National Association of Directors—NJ Chapter
"What You Don't Know About Executive Compensation Can Hurt You!"
November 17, 2016
Background Notes and Selected Source Materials

1. The role of the compensation committee in mitigating risk:[1]

Background Notes:

- Compensation risk assessments are an SEC requirement (since 2010). All listed companies must disclose whether their compensation arrangements are "reasonably likely" to have "a material adverse effect on the Company." This covers all compensation arrangements, not just NEO compensation, which is the focus of the proxy. To satisfy this requirement, companies generally inventory all of their incentive plans, describe the key features of the program and expected payout levels and compare those programs against generally accepted risk areas such as: cash weighting, performance metrics, leverage, payment timing, recoupment policies, committee oversight, etc.
- The board must also consider the *unintended* consequences of pay, including whether it encourages decisions, actions, or behaviors that are not in the interest of shareholders—such as excessive risk-taking or artificial moves to boost the value of awards. The research literature provides substantial evidence that these types of outcomes can occur. But it may difficult to pick up abuses from the vantage point of the Compensation Committee.
- For example, most compensation committees don't get involved in field sales compensation or productivity metrics but these programs can be the source of risk to companies—financial services; channel stuffing in pharma and other industries; health care targets that can jeopardize quality of care, etc.
- However, there may be red flags that are visible to other committees such as an audit or a risk committee, or even the full board, such as
    - Aggressive business strategy or plan
    - Unrealistic revenue growth and/or earnings targets (always met)
    - Growth based entirely on acquisitions versus internal investment
    - Channel stuffing—end of quarter sales into distribution followed by returns
    - Large software deals at quarter ends
    - Sudden "burst" of performance in a historically underperforming area
    - Incentives that pay only based on stock price volatility
    - Increase in customer dissatisfaction

- Executives holding compensation awards whose value is tied to stock price volatility or that pay out only in the case of extreme performance likely require especially vigilant oversight by the board
- Valeant case: The performance stock units granted to the Valeant CEO had a single performance measure: compound total shareholder return over a three-year hurdle. The value payable at the maximum level of TSR was treble the number of the base amount of the shares

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[1] Source Materials: David F. Larcker and Brian Tayan, Stanford Graduate Business School Closer Look Series, April 28, 2016, *CEO Pay at Valeant: Does Extreme Compensation Create Extreme Risk?* Daniel Alter, Program on Corporate Compliance and Enforcement at New York University School of Law, *Wells Fargo's No-Contest Settlement: Leaving the Stage Coach with Broken Windows,* September 28, 2016.

granted. Should the board have included operating- based or non- financial performance measures as well? Do multiple performance measures provide better alignment between CEO and shareholder interests or unnecessary complexity? Which is the better measure of long-term results: accounting measures or stock price?

- Query whether a fraud of the extent of Wells Fargo is something that a Comp Committee or full Board can get a handle on—these were actions of thousands of low-level people, and there is now a class action for $2.6B by these employees claiming, *inter alia*, that Wells Fargo imposed unreasonable sales quotas

2. **Short-term metrics: if the ship sinks, do any boats get to shore?**[2]

Background Notes:

General Design/NEO's:

- General rubric that compensation programs consist of "fixed" component (base salary), a short-term incentive (annual bonus plan) and a long-term component (time based and/or performance based equity). The short-term or annual incentive program often has the largest number of participants in addition to the executive team.
- Start with the company's business objectives and strategy. Then select short-term incentive performance metrics that tie directly to achievement of that strategy. Ensure measures are perceived as fair and practicable and that you have appropriately calibrated the "slope of the achievement curve" for superior, target and threshold performance –are the metrics sufficiently challenging but not so aggressive that employees perceive they are impossible and become demotivated (or behave in a risky manner—see topic 1).
- If the company is "always making its numbers," what does that tell you? What if that is not rewarded with stock price performance? Can consider what metrics analysts and major shareholders are following and view as intrinsic to value creation. Do you look at analysts' ranges and consensus? Are you relying too much on the annual budget? Survey data to the effect that short term targets are anchored to the budget over 70% of the time. Sources can also include peer company practices and metrics. If peers are performing more successfully, is your plan sufficiently stretching management?
- It is about a 50/50 split as to whether senior executives are compensated as a team or as individuals with some component or factor that takes into account individual performance or objectives
- In many companies, NEO's are paid only on the formulation for the entire company, but it is not unusual to see 10-20% tied to personal objectives
- If you use personal objectives, they must be individually assessed, not just treat everyone the same, e.g., if up to 20% of bonus is tied to personal objectives, everyone cannot receive 10%

