

2016 Year-End Key Executive Compensation Reminders and Considerations

With the holiday season upon us, public companies should begin to prepare for the upcoming 2017 proxy season.

Although 2017 may bring significant changes to the executive compensation landscape, the following is a brief summary of the key executive compensation-related reminders and considerations that remain important for public companies to consider as we approach next year's proxy season.

Say-on-Pay and Say-When-on-Pay Votes

Under Dodd-Frank, public companies generally are required to hold a non-binding, advisory "say-when-on-pay" vote at least every six years, beginning in 2011, requesting shareholder advice as to whether say-on-pay votes should be held annually, biennially or triennially. Accordingly, companies that last submitted say-when-on-pay votes to their shareholders in 2011 will need to do so again in 2017. Emerging growth companies (EGCs) generally must hold a "say-on-pay" vote no later than one year after they cease to qualify as EGCs. However, if a company has been an EGC for less than two years after its initial public offering (IPO), the company has up to three years after the IPO to hold the vote. For EGCs, the say-when-on-pay vote is required as early as the first annual meeting after the company ceases to be an EGC, regardless of when the company ceased being an EGC following its IPO. Keep in mind that companies that lose EGC status also will need to revise the compensation disclosure in their proxy statements to incorporate a full compensation discussion and analysis (as opposed to complying with the reduced compensation disclosure requirements that apply to EGCs).

Incentive Compensation Plans and Awards

As public companies gear up for the upcoming proxy season, they should review their cash and equity incentive compensation plans for updates and compliance in the following areas:

- **Section 162(m) Compliance:** Generally, companies must seek shareholder approval of the "material terms" of their incentive compensation plans every five years in order to preserve the availability of the deduction limitation exemption under Internal Revenue Code section 162(m) for qualified performance-based compensation.¹ So companies that last submitted their plans for shareholder approval in or before 2012 should review them to determine if shareholder approval is required in 2017 in order to remain compliant with section 162(m). In addition, companies that have gone public through an IPO since (and including) 2013 should evaluate whether the section 162(m) post-IPO transition period applicable to their incentive compensation plans has expired, such that the plans will need shareholder approval of their material terms for section 162(m) purposes. The material terms include (i) the employees eligible to receive compensation under the plan; (ii) a description of the

business criteria on which the performance goals may be based; and (iii) the maximum amount of compensation the company can pay an employee under the plan based on the achievement of performance goals.

- **Director Limits:** In the *Calma v. Templeton* case against Citrix Systems, the court held that the business judgment rule does not protect directors' decisions in setting their own compensation. Instead, these decisions are subject to review under the "entire fairness" standard, which places the burden on the directors to prove their compensation was entirely fair — not only in amount but also in the process by which it was determined. As a result of *Calma* and other similar cases, companies should consider applying meaningful limitations on director compensation and submitting those limitations to shareholders for approval, which then protects directors' determinations under the business judgment rule. A typical approach is asking shareholders to approve special limits for directors under the company's incentive compensation plans that are less than the 162(m) compensation limits that apply to employee participants in the plans.² Companies currently without such limits in their plans should consider adopting limits this year, especially if the companies intend to submit the plans for shareholder approval of additional shares or to maintain the plans' section 162(m) compliant status.
- **Withholding:** Earlier this year, the Financial Accounting Standards Board adopted rules, effective for annual reporting periods beginning after December 15, 2016, that will permit companies to net settle equity awards for withholding purposes above the minimum statutory tax rate (up to the maximum statutory tax rate) without subjecting the awards to liability (mark-to-market) accounting. Companies should consider amending their equity plans and current award agreements, and approving new form award agreements, to provide additional flexibility for share withholding above the minimum statutory rates.
- **Clawbacks:** In order to allow companies to claw back compensation under possible Dodd-Frank final clawback rules (see below), or pursuant to misconduct under other clawback policies that might be adopted in the future, companies that have not already done so should consider adding provisions in their incentive compensation plans and agreements that provide that all awards made thereunder are subject to such clawback policies.
- **Proxy Advisory Policies:** If companies plan to submit their equity plans for shareholder approval, they should review the policy guidelines of Institutional Shareholder Services (ISS), Glass Lewis and other proxy advisors and institutional investors with respect to equity plan terms, and consider revising the plans to remove such things as evergreen share authorizations, option repricings without shareholder approval, liberal share-counting and single-trigger change in control vesting accelerations.

