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HOT TOPICS FOR COMPENSATION COMMITTEES

In her regular column on corporate governance issues, Holly Gregory examines key developments that compensation committees and their counsel should focus on this year.

With the onset of the 2013 proxy season, much of the compensation committee's work relating to the say on pay vote and preparing compensation disclosure is well underway, if not already completed. Now is a good time for compensation committees and in-house counsel to take stock of developments that will likely impact the committee's agenda and its efforts in the year ahead. Key areas of focus for compensation committees include:

- Refining compensation programs.
- Adhering to new NYSE and NASDAQ listing requirements for compensation committees and independent compensation advisers.
- Evaluating say on pay and director compensation litigation risk.
- Keeping track of potential new SEC regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

Compensation committees should also keep in mind lessons learned about say on pay from the past two proxy seasons, including the importance of improving proxy statement readability and tone and engaging with shareholders to understand their concerns.

>> For information on proxy statement disclosure, search Proxy Statements on our website.

>> For information on engaging with shareholders, search Shareholder Engagement: Looking Back and Planning Ahead on our website.

REFINING COMPENSATION PROGRAMS

Compensation committees need to continually review and refine compensation programs to ensure that they provide fair and reasonable remuneration based on appropriate incentives for executives. Compensation programs should align executive decisions and behaviors with corporate strategy, while also taking into account management continuity and succession issues.

This review and refinement should be grounded in an articulated compensation philosophy and tied to specific benchmarks that will measure success under the company's strategic plan. In formulating a compensation philosophy, compensation committees should consider compensation structure in relation to the culture that they seek to encourage. Key questions include:

- Are collaboration and teamwork highly valued or is success largely driven by "star power" and the conduct of a handful of senior executives?

SAY ON PAY REMINDERS

The following are important reminders regarding the say on pay vote:

- **The two-year exemption for smaller reporting companies has expired.** Smaller reporting companies (those with a float of less than $75 million) are subject to say on pay and say on frequency votes for the first time in 2013.
- **Companies must disclose how they considered last year's say on pay vote.** Whether or not shareholders provided strong support for executive compensation in the 2012 say on pay vote, compensation committees and in-house counsel should pay special attention to the requirement that companies disclose whether and, if so, how, the company considered the results of last year's say on pay vote (*Item 402(b)(1)(vii), Regulation S-K*). Companies need to describe the steps taken in response to the vote and how the results factored into the company's decision-making on compensation.
- **Companies must disclose compensation consultant conflicts.** For the first time, companies must disclose in the proxy statement the nature of any conflict of interest raised by the work of compensation consultants, and how the conflict is being addressed (*Item 407(e)(3)(iv), Regulation S-K*). This applies to consultants who had any role in determining or recommending the amount or form of executive or director compensation during the last fiscal year, whether they were retained by the compensation committee or by management. Although companies are not required to disclose the absence of conflicts, in early proxy statements this year more than a few companies have disclosed that no conflict was found.
- **Companies should take care in responding to a proxy advisor's negative vote recommendations.** While efforts should be made to correct errors or misunderstandings underlying a negative recommendation, some large institutional investors have expressed impatience with supplemental filings that are argumentative in tone.

>> For more information on say on pay voting, search Say on Pay: Takeaways from 2012 and Strategies for 2013 on our website.

- How should culture and ethics relate to executive compensation?

Among other challenges, the compensation committee and board need to define the performance they wish to encourage and how it should be measured. A variety of metrics can be used. Total shareholder return (TSR) is the favored metric of Institutional Shareholder Services Inc. (ISS). However, metrics should relate to corporate strategy. Often, the committee will need to define more granular metrics that in its view are more closely tied to specific behaviors that should lead to growth in TSR over the long term.

To the extent that the compensation committee uses metrics other than TSR to measure executive and company performance, extra efforts should be made to clearly articulate why these more specific metrics are appropriate. Committees also need to determine the appropriate mix of long-term and short-term elements of compensation and the extent to which different metrics should relate to these elements.

In the current environment, compensation committees and their in-house counsel need to apply constructive skepticism and continually question assumptions about:

- Pay mix.
- Performance metrics.
- Pay levels.
- Employment contracts (including sign-on commitments and exit provisions).
- Perquisites.

All elements of executive compensation should be subject to scrutiny. The committee should make sure to clearly articulate the rationale for its approach in the minutes, for purposes of disclosure to both internal and external constituents, as appropriate.

Additionally, with changes in how proxy advisors are considering pay for performance alignment and shifts in their views on peer groups and the use of realized or realizable pay, compensation committees and their in-house counsel should track proxy advisor analysis and 2013 voting results closely.

>> For more information on proxy advisor policy changes, search Key Changes in Proxy Advisor Policies for 2013 on our website.