Broad-based Plan:

- Metrics for a broad-based plan should have relevance for the population: most middle managers can understand and link to their roles with respect to revenue, operating income or other profitability metric, an industry specific metric such as contract values, billings, bookings. Some other metrics may appear more "esoteric" to employees such as EVA, ROIC, Economic

[2] Source Materials: Pearl Meyer on Point, *Looking Ahead to Executive Pay Practices in 2017*, Executive Summary.

Profit and may not be suitable for broad-based plans. Some companies employ a "profit-sharing" approach, e.g., for every dollar above target, the shareholder get x, and the employees get y.

- There are different organizational models as to whether all in the incentive eligible population are compensated on the corporate objectives versus some component of individual objectives or divisional/functional/team objectives
- At the senior management level, there can be more issues between executives if some are measured differently from others given that all are accountable for achievement of the corporate metrics
- Objectives, while fair, should equate to more than doing your job
- Understand the culture and risk tolerance of the company: may conclude that below a certain management level, preferable to pay a higher percentage of, or only, fixed pay versus leveraging any portion of annual compensation. Also influences the demographics of long-term incentive program.

Total Cost of Plan:

- Also understand the dollar value of the rewards at different levels of performance—what is the total cost of the plan, not just the cost for the executive team. Committee has an overall responsibility to insure that the "funding" of annual awards is consistent with corporate performance (e.g., percentage of revenue, % of TSR, % of profit) and affordable for the company and that there is differentiation in award targets by employee level and role, as well as some metric of performance.
- Have not found good benchmarks for broad-based incentive programs, the amount will vary by company and industry. Many companies establish pay targets for each role based on benchmark pay data and roll-up the targets to arrive at the target pool which is paid for target performance, typically measured as profit. This target pool is used for budget planning and can be adjusted based on planned profitability targets/goals.

3. **Long -term compensation plans—feast or famine**[3]

Background Notes:

General Design:

- A well-balanced long-term program will address both retention and performance through, for example, 50% of equity awards time-based and 50% vesting based on achievement of performance metrics over a time period; can have a long-term cash program in conjunction with equity LTI
- Consider whether or not there should be overlap between short-term and long-term metrics
- It's important for the compensation committee to understand the selected metrics and what the pay-out will look like—in dollars and shares—at the end of cycle; ask whether you are comfortable with that number and what that level of pay-out means vis a vis value creation for

[3] Source Materials: Steven Hall & Partners, *The Current Landscape of CEO Long-Term Incentives*; Cydney S. Posner, Cooley LLP, ACC Newstand, *New study shows inverse correlation between CEO pay and performance over the long term*, July 25, 2016; Cydney Posner, Cooley LLP, Is it a mistake to insist that CEO pay be performance-based? March 21, 2016. See also Source material accompanying Topic 5.

shareholders or owners—Monte Carlo analysis

Private Company:

- For private companies, long-term equity plans can be difficult as there may be no liquidity event ever or in the foreseeable future, so long-term cash plans can become the substitute. If you denominate your equity plan in stock, you need to deal with the exiting employee, e.g., is there a "put" or a required buy-back (you may not want a former employee holding stock but a buy-out raises valuation issues and utilization of cash)
- Moving from private to public company status presents many transition issues—management team needs to be educated on the optics, comparison with peer group, and that certain vehicles such as rich severance packages many not be acceptable; also, if owners have not been generous with equity pre-IPO, there may be pent-up demand on the part of employees; need to be mindful of making grants at low prices prior to setting IPO price as this may have negative accounting implications ("cheap stock" issue); also need to be sure to provide for enough of a share pool before company goes public to address whatever grant program board wants to have post-IPO so you are not going to shareholders too soon after IPO

