock at the time of grant as ordinary wage income, notwithstanding that the stock has not yet vested. » Upon a subsequent disposition of the stock (*i.e.*, after it has vested), the difference between the sale price and the amount of income recognized will be treated as a short-term or long-term capital gain or loss, with the clock for the capital gains holding period starting at the time of grant. • The employee must make the 83(b) election within 30 days of the date following the date of grant. • Upon the employee's election, income tax must be withheld and employment tax is due. • If the employee later forfeits the shares, the employee cannot deduct any loss resulting from the forfeited shares (though a capital loss is allowed to the extent any payment was made for the shares when granted).	• The company generally will be entitled to a tax deduction at the time that, and in the same amount as, the employee recognizes income (subject to any limitations under Section 162(m) of the Internal Revenue Code). • If the employee later forfeits the shares, the company must recognize ordinary income equal to the amount of the deduction allowed to the company at the time of the 83(b) election.
Restricted Stock Units	• No income is recognized at the time of grant or by reason of vesting. Ordinary wage income is recognized upon settlement of the award (which might or might not occur coincident with vesting depending on the award design) equal to the value of the shares or cash delivered; income tax must be withheld at the time of settlement. • Employment tax is due upon vesting, regardless of whether shares or cash are delivered at that time (subject to several administrative exceptions).	• The company generally will be entitled to a tax deduction at the time that, and in the same amount as, the employee recognizes income (subject to any limitations under Section 162(m) of the Internal Revenue Code).

Type of Award	Tax Consequences to the Grantee	Tax Consequences to the Company
Bonus Shares	• The employee recognizes ordinary wage income equal to the value of the shares delivered.	• The company generally will be entitled to a tax deduction at the time that, and in the same amount as, the employee recognizes income (subject to any limitations under Section 162(m) of the Internal Revenue Code).

Equity Grant Policies

As discussed in Chapter 4, it may be appropriate to disclose in the CD&A how a company determines when equity-based awards are granted. When the SEC originally published the CD&A requirements, the agency expressed a particular interest in practices regarding the timing and pricing of stock options grants, including practices of selecting option grant dates for executive officers in coordination with the release of material nonpublic information, the timing of option grants to executive officers vis-á-vis option grants to employees generally, the role of the Committee and the executive officers in determining the timing of option grants and the formula used to set the exercise price of an option grant. This interest has recently been revived, as the SEC adopted new disclosure rules in December 2022 regarding grants of option awards in connection with material nonpublic information, as further described in Chapter 10. To a considerable extent, this requirement of the CD&A — and the focus on option grants — arises out of option grant practices that led to shareholder assertions of option backdating (deeming the grant date to be before the corporate action giving rise to the grant), spring-loading and bullet-dodging.

The establishment of a written policy addressing the timing and process for granting equity awards can help the company with shareholder claims and promote the smooth and appropriate operation of the company's equity grant program. In addition to ensuring that the company's equity grants comply with the Committee's charter and state and federal laws, a written policy can accomplish the following objectives:

- To articulate the role that equity grants play in the company's executive compensation philosophy.
- To authorize the delegation of grant-making authority to appropriate committees or individuals (typically with prescribed limits on the individuals to whom they may make grants and with aggregate limits on grant sizes) together with a description of the process to be used in exercising such delegated authority.
    - » Note that the Committee or the board should generally retain the authority to grant awards to Section 16 officers to ensure that the grants are exempt under Exchange Act Rule 16b-3.
    - » In a similar vein, grant authority should be retained by the Committee to the extent compliance with the performance-based compensation exception to Section 162(m) of the Code is intended, which the December 2017 Tax Cuts and Jobs Act limited to qualifying compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and not materially modified after that date. See Chapter 8 for additional discussion about these changes made to Section 162(m).

- To describe the procedure and timing for making annual equity grants, off-cycle equity grants and grants to new hires.
- To formalize the process of recording the date and price of equity awards and communicating such awards to employees.
- To develop standard grant terms and standard grant documentation.
- To establish special rules that apply to director grants (such as meaningful limits on the value of grants or perhaps providing for regular, automatic grants rather than discretionary, ad-hoc grants).
- To establish an error correction process.

A written equity grant policy likely will help ensure that grants are made in accordance with the applicable equity plan's terms, including for example, compliance with limits on the number of shares that may be granted pursuant to awards under the equity plan.

Consideration should be given to designating one or more specific company employees (including human resources, legal and accounting representatives) to be responsible for ensuring compliance with the company's equity grant policies. Moreover, the company's compliance with the policies should be subject to regular internal audit.

Special considerations relating to grants made proximate to M&A activity are discussed in Chapter 12.

Stock Exchange Shareholder Approval Requirements

The NYSE and Nasdaq have each established rules regarding shareholder approval of equity compensation plans. Those rules, which are substantially similar for the NYSE and Nasdaq:

- Require shareholder approval of all equity compensation plans and material revisions to such plans.
- Provide limited exemptions from the shareholder approval requirement for inducement awards to new employees, tax-qualified plans and parallel nonqualified plans, as well as in connection with M&A activity.
- Require companies to disclose publicly the material terms of any inducement award and (in the case of NYSE-listed companies) to notify the NYSE when the company utilizes any of the exemptions from the shareholder approval requirement.
- Prohibit NYSE-member organizations (*i.e.*, broker/dealer firms) from voting on equity compensation plans (regardless of whether the company proposing the plan is listed on the NYSE) in the absence of voting instructions from the beneficial owners of shares.

Plans That Are Not Equity Compensation Plans

The NYSE rules define an equity compensation plan as a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services, whereas the Nasdaq rules refer to a stock option or purchase plan or other equity compensation arrangement pursuant to which options or stock may be acquired by officers, directors, employees or consultants. The following are *not* considered equity compensation plans under the listing rules:

- Plans that are made available to shareholders generally, such as a dividend reinvestment plan.
- Plans that allow employees, directors or other service providers to buy shares on the open market or from the issuer for fair market value.
- Under the Nasdaq rules only, issuances of warrants or rights generally to all a company's security holders.

Material Revisions and Option Repricings

A "material revision" (the NYSE term) or a "material amendment" (the Nasdaq term) includes, but is not limited to, the following types of revisions:

- A material increase in the number of shares available under the plan, other than an increase solely to reflect reorganizations, stock splits, mergers, spinoffs or similar transactions.
- An expansion of the types of awards available under the plan.
- A material expansion of the class of employees, directors or other service providers eligible to participate in the plan.
- A material extension of the term of the plan.
- A material change to the method for determining the strike price of options under the plan.
- A repricing of an option absent a plan provision that permits it or a limitation or deletion of any plan provision prohibiting the repricing of options.

The NYSE commentary to its rule notes that an amendment to an equity compensation plan will not be considered a "material revision" if it curtails rather than expands the scope of the plan in question. In 2016, the NYSE clarified that an amendment to an equity compensation plan to allow for maximum tax withholding is not a "material revision," which was timely because it allowed companies to amend plans without shareholder approval to reflect a recent change to accounting rules giving companies the flexibility to withhold at a rate above the minimum for equity compensation. (Because of the substantial overlap in the provisions of the two rules, commentary on and interpretation of one exchange's rule is often helpful as to the scope of the other.)

Exemptions From the Shareholder Approval Requirement

The listing rules generally exempt the following plans from the requirement to obtain shareholder approval:

- Inducement awards to new employees (the material terms of which must be publicly disclosed).
- Tax-qualified plans intended to meet the requirements of Section 401(a) of the Code (*e.g.*, a broad-based pension plan or a 401(k) plan) or Section 423 of the Code (*i.e.*, employee stock purchase plans).
- Parallel excess plans (the NYSE term) or parallel nonqualified plans (the Nasdaq term), in each case generally meaning a nonqualified pension or savings plan that is designed to make up for limits under the Code on benefits that can be provided pursuant to the underlying tax-qualified plan.

- Rollover of options or other equity compensation awards in connection with a merger or acquisition.
- Post-transaction grants by the acquirer under the target company's pre-existing shareholder-approved plan to individuals who were employed by the target immediately prior to the time the merger or acquisition was consummated.

Public companies should be aware, however, that even if one of the exemptions above is applicable to avoid shareholder approval of an equity plan or award, the NYSE listing rules will still require shareholder approval for the grant of shares or awards to any director, officer, controlling shareholder, member of a control group or any other substantial security holder of the company that has an affiliated person that is also an officer or director of the company if the shares or number of shares issuable under the award exceeds either 1% of the company's shares of common stock or 1% of the voting power of the company's shares outstanding before the issuance.

Securities Law Considerations

The Securities Act requires the registration of each offering of securities unless an exemption is available. Accordingly, when the company makes equity award grants to employees, executives or directors, it must ensure that the offer and sale of securities is registered or that an exemption is available in respect of such offer and sale. State securities laws (so-called blue sky laws) may impose additional requirements. Because of their wide variation and because they generally have less relevance for public companies (in that the federal securities laws preempt state registration requirements for exchange-listed securities), blue sky laws are not discussed here.

Registration

Public companies typically register the offer and sale of equity compensation awards on a Form S-8. Form S-8 is an attractive registration vehicle because, unlike a Form S-1 (and, to a lesser extent, Form S-3), it requires the direct inclusion of little information about an issuer and relies instead upon the issuer's existing SEC filings to ensure that adequate public information is available regarding the issuer. For this reason, Form S-8 is available only to companies that are subject to the reporting provisions of the Exchange Act before filing the registration statement and that have filed all Exchange Act reports (Form 10-Ks, Form 10-Qs, Form 8-Ks, etc.) during the preceding 12 months or for any shorter period for which the company was required to file such reports.

Form S-8 registration statements enjoy two important additional benefits. First, Form S-8 registration statements are not subject to the SEC staff review and comment process, which often can impose lengthy delays and additional costs. Second, Form S-8 registration statements become effective immediately upon filing. These two benefits, taken together, remove many of the delays, costs and burdens companies otherwise face for certain other public offerings (*e.g.*, IPO registration statements). Moreover, in November 2020, the SEC announced that it is proposing simplifying amendments to Form S-8, including clarifying companies' ability to include multiple plans on a single S-8 and other amendments to simplify share counting and fee payments related to Form S-8.

A company registering the offer and sale of securities on Form S-8 must provide a prospectus to each individual who receives an award under the plan. The prospectus provides material information regarding the plan, the company and its securities. The prospectus, however, is not contained in the registration statement that is filed with the SEC.

Exemptions

Public companies rarely rely on exemptions from registration because of the ease with which a Form S-8 may be filed. Private placement exemptions nonetheless are available.

The most used exemptions are found under the SEC's Regulation D or Section 4(a)(2) of the Securities Act. To meet the requirements of these exemptions, however, the issuer often must make extensive disclosures regarding the nature and character of and risk factors relating to the offering. Moreover, while a properly executed private placement is exempt from the registration provisions of the Securities Act, the transaction (and the disclosures made or a lack thereof) remains subject to the anti-fraud and civil liability provisions of the Exchange Act.

Because of these significant limitations on the private placement exemptions and because of the ease with which a Form S-8 may be filed, care generally should be taken to ensure that the offer and sale of shares under the company's equity compensation plan is registered.

Hart-Scott-Rodino Act Filings for Certain Executive Officers and Directors

Officers and directors who hold at least $119.5 million in voting securities in their companies should consider the need to make Hart-Scott-Rodino (HSR) filings to the Federal Trade Commission whenever they increase their holdings through an acquisition of voting securities. The HSR Act establishes a set of notification thresholds that are adjusted annually based on changes to the gross national product. The threshold was increased from $111.4 million to $119.5 million, effective beginning in March 2024. A company's annual preparation of its beneficial ownership table provides a regular opportunity to assess whether any of its officers or directors may be approaching an HSR filing threshold, in which case consulting HSR counsel is recommended. Importantly, HSR counsel also can advise when exemptions are available to obviate the need to file notifications.

An acquisition is considered to occur only when the officer or director obtains beneficial ownership of the shares. Therefore, acquisitions may include, for example:

- Grants of fully vested shares as a component of compensation.
- The vesting or settlement of restricted stock units and performance-based restricted stock units.
- The exercise of stock options.
- Open-market purchases of shares.
- The conversion of convertible nonvoting securities into voting shares.

However, an officer or director would not be deemed to have "acquired" shares underlying restricted stock units or performance-based restricted stock units that have not vested or shares underlying stock options that have not yet been exercised.

A filing requirement is not triggered solely by an increase in the value of an officer's holdings for example, from $112 million to $120 million as a result of share price appreciation. However, if such officer subsequently decided to exercise a stock option, an HSR obligation could be triggered. Notably, an increase in voting power (*i.e.*, holding or acquiring voting securities that provide more than one vote per share) can also trigger an HSR reporting obligation. HSR counsel can help analyze the impact on the filing requirements.

The need for a filing is triggered whenever — after the acquisition of voting securities — an officer or director's holdings of voting securities in the company exceed an HSR filing threshold (the lowest of which is $119.5 million, effective March 6, 2024). Current holdings plus the proposed acquisition are considered to determine whether the threshold has been met.

Higher voting securities thresholds will trigger additional HSR filings.

If a filing is required, the individual would need to make an HSR filing and wait 30 days before completing the triggering acquisition. The filer has one year from clearance to cross the applicable acquisition threshold, and the filer may make additional acquisitions for five years thereafter with no further HSR filings provided that the filer does not cross the next HSR threshold above the level for which the notification was filed. Failure to make filings may lead to enforcement actions by the Federal Trade Commission and the Department of Justice and result in material civil penalties.

Judicial Review of Executive Compensation

A board's decision to fix the compensation of the company's executive officers is typically entitled to judicial deference, especially when the board submits its decision to grant executive incentive compensation to the stockholders for approval and secures that approval. However, when an executive is also a company's controller, compensation decisions may trigger entire fairness review.

In *Tornetta v. Musk*, the board of directors approved an incentive-based compensation plan for the company's CEO who was also allegedly the company's controlling stockholder. The board then submitted the plan to the stockholders, and those that voted at the specially called meeting overwhelmingly approved it. However, when a company stockholder challenged the award as excessive and the product of breaches of fiduciary duty, the Delaware Court of Chancery reasoned that stockholder ratification, without more, did not offset the controlling stockholder's potentially coercive influence. Notably, though the CEO owned approximately 22% of the company's common stock, the court assumed he was a controller for purposes of the motion to dismiss given his role and influence at the company. Because of the undisputed absence of *Kahn v. M&F Worldwide Corp*. (MFW) procedural protections (*i.e.*, conditioning the controlling stockholder transaction at the outset on approval by both a fully functioning special committee of independent, disinterested directors and a fully informed vote by a majority of the minority stockholders), the court applied the entire fairness standard and denied the motion to dismiss.

In light of this decision, boards, in consultation with their advisers, may want to consider whether executives are "controllers" even if those executives have less than mathematical voting control and whether implementing *MFW* procedural protections is appropriate under the circumstances.

Chapter 7

Employment Agreements and Executive Compensation/ Benefit Plans

In addition to the equity compensation described in Chapter 6, the Committee may determine that it is appropriate, as part of the overall compensation philosophy established by the Committee, to adopt additional compensatory plans and arrangements for the company's executives. This chapter outlines some of the more common types of arrangements and certain factors the Committee should keep in mind when considering their implementation.

Employment Agreements and Executive Compensation/Benefit Plans

This Chapter 7 discusses some of the most common executive compensation arrangements and briefly summarizes certain tax consequences of such arrangements. For taxable years beginning after 2017, the changes to 162(m) of the Code (discussed in Chapter 8) can have a significant effect on the availability of the federal income tax deduction for payments under these arrangements.

Employment and Severance Agreements

Companies sometimes memorialize the terms of employment of senior executives in a formal employment contract to have explicit agreement regarding the terms of the employment arrangement, as well as for recruiting and retention purposes, since many executives may be accustomed to having a written contract.

Terms

Items typically covered by the contract provisions include:

- **Title, duties, responsibilities and reporting relationship.** Duties and responsibilities are sometimes set forth in detail, particularly where the executive's role might otherwise be ambiguous or overlap with other employees. Where a position is more traditionally understood and defined (such as the CEO, CFO or general counsel), some companies simply state that the duties and responsibilities will be those "typically associated" with the position. While the CEO typically reports to the board (and may be stipulated in the contract to be nominated to become a member of the board), other executives typically report either to the CEO or to one of the CEO's direct reports, depending on the executive's level. To the extent that the definition of "good reason" (as described below in the "Severance Payments and Benefits" bullet) is triggered by a material adverse change in duties, responsibilities and/or reporting relationship, or the definition of "cause" is triggered by a failure to perform the executive's duties, the specific description of the duties, responsibilities and reporting relationship contained in the employment agreement can be critical in connection with a contested termination of employment.
- **Term of employment.** Executive employment agreements may provide for an indefinite term (with employment continuing until terminated by either party in accordance with the specific terms set forth in the employment agreement), a fixed term (often three to five years) of employment (with the understanding that the contract may be renegotiated as the end of the term nears) or an initial fixed term with an automatic "evergreen" renewal process. An evergreen agreement provides that the agreement will automatically be extended for an additional year (or other period greater or less than a year) unless either party indicates (typically by a date that is three months to a year prior to the end of the then-current term) that it does not wish to extend the contract. In some industries, it is common for contracts to provide for an indefinite term; however, the Committee should carefully consider the limitations on its flexibility that such indefinite term contracts may impose.
- **Base salary.** Employment agreements typically provide for an initial level of base salary and then indicate that the base salary may be increased based on periodic performance reviews. Agreements frequently stipulate that, once increased, the base salary may not be decreased (or materially decreased) without triggering the right

of an executive to terminate employment for "good reason" and receive severance. Alternatively, the employment agreement may permit a decrease in an executive's base salary only as part of companywide reductions in base salary or may provide that an executive's base salary cannot be reduced by more than a particular percentage.

- **Terms of annual and long-term cash incentives.** As discussed in more detail below, companies typically provide annual bonus programs and may provide for long-term cash-based incentives as well. Such bonuses and incentives are often subject to the achievement of performance metrics for a specified performance period. Sometimes companies further stipulate in the employment agreement that the target bonus will be no less than a particular percentage of salary (often 50-100%), or that the executive will participate in incentive plans no less favorable than those of other senior executives. The employment agreement may also specify that the executive must be employed through the last day of the performance period or through the payment date (if later than the last day of the performance period) to be eligible to receive the bonus or incentive payment.

- **Terms of equity awards.** An employment agreement for a newly hired executive or a renegotiated agreement for an existing executive may contain specific terms of one-time "sign-on" equity award grants. Additional provisions may be negotiated as part of the employment agreement, including guarantees of future grants. More typically, the employment agreement will provide that the executive will be eligible for participation in the company's equity plans and will receive grants based on the board's regular grant process for senior executives.

- **Benefits, vacation and perquisites.** Employment agreements at the senior executive level may provide that the individual executive will be eligible to participate in the company's benefit plans on the same basis as such plans are made available to other senior executives. A number of weeks of vacation (typically three to five weeks, most often four weeks) is generally stipulated; however, the employment agreement may instead refer to the company's applicable policy. Participation in perquisite programs is sometimes addressed in the same general manner as benefit plan participation but may be described more specifically if the executive will receive perquisites that either differ from or are more generous than those provided to other executives (*e.g.*, company aircraft usage, home security or relocation benefits).

- **Severance payments and benefits.** This provision enumerates the payments and benefits to be received by the executive upon certain terminations of employment. Typically, amounts in excess of accrued obligations are paid only upon a termination by the company without "cause" or by the executive for "good reason," and the terms of these definitions are among the more carefully negotiated portions of the agreement. The payments may include a multiple of salary (and potentially bonus, based on target or historical bonus rate), welfare benefit continuation and equity vesting (to the extent that vesting is not addressed in the equity plan or individual award agreements, in which case the employment agreement will typically reference the specific treatment provided in those agreements). (Such payments and benefits may be enhanced if the termination by the company without cause or by the executive for good reason occurs in connection with a change in control of the company, as described below under "Change-in-Control Agreements and Plans.") Receipt of such payments and benefits is often subject to the execution and nonrevocation of a release of claims against the company and compliance with the restrictive covenants applicable to the executive (as described below).

- **Restrictive covenants.** These provisions often include restrictions on employment or service with company competitors and solicitation of employees and customers as well as nondisparagement, confidentiality, intellectual property and similar provisions. The nature, duration and extent of these provisions must be carefully reviewed under applicable state and federal law. For example, companies should closely review confidentiality and similar provisions to ensure that these provisions do not violate the whistleblower protections mandated under the Dodd-Frank Act and satisfy conditions established by the Defend Trade Secrets Act (which was enacted in 2016) to preserve certain remedies for the company in actions brought by employees. In addition, many states currently prohibit (*e.g.*, California, Oklahoma and North Dakota) or significantly restrict (*e.g.*, Massachusetts) the use of noncompete clauses. The Federal Trade Commission's proposed nationwide ban on noncompete agreements in the United States is discussed in greater detail in Chapter 10.

