Compensation: ISS Concerns and Mandates (an Annual Program)

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Housekeeping: About Anthony "Tony" Eppert

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- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve the substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- At Andrews Kurth Kenyon LLP, we have a holistic and full-service approach to compensation matters, that considers all substantive areas of compensation, including:

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Housekeeping: Upcoming 2017 Webinars

- Upcoming 2017 webinars:
  - Equity Plans & Award Agreements: The Training Course (2/9/2017)
  - Compensation Committees: A Look at Liability & Fiduciary Issues (3/9/2017)
  - Compensatory Arrangements within Partnerships and LLC (4/13/2017)
  - Designing Equity Compensation Abroad (5/11/2017)
  - Expatriate & Secondment Agreements: Top 10 Issues to Consider (6/8/2017)
  - Pay Ratio Disclosure Rules: The A-Z Training Course (7/13/2017)
  - Trends in Designing Performance-Based Equity Awards (8/10/2017)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/14/2017)
  - How to Properly Design a Nonqualified Deferred Compensation Plan (10/12/2017)
  - Navigating Employee v. Independent Contractor Classifications (11/9/2017)
  - Sharing the Dream: M&A Transactions & Retaining Key Employees (12/14/2017)

- Upcoming 2018 webinars
  - To be determined
  - Suggestions welcomed!

Purpose of this Presentation

- The purpose of this presentation is to discuss Institutional Shareholder Services ("***ISS***") with respect to compensatory matters

- To that end, this presentation covers:
  - Influence of ISS with respect to last proxy season,
  - The ISS framework,
  - ISS updates for the 2017 proxy season,
  - Our experiences on certain select issues, and
  - Action items to consider

Influence of ISS: Select Data Points from Last Proxy Season

- According to Alliance Advisors LLC, there were approximately 2,434 say-on-pay proposals on the proxy ballots, of which:
  - Approximately 1,920 ballots passed (or 98.4%),
  - Approximately 32 ballots failed (or 1.6%), and
  - Approximately 482 ballots were pending or undisclosed as of the Alliance data sweep

- According to the same data report, ISS recommended "Against" 207 of the 1,952 say-on-pay proposals that had voting results
  - This means that ISS recommended an "Against" approximately 10.6% of the time
  - This also means that ISS was successful in its recommendation approximately 15.5% of the time

Influence of ISS: Select Data Points from Last Proxy Season (cont.)

- According to Alliance Advisors LLC, there were approximately 600 proposals to amend equity incentive plans on the proxy ballots, of which:
  - Approximately 438 ballots passed (or 99.1%),
  - Approximately 4 ballots failed (or 0.9%), and
  - Approximately 158 ballots were pending or undisclosed as of the Alliance data sweep

- According to the same data report, ISS recommended "Against" 136 of the 442 proposals that had voting results
  - This means that ISS recommended an "Against" approximately 31% of the time
  - This also means that ISS was successful in its recommendation approximately 2.9% of the time

- Caution
  - For those under the impression that the above statistics are not "all that bad," keep in mind that a "no" recommendation from ISS generally results in 25% to 35% less shareholder support than companies with "yes" recommendations

About ISS

- From the compensatory perspective, the framework of ISS is built around the following 5 global principles :
  - Maintain appropriate pay-for-performance alignment, with an emphasis on long-term shareholder value;
  - Avoid pay-for-failure arrangements or risk of such arrangements;
  - Maintain an independent compensation committee;
  - Provide clear and comprehensive compensation disclosures; and
  - Avoid inappropriate pay to non-executive directors (*i.e.*, to ensure that pay does not compromise independence)

General Voting Guidelines

- Vote against say-on-pay proposals if:
  - There is a misalignment between CEO pay and performance of the company (*i.e.*, pay-for-performance),
  - The company maintains significant problematic pay practices, or
  - The Board exhibits poor communication and responsiveness to its shareholders

- Vote against or withhold from members of the compensation committee (and possibly the full board) if:
  - There is no say-on-pay vote on the ballot and an against vote would have otherwise been warranted due to any of the above,
  - The prior say-on-pay proposal received less than 70% support of the votes cast and the Board failed to adequately respond,
  - The company has recently practiced or approved a problematic pay practice

- For equity-based compensation plan proposals, see Slide 14 for the applicable rules. Additionally, vote against the proposal if certain conditions exist, including:
  - There is a liberal change-in-control definition,
  - The plan is a vehicle for problematic pay practices,
  - The plan creates a significant pay-for-performance disconnect,
  - The plan allows for repricing without shareholder approval, or
  - Any other features are present that are determined to have a significant negative impact on the interests of the shareholders