NEW LISTING REQUIREMENTS

The SEC recently approved NYSE and NASDAQ listing rules designed to tighten compensation committee oversight and independence and to encourage, but not mandate, committee reliance on independent advisers (as required by Rule 952 of the Dodd-Frank Act).

COMMITTEES AND CHARTERS

Those NASDAQ companies that do not have a compensation committee consisting of at least two independent directors and operating under a formal written charter must put one in place. (NYSE listed companies are already required to have a compensation committee operating under a formal written charter and consisting entirely of independent directors, with no minimum number prescribed.)

ASSESSING ADVISER INDEPENDENCE

As of July 1, 2013, an NYSE or a NASDAQ listed company's compensation committee may only select or receive advice from an adviser after conducting an independence assessment. The committee may select or receive advice from an adviser that is not independent, but only after it has conducted the independence assessment. This rule applies to compensation consultants, legal counsel (other than in-house counsel) and other types of advisers, including advisers retained by management but who provide some advice to the compensation committee. However, there are certain exceptions for persons who only consult on broad-based plans or provide non-customized information.

The compensation committee must consider six specific factors (no materiality or other quantitative thresholds apply), which are identical to the six factors the committee must consider in assessing whether the work of compensation advisers creates conflicts of interests for disclosure purposes. These factors include:

- Whether other services are provided to the company by the firm that employs the adviser.
- The amount of fees received from the company by the firm that employs the adviser, as a percentage of that firm's total revenue.
- Policies and procedures designed to prevent conflicts of interest in place at the firm that employs the adviser.
- Any business or personal relationship of the adviser with a member of the compensation committee.
- Any stock of the company owned by the adviser.
- Any business or personal relationship of the adviser or the firm employing the adviser with an executive officer of the company.

COMMITTEE RESPONSIBILITY AND AUTHORITY FOR ADVISERS

The authority of the compensation committee must be expanded as of July 1, 2013 to include:

- Sole discretion to retain or obtain the advice of any adviser.
- Direct responsibility for the appointment, compensation and oversight of the work of any adviser retained by the compensation committee.
- Responsibility, prior to selecting or receiving advice from an adviser, to evaluate the independence of the adviser.

The compensation committee must also be provided with appropriate funding by the company for the payment of reasonable compensation to an adviser retained by the committee.

Rather than adopt an additional bright-line test for compensation committee member independence, the NYSE requires that the board assess the independence of compensation committee members by taking into consideration all relevant factors.

HEIGHTENED COMMITTEE MEMBER INDEPENDENCE STANDARDS

As of the company's first annual meeting after January 15, 2014 or by October 31, 2014, whichever is earlier, compensation committee members must satisfy heightened standards of independence. However, the NYSE and NASDAQ apply different approaches.

Rather than adopt an additional bright-line test for compensation committee member independence, the NYSE requires that the board assess the independence of compensation committee members by taking into consideration all relevant factors. These factors include, but are not limited to:

- The source of compensation of the committee member, including any consulting, advisory or other compensatory fees paid by the listed company to the committee member.
- Whether the committee member is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

In contrast, NASDAQ's approach is similar to the first prong of the audit committee independence test. A director does not qualify as independent for compensation committee purposes if he or she accepts "directly or indirectly, any consulting, advisory or other compensatory fee" from the company or any subsidiary. Like the NYSE, NASDAQ requires that the board also consider whether the compensation committee member

KEY ACTION ITEMS FOR COUNSEL

To ensure compliance and minimize litigation risk, counsel to compensation committees should take the actions set out below.

Refining Compensation Programs

- Ensure there is time on the compensation committee agenda to discuss compensation philosophy in relation to culture and strategy, and to review and revisit:
  - metrics for performance;
  - the mix and level of pay; and
  - appropriate peer groups.
- Ensure the underlying rationale for compensation committee decisions is appropriately captured in minutes and disclosed.
- Review with the compensation committee changes to proxy advisor policies, including those related to peer group selection and realizable pay.

New Listing Requirements

- Determine who "provides advice" to the compensation committee such that an independence assessment is necessary.
- Gather information about relationships that could impact adviser independence based on the enumerated factors and any other factors that the compensation committee may find relevant to its assessment.
- Discuss with the compensation committee whether it wishes to adopt specific policies and procedures for the retention of advisers to help ensure that applicable independence factors are considered prior to retaining or receiving advice from advisers.
- Have the compensation committee assess adviser independence and record its determination in committee minutes.
- Consider including in engagement letters with advisers commitments to provide representations and information about any relationships or changes in relationships that could impact independence.
- Revise D&O questionnaires to address independence criteria applicable to compensation committees. Include questions similar to those asked of the audit committee about receipt of compensation and affiliate relationships.
- Have the board or the appropriate committee assess the independence of compensation committee members.
- Determine whether any changes to compensation committee composition are required as a result of the independence assessment (NASDAQ companies that do not have a formal compensation committee will need to form one).
- Review and revise as necessary the compensation committee charter (NASDAQ companies that do not currently have a charter will need to adopt one).