Proxy advisory firms are also watchful of any provisions that they may view as a problematic pay practice (*e.g.*, excessive severance payments or tax gross-ups), whether or not such provisions are triggered.

While some companies prefer the certainty of entering into an employment agreement (and employment agreements are customary or expected in some industries), other companies enter into more limited agreements with respect to severance and restrictive covenants, without a full employment agreement, while still others prefer not to have any individual agreements at all and rather rely primarily on equity or other compensation arrangements, which may include broad-based or executive severance or change-in-control severance plans, to attract and retain their executive team. This is ultimately a strategic decision, and one made in consultation with internal specialists and external strategic advisers, including compensation consultants.

Disclosure and Say-on-Pay Issues

As described in Chapter 4, employment agreements with new executive officers may be subject to disclosure on a Form 8-K. In addition, existing employment and severance arrangements are described in the CD&A, while amounts paid pursuant to any such agreement appear in the proxy compensation tables (particularly the Summary Compensation Table) and amounts to be paid on termination of employment are described and quantified in the "Potential Payments on Termination or Change in Control" section. In addition to monitoring amounts actually paid to the CEO under any such contract, proxy advisory firms are also watchful of any provisions that they may view as a problematic pay practice (*e.g.*, excessive severance payments or tax gross-ups), whether or not such provisions are triggered.

Change-in-Control Agreements and Plans

Some companies prefer to offer severance protection only for terminations of employment that occur following or in contemplation of a change in control, while others may decide to enhance existing severance benefits for these types of terminations. While many of the considerations associated with these types of arrangements are the same as those discussed earlier in this chapter, some additional considerations apply when entering into or implementing a change-in-control agreement or plan.

Covered Terminations

The definition of "cause" may be narrowed and/or the definition of "good reason" broadened following a change in control, as the acquiring entity will likely be making the determination as to the nature of the termination. In addition, certain pre-change-in-control terminations may be covered where the termination was in contemplation of the change in control.

Benefits

Benefits may be enhanced (for example, by increasing the severance multiplier or providing additional equity vesting) or may be paid in a lump sum following a change in control rather than in installments, which are more common for severance paid outside of a change-in-control period. Changes to the form of payment must be drafted with care and reviewed by specialist advisers so as not to inadvertently create a violation of Section 409A of the Code.

Plan or Agreement

While senior executives have most commonly been provided with change-in-control severance protection through individual agreements, there is an increasing trend toward the use of a change-in-control plan format. This is primarily due to simplicity of administration given that many provisions will apply uniformly to all participants, as well as the ease of amending the plan (although a plan will typically provide that it cannot be amended *following* a change in control). Companies with currently effective agreements may provide a plan for executives without change-in-control agreements and then, as agreements expire, individuals who had been subject to change-in-control agreements may instead be moved into the plan.

Golden Parachute Tax Treatment

Severance payments and equity vesting, along with other payments and benefits provided in connection with a change-in-control-related transaction, may trigger the imposition of "golden parachute" excise taxes, as described in more detail in Chapter 8. In the past, excise tax gross-up provisions — *i.e.*, a provision providing the executive an amount sufficient to leave the executive in the same after-tax position as if the 20% "golden parachute" excise tax had never applied — were more common. However, such provisions, unless in old agreements and thus "grandfathered," will typically cause proxy advisory firms to recommend "against" a say-on-pay proposal and, in certain situations (such as continued violations in consecutive years), can cause the advisory firm to recommend "against" reelection of Committee members. The significance of advisory firms in connection with the setting of compensation strategy is discussed in Chapter 5. More typically in the current climate, change-in-control arrangements provide that payments will be either cut back to a level at which the excise tax does not apply or paid in full (with the executive paying the excise tax), depending on which treatment puts the executive in a better after-tax position. The most economical but least executive-friendly alternative is to provide for a "flat" cutback in all circumstances. These parachute tax considerations are discussed in greater detail in Chapter 8.

Nonequity-Based Annual and Long-Term Incentive Plans

While equity awards (as discussed in more detail in Chapter 6) provide one form of incentive compensation, companies also typically provide cash-based incentives based on annual performance goals, and sometimes also provide longer-term cash-based incentives.

Plan Design

Performance criteria and performance periods are two important components of nonequity-based annual and long-term incentive plans, each of which vary significantly from company to company.

Performance Criteria

Some of the more common financial measures include the following:

- Earnings before interest, taxes, depreciation and amortization (EBITDA).
- Gross or net sales.
- Gross or net income.
- Cash flow.
- Return on assets, capital or equity.
- Total shareholder return (absolute or relative to peers) although in recent years there has been a trend away from using total shareholder return as an exclusive measure.

In addition, companies often use industry-specific measures and nonfinancial corporate performance measures (*e.g.*, opening a specific venue or a specific number of stores).

Historically, these goals (among many others) were listed in a company's omnibus incentive compensation plan, although the changes to the Section 162(m) deduction limitation in the Tax Cuts and Jobs Act of 2017 make that practice less common today, as discussed in greater detail in Chapter 8. The Committee usually consults with the executive team, internal finance specialists and external compensation consultants to determine which measures to use and what targets to set.

Performance Periods

For the typical annual bonus plan, goals are set at the beginning of the performance year (usually within the first calendar quarter for a company with a calendar-based fiscal year), performance is measured as soon as year-end results are available, and bonuses are paid in the first couple of months of the year following the performance year. Long-term cash-based performance plans are more variable in their design. For example, a long-term cash-based performance plan could be structured to have two-year performance periods that do not overlap, or rolling three-year performance periods with a new performance cycle beginning each year. As with identifying appropriate performance criteria and target setting, the selection of a performance cycle should be made based on consultation with internal and external specialists with an eye toward the company's overall business strategy.

Disclosure and Say-on-Pay Issues

As described in Chapter 4, grants and payouts under cash-based incentive plans will be disclosed in the compensation section of the company's annual proxy. Companies should keep in mind the following items regarding the views of proxy advisory firms with respect to cash incentive plans:

- **Challenging goals.** Proxy advisory firms comment negatively on incentive plans containing goals that are deemed (in the view of the advisory firms) to be insufficiently challenging. The company should review the rigor of the plan and its goals when it is being established. In particular, plans with measures which are so qualitative as to potentially be viewed as discretionary have been subject to particularly negative advisory firm commentary.

- **Duplicative measures.** Advisory firms may view using the same measures in the company's annual and long-term plans negatively and potentially characterize the plans as providing duplicate rewards for the same performance. The Committee should review the performance measures used to reward executives under not only the annual and long-term cash incentive plans but also the company's equity plans to confirm that a sufficient variety of measures have been used.

- **Clear disclosure.** Some companies have issued supplemental proxy filings stating that proxy advisory firms have misunderstood and inaccurately described the operation of certain of their compensation plans. Because an advisory firm's erroneous understanding of the company's incentive plans can lead to a negative say-on-pay vote recommendation, the Committee should ensure that the proxy disclosure with respect to these plans is clear.

Deferred Compensation Plans

Most companies maintain tax-qualified 401(k) plans for their U.S. employees, including executives, to provide plan participants with the ability to accumulate retirement savings on a tax-deferred basis. However, the Internal Revenue Code limits the amount that can be deferred each year under tax-qualified retirement plans to an amount that is typically far less than executives would prefer, given the size of their income and tax and financial planning goals. To provide executives with an additional opportunity to defer taxation on employment income, some companies adopt a nonqualified deferred compensation plan permitting deferral of additional income.

Plan Design

By explicitly limiting participation in a nonqualified deferred compensation plan to a select group of management or highly compensated employees, the company can usually, subject to filing a short statement with the U.S. Department of Labor upon plan establishment (sometimes referred to as a "top hat plan letter"), avoid having the plan be subject to requirements related to minimum vesting, funding, and participation or the rigorous fiduciary obligations under the Employee Retirement Income Security Act of 1974, as amended (ERISA). Given ERISA's limited applicability, nonqualified deferred compensation plans can be structured in a number of different ways:

- **Linked plans.** The plan may be specifically linked to the company's 401(k) plan, providing the ability to defer only those amounts that cannot be deferred under the 401(k) plan due to Internal Revenue Code limitations.

- **Elective deferral plans.** The plan may allow elective deferrals by the executive of a percentage of the executive's base salary or annual cash bonus for the plan year, with a range of payment events available (*e.g.*, separation from service, a specified payment date, or the earlier to occur of a separation from service or specified payment date). These elective deferral amounts are fully vested.

- **Matching contributions.** Companies may provide for matching contributions, either linked to the 401(k) plan or an elective deferral plan, or on a completely separate basis. These contributions may vest over time.
- **Earnings.** The participant's account may earn interest at a stipulated rate, or the participant may be able to choose among hypothetical investment options, with the individual's account balance being increased (or decreased) based on the actual performance of such investments.
- **Funding.** While these plans are often unfunded, they may be fully or partially funded via a "rabbi trust" that remains subject to the claims of the company's general creditors. A plan may contain a provision that a change in control will trigger rabbi trust funding of an unfunded or partially funded plans, given that executives may be less confident in the ability or willingness of an acquirer to pay amounts under the plan in the future.

Tax Consequences

Companies should assess the following tax-related issues in connection with the adoption of any nonqualified deferred compensation program:

- **Section 409A conditions.** Most importantly, as described in Chapter 8, Section 409A of the Code was enacted to deal specifically with deferred compensation, and while its intricate rules apply to many different types of compensation arrangements, it perhaps has the greatest impact on the design of deferred compensation plans like those being described here. Rules under Section 409A range from the timing of elections, to the types of events that are permitted to trigger payment, to the manner in which changes to payment elections can be made. If the company is considering the adoption of a deferred compensation plan, it should consult extensively with outside legal specialists and allow sufficient time to make determinations on the various decision points. Some companies eventually determine that it is simplest to adopt a prepackaged plan with an associated adoption agreement from a third-party provider, not unlike the types of documents that are commonly used in connection with standardized 401(k) plans.
- **Corporate tax deductions.** While a tax-qualified retirement plan permits the company to deduct compensation deferred under a 401(k) plan at the time the compensation would otherwise have been paid absent deferral, no corporate tax deduction is available under a nonqualified deferred compensation plan until the date on which the amounts are actually paid to the individual, which may be many years in the future.
- **Employment Taxes.** While income taxation on amounts deferred under a nonqualified deferred compensation plan is generally delayed until such amounts are actually paid to the individual, employment (*i.e.*, FICA/FUTA) taxes are due upon contribution of amounts to the plan (or, if later, when the deferred amounts vest).
- **Section 457A limitations.** As described in Chapter 8, Section 457A of the Code was enacted to limit the use of deferred compensation arrangements by certain tax-indifferent parties referred to a "nonqualified entities" (*e.g.*, foreign corporations located in "tax havens" such as Bermuda or the Cayman Islands, and partnerships, whether domestic or foreign, the profits of which, to a significant extent, are allocable

to tax-indifferent parties) that have no use for the corporate tax deduction available for payments under the deferred compensation arrangement. Section 457A generally provides that amounts deferred under a nonqualified deferred compensation plan sponsored by a "nonqualified entity" are taxable to the executive as soon as the executive's right to the deferred amount is no longer subject to a service-based vesting condition, and if the compensation is not determinable at that time (*e.g.*, because the amount is subject to the achievement of a corporate performance condition that has yet to be achieved), the amount will be taxed when it becomes determinable, but subject at that time to an additional 20% tax and other interest penalties. In contrast to Section 409A, which permits the adoption of a nonqualified deferred compensation plan (and a successful deferral of the tax event) subject to the intricate rules described above, a company that is subject to Section 457A will simply be unable to adopt most types of nonqualified deferred compensation plans (*i.e.*, unable to achieve a successful deferral of the tax event) given that such plans typically provide for payment of the deferred amounts well past the date when any service-based vesting condition for receiving payment of the deferred amounts has lapsed.

Disclosure and Say-on-Pay Issues

The company's annual proxy must include disclosure of amounts accrued or deferred under a nonqualified deferred compensation plan. So long as the plan design is within market parameters (particularly with respect to company contributions), it is unlikely that the plan itself will attract the ire of proxy advisory firms. However, it should be noted that any earnings will be counted by the proxy advisory firms monitoring the CEO's compensation as part of CEO compensation for the year in question.

Supplemental Executive Retirement Plans (SERPs)

Just as Internal Revenue Code regulations limit the benefits available to executives under 401(k) plans, they also limit the amounts that can be provided to executives under traditional "defined benefit" pension plans. Defined benefit pension plans are designed to provide participants with a fixed retirement benefit based on a formula set forth in the plan — for example, a percentage of the individual's compensation in the final five years of employment. Historically, some companies adopted a nonqualified supplemental executive retirement plan (SERP) to provide executives with retirement income in excess of the amounts available under the company's applicable tax-qualified defined benefit plan, while other companies adopted a SERP even in the absence of an existing broad-based retirement plan as part of their strategy to attract and retain executive talent. These types of plans are often disfavored by institutional investors and proxy advisory firms and have become far less prevalent. While the term SERP can also be used to refer to a deferred compensation plan with matching contributions (as described in the previous section), for purposes of this section, the term SERP will be used to refer to a nonqualified defined benefit pension plan.

Plan Design

Similar to nonqualified deferred compensation plans, by limiting participation to a select group of management or highly compensated employees, the company can avoid subjecting the plan to most provisions of ERISA. As with a nonqualified deferred compensation plan, the company should file a statement with the U.S. Department of Labor (a "top hat plan letter") upon establishment of the plan. Given this flexibility, plans can be structured in a number of different ways:

- **Linked plans.** The plan may be specifically linked to the company's qualified defined benefit pension plan (if any) and provide the ability to receive amounts which would have been received under the qualified plan but for Internal Revenue Code limitations.
- **Benefit formulas.** Rather than link the SERP benefit formula to a qualified plan, the SERP may contain its own formula. For example, the plan may provide for an annual benefit equal to a percentage of the final average compensation over a specific number of years of the participant's employment, and may define compensation to include or exclude various types of payments.
- **Forms of payment.** As with qualified defined benefit plans, SERPs may provide for lump sum or installment payments, and more complex versions may include options such as joint and survivor annuities.
- **Benefit variations.** Benefits may be provided at different levels based on the type and timing of the termination of employment (*e.g.*, early retirement, regular retirement, death, disability) and may provide for vesting and payment acceleration upon a change in control.
- **Funding.** While these plans are often unfunded, they may establish that a change-in-control triggers rabbi trust funding, given that executives may be less confident in the ability or willingness of an acquirer to pay amounts under the plan in the future, or may be subject to rabbi trust funding even absent a change in control.

Tax Consequences

Companies should consider the following items from a tax perspective:

- **Section 409A considerations.** As with the deferred compensation plans discussed above, Section 409A of the Code should be carefully considered in the drafting and operation of a SERP, since by its nature a SERP is designed to pay benefits that constitute deferred compensation. Companies should take great care to ensure compliance with Section 409A, which in many cases will require compliance with myriad technical rules.
- **Corporate tax deductions.** No corporate tax deduction is available under a SERP until the date on which the amounts are actually paid to the individual, which may occur many years in the future.
- **Section 457A limitations.** As with the deferred compensation plans discussed above, Section 457A of the Code should be carefully considered as a gating item in connection with the proposed adoption of a SERP, since a company that is Subject to 457A will simply be unable to adopt most types of SERPs (*i.e.*, unable to achieve a successful deferral of the tax event), given that SERPs typically provide for payment of the defined benefit amounts well past the date when any service-based vesting condition to receiving payment of the defined benefit amounts has lapsed.

Disclosure and Say-on-Pay Issues

The company's annual proxy must provide disclosure of pension plans (including SERPs), including the number of years of service and the present value of the benefit and any withdrawals or distributions made in the prior fiscal year, in each case for each NEO. SERPs are an area of focus for proxy advisory firms, particularly when the benefit formula is viewed as especially generous or where additional service credit is granted under certain circumstances (such as upon a change in control). The Committee should consider the terms of any pension plans carefully in consultation with its advisers.

Perquisites

To attract and retain executives, companies may provide perquisites — that is, special programs and benefits that are made available only to senior executives. Whether a particular perquisite is appropriate for a specific company will depend on many factors, including industry standards. Some common types of perquisites are:

- A company car (or allowance).
- Tax and financial planning.
- Executive health programs.
- Country or eating club memberships.
- Use of company aircraft.
- Home security.
- Relocation programs.
- Spousal travel.
- Charitable gift matching.

Prevalence

While the percentage of companies offering perquisites to their executives has decreased in recent years, and the extent and number of perquisites at companies that do offer such programs has narrowed, many companies offer at least one of the perquisites listed above. The perquisites that have become less common are those that can be perceived externally in a negative light, such as country club memberships or use of company aircraft, while tax and financial planning and relocation benefits are among the perquisites most frequently retained. The decision as to whether to offer perquisites to executives is based on a number of factors, including the practices of competitors and whether proxy advisory firms have raised related concerns in past say-on-pay vote recommendations. Where a company provides no perquisites, it typically highlights that fact in its annual proxy.

Tax Issues

In general, the types of perquisites described above are subject to taxation as ordinary income, based on the fair market value of the perquisite in question (which is generally determined based on the amount that the individual would have to pay a third party, in an arm's length transaction, for the item or service). With respect to the personal use of corporate aircraft, there are several valuation methodologies; the most commonly used methodology is the Standard Industry Fare Level (or SIFL) method, which is based on factors including the length of the trip, type of aircraft, number of people accompanying the employee and whether the employee is a "control" or "non-control" individual. "Control" individuals are generally directors and senior executives of the company. These calculations can be complex and should be prepared with the assistance of experienced internal or external specialists.

Disclosure and Say-on-Pay Issues

Perquisites provided to the company's NEOs may need to be specifically disclosed depending on their value. Certain of these amounts, and in particular the value of company aircraft usage, are subject to complex calculation rules (and typically are reported at values that differ from their imputed value for taxation purposes). Some perquisites, such as financial and tax planning assistance, rarely receive comment from the proxy advisory firms. By contrast, other perquisites (especially personal use of the company aircraft and tax gross-ups) may draw a negative comment or negative recommendation, especially if there are several such practices and if they are coupled with other pay practices that are, in the view of the firms, problematic. In recent years, the SEC has brought enforcement actions against a number of companies that failed to disclose in their proxy statements all of the perquisites provided to their executives. Therefore, it is important to carefully consider decisions to categorize certain benefits as business expenses instead of perquisites and to consult with external counsel as necessary when preparing perquisite disclosures.

Chapter 8

Compensation-Related Tax Provisions

This chapter provides an overview of Sections 162(m), 280G and 409A of the Code — the Code sections most frequently implicated by compensation arrangements — and issues facing compensation committees in regard to those provisions.

Compensation-Related Tax Provisions

Section 162(m)

Section 162(m) — Snapshot

- Section 162(m) imposes a limit of $1 million on the amount of compensation that a public company may deduct in any taxable year with respect to compensation paid to each "covered employee" during that year.
- For taxable years beginning after December 31, 2017, a "covered employee" is any individual who, at any time during the year, served as the CEO or CFO of the company, was among the three most highly compensated executive officers (other than the CEO or CFO) regardless of whether such individual was an executive officer as of the last day of the year, or was a "covered employee" for any taxable year beginning after December 31, 2016.
- For taxable years beginning before December 31, 2017, a "covered employee" is any individual who served as the CEO of the company as of the last day of the taxable year or was among the three most highly compensated executive officers (other than the CEO or CFO) who served as an executive officer as of the last day of the taxable year. Note the exclusion of the CFO and the year-end service requirement, both of which were eliminated as part of the Tax Cuts and Jobs Act (TCJA).

Overview[1]

The deduction that a publicly held corporation can claim in any tax year for compensation paid to a covered employee is limited to $1,000,000 (*i.e.*, compensation in excess of this limitation, unless otherwise excludable, is nondeductible to the company). Compensation subject to the $1,000,000 limit does not include employer contributions to tax-qualified retirement plans or amounts excludable from gross income.

Section 162(m) applies not only to corporations with publicly traded equity but also to corporations that have publicly traded debt and foreign private issuers that meet the new definition of a publicly held corporation (even if not subject to the executive compensation disclosure rules of the Securities Exchange Act).