Whistleblowing Protections

Over the past few years, the Securities and Exchange Commission (SEC) increasingly has focused on confidentiality provisions, severance and release agreements and other employee-related agreements that potentially prevent employees from reporting legal violations to the SEC. Companies should review their company policies, handbooks, employment and severance arrangements, and release agreements to ensure they do not prohibit whistleblowing or cooperating or communicating with a governmental agency.

Other Action Items

- **Peer Groups:** Companies should consider informing ISS of any changes the company has made to its benchmarking peer group, to give ISS an opportunity to consider the company's changes in

constructing its peer group. This may be increasingly relevant because ISS recently announced it will use new financial performance metrics in its qualitative pay-for-performance analysis.³ Beginning with proxies filed on or after February 1, 2017, ISS will evaluate a company's performance relative to peers on six financial metrics (rather than just total shareholder return (TSR)), specifically a weighted average of: return on equity; return on assets; return on invested capital; revenue growth; EBITDA growth; and cash flow (from operations) growth.⁴ Each will be analyzed on a three-year basis. The submission window will close on December 9.

- Compensation Advisor Independence: As has been required under Dodd-Frank since 2013, compensation committees must consider the six independence factors set forth in the New York Stock Exchange's and Nasdaq's listing standards prior to selecting or receiving advice from any compensation consultant, legal counsel or other adviser who provides advice to the compensation committee.
- Compensation Risk Assessment:
 - Compensation committees should review management's evaluation of the company's compensation policies and practices, and management's assessment of whether the policies and practices encourage risk taking that is reasonably likely to have a material adverse effect on the company, and the company's proxy disclosure regarding such "pay risk." In the current environment and in view of recent events, in making these pay-risk assessments and reviews, management and committees should keep in mind that pay plans for rank-and-file employees, as well as senior employees, need to be reviewed, and that risks to a company's reputation can have a material adverse effect.
 - In addition, based on proposed rules issued earlier this year under Section 956 of Dodd-Frank, certain financial institutions may be prohibited from maintaining incentive-based compensation arrangements that encourage inappropriate risks that could lead to material financial loss. Covered institutions should consider reviewing the responsibilities of their compensation committees and risk-management, risk-oversight and internal-control personnel to ensure the design, approval, monitoring and review of incentive-based compensation arrangements will comply with the statutes and rules.⁵ However, as noted below, these rules ultimately may not be finalized or may be revised before adoption.
- Employment and Compensation Arrangements and Agreements: Companies should review individual employment and compensation arrangements and agreements (e.g., employment or severance agreements) to determine whether the arrangements and agreements are subject to renewal or extension in the coming year, and if so, on what terms.

Updates on Upcoming Issues

In 2015 and 2016, the SEC issued proposed or final Dodd-Frank rules on various compensation-related matters, including clawbacks, CEO ratio disclosure, pay-versus-performance and hedging disclosures, as follows:

- Clawbacks: In July 2015, the SEC issued proposed rules that would direct national securities exchanges and associations (including NYSE and Nasdaq) to establish listing standards that require public companies to adopt, implement and disclose a compensation clawback policy providing for recovery of excess incentive-based compensation from current and former executive officers.⁶