Failed LTI Program:

- One strategy to guard against a failed program is to make multi-year awards annually so that if one cycle fails, there are other cycles in progress that can be earned; avoid front-loading equity awards (this can be a problem in a company that goes private where large awards may be made at the time of the buy-out or in a newly public company where employees did not receive much equity prior to the IPO; or, if employees dumped equity immediately after the lock-up, you may want to look at equity position and reward those who held more equity through the IPO.
- In any case, when LTI grants are underwater or speculative, employees may be making market comparisons based on their cash compensation
- You can also use the new cycles to address the situation in which the first cycle may have a too aggressive plan
- However, the reality is that the plan may be right and performance is poor
- In those cases, it may make sense to make an award of time-based restricted stock as a retention device—this can be done selectively

4. **To TSR or not to TSR**[4]

Background Notes:

- TSR per Burgman and VanClieaf: "Simply put, TSR is the percentage gain or decline in total shareholder returns, measured as share price appreciation or depreciation, plus dividend reinvestment, over a defined period" such as one, three, five years. While in some cases a

[4] Source material: Roland Burgman and Mark Van Clieaf, *Total Shareholder Return (TSR) and Management Performance: A Performance Metric Appropriately Used, or Mostly Abused?* Rotman International Journal of Pension Management, Volume 5, Issue 2 (Fall 2012); NACD Compensation Series: Put TSR in its Place: Choose the Right Performance Metric for Value Creation (March 10, 2016); ISS Press Release, *Six New Financial Metrics to Supplement TSR*, November 8, 2016; Conference Board, Research Report on CEO and Executive Compensation Practices, 2015 Edition.

company might set a target of an absolute TSR, it is becoming more common to use "relative TSR," which measures a company's TSR against the [median] TSR of a peer group of companies.

- TSR may be an appropriate metric for measuring the performance of a fund, but is it an appropriate metric for incentive compensation? Whether or not and how you "TSR," is a decision to be made in the context of your company.
- TSR is more appropriate as a long-term metric rather than annual and for mature companies rather than newly public (SEC disclosure is 5 years, proxy advisors look at one year, many plans look at three years)
- Also more appropriate for senior management than for mid-management and the general population
- While the purpose of a TSR metric is to reward for enhancing shareholder value, TSR is not the only, and may not be the best, way for achieving this goal
- TSR is a point to point mathematical calculation that compares stock price and average number of shares between two points in time for a peer or measurement group of companies; selection of the group is very important
- TSR is subject to exogenous factors that may or may not affect an entire measurement or peer group: "An untested but generally accepted rule of thumb is that 50% of long-term change in a share price is due to broad macroeconomic factors, 25% to industry-specific factors, and 25% to company-specific factors. Thus some 75% of the influence over share price is broadly out of management's control."
- TSR can be difficult to use for many companies due to "lumpiness" of revenue, short trading history for new companies, trading volatility and the fact that absolute performance (good or bad) may not be reflected in stock price.
- Committees should not be distracted by TSR from identifying those metrics that most closely tie to achievement of corporate strategy and goals.
- TSR can be used with an underperforming company that wants to increase the multiple on which its stock price is determined (input based).
- More stable companies can use TSR as a balance against something that is more under management's control, such as profitability (output based).
- TSR can be a modifier to centerpiece financial metrics. A TSR modifier might be a payout cap for negative relative TSR or an enhancement for positive relative TSR performance.
- Some companies use relative rather than absolute TSR to ameliorate the issue of "all boats rising with the tide" that can result in a windfall and vice versa.
- Many companies do not use TSR at all, opting instead for other metrics that analysts and shareholders consider important such as profitability and return on capital or industry-specific metrics.
- TSR is already embedded in equity metrics as their value is directly tied to stock price performance. Shareholder alignment can be supported by holding period or stock ownership requirements.
- Metrics that demonstrate a strong linkage to TSR: Revenue and EBITDA over 3-5 years; ROIC
- Survey Data:
    - Fred Cook proprietary research (based on the top 250 companies in the S&P 500) indicates that total shareholder return is the most common metric, 54%, followed by profit, 51%. TSR is most commonly measured on a relative basis (87% of the time).
    - Steven Hall survey: Relative TSR most prevalent among large-cap, only a minority of mid- and small-cap; latter prefer earnings for LTIP.
    - Conference Board: On an industry basis, highest prevalence of TSR among utilities,

energy, IT and telecom services industries (50% and up); lowest among consumer, health care, industrials and materials.