Further, the applicable regulations extend the deduction limitation to compensation paid after December 18, 2020, by a subsidiary partnership to an employee where the employee is also a covered employee of a public corporation that is a partner in the partnership (for example, in a so-called "up-C" structure). Specifically, the deduction limitation applies to the public corporation's "distributive share" of the compensation deductions for compensation paid to the public corporation's covered employees by

[1] Prior to the enactment of the TCJA, qualified "performance-based compensation" was not subject to the Section 162(m) limit. The TCJA eliminated the performance-based compensation exemption and also expanded the scope of employees who may qualify as covered employees, such that virtually all compensation paid to a covered employee in excess of $1 million is nondeductible, including post-termination and post-death payments, severance, deferred compensation and payments from nonqualified plans. Compensation payable pursuant to a written binding contract, including compensation payable to the CFO (who was not previously considered a "covered employee" prior to the TCJA) under such a contract that was in effect on November 2, 2017, and not materially modified after that date, remains exempt under a transition rule. Specific operational rules apply in determining both whether a written binding contract was in effect on November 2, 2017, and whether such a contract has been materially modified after such date. The operational rules and guidance from the IRS are complex and certain unresolved issues remain. With the passage of time, fewer grandfathered arrangements remain, but companies should confirm whether they have grandfathered arrangements and be careful not to inadvertently lose the grandfathering benefit.

the partnership. However, compensation paid after December 18, 2020, pursuant to a written binding contract that was in effect on December 20, 2019, and that was not materially modified after that date remains exempt under a transition rule. Specific operational rules apply in determining both whether a written binding contract was in effect on December 20, 2019, and whether such a contract has been materially modified after such date. The operational rules and guidance from the IRS are complex and certain unresolved issues remain.

Covered Employees

Under the TCJA, a "covered employee" includes any individual who served as the CEO or CFO at any time during the taxable year and the three other most highly compensated executive officers (excluding the CEO and CFO) during the taxable year, regardless of whether the individual is an executive officer at the end of the year and regardless of whether the individual's compensation is required to be disclosed for the last completed fiscal year under SEC rules. Additionally, the TCJA expanded the scope of covered employees under Section 162(m) by providing that **any individual who is or was a covered employee for any taxable year beginning after December 31, 2016, will remain a covered employee for all future taxable years** (the "once a covered employee always a covered employee" rule).

The American Rescue Plan Act of 2021 (ARPA) further expanded the scope of a "covered employee" under Section 162(m) and will include — in addition to the CEO, the CFO and the three other most highly compensated executive officers — the next five most highly compensated employees (whether or not they are executive officers). Notably, the next five most highly compensated employees will not follow the TCJA rule of "once a covered employee always a covered employee" and their covered status may change from year to year. The 162(m) expansion under the ARPA will take effect in taxable years beginning after December 31, 2026.

Setting Performance Goals After the TCJA

Even though the Section 162(m) exception for qualified performance-based compensation generally is no longer available, most companies will still want to maintain performance-based compensation programs to appropriately incentivize executives and respond to the demands of pay-for-performance recommendations by proxy advisory firms and shareholders. Proxy advisory firms have become increasingly interested in the rigor of performance goals, and this trend has continued even as companies have more flexibility to establish performance goals without being limited to shareholder-approved goals under the prior rules for qualified performance-based compensation under Section 162(m). Companies should continue to consider the views of shareholders and proxy advisory firms when designing performance goals.

Outside Directors

Because many companies historically designed their compensation programs to qualify for the old Section 162(m) performance-based compensation exception, which required certain actions to be taken by "outside directors," Committee members typically have been "outside directors" for Section 162(m) purposes. While companies will no longer be required to monitor the status of outside directors for purposes of the qualified performance-based exception under Section 162(m) (other than for purposes of certifying results under any remaining grandfathered performance-based arrangements eligible under the transition rule (which at this point are likely quite rare)), companies will still need to comply with the independence requirements for compensation committees under the NYSE and Nasdaq listing standards, as applicable, and the rules for "nonemployee directors" under 16(b) of the Securities Exchange Act. Additionally, proxy advisory firms and shareholders have views and expectations concerning director independence.

Transition Rule for Initial Public Offerings

Prior to the enactment of the TCJA, in the case of an IPO, the Section 162(m) deduction limitation did not apply to plans or agreements in effect prior to the effectiveness of the IPO during a specified transition period (generally ending upon the first meeting of the company's shareholders at which directors are to be elected that occurs after the close of the third calendar year following the year of the IPO). This transition relief has been eliminated for companies that became publicly held after December 20, 2019.

Section 280G

Section 280G — Snapshot

- Section 280G denies a corporation a deduction for "excess parachute payments" made to "disqualified individuals."
- Section 4999 imposes a 20% excise tax on the recipient of any excess parachute payment and requires the corporation to withhold the excise tax from the individual's compensation.

Overview

In general, Section 280G of the Code provides that no deduction is allowed to the company for "excess parachute payments," and Section 4999 imposes an excise tax on the recipient of any excess parachute payment equal to 20% of such amount.

Parachute Payment

A "parachute payment" is any payment made to a "disqualified individual" that is contingent on a change in control of the company including, for example, cash severance benefits, additional retirement benefits and noncash compensation such as the continuation of health insurance coverage, the accelerated vesting of stock options and other equity-based awards.

A payment is considered contingent on a change in control if it would not have been made had the change in control not occurred or if the timing of such payment is accelerated by the change in control. In addition, any payment made pursuant to an agreement (or an amendment to an agreement) entered into within one year before a change in control is presumed (rebuttably) to be contingent on that change in control.

Disqualified Individual

A disqualified individual is any individual who is an employee or independent contractor who is also an officer, a highly compensated individual or a shareholder owning a significant amount of the company's outstanding shares of stock (*i.e.*, stock with a fair market value exceeding 1% of the fair market value of the outstanding shares of all classes of the company's stock).

Excess Parachute Payments and the 299% Safe Harbor

Excess parachute payments consist of the excess of parachute payments over a disqualified individual's "base amount." "Base amount" means the average taxable compensation received by the individual from the company during the five taxable years (or during the individual's entire period of employment if less than five years) preceding the year in which the change in control occurs. The Code provides a "safe harbor" of 300% of the executive's base amount (*i.e.*, the parachute rules do not apply if aggregate parachute payments are less than that amount).

If the parachute payments equal or exceed the safe harbor amount, the entire excess over the base amount (*i.e.*, the five-year average taxable compensation), not just the excess over the safe harbor amount, will be subject to the excise tax and disallowance of deduction. For example, if an executive has a base amount of $100,000, parachute payments of up to $299,999 will not be subject to the excise tax or the disallowance of deduction, but a parachute payment of $300,000 (only $1 more than the safe harbor amount) will result in $200,000 being subject to the excise tax and disallowed as a deduction.

Note that, because of this treatment, an individual entitled to parachute payments only slightly in excess of the individual's safe harbor amount may be in a better after-tax position if the individual's payments are automatically or voluntarily reduced to the safe harbor amount. Such an individual is sometimes said to be "in the valley." In the above example, the individual avoids an excise tax of $40,000 (20% of the $200,000 excess parachute payment) merely by having the individual's payments reduced by $1.

Although theoretically straightforward, calculating parachute amounts is complex. The regulations under Section 280G contain complicated formulas for determining the parachute value of particular types of compensation as well as numerous technical exceptions. Parachute calculations are typically prepared by an accounting firm or outside counsel using company-provided information.

Strategies To Address the Excise Tax

Companies can incorporate several methods into the design of change-in-control severance agreements to address excise taxes. These strategies would also simultaneously spare the company the lost deduction, but given the expansion of Section 162(m) under the TCJA, as described in the preceding section of this chapter, many parachute payments payable to disqualified individuals will already be nondeductible by the company by virtue of the $1 million deduction limitation. For purposes of completeness, this section contains a summary of the various approaches for mitigating the excise tax impact; note, however, that tax gross-ups are viewed unfavorably by proxy advisory firms and are currently characterized as a problematic pay practice that generally will yield an automatic "against" recommendation in respect of the say-on-pay vote.

Cap on payments. To avoid the excise tax, limiting the amount of potential parachute payments to no more than the executive's safe harbor amount may be desirable. This approach is frequently referred to as the "cap" approach.

Example 1: Executives 1 and 2 each have base amounts of $100,000 and have parachute payments of $300,000 and $450,000, respectively. The parachute payments to each of Executives 1 and 2 would be reduced to $299,999.

Valley approach. As an alternative to the cap approach, parachute payments may be cut back to the safe harbor amount only if the cutback results in a higher after-tax payment to the executive after taking into account both the excise tax that the executive would otherwise pay on the excess parachute amount and the larger income tax the executive would otherwise pay if the payment were not reduced — *i.e.*, the company agrees to bear the additional cost of nondeductibility but only if that additional cost results in an increased benefit for the executive. This approach is frequently referred to as the "valley" approach (sometimes also referred to as a "best net benefit" approach).

Example 2: Same facts as Example 1. The parachute payments for Executive 2 will not be reduced because he would retain $200,000 on an after-tax basis ($450,000, less $70,000 excise tax (20% of $350,000) and less $180,000 income tax (assuming a 40% tax rate)) which exceeds the after-tax amount of $179,999 that he would retain if he were "capped" at $299,999 ($299,999 less $120,000 income tax (assuming a 40% tax rate)). Executive 1's parachute payment would again be reduced to $299,999 because the $1 reduction in the payment results in a savings to Executive 1 of $40,000 of excise tax (20% of $200,000).

Gross-up arrangements. Under certain circumstances, providing for a special "gross-up" payment may be appropriate to ensure that the executive receives the after-tax benefit the executive would have received had the payments not been subject to the excise tax. Assuming a marginal tax rate (combined federal, state, local and FICA) of 40%, approximately $2.50 of gross-up payments will be needed to make the executive whole for $1 of excise tax liability ($0.50 for each $1 of excess parachute payment). Such a "gross-up" payment would be nondeductible for federal income tax purposes.

Example 3: Same facts as Example 1. The parachute payment of neither executive will be reduced. Executive 1 would receive an additional payment of approximately $100,000 and Executive 2 would receive an additional payment of approximately $175,000.

In addition, in connection with the occurrence of a change in control, it may be possible to accelerate the payment of a disqualified individual's compensation and benefits to be received in connection with the change in control so that they are received by the individual in the year before the change in control occurs. This may increase the individual's base amount and safe harbor amount accordingly, thereby reducing the amount of the individual's excess parachute payment. In practice, accelerated amounts are often subject to a clawback until the earlier of when the change in control occurs or when the amounts would otherwise be earned. However, given the complexity of Section 280G and possible Section 409A complications implicated by compensation acceleration, the company should engage with sophisticated advisers, including external legal counsel, if it is considering accelerating compensation and benefits to minimize exposure to excess parachute payments and lost tax deductions.

Section 409A

Section 409A — Snapshot

- Section 409A governs the timing of elections to defer compensation, the timing of distributions of deferred compensation and the reporting and taxation of deferred compensation.
- Section 409A covers not only standard nonqualified deferred compensation arrangements, but also often applies to severance arrangements, employment agreements, change-in-control arrangements and certain equity awards.
- A violation of Section 409A will result in immediate inclusion in the individual service provider's income of the vested deferred amounts, a 20% penalty tax (in addition to ordinary income tax on the deferred amount) and interest penalties. Service providers include employees, directors and many independent contractors.
- There is no penalty imposed on the company for failure to comply with Section 409A other than potential penalties related to the failure to report or withhold on amounts that become taxable due to a Section 409A failure.

Overview — What is Section 409A?

Section 409A is concerned with the time and form of payment of deferred compensation. Prior to the enactment of Section 409A, no single Code section governed the taxation of nonqualified deferred compensation. Broadly speaking, Section 409A represents a significant restriction of the contracting parties' ability to control the timing of receipt and inclusion of nonqualified deferred compensation in income. The restriction of control is reflected in the Section 409A rules regarding initial deferral elections, permissible payment events, the ability to accelerate payment of nonqualified deferred compensation (including the prohibition of "haircut" provisions pursuant to which deferred compensation is paid on an accelerated basis with a penalty/reduction (or "haircut") and the rules related to the re-deferral of previously deferred compensation.

Although any detailed explanation of Section 409A is beyond the scope of this handbook, it is important to remember that Section 409A significantly affects the way nonqualified deferred compensation may be structured.

General Application — When Does Section 409A Apply?

Amounts are generally considered deferred if an individual obtains a legally binding right in one tax year to receive compensation in a later tax year. Thus Section 409A can cover not only standard deferred compensation plans but also supplemental executive retirement plans, severance plans, employment agreements, change-in-control agreements, certain equity awards and many other arrangements that were not traditionally thought of as providing deferred compensation.

To Whom Does Section 409A Apply?

Section 409A applies to deferred compensation earned by "service providers." The regulations under Section 409A specify that the term "service provider" includes an individual, a corporation (private and public), a Subchapter S corporation, a partnership, a personal service corporation as defined under Section 269A(b)(1) of the Code (or an entity that would be a qualified personal service corporation if it were a corporation), and a qualified personal service corporation as defined under Section 448(d)(2) of the Code (or an entity that would be a qualified service corporation if it were a corporation). Importantly, Section 409A covers employees, directors, and many consultants. Section 409A does not apply to service providers using the accrual method of accounting. The term "service provider" also includes a person who has separated from service (*i.e.*, a former service provider who is no longer providing services).

Exceptions to Section 409A Coverage

There are three particularly important exceptions to the coverage of Section 409A (in addition to the equity compensation exceptions discussed below). Section 409A does not apply to short-term deferrals, grandfathered benefits and certain severance plans.

Short-Term Deferrals: The short-term deferral rule is a significant exception that covers most annual bonus payments and many lump sum severance arrangements. The short-term deferral exception generally provides that amounts that are only payable no later than 2½ months following the end of the taxable year in which the employee's right to the compensation is no longer subject to a "substantial risk of forfeiture" are not subject to Section 409A.

Grandfathered Benefits: Section 409A does not apply to benefits that were earned and vested as of December 31, 2004, and credited earnings on such amounts (so long as the benefits are not materially modified after such date).

Certain Severance Benefits: Section 409A does not apply to severance payable only in connection with an involuntary termination of employment that does not exceed two times the lesser of the employee's compensation for the year prior to termination or the applicable IRS limit on compensation under a qualified pension plan for the year of termination of employment ($345,000 for 2024). The severance amount must be paid by December 31 of the second year after the year in which the termination occurs.

Complying With Section 409A

Deferred compensation that is subject to Section 409A must comply with rules aimed at restricting the contracting parties' ability to control the timing of receipt and inclusion of the compensation in income. To comply with Section 409A, deferrals must be made pursuant to a written plan that complies with documentary and operational requirements under Section 409A. Generally, Section 409A:

- Strictly limits when compensation may be deferred (*i.e.*, when the initial election to defer compensation may be made).
- Offers limited permissible payment events — namely a specified date (or schedule), death, disability, unforeseeable emergency, separation from service or change-in-control event.
- Strictly limits the ability to change when deferred compensation may be paid (*e.g.*, the ability to either accelerate or delay the payment of deferred compensation).

Many of the rules under Section 409A are complex and many unresolved issues remain.

Special Section 409A Rule Applicable to Public Companies — Six-Month Delay

Section 409A applies to both private and public companies. However, one aspect of Section 409A applies only to public companies — if payment of deferred compensation to an individual who falls within the definition of "specified employee" is triggered by a "separation from service," that payment must be delayed for at least six months after the separation from service. Note that the six-month delay does not apply if the amount payable is not deferred compensation within the meaning of Section 409A (for instance, if the amount is exempt as a short-term deferral) or is triggered by a payment event other than a "separation from service."

The "specified employees" are generally the top 50 highest paid officers of the company (including each of its subsidiaries), provided that the officer's compensation is greater than $220,000 (for 2024). Companies with fewer than 491 employees will have fewer than 50 officers who are specified employees (the maximum number of officers that must be identified is limited to the greater of 10% of the company's employees, rounded to the next higher whole number, or three officers). In addition, any employee who owned more than 5% of the company's stock at any time during the year and any employee who owned more than 1% of the company's stock at any time during the year and received annual compensation greater than $150,000 is also considered a "specified employee." Nonemployee directors are not "specified employees."

Equity Incentive Compensation

Many equity compensation arrangements are either excluded from the definition of nonqualified deferred compensation (*i.e.*, not subject to Section 409A) or can be designed to comply with Section 409A. Tax-qualified equity arrangements (*e.g.*, incentive stock options and employee stock purchase plans within the meaning of Section 423 of the Code) are exempt from Section 409A.

Options/SARs: Stock options and stock appreciation rights to acquire "service recipient stock" are exempt from Section 409A if the exercise price is not less than the fair market value of the stock on the date of grant and the grant does not include any additional deferral features. The Section 409A regulations define "service recipient stock" as stock that, as of the grant date, (a) is common stock for purposes of the Code, (b) does not have a distribution preference, (c) is not subject to a mandatory repurchase obligation and (d) is issued by an "eligible issuer." Generally, an eligible issuer means the company for which the individual provides services and certain affiliates (not including subsidiaries).

Restricted Stock: Restricted stock is generally not subject to Section 409A even in situations where the value of the transferred property may not be immediately includable in income (*e.g.*, where the restricted stock is subject to vesting).

Restricted Stock Units: Unlike restricted stock, a grant of restricted stock units may be subject to the requirements of Section 409A if the grant is not structured as a short-term deferral (*e.g.*, by including provisions that always require payment promptly following vesting of the award). Many restricted stock unit awards are (sometimes inadvertently) subject to Section 409A because of features such as vesting upon retirement or continued vesting following certain employment terminations.

Section 409A Violation Consequences

Deferred compensation that is subject to, and does not comply with, Section 409A must be included in the gross income of the service provider upon vesting. In addition to regular federal income tax on the deferred amount, the service provider is subject to a 20% penalty tax on any deferred compensation that is taxable under Section 409A. Under certain circumstances a substantial interest penalty may be applied in addition to the 20% penalty tax. Certain states also impose additional taxes on noncompliant deferred compensation. For example, California imposes an additional state tax penalty of 5%, bringing the total penalty tax to 25% (exclusive of any interest). Although the Section 409A penalties apply only to the service provider, the service recipient/employer may also be liable for penalties and interest related to the failure to withhold, report and deposit federal income taxes.

Section 457A

Section 457A of the Code was enacted to limit the use of deferred compensation arrangements by certain tax-indifferent parties referred to a "nonqualified entities" (*e.g.*, foreign corporations located in "tax havens" such as Bermuda or the Cayman Islands, and partnerships, whether domestic or foreign, whose profits, to a significant extent, are allocable to tax-indifferent parties) that have no use for the corporate tax deduction available for payments under the deferred compensation arrangement.

Although any detailed explanation of Section 457A is beyond the scope of this handbook, it is important to remember that Section 457A significantly limits the ability of any company that is a "nonqualified entity" from sponsoring a nonqualified deferred compensation plan for employees who are U.S. taxpayers.

Section 457A generally provides that amounts deferred under a nonqualified deferred compensation plan sponsored by a "nonqualified entity" are taxable to the service provider as soon as the service provider's right to receive the deferred amounts is no longer subject to a service-based vesting condition, and if the compensation is not determinable at that time (*e.g.*, because the amount is subject to the achievement of a corporate performance condition that has yet to be achieved), the amount will be taxed when it becomes determinable, but subject at that time to an additional 20% tax and potentially other interest penalty payments.

In contrast to Section 409A, which permits the adoption of a nonqualified deferred compensation plan (and a successful deferral of the tax event) subject to the detailed rules described above, a company that is subject to Section 457A will simply be unable to adopt most types of nonqualified deferred compensation plans (*i.e.*, unable to achieve a successful deferral of the tax event), given that such plans typically provide for payment of the deferred amounts well past the date when any service-based vesting condition for receiving payment of the deferred amounts has lapsed.

Cautionary Note

Because Sections 280G, 409A and 457A of the Code are especially technical in nature, the company should engage with sophisticated advisers, including external legal counsel, at all phases of the compensation process, from design to documentation and implementation, to avoid foot faults that could result in significant negative tax consequences to the company and its employees and other services providers.

Chapter 9

Section 16 of the Securities Exchange Act of 1934

This chapter provides an overview of Section 16 of the Exchange Act and the related rules adopted by the SEC, including rules regarding equity awards made by the Committee. Section 16 applies only in respect of companies that have registered a class of equity securities under Section 12 of the Exchange Act, excluding foreign private issuers.