- **CEO Pay-Ratio Rules:** In August 2015, the SEC adopted final rules requiring companies to disclose their CEO and median compensated employee pay ratio. The rules are effective for fiscal years beginning on or after January 1, 2017, so the CEO pay ratio disclosure will not be required until proxies filed in 2018. However, companies subject to these rules should begin evaluating their ability to comply with the rules and their disclosure strategies.⁷
- **Pay-versus-Performance:** In April 2015, the SEC issued proposed rules that would require companies to include a new Pay-versus-Performance table in proxy statements. The table will show the amount of compensation paid to the company's CEO and other named executive officers, cumulative TSR, and TSR of a peer group over each of the five most recent fiscal years (three years for smaller reporting companies). The rules also would require companies to use the values presented in the table to describe the relationship between executive compensation and the company's performance, and between the company's performance and its peer group's performance.⁸
- **Hedging:** In February 2015, the SEC issued proposed rules that would require companies to disclose in their annual proxies whether any employee or director is permitted to purchase any financial instruments or enter into other arrangements designed to hedge or offset any decrease in the market value of the company's equity securities.

As we have noted in prior *Client Alerts*,⁹ Republicans will control the Presidency and Congress beginning in January. President-Elect Donald Trump previously criticized Dodd-Frank, even suggesting he would consider repealing it. Congressional repeal of Dodd-Frank in part or in whole, or a newly constituted SEC reconsidering any of the SEC's proposed or final Dodd-Frank rules, could affect some or all of these executive compensation-related rules. Whether (or when) any action will be taken on any of these rules is unclear; we therefore recommend that companies continue monitoring and preparing for these upcoming requirements.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

[Michelle L.C. Carpenter](#)
 michelle.carpenter@lw.com
 +1.213.891.7857
 Los Angeles / Orange County

[James D.C. Barrall](#)
 jim.barrall@lw.com
 +1.213.891.8342
 Los Angeles

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Endnotes

- ¹ Section 162(m) of the Internal Revenue Code generally limits deductions for compensation paid to certain executive officers to US\$1 million each per year, unless the compensation is exempt from the cap as "qualified by a publicly-held corporation performance-based compensation."
- ² In *Calma*, the parties reached a settlement under which Citrix Systems agreed to amend its equity compensation plan to incorporate a US\$795,000 cap on the value of equity awards that may be awarded to each non-employee director in any one year.
- ³ ISS' qualitative pay-for-performance analysis compares the issuer's CEO pay and financial performance ranking relative to a peer group defined by ISS.
- ⁴ According to a press release issued by ISS announcing this change, these additional financial measures will supplement its "continued use of total shareholder return as a key metric for assessing corporate performance in the context of evaluating executive compensation".
- ⁵ See previous discussions in Latham & Watkins *Client Alert* Numbers 1177, "[Federal Agencies Propose Rules on Dodd-Frank Incentive Compensation Requirements for Financial Institutions](#)," April 20, 2011, and 1962, "[Revised Rules on Dodd-Frank Incentive Compensation Requirements for Financial Institutions Proposed](#)," May 4, 2016.
- ⁶ See previous discussion in Latham & Watkins *Client Alert* Number 1862, "[How to Navigate the SEC's Proposed Mandate on Clawbacks](#)," August 4, 2015.
- ⁷ See previous discussions in Latham & Watkins *Corporate Governance Alert*, "[SEC Has Issued Proposed CEO Pay Ratio Disclosure Rules](#)," September 2013; and Latham & Watkins *Client Alert* Numbers 1864, "[SEC Adopts CEO Pay Ratio Disclosure Rules](#)," August 12, 2015, and 2026, "[New SEC Staff Guidance on CEO Pay Ratio Disclosure Rules – Determining the Median Employee](#)," October 31, 2016.
- ⁸ See previous discussion in Latham & Watkins *Corporate Governance Commentary*, "[New SEC Rules on Pay versus Performance](#)," May 5, 2015.
- ⁹ See previous discussion in Latham & Watkins *Client Alert* Number 2033, "[Examining the Impact of the 2016 US Elections on Executive Compensation](#)," November 14, 2016.