5. **CEO employment agreements: passé or here to stay? And what happens if the provisions are actually triggered by an exit of the CEOi[5]**

Background Notes:

General Overview:

- (1) new CEO's want an employment agreement ("your best deal is your first deal"), and (2) they are hard to eliminate; there are advantages to the individual and the company if properly crafted.
- Boards many step over the line in trying to attract a new CEO and provide more compensation than is needed; an extravagant package will drive behavior to demand more; pay attention to the talent market and what is the individual's motivation: is he/she just looking for compensation or is there a passion for leading the company
- Try to keep the employment agreement as close as possible to the standard executive plans for severance and change in control; some CEO's want a contract due to distrust that an acquirer can change these programs
- It is also a place in which to secure a non-compete and non-solicit commitment from the CEO that may be different from what applies generally to executives in the company; this may also be a place in which to secure the CEO's agreement to forfeit compensation in the event that there is an event requiring a clawback under Dodd-Frank and/or SEC rules.
- Severance and CIC programs should be "fair and equitable"—shareholders object to egregious severance benefits and multiples of base salary seem to be declining (but see, Wells Fargo $100M retirement package of leader of the organization that committed fraud, now subjected to clawback).
- However, some of the size of packages is attributable to vesting of equity and pay-out of long-term awards and other deferred compensation.
- Therefore you may want to have a Monte Carlo analysis that predicts what the severance will look like under different assumptions for the stock price or other factors.
- Don't be knee-jerk in providing automatic vesting of equity or performance awards on retirement or voluntary/involuntary termination; consider pro-rata vesting of equity and not paying performance awards until the cycle ends and actual performance is determined, then pro-rate the award; may be more generous in CIC situation.
- PwC reports a 16.6% global turnover rate for CEO's in 2015 (10.4% in US) and Challenger, Gray & Christmas reported 944 CEO exits in the US through September 2016.

Regarding the Yahoo! Case—Practical Advice from the Vice Chancellor:

- The case involved the hiring of a new COO for Yahoo! who was a former colleague of the CEO, Marissa Meyer. After 14 months of service, the COO, Henrique de Castro was terminated with a severance package valued at $60M. The case was brought as a demand under section 220 of

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[5] Source Materials: *Study Roundup on Executive Compensation*, PwC Governance Insights, September 20, 2016; Ric Marshall, Linda-Eling Lee, MSCI ESG Research Inc., *Are CEO's Paid for Performance? Evaluating the Effectiveness of Equity Incentives,* July 2016

the Delaware General Corporation Law to inspect books and records. In allowing the case to proceed, Vice Chancellor Laster focused in particular on the various equity awards to be granted to de Castro, and the effect a subsequent termination of employment would have on such awards. In evaluating this aspect of the offer letter, Vice Chancellor Laster created a chart demonstrating the percentage of each type of equity award that would accelerate and vest, as well as the effective percentage of the total equity awards that would be received, if de Castro was terminated without cause after certain periods of time. He notes that the Committee did not have the benefit of such a chart.