Section 16 of the Securities Exchange Act of 1934

Section 16

Section 16 — Snapshot

- Section 16 requires public disclosure of officers', directors' and 10% owners' transactions in company equity securities, including derivative securities, and prohibits them from profiting from short-term trading, regardless of whether they possess any material nonpublic information.

Overview

Section 16 was adopted with the intent of deterring public company insiders from profiting from short-term trading transactions in company stock and related securities. To that end, Section 16 generally requires each Section 16 Insider — each officer or director of a company that has registered a class of its equity securities under Section 12 of the Exchange Act, as well as each beneficial owner of more than 10% of any class of company voting equity security registered under that section — to report transactions in and holdings of company equity securities, to disgorge to the company any profit realized from trading in company equity securities that occurs within a period of less than six months, and to refrain from "shorting" company equity securities. Under case law, persons or entities that may be deemed to have a deputy representing them on the company board of directors may also be subject to Section 16 under the so-called director-by-deputization theory, depending on facts and circumstances.

Section 16 applies to not only stock exchange transactions, but also (in whole or in part) to most other transactions that change a Section 16 Insider's pecuniary interest in company stock or derivative securities, including private purchase or sale transactions, equity-based awards, option exercises, certain transactions in company benefit plans, gifts and tax and estate-planning transactions. Further, Section 16 applies to not only the direct interests of Section 16 Insiders (such as their individual transactions), but also to certain of their indirect interests, such as the interests of their immediate family members sharing the same household; interests via certain trusts for the benefit of themselves or immediate family members; and interests via contractual rights, holding companies, partnerships or other relationships in which the Section 16 Insider has some investment control and the "opportunity, directly or indirectly, to profit or share in any profit derived from a transaction" in company equity securities.

The rules under Section 16 specifically define which "officers" are subject to the provisions of Section 16, although they are generally the same persons as the executive officers required to be named in the company's proxy statement or annual report plus the company's principal accounting officer, together with persons who have taken on any of the relevant positions since such statement or report. The applicable definition captures both holders of specified titles and persons who hold significant policymaking power or oversee principal business units, divisions or functions, without regard to title. Interim occupants of offices may become Section 16 Insiders during the term of their interim service, as may persons who exercise the de facto authority of an office (such as after the departure of an office holder, or an employee of a corporate parent or subsidiary), even absent a title. It is a good practice for the board to annually identify the company's "executive officers" and Section 16 "officers," and to consider whether newly promoted or hired officers, including interim officeholders, should be designated as Section 16 Insiders. These determinations are generally granted considerable deference.

Section 16 applies not only to Section 16 Insiders' transactions in common stock and other classes of company stock, but also to derivative securities.

Section 16 applies not only to Section 16 Insiders' transactions in common stock and other classes of company stock, but also to derivative securities, *i.e.*, securities with a conversion or exchange right at a price related to a company equity security, or which have a value derived from the value of a company equity security. This includes customary employee equity-based awards such as stock options, restricted stock units and stock appreciation rights. So-called performance awards (that is, equity-denominated grants that remain subject to the satisfaction of performance criteria), however, are not derivative securities unless their value (or the criteria by which they are deemed earned) is dependent solely on the passage of time or the value of a company equity security (*e.g.*, performance units earned solely on the basis of the company's stock price reaching some target). Performance awards conditioned on total shareholder return should be considered in light of whether any factor other than share price is significant in satisfying the performance criteria (*e.g.*, if a company does not pay a dividend, total shareholder return may be just another way to describe a stock price target).

The Three Operative Provisions of Section 16

Section 16(a) of the Exchange Act requires that Section 16 Insiders file reports with the SEC identifying themselves and disclosing their holdings of company equity securities when they initially become Section 16 Insiders, and that they continue thereafter to disclose their transactions and holdings in company equity securities for so long as they remain Section 16 Insiders and, in certain circumstances, for up to six months thereafter.

Section 16(b) of the Exchange Act provides for the recovery by the company of any profit realized by Section 16 Insiders on the matched purchase and sale, or sale and purchase, of the company's equity securities within any period of less than six months ("short-swing profits"), unless an exemption applies to one or both of the purchase or sale transactions. Under Section 16(b), a transaction in a particular company derivative security (*e.g.*, buying an exchange-listed call option on company stock) may be "matched" against a transaction in the underlying equity security (*e.g.*, a sale of company stock) or a different company derivative security (*e.g.*, buying an exchange listed put option on company stock). Although the scope of Section 16 extends beyond Committee matters, the Committee often has an important role in providing an exemption from the short-swing profit rule for certain transactions between the company's officers or directors, on the one hand, and the company, on the other hand, as discussed in further detail below.

Finally, Section 16(c) of the Exchange Act requires that Section 16 Insiders refrain from making "short" sales of company equity securities. Neither the company nor the Committee ordinarily plays a significant role with respect to this aspect of Section 16.

Reporting by Section 16 Insiders Under Section 16(a)

Section 16(a) Reporting — Snapshot

- Most transactions by Section 16 Insiders are subject to public reporting.
- The reporting deadline is generally the second business day after the transaction.
- There are limited exemptions for events considered not to present the opportunity for abuse.
- Company personnel customarily assist officers and directors with their reporting obligations, but those obligations are the officer's or director's alone.

Section 16 Insiders are required to file with the SEC an initial statement of beneficial ownership (Form 3) identifying themselves as persons subject to Section 16 with respect to the company and disclosing their beneficial ownership of company equity securities and any related derivatives beneficially owned as of the time they became a Section 16 Insiders.In the case of the company's initial registration of a class of equity securities under Section 12 of the Exchange Act (*e.g.*, in connection with a company going public in the U.S.), such Form 3 filings are due on the same day such registration becomes effective. For persons becoming Section 16 Insiders of an already public company, the Form 3 filing is due within ten days of becoming a Section 16 Insider. Section 16 Insiders are not required to file an additional Form 3 upon taking on a new role, or changing roles, with the company (*e.g.*, an officer who later becomes a director), although a person who ceases to be a Section 16 Insider and then later again becomes one should file another Form 3 in connection with the resumption of Section 16 Insider status.

Section 16 Insiders are further required to file with the SEC a statement of changes of beneficial ownership (Form 4) for most changes in beneficial ownership of any company equity securities, including derivative securities, within two business days of when they occur. Certain transactions such as acquisitions of gifts by the recipient are eligible for deferred reporting, but must be reported (together with any other unreported transactions subject to reporting) on an annual statement of changes in beneficial ownership (Form 5) within 45 days after the end of the company's fiscal year, if not voluntarily reported earlier on a Form 4.

No filing is required to report that a person has ceased to be a Section 16 Insider, although certain related transactions may themselves require a filing (*e.g.*, transactions deemed to occur immediately prior to the effectiveness of the resignation, termination or other event causing such person to cease to be a Section 16 Insider). Also, in some circumstances the obligations of Section 16, including these reporting requirements, may continue to apply to former officers and directors for up to six months after leaving office.

Ordinarily all of these reports are required to be filed on the SEC's EDGAR system and are publicly available; they are also required to be posted on the company's website. Customarily, companies assist their officers and directors in filing such reports, both for Section 16 Insiders' open-market trading, company equity-based grants and tax and estate planning transfers. The company must disclose any Section 16 Insider's failure to timely make any required report, specifying in the company's annual proxy statement and annual report (either directly or by incorporating by reference from the proxy statement) the name of any Section 16 Insider who failed to timely file a report, the number of transactions reported late and the number of instances of late and missing reports.

Although typically the time at which a person becomes a Section 16 Insider, or when a transaction occurs, will be fairly obvious, particular facts and circumstances may require closer consideration. Generally a transaction occurs when a Section 16 Insider's rights and obligations regarding company equity securities become fixed. For instance, although the Committee may give its approval of an equity award on a given date, if that approval is subject to future facts, such as an option strike price determined on a later date, that later date may be the transaction date. Because a determination of the relevant transaction date may be complicated, new award structures should be discussed with company counsel in advance, if possible.

Other complicated issues arise from performance awards, which may not be subject to Section 16 when first awarded but which may become subject to reporting under Section 16 upon the satisfaction of the applicable performance criteria or conditions.

As noted above, other complicated issues arise from performance awards, which may not be subject to Section 16 when first awarded (if the value of such awards, or whether they will ultimately be earned, is dependent on criteria or conditions not based solely on the price of the company's stock or the passage of time), but which may become subject to reporting under Section 16 upon the satisfaction of the applicable performance criteria or conditions.

Certain categories of transactions (largely either transactions of a personal nature or transactions available to broader categories of persons, such as company employees or shareholders generally) are eligible for exemptions from the short-swing profit rule of Section 16(b) — and, in most cases, from the reporting obligations of Section 16(a) as well — making some transactions entirely exempt from reporting and permitting others to be deferred to an annual statement of changes in beneficial ownership (Form 5). Most commonly, Section 16 Insiders may defer to Form 5 the reporting of bona fide gifts (as recipient) and inheritances (both of which are also exempt from the short-swing profit rule), as well as small acquisitions of no more than $10,000 in the aggregate. Transactions occurring pursuant to a qualified domestic relations order (such as in connection with a state court divorce proceeding) are entirely exempt from Section 16, as are most payroll-based transactions in company employee stock purchase plans, 401(k) plans and other benefit plans satisfying Internal Revenue Code coverage and participation requirements. Certain transactions available to or affecting all shareholders on an equal basis, such as normal dividend reinvestments made pursuant to a broad-based dividend reinvestment plan (or pursuant to an employee benefit plan offering the same terms as a broad-based DRIP), and pro rata stock dividends, stock splits and similar transactions applying equally to all shareholders are also exempt from Section 16. Transactions that involve only a change in the form of a Section 16 Insider's beneficial ownership, but not a change in pecuniary interest (*e.g.*, a Section 16 Insider's deposit of company stock into a trust of which the Section 16 Insider is both a trustee and the sole beneficiary or into a limited liability company in which the Section 16 Insider is the sole member), are also exempt from Section 16.

The Short-Swing Profit Rule

Short-Swing Profit Rule — Snapshot

- Section 16 Insiders are required to disgorge any profit that could be ascribed to transactions in company equity securities made within a period of less than six months.
- Calculation of profit is extremely disadvantageous to Section 16 Insiders and a profit can be found even when the economic result of a series of transactions is a loss.
- Plaintiffs' attorneys are active in bringing claims for recovery.
- The Committee may exempt certain transactions from this rule.

As described above, to deter Section 16 Insiders from seeking to profit on short-term trading on the basis of undisclosed information, Section 16(b) requires every Insider to disgorge any "statutory profit" (referred to as Section 16 short-swing profit) realized from any purchase and sale (or any number of these transactions) of equity securities of the company which take place within any period of less than six months. Although adopted to combat misuse by insiders of non-public information, this short-swing profit rule is a strict liability requirement that applies without regard to any showing of actual knowledge, and it may neither be waived nor indemnified by the company. Section 16(b) also permits any shareholder of the company to bring a suit for recovery on the company's behalf if the company fails to do so.

The short-swing profit is calculated on the basis of comparing every sale of company equity securities to every purchase (or vice versa) within a period of less than six months. The short-swing profit rule applies to any purchase of applicable securities (at a lower price) and sale of applicable securities (at a higher price), regardless of whether the same shares are involved in both transactions, and even applies to a transaction in a derivative security, on the one hand, and the underlying common stock or another derivative security, on the other hand.

Although purchases and sales of derivative securities are subject to the short-swing profit rule, the exercise or conversion of an in-the-money option or other derivative security (with a fixed exercise or conversion price) is not subject to the rule, regardless of which side of the transaction the Section 16 Insider falls (although such transactions must be reported). Further, where an Insider holds the right to exercise such a security, its expiration or cancellation for no value will not be subject to the rule.

Calculations of short-swing profit arising from transactions in different classes of securities (such as transactions in options and in the underlying stock) are complicated and often unfavorable to Section 16 Insiders. Further, the short-swing profit that results from a series of multiple purchases and sales within a period of less than six months may exceed the actual net profit of all the transactions. In this way, a series of transactions that are subject to the short-swing profit rule may both produce an actual economic loss and a further obligation to disgorge to the company a hypothetical "profit" that exists only under the unique statutory measurement. Because of these complexities, it is important to consult counsel to identify the potential short-swing profit that may arise from proposed transactions.

Exemptions From the Short-Swing Profit Rule

Absent some special treatment, ordinary transactions between the company and its officers and directors — *e.g.*, the grant of company options or restricted stock, or withholding of shares from an officer's award at vesting — would be subject to the short-swing profit rule. However, as discussed in greater detail below, most transactions between company officers and directors (but not Section 16 Insiders who are only 10% beneficial owners), on the one hand, and the company (or a company subsidiary or employee benefit plan) on the other hand — including to the grant of equity-based awards — are or may be exempt from the short-swing profit rule.

Preapproval Exemption

Preapproval Exemption — Snapshot

- Often called the "16b-3" exemption, this permits the board or Committee to exempt transactions between the company and an officer or director from the short-swing profit rule by giving advance approval.
- The Committee must comprise at least two or more directors and may include only "nonemployee directors."
- "Independent" directors are not necessarily "nonemployee directors."

By giving its advance approval, the board or the Committee (if it qualifies) may exempt from the short-swing profit rule most transactions between the company and a company officer or director, including the grant of equity-based awards or participation in deferred compensation plans.

For purposes of Section 16, an "independent" director under SEC and stock exchange rules is not necessarily a "nonemployee director." The requirements to qualify as a "nonemployee director" for this purpose are discussed in Chapter 11. If the Committee does not consist solely of two or more nonemployee directors, the Committee should consider forming a qualifying subcommittee to make approvals for purposes of this exemption. Alternatively, the Committee can recommend to the board that the board make such approvals for any grants to be made to company directors and Section 16 officers for purposes of this exemption.

Accordingly, the Committee (or the board) should approve in advance transactions between the company and its officers and directors that are intended to be exempt from the short-swing profit rule. Although advance approval is most commonly used to exempt equity-based awards, this exemption from the short-swing profit rule is available for any transaction between the company and an officer or director (other than a Discretionary Transaction as described below), and so may also be used to exempt officer or director participation in private placements of company stock, company repurchases of company stock from officers or directors in issuer self-tender offers, net settlement of equity awards to satisfy tax withholding and exercise price obligations, participation in company-sponsored deferred compensation plans investing in company securities, officer and director participation in mergers involving company equity securities, and other transactions involving the company. The Committee's (or the board's) approval of any such transaction should be sufficiently specific to the transaction to maintain the availability of the exemption.

The major exception to the board's or Committee's power to grant this exemption is for certain volitional, participant-directed transactions under employee benefit plans, such as an officer's or director's decision to exchange into or out of a company stock fund in a 401(k) plan, from or into another investment under that plan, or to fund a cash withdrawal from such a plan by disposing of company equity securities in the plan. The transactions are defined as "Discretionary Transactions" and are subject to different rules, as discussed further below.

Benefit Plan Exemptions: Except for Discretionary Transactions (which are discussed below), an officer's or director's transactions in company equity securities pursuant to a qualified stock purchase plan, an employee benefit plan, or an excess benefit plan operated in conjunction with a qualified employee benefit plan are entirely exempt from the short-swing profit rule of Section 16(b) and the reporting obligations of Section 16(a). Most commonly, these exemptions apply to ordinary transactions in plans satisfying applicable Internal Revenue Code coverage and participation requirements, such as a payroll-based investment in the company stock funds in a company 401(k) plan or purchases through a company ESOP, as well as in plans that provide greater benefit or contribution limits than those permitted by the Internal Revenue Code, but which are operated in conjunction with an employee benefit plan (*e.g.*, supplemental plans that offer benefits on the basis of the same formula that applies under a broadly available employee plan, but which apply with respect to compensation beyond the limit required in respect of the broadly available plan).

Other Exemptions: In addition to advance approval by the board or Committee, shareholder approval or ratification of a transaction made by an officer or director (other than a Discretionary Transaction) may also exempt the transaction from the short-swing profit rule. Such approval or ratification will be effective for purposes of the exemption only if it is given at a meeting by holders of a majority of the shares present or represented at the meeting and entitled to vote, or by written consent of a majority of the shares entitled to vote. In either case, the shareholders must be sufficiently informed that their approval would exempt the transaction from the short-swing profit rule, the approval must otherwise be made in compliance with the federal proxy rules and other requirements under Section 14 of the Exchange Act, and any ratification must be received no later than the date of the next annual meeting of shareholders of the company.

A company officer or director may also secure an exemption from the short-swing profit rule for an acquisition of company equity securities from the company by holding the acquired securities (or the underlying securities, in the case of derivative securities) for at least six months. No similar exemption is available for officer or director dispositions.

Discretionary Transaction Exemptions: A Discretionary Transaction is a transaction pursuant to an employee benefit plan that: occurs at the volition of the plan participant; is not made in connection with the participant's death, disability, retirement or termination; is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and results in either an intraplan transfer involving a company equity securities fund or a cash distribution or withdrawal funded by a volitional disposition of a company equity security. In short, these are voluntary, in-service "fund switching" transactions within benefit plans, such as deferred compensation plans, or "cash out" transactions funded by the disposition of company equity securities. Discretionary Transactions do not include investments in employee benefit plans made by the contribution of money from outside the plan (*e.g.*, payroll contributions or employer "matching" contributions). Transactions that are not Discretionary Transactions because they fail to meet one or more of the criteria enumerated above may be eligible for the other exemptions discussed further above (*e.g.*, the advance-approval exemption). Although the date of the election governs whether the Discretionary Transaction is exempt from the short-swing profit rule, the other aspects of the transactions relevant to Section 16 (*e.g.*, the date on which the reporting obligation arises) are determined by when the transactions actually occurs.

A Discretionary Transaction is exempt from the short-swing profit rule of Section 16(b), but not from the reporting requirements of Section 16(a), if the transaction is effected "pursuant to an election made at least six months following the date of the most recent election, with respect to any plan of the company, that effected an [opposite-way transaction]." Accordingly, where Section 16 Insiders are permitted by the terms of benefit plans to make Discretionary Transactions, it is important that company policies and procedures either preclude a Section 16 Insider from making opposite-way Discretionary Transactions within any six-month period or that the company at least advise the insider of the implications of making a later Discretionary Transaction within six months after an earlier one.

Effect of Mergers on Officer and Director Equity

In a merger of two companies, equity securities of the target company are surrendered and equity securities of the acquiring company may be acquired. Absent an exemption from Section 16(b), these dispositions of target company equity securities by a company's officers and director may be treated as "sales," and acquisitions of the acquiring company's equity securities by that company's officers and directors (including persons who take such offices in connection with the merger) may be treated as "purchases." Although such dispositions of target company equity securities may not literally be transactions "between" the issuer and its officers and directors, the staff of the SEC agreed with an interpretive request made by Skadden in 1999 pursuant to which the advance approval of the applicable company's board of directors or a qualifying committee will exempt the disposition of the target company's equity securities or the acquisition of the acquiring company's equity securities. Note that in two-step mergers (that is, a tender offer by the acquirer followed by a back-end merger), a target company officer's or director's participation in the tender offer is not seen as a transaction with the company that issued the shares and accordingly is not likely to qualify for the advance approval exemption.

Recent SEC Rulemaking

On December 14, 2022, the SEC made several rule amendments, including some changes impacting Section 16 reporting. For any Form 4 or 5 filed on or after April 1, 2023:

i. A company can no longer report gift dispositions on a delayed basis on a Form 5, and instead must report them on a Form 4 within two business days following the transaction. Acquisitions by gift are still eligible for delayed reporting on a Form 5 within 45 days after the end of the company's fiscal year or any time earlier on a Form 4, voluntarily.

ii. A new Rule 10b5-1 checkbox has been added to Forms 4 and 5. Any Section 16 Insider who trades under a plan intended to satisfy the affirmative defense conditions of Rule 10b5-1 must check the box and provide the date such plan was adopted.

Chapter 10

Executive Compensation Trends and Developments

The world of executive compensation is a dynamic one, in part because of the keen attention it commands. The standards by which executive compensation is evaluated and the legal and regulatory environment are constantly changing. Recent years have seen no slowdown in the pace of trends and developments affecting executive compensation. The recent increase in SEC rulemaking activity is a reminder that executive and director compensation do not exist in a vacuum, but rather are shaped by changes in our larger and unpredictable environment.

Committee members need to be familiar with compensation trends and developments so they can design compensation programs that align with evolving best practices, reduce the risk that the company will become a target of unwelcome attention, and continue to effectively attract and retain employees.

