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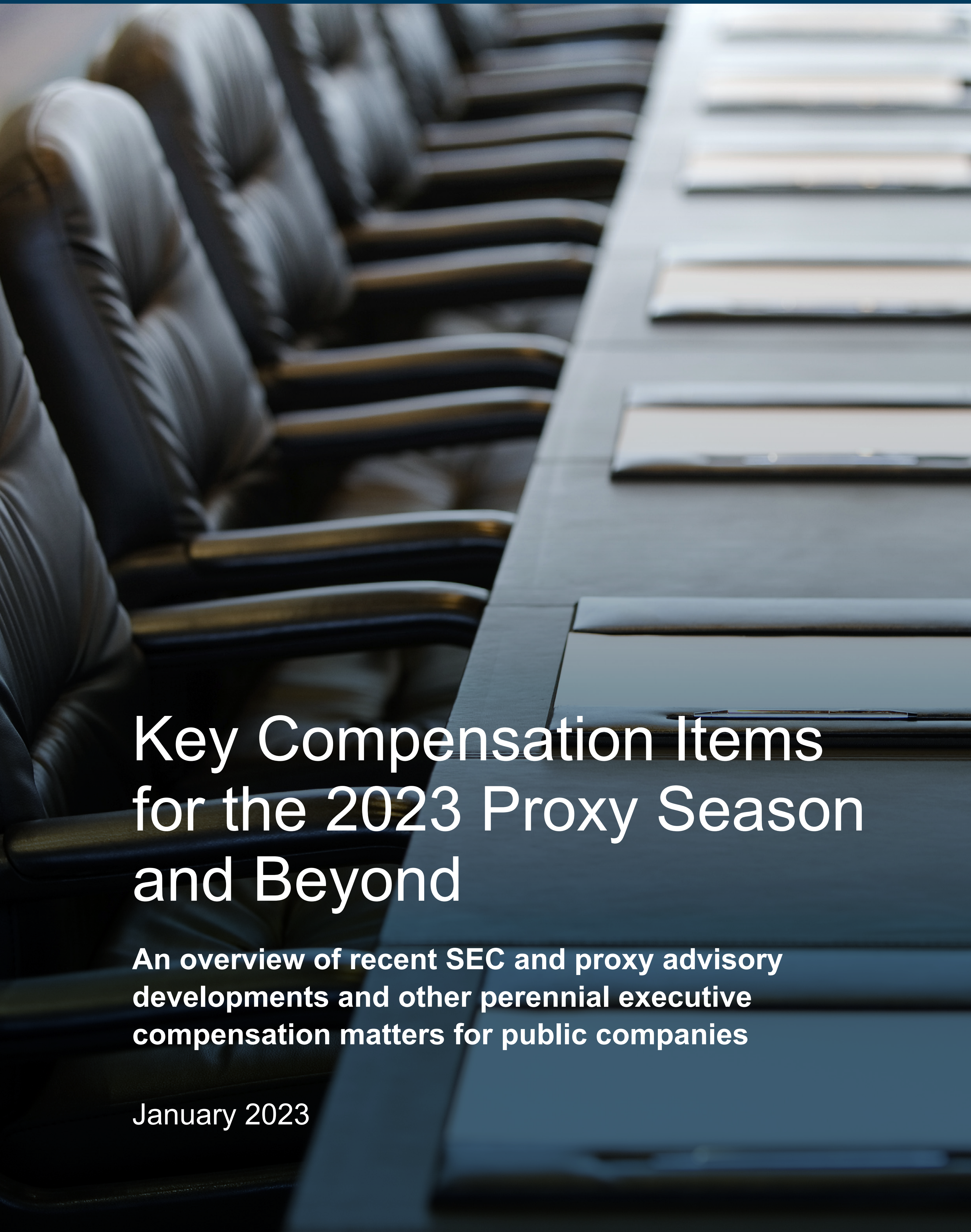

Key Compensation Items for the 2023 Proxy Season and Beyond

An overview of recent SEC and proxy advisory developments and other perennial executive compensation matters for public companies