Board Communications

- In evaluating an item on a ballot, ISS will consider the Board's responsiveness to investor input and engagement on compensation issues

- Bad facts include:
  - Failure to respond to a majority-supported shareholder proposal on executive pay;
  - Failure to "adequately" respond to a prior say-on-pay proposal that received less than 70% of the votes cast

- Addressing this latter point, ISS will evaluate:
  - The company's response, including:
    - Whether the company adequately addressed and disclosed engagement efforts with major institutional shareholders on issues giving rise to the low support,
    - Whether specific actions were taken to address the issue, and
    - Whether any other actions were taken by the Board
  - Whether the issues raised are recurring or isolated;
  - The company's ownership structure; and
  - Whether support was less than 50% (which would require the highest degree of responsiveness)

Problematic Pay Practices

- There are numerous problematic pay practices that ISS will evaluate on a case-by-case basis to determine whether such are contrary to a performance-based pay philosophy, including:
  - Multi-year guarantees of pay,
  - Excessive new-hire packages,
  - Incentives that motivate excessive risk-taking (discussed on next slide),
  - Abnormally large bonus payouts without performance linkage or proper disclosure,
  - Excessive perquisites,
  - Excessive severance and/or change in control provisions (*e.g.*, single triggers, new or materially amended agreements containing excise tax gross-ups, etc.),
  - Dividends or dividend equivalents paid on unvested performance shares or units,
  - Internal pay disparity (*i.e.*, excessive differential between CEO total pay and that of the next highest paid NEO), and
  - Repricings without prior shareholder approval

Problematic Pay Practices (cont.)

- However, the following problematic pay practices are deemed "significant," the presence of which will likely result in an adverse recommendation from ISS:
  - Repricing without shareholder approval,
  - Excessive perquisites or tax gross-ups,
  - New or extended executive agreements that provide for:
    - Change-in-control payments exceeding 3x (base + average/target/most recent bonus),
    - Single trigger or modified single trigger change-in-control severance payments (unless there was at least a substantial diminution of duties), and
    - Excise tax gross-ups for change-in-control payments

- The following are examples of incentives that could motivate excessive risk-taking:
  - A single or common performance metric used for short- and long-term plans,
  - Mutli-year guaranteed bonuses,
  - Mega annual grants providing unlimited upside and no downside risk, and
  - High pay opportunities relative to industry peers

- ISS acknowledges that risky incentives can be mitigated with rigorous clawback provisions and robust stock ownership/holding guidelines

Equity Plan Scorecard

- The equity plan scorecard ("***EPS***") was adopted by ISS in 2015 and weighs positive and negative factors around the following 3 pillars:
  - Plan cost,
  - Plan features, and
  - Grant practices

- "Plan cost" means 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***") in relation to peers. Plan cost considers both:
  - SVT on new shares requested, plus outstanding unvested/unexercised grants; and
  - SVT on new shares requested, plus shares remaining for future grants

  (Note: SVT = the estimated cost of shares issued under a company's equity plans, differentiating between full value awards and stock options, where applicable. An ISS proprietary model is used)

- "Plan features" considers:
  - The presence of any single-trigger awards (though performance-based awards could have its vesting schedule adjusted to reflect actual or pro rata performance),
  - Discretionary vesting authority,
  - Liberal share recycling,
  - Lack of minimum vesting periods, and
  - Dividends payable prior to vesting

Equity Plan Scorecard (cont.)

- "Grant practices" considers:
  - The company's 3-year burn rate relative to its industry/market cap peers;
  - Vesting provisions in the most recent CEO equity grants (with a 3-year look-back);
  - The estimated duration of the plan (based on the sum of shares remaining available and the new shares requested, divided by the average annual shares granted during the prior 3 years);
  - The proportion of the CEO's most recent equity grant/awards subject to performance conditions;
  - The existence of any clawback policy;
  - The existence of any post-exercise or post-vesting share-holding provisions

- For S&P 500 and Russell 3000 issuers, each of the above 3 pillars have the following scoring, with 53 points out of 100 potential points required to "pass" (though in practice ISS pushes 56 or 57 points as a recommended pass):
  - Plan cost = 45 potential points
  - Plan features = 20 potential points
  - Grant practices = 35 potential points