Executive Compensation Trends and Developments

This chapter focuses on recent trends and developments in executive compensation, such as the SEC's recent rulemaking activity, proposed rules concerning noncompete provisions, and amendments to Rule 10b5-1 trading plans and related disclosure, among other developments. In particular, two rulemaking initiatives — the pay-versus-performance disclosure rules and clawback policy requirements (both discussed below) — will continue to command significant attention in 2024.

Pay-Versus-Performance Disclosure Requirements

On August 25, 2022, the SEC adopted final rules requiring public companies to disclose the relationship between the "compensation actually paid" to a company's NEOs (as defined in the rules) and the company's financial performance. The final rules implement the pay-versus-performance disclosure requirements mandated by Section 953(a) of the Dodd-Frank Act enacted in 2010. Companies are required to incorporate this disclosure into those proxy or information statements that include executive compensation disclosure for fiscal years ending on or after December 16, 2022, meaning that calendar-year companies needed to include this new disclosure in their proxy statements filed in 2023 for the first time.[2]

The pay-versus-performance disclosure requirements are described in greater detail in Chapter 4 above.

Final Clawback Rules

Committees can expect during the years ahead to be involved in ensuring compliance with the SEC's clawback rules. As described in Chapter 2, the SEC adopted in the fall of 2022 long-awaited final rules implementing the incentive-based compensation clawback provisions of the Dodd-Frank Act. The final rules directed the stock exchanges to establish listing standards requiring listed companies (including foreign private issuers) to develop and implement a policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers and to satisfy related disclosure obligations if a clawback is triggered. The NYSE and Nasdaq established corresponding clawback listing standards became effective on October 2, 2023, and listed companies were each required to adopt a compliant clawback policy by no later than December 1, 2023.

In 2024 and beyond, Committees and their delegates will be responsible for administering their clawback policies, giving rise to questions regarding whether recovery of compensation is legally required, which compensation constitutes incentive-based compensation subject to recovery, how much compensation to recover, the best method for recovering compensation and how the Dodd-Frank clawback policy interacts with any other clawback policies maintained by the company. A detailed discussion of these new clawback rules is included in Chapter 2 of this handbook.

[2] Smaller reporting companies have similar but slightly reduced pay-versus-performance disclosure requirements. Emerging growth companies are exempt from the pay-versus-performance disclosure requirements.

Noncompete Arrangements Are in Jeopardy

In January 2023, the Federal Trade Commission (FTC) issued a notice of proposed rulemaking that, if enacted and enforced, would largely prohibit companies from entering into agreements containing restrictive noncompete covenants with employees and require companies to rescind existing noncompete clauses with narrow exceptions. This rulemaking is inspired by the FTC's view that noncompete provisions harm workers and undermine competition. The FTC's proposed rule would not prevent companies from entering into other forms of restrictive covenants with employees (*i.e.*, nondisclosure and nonsolicitation restrictions), as long as the covenants are not written so broadly as to constitute "de facto" noncompete covenants.

Regardless of whether the FTC's proposed noncompete rule is implemented, the agency has signaled an aggressive commitment to restricting the enforcement of noncompetes and other conduct it deems to constitute unfair competition.

Committees should keep in mind that, in many U.S. states, the removal of noncompete clauses would represent a fundamental shift in the negotiation and design of new executive compensation arrangements, including employment agreements, separation agreements, severance plans, and equity plans and award agreements.

The high volume of comments received by the FTC delayed its vote on the rule, which is currently anticipated to occur in April 2024. If the FTC adopts a nationwide ban of noncompete provisions as proposed, we expect the final FTC rule to be subject to multiple legal challenges.

For now, Committees should be aware that changes to restrictive covenant laws may be forthcoming and be prepared to review and update their restrictive covenant arrangements and practices in the upcoming years. In addition, Committees may want to exercise caution when granting new severance benefits or equity awards in consideration for an executive's compliance with noncompete restrictive covenants.

Rule 10b5-1 Changes

The SEC adopted several amendments and new disclosure requirements intended to address what it perceives may be abusive practices relating to Rule 10b5-1 trading plans. These amendments to Rule 10b5-1 largely apply to officers and directors: The SEC decided not extend the amendments to issuers other than with respect to certain disclosure requirements, which are discussed below.

Rule 10b5-1 under the Exchange Act provides an affirmative defense to insider trading for individuals and issuers that trade issuer securities under trading plans entered into in good faith at a time when the individual or issuer does not possess material nonpublic information. Thus, properly established Rule 10b5-1 plans permit insiders to trade during closed windows. Some insiders use Rule 10b5-1 plans to set up sell-to-cover arrangements in connection with the vesting or settlement of equity awards during closed trading windows. The new conditions that an insider must satisfy to use the affirmative defense under Rule 10b5-1 include:

a. **A cooling-off period.** The amendments require a minimum "cooling-off period" between the date a Rule 10b5-1 trading plan is adopted or modified and when trading under the plan commences. (Modifications that do not change the sales or purchase prices or price ranges, the amount of securities to be sold or purchased or the timing of transactions under a Rule 10b5-1 trading plan do not trigger a new cooling-off period). With respect to directors and officers,[3] the applicable cooling-off period must continue through the later of (i) 90 days after the adoption or modification of the trading plan or (ii) two business days following the filing of the Form 10-Q or Form 10-K for the fiscal quarter in which the plan was adopted or modified (not counting the 10-Q or 10-K filing date as one of the two business days, regardless of the time of day of the filing). In any event, the required cooling-off period is not required to exceed 120 days following adoption or modification of the plan. With respect to persons other than issuers, directors or officers, the applicable cooling-off period is 30 days after the adoption or modification of the trading plan. No cooling-off period is required for issuers.

b. **Director and officer representations.** When adopting a new or modified Rule 10b5-1 trading plan, a director or officer is required to include in the plan written representations certifying that the director or officer (i) is not aware of material nonpublic information about the issuer or its securities and (ii) is adopting or modifying the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Exchange Act Rule 10b-5.

c. **Prohibitions against multiple, overlapping plans.** Persons other than issuers generally are prohibited from having more than one Rule 10b5-1 trading plan for open-market purchases or sales of an issuer's securities. This prohibition does not apply where a person transacts directly with the issuer, such as participating in employee stock ownership plans (ESOPs) or dividend reinvestment plans (DRIPs), which are not executed on the open market. Also, the prohibition does not apply to plans authorizing an agent to sell only enough securities as are necessary to satisfy tax withholding obligations arising exclusively from the vesting or settlement of a compensatory award, such as on the vesting of restricted shares or the settlement of restricted stock units ("sell-to-cover" Rule 10b5-1 plans), provided that the award holder is not permitted to exercise control over the timing of such sales. (This exemption for sell-to-cover Rule 10b5-1 plans does not apply to sales incident to the exercise of option awards, because the person exercising the option controls the timing of such sales.) The amendments also make clear that a series of separate contracts with different broker-dealers to execute trades pursuant to a single Rule 10b5-1 trading plan is treated as a single plan. Also, a person other than an issuer may maintain two separate Rule 10b5-1 plans for open-market purchases or sales of an issuer's securities if trading under the later-commencing plan is not authorized to begin until after all trades under the earlier commencing plan are completed or expire without execution. If the first plan is terminated early, the first trade under the later-commencing plan, however, cannot be scheduled to occur until after the effective cooling-off period following the termination of the earlier plan.

d. **Limitations on single-trade arrangements.** In any 12-month period, a person other than an issuer is limited to one "single-trade plan," which is a plan designed to effect the open-market purchase or sale of the total amount of the securities subject to the plan as a single transaction. A plan will not be treated as a single-trade plan if, for example, it gives the person's agent discretion over whether to execute the plan as a single transaction, or provides that the agent's future acts will depend on events or data not known at the time the plan is entered into and it is reasonably foreseeable at the time the plan is entered into that the plan might result in multiple

[3] "Officers" refer to Section 16 officers for purposes of these rules.

trades. Also, sell-to-cover Rule 10b5-1 plans are exempt from this limitation. As with the cooling-off period, the SEC refrained for now from adopting prohibitions against multiple, overlapping plans and applying limitations to single-trade plans for issuers.

e. **An expanded good faith requirement.** The current Rule 10b5-1 requires that persons enter into plans in good faith. The amendments add to that a requirement that the person who entered into the Rule 10b5-1 plan "has acted in good faith with respect to" the plan, thus extending the good faith requirement and making it an ongoing obligation throughout the duration of the plan. As an example, the SEC notes that influencing the timing of an issuer's disclosure so that trades under a plan are more profitable would violate this ongoing good faith requirement. The amendments should not affect the affirmative defense available under a Rule 10b5-1 plan that was entered into prior to the amendments' effective date unless that plan is modified after the effective date of the amendments.

f. **Issuer disclosures.** The amendments introduce the following new disclosure requirements for issuers:

(i) Insider Trading Policies and Procedures Exhibits: Under new Regulation S-K Item 408(b), an issuer must disclose on Form 10-K or in the annual meeting proxy statement whether the issuer has adopted insider trading policies and procedures governing the purchase, sale and/or other dispositions of the issuer's securities by directors, officers, employees and the issuer itself that are reasonably designed to promote compliance with insider trading laws, rules and regulations and with applicable listing standards. If the issuer has adopted such policies and procedures, it must file a copy of them as an exhibit to its annual report on Form 10-K. If no insider trading policies or procedures are in place, the issuer will need to explain why.

Foreign private issuers must provide analogous disclosure, including filing a copy of their insider trading policies and procedures as an exhibit, in their annual reports pursuant to new Item 16J on Form 20-F.

These disclosure and exhibit filing requirements begin with the first filing covering the first full fiscal-year period beginning on or after April 1, 2023 (October 1, 2023, for smaller reporting companies). Thus, for calendar year companies, the disclosure requirements do not apply until the proxy statement filed in 2025 for the 2025 annual shareholder meeting (or the Form 10-K filed in 2025 for the fiscal year ending December 31, 2024), and the exhibit filing requirement does not apply until the Form 10-K or 20-F filed in 2025 for the fiscal year ending December 31, 2024.

(ii) Adoption, Modification and Termination of Rule 10b5-1 Plans and Certain Other Trading Arrangements by Directors and Officers: Under new Regulation S-K Item 408(a), issuers must disclose quarterly on Forms 10-Q and 10-K:

- Whether any director or officer has adopted, modified or terminated a Rule 10b5-1 plan or non-Rule 10b5-1 trading arrangement in the last quarter.
- A description of the material terms of each plan (other than pricing terms), including the name and title of the director or officer; the date the plan was adopted, modified or terminated; the plan's duration; and the total amount of securities to be purchased or sold under the plan.

These quarterly disclosure requirements began with the first filing covering the first full fiscal quarter beginning on or after April 1, 2023 (October 1, 2023, for smaller reporting companies). Thus, most companies (other than smaller reporting companies) have been subject to these quarterly disclosure requirements since they filed their Forms 10-Q for Q2 2023.

Disclosure of Option Grants Close in Time to the Release of Material Nonpublic Information; Related Staff Accounting Bulletin

Under new Regulation S-K Item 402(x), issuers (including smaller reporting companies and EGCs) will be required to disclose on Form 10-K or in the annual meeting proxy statement the issuer's policies and practices regarding the timing of option awards[4] in relation to the disclosure of material nonpublic information. Issuers will need to discuss (i) how the timing of option awards is decided; (ii) how material nonpublic information is considered, if at all, when determining the timing and terms of option awards; and (iii) whether disclosure of material nonpublic information is timed to affect the value of such option awards.

Issuers also will be required to disclose in a new table any options granted in the last completed fiscal year to NEOs that were granted within four business days before or one business day after the (i) filing of a periodic report on Form 10-Q or 10-K or (ii) filing or furnishing of a current report on Form 8-K that contains material nonpublic information (other than disclosure of a material new option award grant under Form 8-K Item 5.02(e)). The table should provide the following:

- Each award (including the grantee's name, the number of securities underlying the award, the date of the grant, the grant-date fair value and the option's exercise price).
- The percentage change in closing market price of the securities underlying each award on the trading day before and after disclosure of the material nonpublic information.

These disclosure requirements will be effective for the proxy filing that covers the first full fiscal year beginning on or after April 1, 2023 (or October 1, 2023, for smaller reporting companies). Thus, for calendar year companies, these disclosure requirements do not apply until the proxy statement filed in 2025 for the 2025 annual shareholder meeting (or the Form 10-K filed in 2025 for the fiscal year ending December 31, 2024).

This renewed focus on option grant timing includes an accounting aspect as well. In November 2021, the SEC issued Staff Accounting Bulletin No. 120 (SAB 120), which addresses how companies should recognize and disclose the cost of providing so-called "spring- loaded" equity awards to executives for purposes of Accounting Standards Codification 718 (ASC 718). A "spring-loaded" award is one made prior to (and proximate to) the disclosure of positive and previously nonpublic material information by the company.

[4] Regulation S-K Item 402(x) applies only to "options." Regulation S-K Item 402(a)(6)(i) defines options as "instruments such as stock options, stock appreciation rights and similar instruments with option-like features," which excludes full-value awards such as restricted shares and RSUs. This focus on options in Regulation S-K Item 402(x) [contrasts?] with the existing CD&A disclosure requirement under Regulation S-K Item 402(b)(2)(iv) ("how the determination is made as to when awards are granted, including awards of equity-based compensation such as options"), which has been required since 2007 when it was added in connection with option backdating scandals in the early 2000s, and which the SEC clarified in C&DI 118.01 applies to options and full-value awards such as restricted shares and RSUs.

Under SAB 120, a company that grants an equity award while in possession of positive material nonpublic information should consider whether adjustments to the following are appropriate when determining the fair-value-based measure of the award for purposes of ASC 718: (i) the current price of the underlying share or (ii) the expected volatility of the price of the underlying share for the expected term of the share-based payment award. Significantly, SAB 120 applies to all equity awards (including restricted shares and RSUs), not just option awards.

Taken together, the new Item 402(x) disclosure requirements and SAB 120 indicate that Committees should be cognizant of the timing of equity grants and the public disclosure context in which such grants are made. While focus most often falls on the interplay between grant timing and disclosure of material nonpublic information in the context of option awards and positive disclosure, a company that grants full-value awards that are sized based on a market value for the underlying shares — and makes such a grant in advance of the public announcement of material nonpublic information — should at a minimum have a record of considering whether those awards were sized appropriately given the potential impact of the announcement on the award value.

Whether companies will react to this focus by adopting fixed grant timing policies or through other means (such as requiring that grants be made effective only during open trading windows) remains to be seen. In anticipation of potentially expanded regulatory focus concerning the interplay between material nonpublic information and equity awards, some companies are also timing vesting and settlement of their equity awards to occur during open trading windows.

SEC Enforcement Activity

The SEC has demonstrated interest in enforcing Regulation S-K Item 402 compensation disclosure requirements, particularly involving disclosure of perquisites. Such disclosure requirements are described in greater detail in Chapter 4.

For example, in January 2017, the SEC issued an order instituting cease-and-desist proceedings against MDC Partners for its failure to disclose more than $11 million in perquisites paid from 2009 to 2014 to its then-CEO. MDC took a number of remedial actions and paid a $1.5 million penalty to settle those charges, among others. In May 2017, the SEC issued a separate order against the CEO alleging that he knew, or was reckless in not knowing, that the proxy statements contained materially false and misleading executive compensation disclosures and that the statements omitted numerous personal expenses for which he sought reimbursement as business expenses. The CEO agreed to repay the perquisites and personal expense reimbursements, pay $5.5 million in disgorgement and penalties to the SEC and observe a ban on serving as an officer or director of a public company for five years.

In early July 2018, the SEC issued an order finding that The Dow Chemical Company failed to properly disclose approximately $3 million in perquisites. The SEC imposed a $1.75 million penalty, required Dow to retain an independent consultant to evaluate and recommend changes to the company's policies and procedures relating to perquisites disclosure and ordered Dow generally to implement the consultant's recommendations.

Later that same month, the SEC filed a complaint against the CEO of Energy XXI alleging various disclosure violations, including the company's failure to report at least $1 million in compensation over a five-year period — including expenses that the SEC claimed were unreasonable, personal and/or not appropriately documented. The CEO agreed to pay a $180,000 penalty and observe a five-year ban on serving as an officer or director of a public company.

In September 2019, the SEC settled charges against Nissan Motor Co., Ltd., its former CEO Carlos Ghosn and a former director related to false financial disclosures that omitted more than $140 million to be paid to Ghosn in retirement. According to the SEC, the falsification involved secret contracts, backdating letters to grant Ghosn interests in Nissan's long-term incentive plan, changing the calculation of Ghosn's pension allowance and misleading Nissan's CFO. The SEC made the charges in an administrative proceeding and a separate federal district court action, each generally implicating the anti-fraud provisions of the Exchange Act. The settlements of those charges involved, among other things, a payment by Nissan of a $15 million penalty, a payment by Ghosn of a $1 million penalty and a payment by the director of a $100,000 penalty, in each case without their admitting to or denying the SEC's allegations and findings. While the case did not directly implicate proxy disclosure requirements, it serves as another reminder of the SEC's focus on ensuring that investors know how, and how much, a company compensates its top executives.

In June 2020, the SEC settled charges against Argo Group International Holdings and imposed a $900,000 civil penalty for failing to fully disclose perquisites provided to the company's former CEO. In proxy statements for 2014-18, Argo disclosed approximately $1.2 million in perquisites, chiefly retirement and financial planning benefits; however, according to the order, the company paid approximately $5.3 million for other perquisites such as aircraft use, housing and club memberships, even after a shareholder issued a press release alleging undisclosed perquisites. In addition, in September 2021, Hilton Worldwide Holdings Inc. agreed to settle SEC charges and pay a $600,000 civil penalty for failing to fully disclose approximately $1.7 million worth of travel-related perquisites the company provided to executive officers from 2015-2018, including the CEO's personal aircraft use and executives' hotel stays. The SEC found that Hilton had failed to appropriately apply the perquisite disclosure rules to its system for identifying, tracking and calculating perquisites. Neither company admitted or denied guilt.

The SEC continued to focus on perquisite disclosure enforcement in 2021. In February 2021, the SEC settled charges against Gulfport Energy Corporation and its former CEO, Michael G. Moore, for failing to properly disclose approximately $650,000 in executive compensation in the form of perquisites received by Mr. Moore and failure to disclose certain related-person transactions involving Mr. Moore from 2014 to 2018. This included the cost of Mr. Moore's use of Gulfport's chartered aircraft for certain travel and costs associated with his use of a company corporate credit card for personal expenses that were not repaid in a timely manner. The delayed credit card repayments resulted in Gulfport extending Mr. Moore interest-free credit and carrying a related-person account receivable. The SEC also found that Gulfport failed to disclose that it paid Mr. Moore's son's landscaping company approximately $152,000 in 2015 for its services and that Mr. Moore contributed to Gulfport's violations by failing to supply required information that would have allowed Gulfport to identify and disclose the perquisites and related-person transactions. The SEC considered Gulfport's significant and timely cooperation with the agency's investigation and imposed remedial measures in determining to accept Gulfport's settlement offer. Specifically, the SEC noted that Gulfport replaced key personnel, developed an internal audit function, enhanced existing policies and procedures and instituted a new review and tracking process. Mr. Moore paid a civil penalty in the amount of $88,248 in connection with this enforcement action. Gulfport and Mr. Moore did not admit or deny the SEC's findings.

In 2023, the SEC settled charges against Stanley Black & Decker Inc. for failing to disclose at least $1.3 million worth of perquisites or personal benefits paid to, or on behalf of, its executive officers and a director between 2017 and 2020. The undisclosed perquisites consisted primarily of expenses associated with executive and director use of corporate aircraft. Notably, Stanley Black & Decker Inc. self-reported the perquisite disclosure failures to the SEC, cooperated with the SEC's investigation and adopted remedial measures, which contributed to the SEC's willingness to allow the company to settle without a civil monetary penalty.

In light of the foregoing, companies should ensure that their policies and procedures for compliance with perquisite disclosure rules — a relatively tricky area of disclosure — are appropriate and consistently followed. In practice, determining whether a benefit is a perquisite can be difficult. Although the SEC has provided general principles and interpretive guidance, companies must analyze the applicable facts and circumstances to determine whether a benefit is a perquisite, which can be complicated given that significant grey areas remain. Once a company has determined perquisites, the related disclosure rules are also complicated, so ensuring compliance will require careful attention. In addition, if a company discovers that it unintentionally failed to disclose material perquisites, it should strongly consider self-reporting the failure to the SEC, given that the SEC intends to incentivize self-reporting and cooperation and may be more lenient with penalties under such circumstances.