January 2023

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Introduction

Each year brings new executive compensation rules and considerations, whether based on Securities and Exchange Commission (SEC) rules, developments under the Internal Revenue Code, litigation trends, institutional adviser sentiment, or proxy advisory firm policy updates. As a result, US public companies will need to be on top of the changing executive compensation rules when preparing their proxy statements and annual meeting agendas. We provide an overview of key regulatory developments, including final rules from the SEC on pay versus performance disclosures, clawback policies and 10b5-1 insider trading plans, updates to Institutional Shareholder Services (ISS) and Glass Lewis voting guidelines, considerations relating to CEO pay ratio disclosures and equity plan proposals and other important proxy season housekeeping and reminders, including as they relate to say on pay and the say on pay frequency vote and compensation advisor independence and risk assessments. Companies should consult with their legal, tax, and accounting advisers to confirm compliance with disclosure requirements, tax law developments, recent litigation trends, and other considerations that will require continued attention in 2023 and beyond.

Pay Versus Performance Disclosure

In August 2022, the SEC issued final rules requiring publicly traded companies to provide both tabular and narrative and/or graphical disclosure of the relationship between executive compensation "actually paid" by the company to its named executive officers and the company's performance over a specified time period. Pay versus performance disclosure will be required on any proxy or information statement covering a fiscal year ending on or after December 16, 2022. The new disclosure is not required for emerging growth companies (EGCs), foreign private issuers, or registered investment companies. For companies required to provide pay versus performance disclosure in 2023, please refer to the discussion of the rules in this Latham Client Alert.

Proxy Action Item
The new pay versus performance disclosure obligations require advance planning and effort for the 2023 proxy season. For example, companies will need to undertake a number of new fair value calculations under Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 718, Compensation—Stock Compensation (ASC Topic 718). Companies should begin to consider how they intend to comply with the new rules and prepare to provide complete and effective pay versus performance disclosure for the coming proxy season.

Clawbacks

In October 2022, the SEC adopted final rules directing the stock exchanges to issue rules requiring publicly traded companies to implement policies for the recovery of incentive compensation that is erroneously received by current or former executive officers during the three-year period preceding the date the issuer is required to prepare an accounting restatement, without regard to any misconduct. The new clawback policies will apply to "Big R" restatements as well as "little r" restatements. Issuers will likely be required to implement clawback policies by the end of 2023 or early 2024. The new clawback policies will apply to nearly all listed issuers, including smaller reporting companies (SRCs), EGCs, and foreign private issuers. For more information regarding navigating the SEC's new clawback rules, please refer to the discussion of the rules in this Latham Client Alert.

Proxy Action Item

Companies should begin to review their existing clawback policies to better understand what changes will be required. In addition, companies should review their current incentive compensation plans and agreements and add provisions to any new plans and award agreements that such awards will be subject to any such clawback policies adopted by the company in the future.

Rule 10b5-1 Updates

On December 14, 2022, the SEC adopted final rules regarding amendments to Rule 10b5-1 and related insider trading disclosure requirements. The rules impose new conditions on Rule 10b5-1 trading plans that will become effective February 27, 2023, including minimum "cooling off" periods for directors, officers, and persons other than the company. Amended Rule 10b5-1 also provides that, for persons other than the company, only one trading plan is permitted at a time, subject to a few limited exceptions, including for plans that authorize sell-to-cover transactions to satisfy tax withholding obligations incident to the vesting of certain equity awards, such as grants of restricted stock and restricted stock units, provided that such sell-to-cover arrangements authorize the sale of only enough securities necessary to satisfy tax withholding obligations arising exclusively from the vesting of a compensatory award. This exception does not apply to sales incident to the exercise of stock options.