Pay-for-Performance

- The purpose of the pay-for-performance analysis is to identify strong/satisfactory alignment between pay and performance over a sustained period. For Russell 3,000 issuers, the requisite inquiry begins with a quantitative test, and if any portion of the quantitative tests indicates a pay-for-performance misalignment, then ISS will use a qualitative test (*i.e.*, to determine whether mitigating factors exist) before making a voting recommendation

- 1st part – Quantitative – Peer group alignment
  - Addresses the degree of alignment between the company's annualized TSR rank and the CEO's annualized total pay rank within a peer group, measured on a relative basis over a 3-year period (**Note:** the new 6 financial metrics discussed on Slide 16 will not be used during 2017 for purposes of the quantitative test, but may be considered for purposes of the qualitative test on the next slide)
  - For purposes of the above, the peer group will generally consist of 14-24 companies, organized by market cap, revenue, GICS industry group, and certain of the company's selected peer group members

- 2nd part – Quantitative – CEO peer group alignment
  - Analyzes the multiple of the CEO's total compensation relative to the peer group median of CEO total compensation

- 3rd part – Quantitative – Absolute alignment
  - Addresses the degree of alignment between the trend in CEO pay and the company's TSR over the prior five fiscal years

Pay-for-Performance (cont.)

- If ISS believes the peer group alignment or absolute alignment demonstrates the existence of significant misalignment of long-term pay-for-performance, then it will analyze the following 11 non-weighted qualitative factors:
  - The ratio of performance-based to time-based equity awards;
  - The overall ratio of performance-based compensation;
  - The completeness of disclosure;
  - Whether performance targets are easily achievable;
  - The application of the compensation committee's use of discretion in determining whether performance metrics are otherwise satisfied;
  - The magnitude of pay opportunities;
  - The company's peer group benchmarking practices;
  - Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
  - Special circumstances relating to attrition or anomalous equity grant practices (*e.g.*, special one-time grants);
  - Realizable and realized pay compared to grant pay; or
  - Any other factors deemed relevant

- Notwithstanding the foregoing, ISS FAQ 21 provides that even in situations where a company received a "low" concern in the quantitative analysis, that ISS will still evaluate such company's incentive programs for problematic incentive designs (*e.g.*, tax gross-ups, etc.)

ISS Updates for the 2017 Proxy Season

- A new factor was added to the Equity Plan Scorecard ("***EPSC***") that addresses the payment of dividends on unvested awards
  - Full points if the equity incentive plan expressly prohibits payment of dividends prior to the underlying award becoming vested (though it is permitted to accrue dividends and pay them upon vesting)
  - This prohibition applies to ALL awards under the equity incentive plan
  - No points if there is no express prohibition (*i.e.*, operational compliance will not suffice)

- Additionally, the vesting factor under EPSC was modified
  - Full points will be provided only if the equity plan specifies a minimum vesting schedule for ALL awards under the equity plan (compared to the prior policy where at least full value awards OR appreciation only awards had to contain a minimum 1 year vesting schedule), subject to a 5% carveout
  - No points if the equity plan provides otherwise, or if award agreements are permitted to provide for a vesting schedule that is less than the above minimum schedule

ISS Updates for the 2017 Proxy Season (cont.)

- Proposals with respect to Section 162(m) amendments AND amendments relating to administrative matters/features
  - Vote in favor of the amendment IF the proposal:
    - Only addresses administrative matters/features, or
    - Only seeks approval for Section 162(m) purposes AND the committee that administers the plan consists of independent and outside directors (as determined by ISS policies)
  - If instead a Section 162(m) proposal is bundled with another proposal, or if the company is presenting the plan to its shareholders for the first time following an IPO, then any ISS recommendation will be applied on a case-by-case basis
- With respect to all other proposals relating to an equity plan or a cash-based incentive plan, ISS will vote on a case-by-case basis, with resulting recommendation based upon:
  - EPSC evaluation and overall impact of amendment(s) – applicable if the proposal requests an increase in the share reserve or the amendment(s) could increase the TSV,
  - EPSC evaluation and overall impact of amendment(s) – applicable if the plan is being presented for the first time after an IPO (and applied without regard to whether an increase in the share reserve is sought), or
  - Overall impact of the amendment(s) (with the EPSC evaluation being shown for information purposes) – applicable if there is NO amendment to increase the share reserve AND it is deemed that the amendment would not increase TSV to employees

ISS Updates for the 2017 Proxy Season (cont.)