Recent Developments in Delaware Corporation Law

In August 2023, Delaware General Corporation Law (DGCL) 157 was amended to provide greater clarity on the requirements for structuring a delegation to grant equity awards. In particular, DGCL 157(c), which governs the Committee's or the board's delegation of its authority to issue stock options and stock rights (including RSUs), has been expanded to expressly empower the "person or body" to whom delegation authority is granted to determine the terms and conditions of the awards granted pursuant to the delegation, as opposed to being required to make grants on terms and conditions (or using standard award forms) previously approved by the Committee or the board.

In addition, the authorizing resolutions must meet the following requirements (many of which are consistent with long-standing requirements under the DGCL that existed prior to the August 2023 amendments):

- **Share Cap:** The authorizing resolutions must establish a cap on the maximum number of shares issuable pursuant to awards granted by the delegate.
- **Time Limit:** The authorizing resolution must contain two time limits: (i) a limit on the period in which the delegate is authorized to grant options or RSUs (*e.g.*, the delegate may grant awards for one year following the date of the date of the authorizing resolutions), and (ii) a period during which the shares issuable upon exercise of the option or settlement of the RSUs may be issued in respect of those options or RSUs granted pursuant to the delegation (*e.g.*, specifying that options have a 10-year term and that the RSUs must be settled prior to a specified date following the grant date).
- **Minimum Consideration:** The authorizing resolutions must state: (i) the minimum consideration, if any, payable by a grantee for the grant of an option or RSU (this may be zero); and (ii) the minimum consideration, if any, payable by the grantee for the shares issuable upon exercise of the option or settlement of the RSUs (under DGCL 153, for new issuances of shares of stock with a par value, this must be at least equal in value to the par value of the shares, although treasury shares may generally be reissued for consideration worth less than the par value of the shares). The authorizing resolutions may permit the minimum consideration to be paid in cash, tangible or intangible property or any benefit

to the company, or any combination thereof. Thus, the authorizing resolutions may provide that the value of the services (past or future) provided by the grantee to the company in connection with the grant are sufficient consideration for purposes of any such minimum consideration requirement.

Note that the Committee or the board should generally retain the authority to grant awards to directors and Section 16 officers to ensure that the grants are exempt under Exchange Act Rule 16b-3, and therefore the authorizing resolutions should make clear that any delegated authority to make equity grants does not extend to grants to directors or Section 16 officers. Under DGCL 157(c), the authorizing resolutions must also prohibit any grants by the delegates to themselves.

Compensation in Today's Employment Environment

Sound compensation practices need to account for the possibility (if not the likelihood) that unforeseen circumstances could call into question the underlying rationale of such practices such that they fail to incentivize appropriate responses, wrongly reward inappropriate responses or unduly punish executives or directors for matters beyond their control.

For example, as was seen during 2020, with respect to annual cash incentive programs — most of which were designed and implemented before the scope of the COVID-19 pandemic was well understood — adjustments were common, including changes to performance metrics or the addition of discretion to rationalize a program's payment profile after the program's establishment. By contrast, adjustments to long-term programs, at least those midcycle, were understandably less common, given that well- conceived programs should arguably have been designed to function appropriately for most companies under many different fact patterns, including "down" scenarios. ISS seemingly recognized these differences, initially signaling considerably more tolerance for changes to annual as opposed to long-term programs in connection with COVID-19.

Well-conceived compensation programs must also anticipate types of uncertainty beyond global pandemics. Recent years have brought political uncertainty and stark differences between expected governance and legislation. In addition, the narrow margins in Congress present related uncertainties, including, for example, the likelihood of new tax legislation, the resulting regulatory burdens that companies may face and the evolving enforcement posture of regulatory agencies (for example the SEC's recent level of rulemaking activity). The transition for some companies to full or partial remote working has created additional challenges in compensation and staffing.

Perhaps the only certainty in respect of compensation practices is that there will be uncertainty. The goal thus becomes establishing a flexible framework that incentivizes and rewards behavior over a broad range of circumstances while remaining tailored to the company's core values and goals.

Litigation

Executive compensation practices have seen various "waves" of litigations in recent years, in addition to the seemingly perpetual series of one-off challenges to executive compensation decisions. The latter cases — often involving claims of breach of fiduciary duty and corporate waste — are of course significant to any individual company but are less relevant to this handbook because of their typically fact-intensive nature.

Some of the earlier "waves" of cases dealt with matters such as failed say-on-pay votes under Dodd-Frank and failure to qualify for then-available exceptions to the otherwise applicable federal income tax deduction limitations under Section 162(m) of the Code.

Probably the most significant litigation development was the wave of proxy litigation that began in 2012 and was initiated primarily by a single plaintiffs' law firm. The strategy borrows from an approach common in the M&A context, where a shareholder alleges that merger proxy disclosure is inadequate because it misstates or omits material information. The shareholder seeks to delay the vote to approve the transaction until supplemental disclosure is provided, and such suits often settle (generally with attorney's fees paid) once the supplemental disclosure is provided.

The litigation alleging proxy disclosure deficiencies borrows from an approach common to the M&A context.

In the executive compensation context, the case is typically filed (or, in many instances, no case is filed but a letter threatening a lawsuit is sent to the company) shortly after the company files its definitive proxy statement and seeks to delay the annual meeting until supplemental disclosure is provided. The plaintiff's threatened or actual claims allege breaches of fiduciary duties in connection with compensation-related proposals, generally the say-on-pay proposal or a proposal to adopt or increase the amount of shares reserved under an equity compensation plan.

These cases are generally brought as putative class actions in the state court in which the company's principal place of business is located. The demands for additional disclosure often are not based on allegations of deficient disclosure under SEC rules but rather on the theory that a director may breach the director's state-law fiduciary duties by failing to disclose material information in connection with a request for shareholder action (*e.g.*, the say-on-pay or equity compensation plan approval vote). Plaintiffs claim that a variety of additional information is necessary for shareholders to make an informed vote.

A preliminary injunction was granted in one of the earliest cases, the April 2012 California state court case of *Knee v. Brocade Communication Systems, Inc.* In that case, plaintiffs alleged insufficient disclosure regarding a proposal for a relatively significant increase in shares reserved for issuance under an equity plan where the increase was based on undisclosed equity grant projections. Despite the plaintiffs' initial victory in that case, companies that have been willing to resist these lawsuits have largely been successful. In a string of 2013 decisions, courts held that the information requested by plaintiffs, while potentially helpful, was not material and thus not a required subject of disclosure.

Some companies concerned about potential disruption to their annual meetings have been willing to settle these claims, however. These settlements have generally involved supplemental disclosure and payment of plaintiffs' attorneys' fees (up to $625,000 in one case).

While "investigations" have continued to be announced by law firms specializing in this type of litigation, it appears there has been a slowdown in reported litigation activity arising from those investigative efforts. The company should nevertheless remain aware of the threat of litigation.

Although there is no single approach to avoiding these lawsuits and shareholder demands, the company should determine whether additional proxy disclosure is warranted, particularly with respect to equity compensation plan proposals.

Not surprisingly, more fulsome equity compensation plan proposal disclosure is more common than in years past, and that includes the type of information that has typically been provided in supplemental disclosure as part of claim settlements, including as applicable:

- A summary of the relevant information presented to the Committee by its independent compensation consultant.
- How the board determined the number of additional shares to be authorized.
- The contemplated size and timing of new award issuances and the potential equity value and/or costs of the issuance of the additional shares.
- The dilutive impact that issuing additional shares may have on existing shareholders and the amount of planned additional stock repurchases.
- The company's gross burn rate, net burn rate and overhang — which is sometimes compared to the compensation peer group or the survey data used to formulate the overall size of the plan.
- A detailed breakdown of the different groups of individuals who may receive grants under the plan (*e.g.*, employees, directors, consultants), the size of each such group and the extent to which foreign subsidiary employees receive grants.

Providing such disclosure in the proxy as initially filed may make the company a less likely target of this type of litigation.

More recently, a number of cases have addressed instances where executive compensation arrangements appear to involve self-dealing, particularly with respect to companies that have controlling shareholders. For example, in *Tornetta v. Musk*, the Delaware Court of Chancery ordered rescission of Tesla CEO Elon Musk's $55.8 billion compensation plan after concluding that the defendants failed to prove that the "largest potential compensation opportunity ever observed in public markets" was entirely fair.

Areas of Particular Shareholder Scrutiny

Executive Airplane Use

Given the SEC's increased attention on perquisites, it is not surprising that shareholders also consider the topic, particularly company airplane usage, to be a hot-button issue. Activist shareholders have drawn attention to the use of company airplanes by executives, often through direct contact with the company, calling into question the company's airplane use policies or practices. Activist shareholders have been particularly critical of such airplane use where a company's overall financial performance is not meeting expectations.

As discussed in Chapter 7 above, perquisites related to personal airplane use by company executives may draw a negative comment or negative vote recommendation from proxy advisory firms, particularly if they are coupled with other pay practices that are, in the view of the advisory firms, problematic.

In light of this growing attention on the use of company aircraft by executives, companies and Committees should review their existing policies and practices regarding airplane use and determine whether the extent of such use is appropriate for the company's specific circumstances. Committees also should look closely at the company's perquisite-related disclosures to ensure accuracy and compliance with the disclosure rules.

Impact of the #MeToo Movement

The #MeToo movement brought renewed focus to the gender-based policies and practices of companies. Corporate #MeToo incidents indicate that allegations of sexual misconduct at public companies adversely affect both a company's share price and a company's reputation. As a result, Committees have taken an increasingly active role aimed at preventing and responding decisively to sexual misconduct in the workplace, including by updating company policies and procedures relating to sexual misconduct and becoming more involved in situations where an executive faces allegations of misconduct. Additionally, some companies have amended their Committee charters to give the Committee authority to oversee these issues relating to sexual misconduct. It is advisable for the Committee (or, if not the Committee, some other committee of the board or the board as a whole) to work with the company's management to periodically review and update the company's policies on sexual misconduct, including training and reporting procedures related to such conduct as well as the Committee's role in overseeing allegations of sexual misconduct.

The #MeToo movement also has impacted executive compensation practices. Committees are increasingly considering whether to include specific terms in their executive compensation plans and agreements and in some cases, broad-based employee benefit plans, to address the consequences of sexual misconduct in the workplace and to deter such behavior. For example, some companies have revised their definitions of "cause" to include sexual misconduct, expressly permitting the company to terminate an individual's employment for cause and potentially limit a specified benefit if the individual is determined to have engaged in sexual misconduct. Some companies also have been asking newly hired executives to make affirmative representations or warranties that they have not been subject to any sexual misconduct claims or otherwise engaged in such behavior. Finally, some companies have contemplated updating their compensation recovery (clawback) policies to provide for clawback of compensation if an executive is determined to have engaged in sexual misconduct in the workplace.

Gender Pay Gap and Workplace Equity Issues

Human capital management, including pay and workplace equity, also has become an area of significant focus for investors, with a number of institutional investors engaging with companies on the issue. There is a growing call for companies to perform equal pay audits of their workforces, to publicly commit to workplace equality and to provide increased disclosure evidencing to investors the extent to which the company's stated commitments are being achieved. Investors are increasingly focused on equal access to higher paying positions within the company (commonly referred to as the "pay gap") as opposed to strictly equal pay for the same position.

Fifty-one states and U.S. territories have enacted pay equity laws. In light of the increased focus on pay equity issues, Committees are advised to discuss the issue of gender pay equity proactively, ideally before a company is targeted by a shareholder activist. Companies also may want to consider disclosing policies and programs that support gender equity and related efforts in respect of recruiting, employee development and elimination of unconscious bias. A number of companies have begun including voluntary disclosure describing the company's commitment to, and programs on topics related to, human capital management generally, including creating a diverse and inclusive work environment and overseeing matters relating to culture, employee engagement and talent development.

The SEC's disclosure rules require human capital disclosures that are material to understanding the company's business as a whole. Under these disclosure rules, a company is required to describe the following:

i. The company's human capital resources, including the number of employees (as currently prescribed).

ii. Any human capital measures or objectives that the company uses in managing the business, such as measures or objectives that address the development, attraction and retention of personnel, depending on the nature of the company's business and workforce.

The SEC did not define "human capital" or mandate a specific set of metrics, noting that the meaning of human capital and measures and objectives in this context vary significantly and may evolve over time. The agency emphasized that each company's disclosure "must be tailored to its unique business, workforce, and facts and circumstances."

In September 2023, the SEC's Investor Advisory Committee (IAC) approved a subcommittee recommendation relating to disclosure of human capital management.

The IAC recommendation includes:

- Adding quantitative disclosures to the business description under Item 101 of Reg S-K. Specifically, the IAC recommends that the SEC require companies to provide a breakdown of how many employees are full-time, part-time or contracted, as well as to detail workforce turnover, retention, cost and demographic data.
- Adding qualitative disclosures in the Management Discussion and Analysis. The IAC recommends that narrative disclosure be required relating to how the company's labor practices, compensation incentives and staffing fit within its broader corporate strategy.

What impact, if any, the IAC's recommendations will have on disclosure requirements remains to be seen. A semiannual regulatory agenda filed with the federal Office of Management and Budget indicated the SEC could have introduced rules to increase human capital disclosure as early as October 2023, but there is no definitive date for when the SEC may propose such rules.

ESG Considerations

ESG-related considerations represent another area of focus that continues to attract attention from customers, investors and employees. ESG factors cover a wide range of issues, including measures of company carbon emissions, labor and human rights policies and corporate governance structures. Many large investors and advisory firms increasingly are interested in assessing the long-term investment risks and benefits associated with ESG matters. Indeed, some large investors have published proxy voting and engagement guidelines relating to ESG issues. Glass Lewis has stated that it will note as a concern boards of S&P 500 companies that do not provide clear disclosure regarding board-level oversight afforded to environmental and/or social issues. Furthermore, Glass Lewis generally will recommend voting against an S&P 500 company's governance committee chair if the company fails to provide explicit disclosure concerning the board's role in overseeing environmental and/or social issues.

In recognition of the growing attention on ESG factors (and as noted above), an increasing number of companies have started tying executive incentive compensation performance metrics to ESG factors. Committee members should consider whether such ESG-related metrics are appropriate for a company's incentive programs and, regardless of the decision regarding incentive programs, whether it is appropriate to proactively disclose ESG topics in the company's public filings.

Glass Lewis has indicated that a company's particular circumstances should inform its decisions about whether and how to feature environmental and social (E&S) metrics in company compensation programs. Specifically, companies should consider factors such as their industry, size, risk profile, maturity, performance, financial condition and other relevant internal and external factors when determining whether and how to feature E&S metrics in their compensation programs.

Additionally, Glass Lewis expects companies to provide robust disclosure when they introduce E&S criteria into their executive incentive programs, including:

- How the E&S criteria align with the company's strategy.
- The rationale for selecting specific E&S metrics.
- A description of the target-setting process and corresponding payout opportunities.
- The basis on which E&S metrics will be assessed, particularly with respect to qualitative metrics.
- Identification of targets for quantitative E&S metrics on an *ex ante* basis or the rationale for why the board believes it is unable to make such a disclosure.

Glass Lewis made clear that some behaviors should be regarded as baseline requirements for executive performance and therefore should not generally need to be incentivized. For example, Glass Lewis indicates that it would support shareholder challenges against using metrics to reward executives for ethical behavior or compliance with policies and regulations.

Evolving Committee Responsibilities

The ongoing enhanced focus on ESG issues has also highlighted an expansion in Committee responsibilities at some companies to focus more broadly on "human capital" management and governance rather than just executive compensation. Committees are increasingly being given authority over diversity and inclusion programs, particularly if the success of such programs become the subject of compensation incentives. And increasing numbers of companies are changing the name of their "Compensation Committee" to better reflect in their view these expanded responsibilities, including for example a focus on "people" or "talent" and human capital more generally in addition to compensation. Companies will want to revisit their Committee charters as they think through any potential changes to the role of their Committee and how any expanded role intersects with that of other board committees — for instance in the area of succession planning.

Chapter 11

Eligibility To Serve

Under the Exchange Act, as amended by the Dodd-Frank Act, each member of the Committee must be an independent member of the board. In addition, in order to take advantage of certain exemptions under the short-swing profit recovery rules under the Exchange Act, each member of the Committee also must qualify as a "nonemployee director" for purposes of Section 16 of the Exchange Act.

Eligibility To Serve

Independence for Exchange Purposes

Even prior to the enactment of the Dodd-Frank Act, the NYSE and Nasdaq required Committee members to be independent under their general standards on director independence. Under these general standards, the NYSE and Nasdaq apply their own tests to determine whether a director is independent. With the enactment of the Dodd-Frank Act, the NYSE and Nasdaq were required to develop additional independence requirements specific to members of the Committee.

The NYSE and Nasdaq standards for Committee member independence are generally consistent with each other. Each member must qualify as independent pursuant to the general standards on independence and, in addition, the board must make an affirmative determination that each Committee member is independent after considering the following factors:

- Whether the Committee member receives compensation from any person or entity (including any consulting, advisory or other compensatory fees paid by the company to the Committee member) that would impair the Committee member's ability to make independent judgments about the company's executive compensation.
- Whether an affiliate relationship places the Committee member under the direct or indirect control of the company or its senior management or whether it creates a direct relationship between the director and senior management, in each case of a nature that would impair the Committee member's ability to make independent judgments about the company's executive compensation.

Both the NYSE and Nasdaq generally allow a listed issuer to cure a failure to comply with the independence standards applicable to Committee members. If a Committee member ceases to be independent for reasons outside of the Committee member's control, the member may continue to serve on the Committee without disqualifying the company until the earlier of its next annual shareholders' meeting or the one-year anniversary of the event that caused the Committee member to no longer be independent. The Committee member independence requirements are also subject to transition relief periods for IPOs, spinoffs, carve-outs, companies emerging from bankruptcy and certain other circumstances.

Rule 16b-3 Requirements

As discussed in Chapter 9, Section 16(b) of the Exchange Act provides that certain company insiders are generally liable to the company for any profits resulting from the sale of company equity securities within six months following an acquisition. Rule 16b-3 under the Exchange Act provides an important exception for awards granted to an officer or director where the grant is approved by a committee composed solely of two or more "nonemployee directors."

Rule 16b-3 provides that a director is a "nonemployee director" if the following requirements are met:

- The director is not an officer or employee of the company or a company parent or subsidiary.

- The director does not receive compensation from the company or a company parent or subsidiary for services rendered in any capacity other than as a director of the company, except in an amount that since the beginning of the fiscal year does not exceed the amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K ($120,000).
- The director does not have an interest in any "related party" transaction for which disclosure would be required in the company's proxy statement pursuant to Item 404(a) of Regulation S-K.

Disclosure under Item 404(a) is generally required for any transaction occurring after the beginning of the company's last fiscal year, or for any currently proposed transaction, in which the company was or is to be a participant for which the amount involved exceeds $120,000 and in which any "related person" had or will have a direct or indirect material interest. The term "related person" generally means any director or executive officer of the company or their immediate family members, any nominee for director or their immediate family members, or a beneficial owner of more than 5% of the company's voting securities or their immediate family members.[5]

[5] A company that has old (predating November 2, 2017) performance awards under Code Section 162(m) may also need to make sure its Committee members comply with the corresponding independence definition under those rules; however, such arrangements are increasingly rare.

Chapter 12

Special Considerations in the M&A Context

Executive compensation receives special attention in the M&A context because of the significant payment amounts that are often involved and the requirement that the company publicly disclose arrangements related to change in control as well as actual and potential payments and benefits. Committee members should be familiar with the compensation incentives of company management in the M&A context; those incentives may differ depending on whether the company is the target or the acquirer. Moreover, when the company is the acquirer, Committee members may be asked their views regarding the compensation potentially payable to management of the target.

Special Considerations in the M&A Context

Compensation Programs

Where the company is the target in a pending or anticipated transaction, the principal goal of the board is to ensure that the company's shareholders receive the best value for their shares. Executive compensation programs can further this goal by encouraging the continued attention and dedication of management to their assigned duties (including facilitating execution and closing of a sale agreement) and discouraging premature management departures or distraction that would be detrimental to the company and its shareholders. The most typical tools in this regard include:

- Employment agreements with severance provisions.
- Change-in-control severance agreements (a severance agreement that pays only in the event of a termination relating to a change in control).
- Retention agreements (whether on a stand-alone basis or as a complement to existing severance protections).

Who should have such agreements and what their specific provisions ought to be is a question unique to each company and situation. It is important to analyze those questions in the overall context of the company's compensation program, for example with regard to how any existing or contemplated transaction-specific arrangements complement the anticipated treatment of existing long-term incentive awards in the transaction.