Litigation Risk

- Monitor litigation developments related to compensation issues carefully.
- Update the compensation committee and the board on the litigation risks related to compensation decisions and disclosure.
- Ensure that disclosure is clear and provide information relevant to shareholders' interests in making informed decisions on compensation matters.
- Review peer company disclosure to ensure that company disclosure is relatively in line.
- Review compensation committee processes, particularly relating to new share reserve amounts and benchmarking, and ensure that appropriate minutes in final form reflect the deliberations and actions of the compensation committee and the board.
- Assess whether equity plans provide meaningful limits on the value of equity that non-employee directors can award themselves.
- Consider including an annual per person limit on the number or dollar value of shares that may be granted to a non-employee director (for example, a sublimit) in a future plan amendment or a new plan.

New SEC Regulations under the Dodd-Frank Act

- Monitor SEC rulemaking developments closely, as well as the regulatory environment in general.
- Confirm that compensation plans and any employment contracts provide that incentive compensation is subject to clawback to the extent required or allowed by law or regulation.

is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

Smaller reporting companies and controlled companies are exempt from the heightened independence requirements for compensation committee members and their advisers.

LITIGATION RISK

Compensation committees and their counsel should be aware of current say on pay and director compensation litigation.

ROUND TWO SAY ON PAY LITIGATION

The Dodd-Frank Act expressly states that the say on pay vote is not binding and does not create or imply any change to the fiduciary duties of board members. However, failed say on pay votes have given rise to shareholder derivative lawsuits alleging breach of fiduciary duty. The vast majority of these cases have been dismissed for failure to adequately allege demand futility and therefore failure to make demand on the company's board of directors prior to filing suit.

More recently, the plaintiffs' bar is filing suits to enjoin the annual meeting unless the company supplements its proxy statement with more detailed executive compensation disclosure and pays fees to the plaintiffs' law firms. These highly coercive suits may seek to enjoin:

- The say on pay vote.
- A vote on a new or amended compensation plan.
- A vote on a charter amendment to increase authorized shares.

The suits claim that directors breached their fiduciary duties (aided and abetted by management) by not providing adequate disclosure in the proxy statement to enable shareholders to make informed voting decisions. Given the timeframe, with a few weeks until the scheduled meeting, the company faces pressure to settle rather than face the uncertainty and expense of litigation and a postponed meeting.

There are some signs that courts are hesitant to support the plaintiffs' claims. In *Noble v. AAR Corp., No. 1:12-cv-07973 (N.D. Ill. Oct. 9, 2012)* and *Gordon v. Symantec Corp., No. 1-12-cv-231541 (Cal. Sup. Ct. Santa Clara)*, the courts denied granting injunctive relief to plaintiffs on the grounds that they had failed to establish that the law required more information than what had been supplied.

DIRECTOR COMPENSATION LITIGATION

A recent Delaware Court of Chancery decision, *Seinfeld v. Slager, 2012 WL 2501105 (Del. Ch. Jun. 29, 2012)*, highlights a potential fiduciary duty issue that may arise related to equity awards to non-employee directors. In denying defendants' motion to dismiss a breach of fiduciary duty claim, the court indicated that the presumptive benefits of the business judgment rule may not apply where directors have relatively unbounded discretion in determining the equity amounts they award themselves.

The plan at issue gave directors the ability to award themselves 1.25 million shares per director per year, potentially more than $21.7 million (grant date value) each. The court stated that "there must be some meaningful limit imposed by the stockholders on the Board for the plan to receive … the blessing of the business judgment rule." The court contrasted another Delaware Court of Chancery case, *In re 3COM Corp. Shareholders Litigation, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999)*, where the option plan at issue had "sufficiently defined terms" and therefore the defendant directors were entitled to business judgment rule protection.

NEW SEC REGULATIONS UNDER THE DODD-FRANK ACT

The SEC has indicated in its Unified Agenda of Regulatory and Deregulatory Actions that it expects to propose and adopt final rules in 2013 regarding the following outstanding Dodd-Frank Act mandates:

- Disclosure of:
  - the relationship between executive compensation actually paid and the company's financial performance (pay for performance); and
  - the ratio of CEO compensation to employee compensation (pay equity).
- Disclosure of policies on employee and director hedging of company stock.
- Stock exchange listing rules requiring listed companies to develop, implement and disclose a "clawback" policy for executive compensation.

These rules have not yet been proposed and the Dodd-Frank Act did not impose a legislative deadline.

The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Weil, Gotshal & Manges LLP or its clients.