- Consider who should lead the negotiation; make sure it is someone who is not conflicted by virtue of having a close relationship with the candidate
- Make sure that you understand key features of the agreement and take time to review; get updated on changes that occur during the negotiation and their impact on the numbers

Survey Data on CEO pay packages:

- MSCI survey data (smallest company had $2.4B in revenue) uses data from proxy statement summary comp table: companies with CEOs who were paid above the median over the 10-year period significantly underperformed those companies where cumulative CEO summary pay was below their median pay group. Companies with the highest cumulative CEO total summary pay levels had lower rather than higher returns. In both tests, the highest returns were achieved by those companies whose cumulative total summary pay figures were at the lower end of the spectrum. "Equity incentive awards now comprise 70% or more of total summary CEO pay in the United States, based on our calculations. Yet we found little evidence to show a link between the large proportion of pay that such awards represent and long-term company stock performance."
- A different study by executive compensation consulting firm Pay Governance found a different result—using a different method. The firm focused on realizable pay instead of the accounting measurement of pay. Pay Governance says pay opportunity isn't the best metric to evaluate a pay-for-performance plan because it is an accounting figure that declares the grant-date value of stock options and restricted stock units without tracking their change in value over time. In contrast, Pay Governance's realizable pay methodology tracked the value of CEO equity awards after the grant date to see how the value of the CEO's awards actually changed in comparison to changes in shareholder value (i.e., total shareholder returns (TSR)).
- Pay Governance's research showed that realizable pay for CEOs at high-performing companies (with high TSR) had median three-year CEO realizable pay that was $21 million higher than companies with lower TSR performance. Companies with negative TSR had realizable pay that was 39 percent lower than the accounting measurement of pay. The Pay Governance research looked at 330 S&P 500 CEOs with tenure of three years or more by the end of 2014.
- Query whether the Pay Governance survey is self-fulfilling: if a large portion of compensation is tied to equity then it is going to be axiomatic that higher TSR (stock price) will drive a higher value pay-out.

6. **Paying yourself in the current environment**[6]

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[6] Source Materials: NACD *2015/*2016 Director Compensation Survey; Morgan, Lewis & Bockius, *Settlements of Director Compensation Litigation Raise Issues* (September 30, 2016); Winston & Strawn, *Settlement of Lawsuit over Director Compensation Offers Useful Guidance* (September 14, 2016); David A. Katz, Harvard Law School Forum on Corporate Governance & Financial Regulation, *Dealing with Director Compensation* (May 22, 2015);

Background Notes:

General Design:

- Whether a public or private company board, look at the market—don't want to overpay or underpay (may make it difficult to attract qualified directors)
- Most boards can look at their compensation every 2-3 years and survey data reflects that board compensation does not move appreciably from year to year, although Equilar reports 17% increase since 2011 according to PwC; NACD survey of 1400 companies showed 1% increase overall from 2014 to 2015 with the largest percentage in the microcap category.
- The structure of public company board compensation is actually fairly consistent across companies regardless of size although proportions and amounts may differ depending on industry and size: cash portion that may consist of: retainer, cash supplements for board chair/LD/committee chairs, committee member supplements (meeting fees dwindling—Equilar 2017 survey reports: The percentage of companies offering meeting fees decreased from 33.9% in 2011 to 18.2% in 2015); and an equity portion which may consist of options and/or full value shares (options less prevalent but in some sectors still in use, e.g., emerging companies may have a higher prevalence of options; newly public companies may have residual options granted pre-IPO; have to consider whether a post-IPO incentive plan creates conflict of interest for directors).
- Should you look at peer group compensation? And/or broader survey data: ISS says: This relative measure expresses the prior year's average outside director's pay (based on total compensation reported for each director in the company's proxy statement) as a multiple of the median pay of its ISS-determined comparison group for the same period. The calculation for this measure is: the average outside director's total pay divided by the median average outside director total pay level for the comparator group.

Litigation:

- Recent litigation has concerned primarily the equity components of board compensation. Plaintiffs are looking for "low-hanging fruit" where board compensation programs do not explicitly provide for a limit on stock compensation or the limit is not reasonable, e.g., a limit of 1 million shares of stock per director per year that translates into a possible award of tens of millions of dollars (e.g., $55M for Citrix and $100M for each of Facebook and Celgene). As the board's decision involves self-dealing, the entire fairness test applies, which allows plaintiffs to get past motions to dismiss
- Recent settlements don't represent a large enough universe to generalize but the following factors may be part of the mix:
  - A hard cap on director equity expressed as a dollar amount and not as a number of shares; could include an escalator to address inflation
  - Submission of the cap to a shareholder vote although not required under NYSE or NASDAQ rules in order to secure benefit of Delaware business judgment rule (w/o escalator you