Even where the company is the acquirer, it is important to understand the consequences of existing company executive compensation arrangements to identify any potential unintended consequences of the transaction. For example, there may be circumstances under which an existing change-in-control definition may unexpectedly be triggered, particularly in scenarios where the definition is of older vintage and the transaction approximates a merger of equals. While the triggering of the definition could be appropriate in some limited circumstances (for instance, where post-closing synergies could affect the company's employees), shareholders may view such a circumstance skeptically (particularly if single-trigger equity vesting (*i.e.*, vesting upon the change in control, without the requirement of a qualifying termination) is the result). The acquisition also may require performance metrics under the company's existing incentive compensation programs to be adjusted or eliminated in light of the post-closing corporate structure.

Committee members should periodically review existing arrangements related to changes in control and consider the need for new, amended or different arrangements so that the arrangements continue to serve their intended purpose as the company's circumstances evolve over time. As discussed below, revising programs may become more difficult once an actual transaction is contemplated, so implementing changes on a "clear day" is generally preferable.

Due Diligence Considerations

Where the company is the acquirer, understanding the consequences of the contemplated transaction for the target company's executive compensation arrangements, including not only the cost but also the executive retention implications, is critical.

From an operational perspective, the existence of a different compensation program at the target may be an indication of potential obstacles to a successful integration of the two companies for cultural or other reasons.

Regardless of whether the company is the target or acquirer, special attention should be paid to golden parachute (Code Section 280G) tax treatment, which is discussed in Chapter 8. Any loss of tax deduction for golden parachute payments will add to the cost of severance payments, particularly if the payments are "grossed up" for the excise tax imposed on the executive. As noted in Chapter 8, golden parachute gross-ups have become less common in recent years but nevertheless continue to exist and have the potential to be very costly.

Scrutiny of New Compensation Programs

Adoption by a target company of new (or amendments to existing) compensation programs when a takeover or other M&A activity is pending or anticipated can be subject to enhanced scrutiny, including if the action can be characterized as a defensive measure. In such a case (under the so-called Unocal standard), directors must be able to demonstrate that:

- They had a reasonable basis for concluding that there was a danger to corporate policy and effectiveness.
- The adoption of new compensation programs or amendments to existing programs was reasonable in relation to the threat posed.

If this standard is satisfied, the directors will be entitled to the protections of the business judgment rule (as discussed in Chapter 1). Because of the risk that the standard may not be satisfied (and since the action may cause the directors' activities to be more closely scrutinized in any event), it is advisable to adopt new compensation programs or amend existing programs when there is no pending or anticipated M&A activity involving the company.

Special Considerations in the Case of a Tender Offer — Best Price Rule

Pending tender offers present special concerns for compensation arrangements because of the SEC's "best price rule," which requires that all tendering security holders be paid the same consideration in a tender offer.

Historically there had been concerns that compensatory and other arrangements with a company's security holders, who may be employees or have other relationships with the company, could be deemed additional consideration for their tendered shares above and beyond the price offered and paid to other security holders in the tender offer, in violation of the best price rule.

Due to the particular focus on compensatory arrangements, the SEC adopted a specific exemption from the best price rule for employee compensation, severance and benefit arrangements. Accordingly, the best price rule *does not apply* to the "negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such an arrangement, with respect to any security holder" where the amount payable under the arrangement:

- Is being paid or granted as compensation for past services performed or future services to be performed or refrained from (*i.e.*, noncompetition agreements), and matters incidental to those services.
- Is not calculated based on the number of securities tendered or to be tendered by the security holder.

A nonexclusive safe harbor provides that an arrangement entered into in connection with a tender offer (whether conducted by a third party or an issuer) will be deemed to be within the exemption if it was approved as being an employment compensation, severance or other employee benefit arrangement.

- In a third-party tender offer, this approval generally must be granted by the compensation committee of either the bidder (if the bidder is a party to the arrangement) or the subject company (regardless of whether the subject company is a party to the arrangement).
- In an issuer self-tender, the approval generally must be granted by the compensation committee of the issuer (regardless of whether the issuer is a party to the arrangement) or, if an affiliate of the issuer is a party to the arrangement, that affiliate.

Although the safe harbor is available to eliminate any doubt that approved compensatory arrangements fall within the exemption from the best price rule (and using it is common practice), compliance with the terms of the exemption itself, without reference to the safe harbor, is sufficient to remove the arrangement from the scope of the best price rule.

Disclosure Considerations

Companies should consider disclosure requirements in connection with the establishment or amendment of arrangements related to changes in control and related compensation arrangements. Note that public disclosure of executive (and director) compensation arrangements that are implicated in a change-in-control transaction can include specific amounts and values. Such disclosure can be subject to media interest as well as investor scrutiny. Additionally, a company generally must publicly disclose the establishment or amendment of change-in-control-related compensation and benefit arrangements affecting the company's executive officers immediately following adoption. The investment community may view this adoption as a signal of the company's intentions — so a Committee may defer certain compensation decisions to avoid premature disclosure of the company's strategy. This compensation-related disclosure can also be of interest to the plaintiff's bar, reinforcing the incentive to ensure that the process and substance of deal-related compensation arrangements is thoughtful and thoroughly vetted by both the Committee and sophisticated advisers.

Chapter 13

Director Compensation

Nonemployee director compensation considerations differ from those applicable to executive compensation in some significant respects, and compensation awarded to directors continues to come under particular scrutiny from shareholders. This chapter provides an overview of some typical director compensation arrangements and discusses certain special considerations that apply.

Director Compensation

Overview

Often the board as a whole sets the compensation of nonemployee (or "outside") directors, though in some cases that responsibility may fall within the duties assigned by the board to the Committee or another committee of the board, or the Committee (or other such committee) may make recommendations to the board about the director compensation program.

Certain of the considerations discussed in the context of an executive compensation program apply to the establishment of director compensation as well, although, as described below, director compensation programs typically have fewer components than executive compensation programs.

The focus of director compensation is different from the focus of executive compensation. The focus of director compensation is on encouraging director oversight of management and protecting the long-term interests of shareholders. By contrast, a focus of the executive compensation program will also include, among other things, incentivizing business results, rewarding successful strategic decisions during the course of the day-to-day management of the company and retaining the services of high achievers. Given these differing points of emphasis, director compensation programs focus less on driving particular results and more on aligning with shareholder interests and encouraging ongoing engagement and fresh perspectives.

Components of Director Compensation

Directors typically are compensated through a mix of cash and equity with a modest emphasis on equity, particularly for larger companies. More specifically, directors historically have received some or all of the following forms of compensation:

Cash Compensation	Equity Compensation
Annual cash retainer and fees for committee service	Stock options
Per-meeting fees	Restricted and unrestricted stock awards
Deferred cash	Stock-based awards (*e.g.*, RSUs)

ISS considers it a problematic pay practice for directors to receive retirement benefits or other perquisites. Nevertheless, in addition to reimbursement for travel and other business expenses, directors sometimes receive additional benefits, such as life, travel and accident insurance; perquisites (if provided, typically including products, services or health insurance at reduced costs and/or participation in matching charitable contribution programs); and perquisites for spouses and other family members (such as travel to board meeting locations and entertainment while there). These types of additional director benefits have become increasingly rare over time.

Director compensation programs vary widely based on a company's size, industry and other factors. However, several generalizations can be made.

First, companies generally have moved away from per-meeting fees toward annual cash retainers. This trend is the result of a number of factors, including the expectation of ongoing communications among directors outside of the company's formal meetings. Most directors at public companies are already strongly incentivized to attend board and committee meetings without the added incentive of per-meeting fees. The proxy advisory firms described in Chapter 5 track the attendance of these meetings, and if a director fails to attend at least 75% of a company's meetings, the proxy advisory firms generally will recommend voting against the director's reelection.

Second, the general trend in equity compensation (for both directors and executives) has moved away from stock options in favor of full-value awards in the form of restricted stock or restricted stock units. (Additional information about these types of awards and equity-based compensation more generally is provided in Chapter 6.) Full-value awards are granted in either fixed-dollar or fixed-share amounts, but the trend has favored fixed-dollar equity awards, which afford a board additional precision in determining the absolute grant date dollar value of equity compensation. These awards are generally granted at the time of the company's annual shareholder meeting and typically vest subject to continued service through the next annual shareholder meeting. ISS considers it a problematic pay practice for directors to receive performance-conditioned incentive awards and such awards are quite rare for directors.

Third, at many companies, directors who take on additional responsibilities receive additional compensation. For example, a nonexecutive chairperson may receive a larger annual retainer than other board members due to the additional duties that come with the position. Members of the audit, compensation or other committees also may receive larger annual retainers or larger per-meeting fees, and the chairs of the various board committees may receive additional compensation for serving in those roles.

Finally, for the reasons described below, some companies impose specific limitations on director compensation awarded pursuant to shareholder-approved compensation plans, although the utility of doing so is uncertain.

Stock Ownership Guidelines

Stock ownership guidelines for directors are the norm among public companies. These guidelines serve as an important link between the interests of directors and shareholders and seek to achieve the desired linkage by requiring each director to acquire and hold a meaningful number of the company's shares while serving as director. The number of shares varies from company to company, but, typically, the value of shares that a director must hold is equal to a specified multiple of the director's annual cash compensation. Multiples typically range from three to five times a director's annual cash compensation. ISS believes that the requirement should be at least four times the annual cash retainer. Directors are generally given a period of time following their initial appointment —typically between three and five years — to accumulate the shares required to meet the stock ownership requirement.

In 2021, ISS made clear that companies will no longer receive ISS credit for having stock ownership guidelines if such guidelines permit unearned performance awards or unexercised stock options (including vested unexercised options and "in the money" value of options) to count toward meeting stock ownership requirements. Unvested full-value awards that require no exercise, such as time-based restricted stock and restricted stock units, may count toward stock ownership requirements without jeopardizing ISS credit.

Glass Lewis similarly introduced new guidance about its views on stock ownership guidelines in its 2024 U.S. Benchmark Policy Guidelines. Specifically, Glass Lewis expects companies to have minimum stock ownership rules for their named executive officers and to include clear disclosure in the CD&A about the stock ownership guidelines and how different types of equity awards are counted towards satisfying the guidelines. Glass Lewis also maintains unearned performance-based full-value awards and unexercised stock options should not be counted towards satisfying the guidelines.

Important Director Compensation Case Law

Standard of Judicial Review

Where compensation decisions involve directors paying themselves, Delaware case law provides that the protections of the business judgment rule typically will not be available.[6]

As discussed in Chapter 1, under Delaware law, a claim involving director conduct generally is subject to review under the "business judgment rule," under which the court will presume the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the decision at issue was in the corporation's best interest. This deferential standard does not apply if a majority of directors are interested in the decision or beholden to someone who would derive a personal financial benefit from the decision. Consequently, claims relating to director compensation typically are reviewed under a more onerous level of scrutiny — the "entire fairness" test — which requires that directors bear the burden of proving that their compensation decision was entirely fair to the corporation.

However, if the board can show that the challenged decision was ratified by a vote of fully informed stockholders, then the entire fairness review will not apply, and director action will be reviewed under the more deferential business judgment rule. In recent years, a number of Delaware lower court cases had examined the extent to which shareholder approval of an equity compensation plan is sufficient to cause grants to directors under such plans to be analyzed under the business judgment rule. Those cases held that stockholder approval of a discretionary equity plan could constitute "ratification" if the equity plan contained a "meaningful limit" on director compensation.

In 2017, the Delaware Supreme Court issued a decision, *In re Investors Bancorp, Inc. Stockholder Litigation*, which held that, except under limited circumstances, the deferential business judgment rule will not be applied in reviewing challenges to director compensation awards granted by Delaware companies pursuant to stockholder-approved equity plans. Instead, such awards will be subject to the entire fairness standard of review.

In that case, the board of directors submitted an equity plan for stockholder approval pursuant to which the maximum number of shares that could be issued to all directors totaled 30 percent of all option or restricted stock shares available for awards. The plan did not impose any other limits on grants to directors. After the plan was approved by the company's stockholders, the directors awarded themselves equity awards, the aggregate grant date fair value of which for all 12 board members was approximately $51.5 million. The plaintiff alleged that the directors' compensation exceeded the compensation paid to directors of peer companies. Although the Court of Chancery noted that the director awards in this case appeared to be quite large, it dismissed the case because the plan

[6] The focus of this discussion is on Delaware law, due to the prevalence of Delaware as the state of incorporation for U.S. public companies.

contained "meaningful, specific limits on awards to all director beneficiaries," and the actual awards granted fell within those limits. As a result, the Court of Chancery found that the stockholder approval of the plan was sufficient to allow defendants to invoke a stockholder ratification defense.

However, the Delaware Supreme Court reversed the Court of Chancery's decision, holding that the discretion granted to directors in the equity plan to approve specific awards precluded the stockholder ratification defense. Consequently, the Delaware Supreme Court found that the grants were "self-interested decisions" and subject to the entire fairness standard of review.

According to the Delaware Supreme Court, ratification is a permissible defense in two scenarios: (1) when stockholders approve specific director awards and (2) when the equity plan is a self-executing formula plan, such that the directors have no discretion in granting the awards to themselves. If directors retain discretion to make awards under the general parameters of a plan — even when the parameters are specific to directors — then the shareholder ratification defense cannot be used to foreclose a breach of fiduciary duty claim.

On May 31, 2019, the Delaware Court of Chancery relied upon the decision in *Investors Bancorp* in a case stemming from compensation paid to directors of The Goldman Sachs Group, Inc. (*Stein v. Blankfein*). In that case, the court held that because the directors had the discretion to set their own compensation pursuant to stock incentive plans with no meaningful limit on the compensation they could pay themselves, the entire fairness standard of review applied. The defendants attempted to avoid the application of the entire fairness standard of review by including a statement in the stock incentive plans to the effect that the directors could not be held liable for any action taken in good faith with respect to the stock incentive plans or any awards granted pursuant to such plans. The defendants argued that because the shareholders approved the plans with the "good faith" language, the plaintiff had to show that the directors' actions were taken in bad faith. The Court of Chancery disagreed. The court found that this provision was insufficient to bind the stockholders who approved the plans and could not operate as a waiver of their rights because the stockholders were not informed of the contemplated self-interested transactions, which would otherwise be subject to entire fairness review. The Court of Chancery, however, did not state that all such waivers would be held invalid if the elements of a waiver were present, including (i) a right or requirement that (ii) is known to the waiving party and (iii) that the waiving party intends to waive the right.

In light of the rulings in *Investors Bancorp and Stein*, the utility of director specific limits on compensation is unclear, as is the question of whether stockholders can waive their right to enhanced scrutiny.[7] While director limits that still permit discretion when making the awards clearly no longer are sufficient to secure business judgment rule review (even if shareholder approved), they may serve as evidence that there was — or at least serve as a catalyst for establishing — a process for determining that actual director compensation was in fact entirely fair. Moreover, as a result, prospective plaintiffs may prefer to target companies without such limits. For companies that already had established such limits, eliminating them may, as a practical matter, prove difficult to explain to shareholders absent compelling circumstances.

[7] The *Investors Bancorp* progeny continues to develop. Recently, in *Knight v. Miller*, the Court of Chancery addressed a stockholder plaintiff's challenge to options that the members of a compensation committee granted to themselves, other members of the board and corporate officers. Relying on *Investors Bancorp*, the vice chancellor held that regarding the grants to directors, the entire fairness review applied and that the plaintiff had a stated a claim for breach of fiduciary duty.

Derivative Action Pleading Requirements

An October 2019 decision of the Delaware Court of Chancery shed important light on the related question of what pleading requirements are applicable to a shareholder derivative suit alleging excessive director compensation. The case involved a claim by a stockholder of Ultragenyx Pharmaceutical Inc. that the company's board had awarded itself excessive pay. Under applicable Delaware law, a stockholder asserting such a claim has two mutually exclusive options: make a pre-suit demand on the board or plead with particularity the reason it would have been futile to do so. A stockholder who makes a pre-suit demand may not later claim demand futility, but instead must make the more difficult claim that the board wrongfully refused the demand, which is essentially a business judgment analysis. The Court of Chancery has noted that pleading demand futility is a steep road, but that making a pre-suit demand road is "steeper yet."

Some members of the plaintiffs' bar have sought — as the Court of Chancery put it — to "cover all the bases" by sending a stockholder communication within the meaning of the applicable Delaware rule for a demand, but later claiming that they did not make a demand. As part of that tactic, the plaintiff's counsel in *Ultragenyx* sent a pre-suit letter to the company's board "suggesting" that the board take remedial action, while expressly stating that the letter was not a demand within the meaning of the applicable Delaware rule. The court likened this approach to a famous 1929 surrealist painting by René Magritte depicting a pipe above the caption, "This is not a pipe."

Upon receipt of the letter, the company's board treated it as a demand and conducted an investigation into the allegations and concluded not to pursue them on behalf of the company. The defendants (the company and its directors) subsequently moved to dismiss the complaint because the plaintiff had failed to plead wrongful demand refusal. The court agreed that the pre-suit letter was in fact a pre-suit demand. Revealing what it called the "proverbial wolf in sheep's clothing," the court found that the pre-suit letter was not "a harmless letter seeking prospective board action" but rather "something with far more legal bite — a pre-suit demand." As such, the court found that the board's determination that it would be in the best interests of the company not to authorize commencement of a civil action or changes in its board compensation practices was a proper exercise of its fiduciary duties and entitled to the protection of the business judgment rule.

The court went on to hold that when considering whether a communication is a demand, the court is not constrained by "the subjective intent of the sender," there are no "magic words" establishing whether a communication is a demand and Delaware's prohibition on stockholders both making a demand and pleading demand futility "would become a virtual nullity if a stockholder could avoid a judicial determination that pre-suit demand was made by simply stating 'this is not a demand' in [a] pre-suit communication to a board." The opinion stands as a clear rejection of plaintiffs' counsel using a tactical, "stock form" letter to pressure a board to settle baseless director compensation claims.

ISS Voting Policy Relating to Director Compensation

ISS' policy currently provides for potential adverse vote recommendations for board or Committee members who are responsible for approving or setting director compensation where there is a recurring pattern (two or more consecutive years) of excessive director pay without disclosure of a compelling rationale for those prior years or other mitigating factors.

The underlying methodology identifies high director pay through a quantitative analysis, which is followed by a qualitative analysis of a company's disclosure to determine if any concerns over excessive compensation can be mitigated.

The quantitative analysis focuses on identifying director compensation outliers, which ISS has deemed to include any director with pay figures above the top 2% of all comparable directors. It compares directors' compensation within the same two-digit Global Industry Classification Standard group and within the same index grouping. The index groupings include S&P 500, combined S&P 400 and S&P 600, remainder of the Russell 3000 index, and the Russell 3000-Extended. Similarly, pay for directors in board-level leadership positions that typically provide for a compensation premium — limited to nonexecutive chairs and lead independent directors — are compared to the compensation of other directors in similar leadership positions at companies within the same index and sector.

ISS identified several factors that typically would serve to mitigate issues with high director pay, including the following:

- Onboarding grants for new directors that are clearly identified to be one-time in nature.
- Payments related to corporate transactions or special circumstances (such as special committee service, requirements related to extraordinary need or transition payments to a former executive for a limited period).
- Payments made in consideration of specialized scientific expertise (as may be necessary in certain industries such as biotech/pharma).
- Payments made to directors in a sector-index grouping where there is a narrow distribution of pay magnitude.

Payments to directors in connection with separate consulting/service agreements are assessed by ISS on a case-by-case basis with a particular focus on the company's rationale and the extent to which the required services go beyond typical director responsibilities, whether the agreement has a set term and what additional benefits it confers on shareholders.

ISS has indicated that the following circumstances generally will not mitigate concern around high director pay:

- Payments made to reward general performance/service.
- Payments made under separate consulting/service agreements that have an indefinite or prolonged term or which provide payments for services that appear to be within the scope of routine director responsibilities.
- Payments that ISS identifies as problematic for nonemployee directors, such as performance-conditioned incentive pay, perquisites and retirement benefits.