- ISS has published a new policy with respect to proposals seeking shareholder ratification of non-employee director compensation
  - In the past, ISS generally had no policy for evaluating non-employee director compensation
  - However, likely in response to *Calma*, a number of non-employee director proposals were submitted to shareholders in 2016 (thus causing ISS to develop a program to analyze such proposals)

- Qualitative factors that will be considered include:
  - Director compensation compared to companies with a similar corporate profile,
  - Any problematic pay practices with respect to non-employee director compensation,
  - Presence of any stock ownership guidelines (*i.e.*, at least 4x the annual cash retainer) or hold requirements applicable to non-employee directors,
  - Vesting schedules with respect to equity awards,
  - The mix between cash and equity compensation,
  - Presence of any meaningful limits on director compensation (*i.e.*, likely a result from the *Calma* case),
  - Presence of retirement benefits and/or perquisites, and
  - The quality of the disclosure addressing non-employee director compensation

- As to proposals with respect to equity plans for non-employee directors, ISS is expanding its qualitative factors to also include the above

ISS Updates for the 2017 Proxy Season (cont.)

- Addressing pay-for-performance and whether there is potential for pay-for-performance misalignment, ISS is adding the following financial metrics (in addition to the current sole financial metric of TSR):
  - Return on equity,
  - Return on assets,
  - Return on invested capital,
  - Revenue growth,
  - EBITDA growth, and
  - Growth in cash flow from operations

- Financial performance will be measured by a weighted average of the above 7 financial metrics (*i.e.*, TSR plus the new 6 financial metrics)
  - Weightings will vary depending on the company's GICS code

- This means that a company's CEO pay will be compared to the three-year financial performance of the weighted average of the above 7 financial metrics

- For the 2017 proxy season, the foregoing will be used by ISS at its discretion only with respect to the qualitative pay-for-performance tests, and the foregoing will not be used for the quantitative pay-for-performance test

Legislative and Regulatory Attention?

- On November 15, 2016, the U.S. Government Accountability Office ("***GAO***") published its findings on the role and influence of proxy advisory firms and SEC oversight of the same (here: http://www.gao.gov/assets/690/681050.pdf)
  - The review by the GAO was requested by a subcommittee of the Senate Committee on Banking, Housing and Urban Affairs
  - The conclusions of the GAO were as one would expect, with ISS and the likes having increased influence

- Corporate Governance Reform and Transparency Act of 2016 (the "***Act***")
  - Found here: https://www.govtrack.us/congress/bills/114/hr5311
  - Received support of the House Financial Services Committee
  - Likely to see similar bills in the near future

- The provisions of the above Act include a requirement that proxy advisors:
  - Register with the SEC,
  - Retain an ombudsman to receive complaints with respect to inaccurate voting information,
  - Disclose potential conflicts of interest, and
  - Provide an opportunity for issuers to review and comment on proposed recommendations by proxy advisors PRIOR to such report being provided to investors

Action Items to Consider

- When setting financial goals under a company's annual incentive program or LTIP for 2017, compensation committees should consider the 6 new ISS financial metrics
  - Especially since such new financial metrics, based on investor feedback to ISS, reflect investor views on how compensation should be analyzed vis-à-vis company performance

- Consider whether to amend the equity incentive plan to:
  - Require a minimum 1-year vesting schedule that would apply to ALL awards under the plan (with a carve out up to 5%),
  - Expressly prohibit the payment of dividends on unvested awards,
  - Create a stand-alone equity plan for non-employee directors, and/or
  - To seek shareholder ratification of non-employee director compensation per the teachings of *Calma* and create "meaningful" sub-limits

- Consider whether any Section 162(m) proposals should be bundled with any other equity incentive plan proposals, or instead, whether such should be stand-alone and separate proposals

Action Items to Consider (cont.)

- With respect to any equity plan amendments to increase the tax withholding rate, such an amendment would be viewed by ISS as administrative (*see* Slide 14)
  - However, for those equity plans with liberal share counting, the foregoing applies only if the amendment stipulates that only the shares netted/withheld up to the minimum tax withholding rate may be recycled (*i.e.*, those shares netted/withheld on the spread between the minimum rate and the maximum rate could not be recycled and must be forfeited)

Don’t Forget Next Month’s Webinar

- Title:
  - Equity Plans & Award Agreements: The Training Course
- When:
  - 10:00 am to 11:00 am Central
  - February 9, 2017

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