Under the new rules, companies must provide quarterly disclosures, beginning with the Form 10-Q for the second quarter of 2023 for calendar-year companies, for each of their directors and officers regarding any adoption, modification, or termination of Rule 10b5-1 plans or any other written trading arrangements that do not qualify for the Rule 10b5-1 affirmative defense, including a description of the material terms of each plan other than pricing terms. Companies must provide annual disclosures, beginning no earlier than the Form 10-K and proxy statement to be filed in 2024 for calendar-year companies, regarding their insider trading policies and the timing of stock option awards in relation to disclosure of material nonpublic information. This includes tabular disclosure of options granted to named executive officers within four business days before or one business day after filing a periodic report or a current report on Form 8-K announcing material nonpublic information. In addition, effective February 27, 2023, dispositive gifts by Section 16 reporting persons will be reportable on Form 4 within two business days and, effective April 3, 2023, Forms 4 and 5 will feature a mandatory checkbox to indicate whether a reported transaction occurred under a Rule 10b5-1 plan, and if so, the plan's adoption date.

For more information regarding the SEC's new Rule 10b5-1 plan and disclosure requirements, please refer to the discussion of the rules in this Latham Client Alert.

Proxy Action Item

Companies that currently have sell-to-cover arrangements will want to review their existing arrangements to assess compliance with the new rules and any related disclosure requirements.

Proxy Advisory Policy Updates

ISS and Glass Lewis recently released updates to their 2023 voting policies (along with updates to ISS's compensation and equity plan-related FAQs). The Glass Lewis voting guidelines are effective for all companies with annual meetings on or after January 1, 2023, and the ISS voting guidelines are effective for all companies with annual meetings on or after February 1, 2023. Below is a summary of certain compensation-related policy changes and updates that companies should consider while preparing for the 2023 proxy season.

Key ISS Updates

Severance for Terminations Not Described as Involuntary Now a Problematic Pay Practice	ISS has updated its 2023 policy guidelines to include its view, as currently described in its U.S. Compensation Policies FAQs, that severance payments received by an executive when the termination is not clearly disclosed as involuntary (e.g., a termination without cause or a resignation for good reason) is a problematic pay practice that carries significant weight in ISS's overall consideration and may result in adverse vote recommendations. ISS also clarified that with respect to its evaluation of the problematic pay elements of a company's executive compensation program, the evaluation is not confined to "non-performance-based pay elements" and further clarified that the examples of problematic pay practices identified in the policy are not an exhaustive list of practices that may result in adverse vote recommendations.
ISS Moves to a "Value-Adjusted Burn Rate" Calculation	Effective for meetings on or after February 1, 2023, ISS will use a "Value-Adjusted Burn Rate" calculation in its determination of burn-rate benchmarks utilized in Equity Plan Scorecard evaluations. Historically, ISS has utilized a "Volatility-Based Adjusted Burn Rate" calculation, which is used as an estimate for the rate at which a company is granting new shares underlying equity awards, using a full-value multiplier based on the company's three-year stock price volatility to account for the difference in value between a stock option and a full-value share (i.e., restricted stock units and restricted stock). The Value-Adjusted Burn Rate calculation will be based on the actual stock price for full-value awards, and the Black-Scholes value for stock options, which, according to ISS, will provide a more precise measure of the value of recently granted equity awards than the prior calculation based on an approach using a full-value multiplier. The Value-Adjusted Burn Rate will be calculated as follows: ((# of options * option's dollar value using a Black-Scholes model) + (# of full-value awards * stock price)) / (Weighted average common shares * stock price). Additionally, Value-Adjusted Burn Rate benchmarks will be calculated as the greater of: (1) an industry-specific threshold based on three-year burn rates within the company's GICS group segmented by S&P 500, Russell 3000 index (less the S&P 500), and non-Russell 3000 index; and (2) 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. Year-over-year burn-rate benchmark changes will be limited to a predetermined range above or below the prior year's burn-rate benchmark.

Clawback Provisions	ISS did not make changes to its policy regarding clawbacks this year in light of the SEC's new clawback rule. However, ISS did clarify that to receive credit under its Equity Plan Scorecard for an equity plan proposal, companies must include both time-based and performance-based equity awards in their clawback policy, even though the new SEC rule generally exempts time-based awards.