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ISS Governance QuickScore 2.0: An Overview (January 2014); ISS U.S. Proxy Voting Guidelines (Updated February 2016); Skadden Arps Meagher & Flom 2016 Compensation Committee Handbook.: Cleary Gottlieb, Section 409A and the Six-Month Delay – Don't Forget Your Directors (February 8, 2016); PwC Governance Insights excerpt of Equilar Director Pay Trends 2016 (October 18, 2016); Equilar Blog: Director Pay Limit Disclosures Doubled in 2016, October 17, 2016.

would need to return to shareholders to increase the cap)
    - Independent compensation consultant to assess the program annually
    - Amendment to compensation committee charter to review board comp annually (if not already in charter)
    - Enhance disclosure in proxy statement to describe philosophy and process for deciding on board's comp, plus disclosure of individual director pay if you are not already doing—Equilar reports that proxy disclosure of limits on director pay has increased substantially in 2016.
- Not clear that boards should rush to do the above: but board compensation programs should have "meaningful" limits; review by an outside consultant is a prudent safeguard.
- $425K paid to plaintiffs to settle Citrix case
- Consider whether director pay could be attacked as corporate waste even in the case of a private company with minority shareholders although potentially a high bar for Delaware corporations. May want all shareholders to approve or ratify?

Stock Ownership Guidelines:

- Many companies use a multiple of the cash retainer; others have a retention requirement, e.g., you must hold 50% of the after-tax proceeds of vested restricted stock or the exercise of an option, versus a 5-year period in which to accumulate stock ownership. Can also require or allow directors to elect to take a portion of the cash retainer in stock
- ISS looks for 2X cash retainer and holding shares through and after retirement (see below)
- Private companies should also think about stock ownership guidelines or holding policy; post IPO lock-up, you may not want directors dumping all of their stock, acknowledging that they will want some liquidity especially if you have shareholders selling in the IPO

Tax Pitfalls that require expert advice:

- Need to pay attention to tax consequences to directors in both public and private companies when paying non-cash compensation; §83(b) election not available to RSU's versus actual restricted shares and an ascertainable fair market value is needed); may want to consider deferred compensation option that complies with §409A such as 6-month delay in distribution after retirement
- . Can be an issue for executive chairs or directors of smaller companies, especially newly public where still have retained a substantial ownership interest:
    - An officer whose annual compensation is greater than $170,000 (up to the lesser of 10% and 50 employees),
    - A 5% owner, or
    - A 1% owner receiving annual compensation of more than $150,000.

Other Commentary from Proxy Advisors

- Influential proxy advisors also have taken positions on director compensation. Institutional Shareholder Services recommends a case-by-case vote on compensation plans for outside directors, based on the cost of the plans against the company's ISS-generated benchmark. ISS recommends a vote in favor of a plan if it contains (1) director stock ownership guidelines of a minimum of three times the annual cash retainer, (2) minimum vesting of three years for stock options or restricted stock, or deferred stock payable after three years, (3) a mix of cash and

equity, with a five-year vesting or deferral requirement on the equity if the value of the equity is a majority of the director's compensation, (4) no retirement benefits or perquisites to non-employee directors and (5) detailed disclosure in tabular form for each non-employee director for the last fiscal year.