With *Investors Bancorp* and this ISS policy in mind, the board should consider taking the following actions to the extent it has not yet already done so:

- Carefully review any limits that currently apply under its cash and noncash director compensation programs.
- If the board determines that the current director compensation programs do not include meaningful limits, consider amending the applicable plan to include meaningful limits and seeking shareholder approval of the amended plan. As explained above, however, the utility of such shareholder approval is at best uncertain (though ISS views the limits as a positive feature in any event). Accordingly, companies also may wish to consider whether to provide for grants of director compensation awards pursuant to a stockholder-approved formula plan or via grants of awards specifically approved by stockholders.
- If a shareholder ratification or waiver defense is not available or otherwise not likely to prevail, consider and develop the relevant factors that would provide a basis for withstanding "entire fairness" scrutiny. Among other steps in that regard, companies should work with their compensation consultants to regularly conduct a peer review of their director compensation programs to determine whether their director compensation, including equity grants, are reasonable. Companies should carefully document this process and disclose it in their annual proxy statements.
- Ensure that the disclosure regarding director compensation in the company's annual proxy statement is clear and expand it beyond historical norms if necessary to provide a thorough description of its amount and how that amount was determined. While it is clear that nothing along the lines of a CD&A is required, it may be appropriate in particular — as has become increasingly common — to include additional detail regarding the process used by directors to evaluate and set their compensation and any role played by compensation consultants in that regard.
- If director compensation is above the top 2% of pay to all comparable directors, describe any and all mitigating factors that would justify such outlier compensation to avoid a possible unfavorable vote recommendation.

Concluding Note

As is obvious from the heft of this handbook — even notwithstanding its summary and nontechnical approach — the task faced by Committee members is both formidable and constantly evolving. The world of executive compensation is a dynamic one where new ideas and issues regularly arise, and Committee members need to stay abreast of these while viewing new developments in their proper historical, legal, economic and societal context. We hope this handbook will help Committee members better understand their responsibilities, arm them with the information they need to discharge those responsibilities and enable them to make the best use of their advisers.

Appendix

- Sample Compensation Committee Calendar of Meetings and Responsibilities
- Glossary of Commonly Used Terms

The chart below sets forth an illustrative allocation of Compensation Committee responsibilities for a corporation listed on the New York Stock Exchange with a fiscal year coinciding with the calendar year.

Committee Responsibility	Ongoing/ As Necessary	Feb	Mar	Aug	Nov
Oversight of Executive Compensation and Employee Benefit Programs					
Review the company's executive compensation programs and determine whether they remain effective to attract, motivate and retain executive officers and other key personnel.	•				
Meet with senior risk officers to discuss the company's compensation policies and practices for employees as they relate to risk management and risk-taking incentives.		•			
Annually review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and either as a committee or together with the other independent directors (as directed by the board) determine and approve the CEO's overall compensation levels based on this evaluation and in accordance with any applicable employment agreement then in effect.		•			•
Review and approve, annually and at the time of any new executive officer hire, the following with respect to the executive officers of the company: (a) the annual base salary amount; (b) special bonus arrangements, if any; (c) any long-term incentive compensation (including cash-based bonuses and equity-based awards and opportunities); (d) any employment agreements, severance arrangements and change-in-control and similar agreements or provisions, and any amendments, supplements or waivers thereto; and (e) any perquisites or other special or supplemental benefits, including retirement benefits and perquisites provided to such persons during and after employment with the company.	•	•			•
Consider, recommend, administer and implement the company's incentive compensation and equity-based plans in which the CEO, executive officers and other employees of the company and its subsidiaries participate, including: (a) approving option grants and restricted stock or other awards, considering the timing of such grants in connection with material nonpublic information as applicable; (b) interpreting the plans; (c) determining rules and regulations relating to the plans; (d) modifying or canceling existing grants or awards; and (e) imposing limitations, restrictions and conditions upon any grant or award as the Committee deems necessary or advisable	•	•			
Annually review and adopt, or recommend to the board, as appropriate, the adoption of new, or the amendment of existing, compensation plans by the company and any increase in shares reserved for issuance under existing equity-based plans.	•	•			

Committee Responsibility	Ongoing/ As Necessary	Feb	Mar	Aug	Nov
Monitor the company's compliance with applicable laws and regulations affecting compensation and benefits matters, including: (a) overseeing policies on structuring programs to preserve tax deductibility, (b) overseeing compliance with the requirements of the Sarbanes-Oxley Act of 2002 relating to 401(k) plans and loans to directors and officers and (c) overseeing compliance with NYSE rules regarding shareholder approval of equity-based compensation plans.	•	•			
Enforce the Dodd-Frank Clawback Policy to the extent required and ensure that disclosure requirements regarding compensation recovery thereunder are satisfied.	•				
Review and approve retention of compensation consultants and other outside advisers as applicable and appropriate (following consideration of the applicable independence factors).	•				
Review and approve policies regarding the independence of compensation consultants.				•	
Compensation Disclosures in Proxy Statement					
Review and discuss the CD&A with the company's management (including consideration of the results of the most recent say-on-pay vote) and determine whether to recommend to the board that the CD&A be included in the company's proxy statement.		•			
Prepare an annual Compensation Committee Report, as required by the SEC, for inclusion in the company's annual proxy statement.		•			
Review all equity compensation plans and equity plan proposals to be submitted for shareholder approval under exchange listing standards.	•	•			
Evaluations and Other Responsibilities					
Annually review the Committee's own performance.		•			
Review and reassess the adequacy of the Committee's charter annually and recommend any proposed changes to the board for approval; ensure current charter is posted on company website.		•			
Report regularly to the board on the Committee's activities.		•	•	•	•
Carry out any additional responsibilities that have been allocated to the Committee (*e.g.*, those relating to succession planning, diversity reporting, pay equity and other human capital issues, as applicable).	•				

Glossary of Commonly Used Terms

162(m)
Section 162(m) of the Internal Revenue Code, which imposes a limit of $1 million on the amount of compensation that a public company may deduct in any calendar year with respect to compensation paid to each "covered employee." A commonly used exception to the limitation for performance-based compensation is now generally unavailable except in the rare case of very old awards.

280
Section 280G of the Internal Revenue Code, which generally provides that "excess parachute payments" made to certain individuals are nondeductible by the payor company (and, pursuant to Section 4999 of the Internal Revenue Code, subject to a 20% excise tax imposed on such individuals, in addition to any regular income taxes due with respect to such payments). See Chapter 8.

409A
Section 409A of the Internal Revenue Code, which generally imposes strict limitations on the timing of elections to defer compensation, the timing of distributions of deferred compensation, and the reporting and taxation of deferred compensation. See Chapter 8.

Base Amount or 280G Base Amount
An individual's base amount for purposes of Section 280G of the Internal Revenue Code is the average of the individual's compensation from the employer that was includible in the individual's gross income for the most recent five calendar years ended prior to the year in which the change in control occurs (or, if fewer than five years, the entire period of employment).

Best Net Provision
Provision pursuant to which payments are cut back to a level that would not trigger the excise tax under Section 4999 of the Internal Revenue Code unless the individual would be in a better economic position (generally on an after-tax basis) in receiving all amounts and simply paying such excise tax.

Blue Sky or Blue Sky Laws
State laws and regulations concerning the registration and issuance of securities.

Bullet-Dodging
The practice of delaying an equity award grant until unfavorable news becomes public; with the result that the recipient receives an award with a lower exercise price or greater number of shares.

Burn Rate
ISS changed its calculation of burn rate effective for annual meetings on or after February 1, 2023, to feature a Value-Adjusted Burn Rate. Annual Value-Adjusted Burn Rate equals = ((# of options * option's dollar value using a Black-Scholes model) + (# of full-value awards * stock price)) / (Weighted average common shares * stock price). The VABR calculation values grants in each fiscal year separately, based on the applicable ISS Quarterly Data Download (QDD) date and QDD data in the applicable fiscal year.

Cashless Exercise
A method of exercising a stock option that allows the holder to acquire the underlying stock without a cash payment to cover the exercise price. This can be a broker-assisted cashless exercise or a net exercise (see below).

CD&A
The Compensation Discussion and Analysis section required in a public company annual proxy statement or Form 10-K pursuant to Item 402(b) of Regulation S-K.

Cutback or 280G Cutback Provision
Provision pursuant to which change-in-control-related payments and benefits must be reduced to a level that would not trigger the excise tax under Section 4999 of the Internal Revenue Code. Also referred to as a "cap" or "280G cap."

Dodd-Frank
The U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act. The 2010 federal law has the stated aim to "promote the financial stability of the U.S. by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

Double Trigger
Rights, payments or benefits that result from, or are triggered by, the occurrence of a change in control of the company followed by or coincident with a second event (generally, certain limited types of employment terminations, *e.g.*, termination without cause or termination for "good reason" (generally an adverse change to terms or conditions of employment)).

EGC
An emerging growth company, which is generally defined under the JOBS Act as a company with gross annual revenue of less than $1.235 billion during its most recently completed fiscal year and whose first public offering of common equity securities occurred on or after December 9, 2011.

ERISA
The U.S. Employee Retirement Income Security Act of 1974, as amended.

Excess Benefit Plan
A nonqualified defined contribution plan maintained by an employer to provide benefits for certain employees in excess of the limitations imposed on tax-qualified plans under Section 415 of the Internal Revenue Code.

Excess Parachute Payment
Internal Revenue Code Sections 280G and 4999 are triggered if all parachute payments equal or exceed three times the individual's base amount. The amount of the payment that is not deductible under Section 280G and subject to the excise tax under Section 4999 (the excess parachute payment) is any payment in excess of one times the individual's base amount once the trigger amount is reached.

Exchange Act
The U.S. Securities Exchange Act of 1934, as amended.

Externally Managed Issuer
A company (for instance, many REITs) whose management functions are performed by a management company and the individuals the management company employs rather than by individuals treated as employees of the externally managed issuer itself.

Form 3; Form 4; Form 5
These forms are sometimes referred to as "Section 16 Filings" as they are mandated under Section 16 of the Exchange Act. Every director, officer or owner of more than 10% of a class of equity securities registered under Section 12 of the Exchange Act must file with the SEC a statement of ownership regarding such security. The forms contain information on the reporting person's relationship to the company and on purchases and sales of such equity securities; the initial filing is on Form 3; changes in beneficial ownership are reported on Form 4; and an annual statement of beneficial ownership of securities is made on Form 5. See Chapter 9.

Full-Value Awards
Stock-based awards in which the recipient receives the entire value of each share that vests, as with restricted stock or restricted stock units. In contrast, stock options and stock appreciation rights only provide a value equal to the increase in share price over the exercise price or strike price (if any) and thus do not constitute full-value awards. See Chapter 6.

Fungible Share Counting
A fungible or flexible share-counting provision in a stock plan used to determine how many shares have been used and how many remain available for issuance under the plan. Stock awards that are viewed as more dilutive of shareholders are weighted more heavily against the plan's share reserve than less dilutive awards are. For example, while stock options may reduce the plan reserve by one share for each option granted, in fungible share counting, restricted stock or restricted stock units ("full-value awards") reduce the pool by a greater number (*e.g.*, two shares for each restricted stock unit granted). The ratio selected also will generally reflect the higher value/cost that proxy advisory firms place on full-value awards when evaluating whether to recommend a for or against vote on a proposal to approve or amend a company's stock plan.

Glass Lewis
A proxy advisory firm. See Chapters 1, 3 and 5.

Golden Parachute
See "Parachute or Parachute Payment" below.

Gross-Up
An additional payment to an individual to make the individual whole for tax on a certain payment (for instance, excess parachute payments).

In the Money
A phrase used to describe a stock option (or SAR), the exercise or strike price of which is less than the fair market value of the shares underlying such option as of a particular date.

Insiders
Directors, officers and principal shareholders (owners of more than 10% of a class of equity securities registered under Section 12 of the Exchange Act) of public companies who are subject to the reporting and other provisions of Section 16 of the Exchange Act. See "Section 16" below.

ISO
An "incentive stock option" within the meaning of Section 422 of the Internal Revenue Code, which generally is eligible for favorable tax treatment for the recipient. See Chapter 6.

ISS
ISS (Institutional Shareholder Services), a prominent proxy advisory firm. See Chapters 1, 3, 5 and 10.

JOBS Act
U.S. Jumpstart Our Business Startups Act. The 2012 federal law is intended to facilitate the funding of small business in the U.S. by easing certain securities regulations.

LTIP
Long-term incentive plan; may refer to cash- or equity-based awards — generally with a performance period of more than one year.

Modified Gross-Up
A gross-up paid if the change-in-control payments exceed a specified amount over the individual's safe harbor (also known as parachute threshold). For example, an agreement may provide that the gross-up will be payable only if the aggregate amount of the change-in-control payments exceed the safe harbor amount by 10% or more. Generally, if the change-in-control payments are below this percentage they will be reduced to the safe harbor amount. See "Cutback or 280G Cutback Provision" above.

NEO
Named Executive Officer, referring to the executive officers of a publicly traded company as defined by Item 402(a) of Regulation S-K (or Item 402(m)(2) of Regulation S-K, in the case of a smaller reporting company). See Chapter 4. The compensation of NEOs is disclosed in the company's annual proxy statement.

Net Exercise
A method of exercising a stock option that entails the withholding of a number of underlying shares upon stock upon exercise with a value equal to the aggregate exercise price (and related employment and withholding taxes, where applicable) with respect to the number of stock options being exercised, so that the recipient does not have to remit cash to exercise the option.

Nonqualified Deferred Compensation Plan
Generally, an unfunded, unsecured promise by an employer to pay compensation at a specified time or upon a specified event in the future or a plan providing for the same. Section 409A of the Internal Revenue Code contains a specific definition of "nonqualified deferred compensation" for purposes of the statute and regulations thereunder. See Chapter 8.

NQSO or Nonqualified Option
A Stock Option that does not qualify for the tax deferral and other tax benefits available to an Option that is an "incentive stock option" within the meaning of Section 422 of the Internal Revenue Code.

Option or Stock Option
An equity award representing the right to purchase a specified number of shares of common stock at a stated exercise price for a specified period of time subject to the terms, conditions and limitations described in an award agreement or in the equity compensation plan pursuant to which the award is granted. See Chapter 6.

Out of the Money
A phrase used to describe a stock option (or SAR), the exercise or strike price of which is not less than the fair market value of the shares underlying such stock option. Also known as "underwater."

Parachute or Parachute Payment
A compensatory payment made or benefit provided to a "disqualified individual" that is contingent on a change in control of the company, including noncash compensation such as the continuation of health insurance or the acceleration of vesting of otherwise unexercisable or restricted equity compensation. See Chapter 8.

Pay for Performance
Compensation linked to the achievement of specified performance goals or measures (as opposed to compensation for continued services over time). See Chapter 5 and Chapter 8.

Pay Versus Performance or PVP
The Pay Versus Performance section required in a public company annual proxy statement or Form 10-K pursuant to Item 402(v) of Regulation S-K, which discloses the relationship between executive compensation actually paid to the NEOs and the company's financial performance. See Chapter 4.

Proxy Advisory Firms
Firms retained by institutional shareholders to analyze and provide guidance on corporate governance matters and recommend for or against approval of company proposals submitted for approval by shareholders, including election of directors and compensation-related proposals. See Chapter 5.

Qualified Plan
Generally, an employee benefit pension plan that meets the requirements of Section 401(a) of the Internal Revenue Code, which enables the retirement benefits to be provided under the plan in a tax-favored manner.

Regulation BTR
Regulation Blackout Trading Restriction under Section 306 of the Sarbanes-Oxley Act of 2002 relating to restrictions on insider trades during retirement plan blackout periods.

Regulation S-K
A regulation under the Securities Act of 1933 that sets forth reporting requirements for various SEC filings used by public companies.

REIT
A real estate investment trust, a company that owns and often operates real estate-related assets. To qualify for certain tax advantages available to REITS, a REIT must meet certain investment and income requirements and must distribute a significant portion of its taxable income each year in the form of dividends to its shareholders.

Restricted Stock or Restricted Shares
An award of common stock that is subject to forfeiture and transferability restrictions until it vests. See Chapter 6.

Restricted Stock Units
An equity-based award representing a promise to deliver a share of stock or the equivalent cash value in the future, subject to the terms, conditions, restrictions and limitations described in an award agreement or in the equity compensation plan pursuant to which the award is granted. The term can be used interchangeably with the term "phantom stock." See Chapter 6.

S-8
A registration statement filing with the SEC used by a publicly traded company to register the sale of securities that will be offered to its directors, employees and other individual service providers under benefit or incentive plans. See Chapter 6.

Safe Harbor or 280G Safe Harbor
Under Section 280G of the Internal Revenue Code, the safe harbor is three times the executive's base amount (generally 5-year average W-2 compensation), less one dollar. The safe harbor may also be referred to as an individual's "parachute threshold." See Chapter 8.

Say on Pay
The requirement that the company submit the remuneration of NEOs to a nonbinding, advisory vote of the company shareholders. In the U.S., Dodd-Frank introduced say-on-pay disclosure and requires public companies to submit to shareholders a resolution to approve, on a nonbinding, advisory basis, the compensation of the company's NEOs as disclosed "pursuant to Item 402 of Regulation S-K" (generally as set forth in the company's annual proxy statement). See Chapter 4.

Section 16
A section of the Exchange Act that, among other things, describes the various regulatory filing responsibilities that must be met by directors, officers and principal shareholders (owner of more than 10% of a class of equity securities registered under Section 12 of the Exchange Act) with respect to transactions in an issuer's equity securities. See Chapter 9.

Section 83(b) Election
An election made by the recipient of certain compensatory restricted property, typically restricted stock, to include the value of the property in income on a current basis although the property remains subject to a substantial risk of forfeiture and the value of the property would not be includable in income absent such an election. See Chapter 6.

SERP
A supplemental executive retirement plan that is not qualified under Section 401(a) of the Internal Revenue Code. See Chapter 8.

Single Trigger
Rights, payments or benefits that solely result from, or are solely triggered by, the occurrence of a change in control of the company. A "modified single trigger" incorporates the requirement of a termination of employment for any reason, generally meaning the right to "walk away" following a change in control and receive the specified payments or benefits. Change-in-control payments or benefits that require an employee to be terminated without cause or resign following an adverse change to employment terms and conditions are commonly referred to as "double trigger" (see above).

Six-Month Delay or 409A Six-Month Delay
A rule under Section 409A of the Internal Revenue Code providing that deferred compensation payable upon a Specified Employee's (see below) separation from service cannot be paid until six months after a Specified Employee's separation from service (or, if earlier, the employee's death). The six-month delay rule is one of the 409A rules that require documentary compliance as well as operational compliance, meaning that the plan document must expressly provide for the six-month delay. See Chapter 8.

Specified Employee
For purposes of the six-month delay rule under Section 409A of the Internal Revenue Code, a key employee of a public company, as determined under Section 409A regulations.

Spring-Loading
Deliberately making equity award grants before favorable news about a company becomes public in order to benefit award recipients due to an expected increase in the price of the share underlying the award.

Stock Appreciation Rights or SARs
An equity award representing the right upon exercise to a number of shares with a value equal to the increase in the value from the grant date of a specified number of shares over a specified period of time (sometimes payable in cash rather than shares). See Chapter 5.

TCJA
The "Tax Cuts and Jobs Act," the name typically given to the sweeping federal tax reform legislation enacted in December 2017.

Top-Hat Plan
A nonqualified deferred compensation plan (*e.g.*, a SERP) established to provide unfunded deferred compensation benefits only to a select group of management or highly compensated employees. A top-hat plan is exempt from most of the strict ERISA requirements that govern qualified retirement benefit plans.

TSR
Total Shareholder Return, a measure of the performance of the company's stock over time.

Underwater
Typically used to describe an Option or SAR for which the exercise or strike price is not less than the then-current market value of the underlying share. See "Out of the Money" above.

Skadden Executive Compensation and Benefits Group Contacts

Erica Schohn / Partner
erica.schohn@skadden.com
212.735.2823

Page W. Griffin / Partner
page.griffin@skadden.com
650.470.4560

Shalom D. Huber / Partner
shalom.huber@skadden.com
212.735.2483

Joseph M. Penko / Partner
joseph.penko@skadden.com
212.735.2618

Joseph M. Yaffe / Partner
joseph.yaffe@skadden.com
650.470.4650

Michael A. Wiseman / Partner
michael.wiseman@skadden.com
212.735.2662

Louise Batty / Counsel
louise.batty@skadden.com
44.20.7519.7245

Kristin M. Davis / Counsel
kristin.davis@skadden.com
650.470.4568

Berit R. Freeman / Counsel
berit.freeman@skadden.com
212.735.2112

Evgueni Gokhmark / Counsel
genia.gokhmark@skadden.com
212.735.2865

Jeffrey A. Lieberman / Counsel
jeffrey.lieberman@skadden.com
212.735.2734

Timothy F. Nelson / Counsel
timothy.nelson@skadden.com
617.573.4817

Young M. Park / Counsel
young.park@skadden.com
617.573.4877

Laura Westfall / Counsel
laura.westfall@skadden.com
212.735.3912

Stephanie Birndorf / Associate
stephanie.birndorf@skadden.com
650.470.3117

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