Key Glass Lewis Updates

Long-Term Incentives	Glass Lewis updated its 2023 voting guidelines to increase the threshold for the minimum percentage of executive long-term incentive grants that should be performance-based from 33% to 50%. Beginning in 2023, Glass Lewis will raise concerns in its analysis of executive compensation programs that provide less than 50% of an executive's long-term incentive awards in the form of performance-based awards. Glass Lewis notes that it may refrain from a negative recommendation in the absence of other significant issues with the program's design or operation, but a negative trajectory in the allocation amount may lead to an unfavorable recommendation.
"Mega-Grants"	Glass Lewis clarified its approach for evaluating certain outsized awards (so-called "mega-grants"), indicating that it will consider whether the awards present concerns such as excessive quantum and lack of sufficient performance conditions and/or are excessively dilutive, among others. Glass Lewis will generally recommend against the chair of the compensation committee when such mega-grants have been granted and include any of the aforementioned concerns.
One-time Awards and Front-Loaded Awards	Glass Lewis has expanded its discussion regarding what is considered reasonable disclosure in terms of onetime awards (which are not necessarily mega-grants). Specifically, Glass Lewis included that it expects a discussion surrounding the determination of quantum and structure for such awards. Glass Lewis also expressed concerns with respect to front-loaded incentive awards, noting that such awards restrain the ability of the board of directors or compensation committee to respond to unforeseen factors during the term of the awards.

Company Responsiveness (for Say-on-Pay Vote)	Glass Lewis generally looks for robust disclosure regarding a company's responsiveness to a say-on-pay support level below 80%. For 2023, Glass Lewis clarified that, when assessing the level of opposition to say-on-pay proposals, it may further examine the level of opposition among disinterested shareholders as an independent group. In its evaluation of a company's response to low support levels, Glass Lewis expanded its discussion of what is considered robust disclosure, including a discussion of the reasons for not implementing changes to the executive compensation pay decisions that drove low support and the intentions going forward.
Pay for Performance	Glass Lewis clarified that its pay for performance methodology is not impacted by the SEC's new pay versus performance disclosure rules. However, Glass Lewis specified that the new rule may be reviewed in its evaluation of executive pay programs on a qualitative basis.
Exercise of Discretion Over Incentive Compensation Payouts	Glass Lewis added a new discussion regarding the exercise of compensation committee discretion on incentive payouts. Glass Lewis noted that it recognizes the importance of the compensation committee's judicious and responsible exercise of discretion over incentive pay outcomes to account for significant events that would otherwise be excluded from performance results of selected metrics of incentive programs. Glass Lewis said that it believes that companies should provide a thorough discussion of how such events were considered in the committee's decisions to exercise discretion or refrain from applying discretion over incentive pay outcomes.
Clawback Provisions	Glass Lewis revised its discussion on clawback policies to reflect the SEC's new clawback rules discussed above. During the period between the announcement of the SEC's rules and the effective date of the new listing requirements, Glass Lewis will continue to raise concerns for companies that maintain clawback policies that only meet the requirements set forth by Section 304 of the Sarbanes-Oxley Act. However, Glass Lewis noted that disclosure by companies of early efforts to meet the standards of the final rules may help to mitigate concerns.

Proxy Action Item

Companies should consider how ISS's and Glass Lewis' voting policies may affect their proxy proposals and executive compensation disclosure. Enhanced disclosure and additional planning prior to a proxy filing may be appropriate in certain cases to counter a potential adverse recommendation.

Focus on Executive Severance Payments and Terminations

In light of ISS's increased focus on disclosure regarding executive termination arrangements discussed above, companies should consider the disclosure relating to executive terminations and corresponding severance payments. ISS's view is that severance is intended for involuntary or constructive job loss and is not appropriate for executives who voluntarily resign or retire. ISS has noted that indicating an executive "stepped down" or that the executive and board "mutually agreed" on a departure does not clearly indicate an involuntary termination, and the payment of severance without disclosure of a corresponding involuntary termination is a problematic pay practice under ISS policies that will likely trigger an adverse vote recommendation. In order to enable investors to fully evaluate severance payments, a company should disclose both the type of termination (e.g., termination without cause or resignation for good reason) as defined under the agreement as well as the provision by which severance payments were made under the agreement.