- Glass Lewis opposes performance-based equity grants to directors, but otherwise takes a generalized view that outside directors should receive "reasonable and appropriate compensation," with fees being competitive but not excessive. Glass Lewis has its own proprietary model to value equity plans compared to peer companies and uses its analysis to determine its recommendations on director compensation plans.
- ISS General Recommendation: Vote case-by-case on compensation plans for non-employee directors, based on:
  - › The total estimated cost of the company's equity plans relative to industry/market cap peers, measured by the company's estimated Shareholder Value Transfer (SVT) based on new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants;
  - › The company's three year burn rate relative to its industry/market cap peers; and
  - › Certain plan features.
- On occasion, director stock plans that set aside a relatively small number of shares will exceed the plan cost or burn rate benchmark when combined with employee or executive stock compensation plans. In such cases, vote for the plan if all of the following qualitative factors in the board's compensation are met and disclosed in the proxy statement:
  - Director stock ownership guidelines with a minimum of three times the annual cash retainer;
  - Vesting schedule or mandatory holding/deferral period:
  - A minimum vesting of three years for stock options or restricted stock; or
  - Deferred stock payable at the end of a three-year deferral period.
  - Mix between cash and equity:
  - A balanced mix of cash and equity, for example 40% cash/60% equity or 50% cash/50% equity; or if the mix is heavier on the equity component, the vesting schedule or deferral period should be more stringent, with the lesser of five years or the term of directorship.
  - No retirement benefits, or perquisites provided to non-employee directors; and
  - Detailed disclosure provided on cash and equity compensation delivered to each non-employee director for the most recent fiscal year in a table. The column headers for the table may include the following: name of each non- employee director, annual retainer, board meeting fees, committee retainer, committee-meeting fees, and equity grants.

7. Do compensation committees care about proxy advisors?[7] [Say on Pay; Equity Plans; Withhold Votes on Compensation Committee Members)

Background Notes:

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[7] Source Materials: PwC Governance Insights Center/Cleary Gottlieb, *The Influence of Proxy Advisors on Compensation* (July 2016); PwC, *2016 Annual Corporate Directors Survey*, October 2016.; Cydney Posner, Cooley LLP, *Does a low favorable vote for a say-on-pay proposal affect directors' reputations outside the company?* September 22, 2016.

- ISS and Glass-Lewis have 90% of the “market” of institutional investors. Their compensation-related recommendations can directly impact votes on Say-on-Pay, approval of equity plans and whether compensation committee members are re-elected. At the same time they apply a rules based “best practices” approach that does not take individual companies’ distinctions into account and may be more rigid or restrictive than what shareholders themselves are willing to accept.
- Compensation consultants continue to have the strongest influence on director decisions about executive compensation. Fifty-four percent of directors describe them as very influential—up 17 percentage points from 2013. Proxy advisory firms also saw their influence increase over the last several years; 59% of directors now describe them as at least moderately influential, compared to 49% three years ago. But CEO pressure declined as an influence; only 34% of directors now describe it as at least moderately influential (compared to 45% who said so in 2013).
- No one wants a negative say-on-pay recommendation, although this is not fatal, but it will create a greater risk of a low say-on-pay vote, especially if both ISS and Glass-Lewis recommend against.
- You may need to approach shareholders directly to get support for say-on-pay or for an equity plan—the company may do this but it is recommended that you do not have the CEO discuss his/her own compensation with shareholders.
- You can engage with the proxy advisors but it is recommended that you do this in the off-season, e.g., summer; the same is true for institutional investors.
- Outside compensation advisors can assist you with say-on-pay as well as getting approval of equity plans.
- You may be able to use both of these shareholder approval opportunities to remove egregious provisions from plans and employment agreements—something to think about if going to shareholders first time after IPO and you still have “private company” provisions in the plan, e.g., committee has a lot of discretion to accelerate or waive conditions.
- Moving from a private to a public company presents many transition issues—having to present compensation or a plan to shareholders, or even just proxy disclosure, can help educate the management team as to peer group comparisons, poor optics, more rigorous administration of equity awards and so on.
- Especially challenging in private companies where you don’t have pressure from the public and proxy advisors and it is difficult to recruit with no equity, so cash becomes a substitute.
- Very important for Comp Committee to review CD&A or whatever comp disclosure is required for Jobs Act companies—make sure it reflects the Committee’s compensation philosophy, explains linkage to company strategy, why the program is appropriate for the company; explain what you do and explicitly what you don’t do rather than being silent about not doing something that advisors/investors may consider objectionable such as tax gross-ups on CIC.
- Need to weigh the benefits of contacting advisors versus investors—the former rarely change their recommendations.