Proxy Action Item
Companies should carefully consider disclosure related to executive departures, especially when they have provided severance payments.

CEO Pay Ratio

Pursuant to the SEC rules requiring companies to disclose their CEO and median-compensated employee pay ratio, a company is only required to identify its median employee once every three years, unless there has been a change to its employee population, employee compensation arrangements, or the median employee's circumstances that the company reasonably believes would result in a significant change to its pay ratio disclosure. Note that the rule does not, however, preclude a company from identifying a new median employee each year, should the company choose to do so. Each public company subject to the CEO pay ratio requirement[1] will need to make an annual determination as to whether its median employee may continue to be used in years two and three. Therefore, a company should take the following key steps in making that annual determination:

Step 1	***Has the company previously disclosed a CEO pay ratio?*** If the answer is yes, move to Step 2. For companies required to disclose their CEO pay ratio for the first time during 2023, please refer to the discussion of the rules governing the calculation of the ratio in this Latham Client Alert. Companies should also note that once the same median employee has been used for three years, the company will need to identify a new median employee in accordance with the SEC rules.
Step 2	***Has there been a significant change in the company's employee population or compensation arrangements that would result in a significant change to the company's pay ratio disclosure?*** If the answer is no, move to Step 3. If the answer is yes, then a new median employee must be identified. The company will need to disclose the fact that it has identified a new median employee and include the required information regarding the assumptions used in that calculation.
Step 3	***Have the median employee's circumstances changed (such as a departure, promotion, or significant change to compensation) in a manner that would result in a significant change to the company's pay ratio disclosure?*** If the answer is no, move to Step 4. If the answer is yes, and it is no longer appropriate for the company to use the median employee because there has been a change in the original median employee's circumstances (such as a departure, promotion, or significant change to compensation), the company may elect to use another employee whose compensation is substantially similar to the original median employee based on the compensation measure used to select the original median employee. Alternatively, the company may elect to run a full analysis to identify a new median employee.
Step 4	***Has there been no significant change to the company's employee population or compensation arrangements, and have the median employee's circumstances remained the same?*** If the answers to the questions in Step 2 and Step 3 are no, and if the company will continue to use the same median employee, the company must disclose this information in its CEO pay ratio disclosure and briefly describe that there have been no changes that the company reasonably believes would significantly affect its pay ratio disclosure. As a reminder, the total annual compensation of the median employee must still be recalculated for the previous fiscal year, and the CEO pay ratio must be recalculated based on the CEO's previous fiscal year compensation. In preparing for their 2023 proxy statements, companies may consider including supplemental disclosures that they believe will provide helpful context to investors, such as adding language to contextualize the pay of rank-and-file employees and more broadly discussing human capital practices. However, supplemental CEO pay ratios are still relatively uncommon.

Proxy Action Item

Although most companies will not need to identify a new median employee for purposes of their CEO pay ratio disclosure every year, all companies will need to determine annually whether a new median employee should be identified and include the appropriate required disclosure based on their circumstances.

In addition, companies with two principal executive officers during 2022 will need to determine how they want to calculate the CEO's compensation for purposes of the pay ratio disclosure based on one of the SEC's permitted methods, which are described in detail in this Latham Client Alert.[2]

Equity Plan Matters

While some companies are already planning to include equity plan proposals in their annual meeting agendas during 2023, whether to adopt new plans, obtain additional shares, or for other reasons, all companies should consider reviewing the following items annually with respect to their equity plans:

- **Plan Expiration Dates.** Companies should review their existing equity plans to determine whether the plans are subject to expiration in the coming year, and whether they should take action at the 2023 annual meeting to extend the plan or adopt a new plan prior to any such expiration. The best practice is to seek approval of a new plan or plan extension in the year prior to the year of expiration, if possible.
- **Share Reserves.** Companies should review their existing equity plans to determine whether additional shares will be needed and when. Companies can then strategically plan the best approach to seek stockholder approval of additional shares.
- **Other Plan Limitations.** Companies should take the opportunity to review individual award limits and determine whether they are still able to administer their equity compensation programs within such individual award limits. Companies should also review compliance with minimum vesting provisions.
- **Form 10-K Disclosure.** Companies should annually review the footnote disclosure in their Annual Report on Form 10-K regarding equity plans for accuracy and consistency with plan documents. This can be especially important in a year in which an equity plan proposal is on the calendar, as ISS may default to a company's Form 10-K disclosure in its evaluation if all necessary information is not included in the proposal. If a company grants performance awards, it is helpful to ensure that burn rate information is included in the Form 10-K as suggested per ISS policies so that ISS will consider performance awards accurately in its burn rate analysis.

Companies that are already planning to include equity plan proposals in their annual meeting agendas during 2023 to adopt new plans, obtain additional shares, or for other reasons will also want to consider the following items when crafting their new or amended equity plans and the related proposals, in addition to consideration of the proxy advisory firm voting policies on equity plan proposals:

- **Adoption of a New Plan or Restatement of an Existing Plan.** Companies that have identified a need to seek stockholder approval for additional shares or other reasons will want to consider whether to restate an existing plan or, potentially, adopt a new plan. Adopting a new plan may present certain advantages, especially with respect to application of proxy advisory firm policies regarding certain changes that may be viewed as adverse to stockholders if implemented through a restatement (e.g., removal of individual award limits). However, adopting a new plan may necessitate the drafting of new award agreements and changes to existing administrative systems. If a company decides to adopt an amendment to an existing plan (as opposed to a restatement), it will want to include either a specific cross-reference to the public filing of the existing plan or the existing plan itself in the proxy, as ISS may recommend against a plan amendment (it views a summary of the plan alone as insufficient to enable investors to make an informed evaluation of the full equity plan, as proposed to be amended).
- **Director Compensation Provisions.** Companies may wish to include specific dollar-denominated director compensation limits or formula director awards in their equity plans, or even adopt a separate formulaic, stockholder-approved director plan, to address increased risk of legal attacks on director compensation in their equity plans. Companies should also carefully review any disclosure in their equity plan proposals related to potential awards to directors.
- **Clawbacks.** As mentioned above, in October 2022, the SEC adopted final rules requiring publicly traded companies to implement policies for the recovery of incentive compensation that is erroneously received by current or former executive officers during the three-year period preceding the date the issuer is required to prepare an accounting restatement, without regard to any misconduct. In order to allow companies to claw back compensation under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) final clawback rules, or pursuant to misconduct under other clawback policies that might be adopted in the future, companies that have not already done so should add provisions in their incentive compensation plans and agreements providing that all awards made thereunder are subject to such clawback policies.

Proxy Action Item
Companies should carefully evaluate a number of plan provisions and drafting considerations if an equity plan proposal is on their annual meeting agenda.

Reporting Status

EGCs Should Confirm Continuing EGC Status or Date of Loss of Status

Companies that previously qualified as an EGC should review whether they will remain in EGC status for 2023. EGCs are given a temporary transition period during which they are required to comply with scaled disclosure requirements. A company will remain an EGC until the earliest of:

- the last day of any fiscal year in which the company earns $1.235 billion or more in revenue;
- the date when the company qualifies as a “large accelerated filer,” with at least $700 million in public equity float;

- the last day of the fiscal year ending after the fifth anniversary of the initial public offering (IPO) pricing date; or
- the date of issuance, in any three-year period, of more than $1.0 billion in non-convertible debt securities.

EGC status will ordinarily terminate on the last day of a fiscal year.[3]

Potential New Requirements if Exiting EGC Status

An EGC generally must hold a say-on-pay vote no later than one year after it ceases to qualify as an EGC. However, if a company has been an EGC for less than two years after its IPO, the company has up to three years after the IPO to hold the vote, though a say-when-on-pay vote may need to occur earlier. 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.

Notably, companies that lose EGC status (and do not qualify as an SRC) will also need to revise the compensation disclosure in their proxy statements to incorporate a full compensation disclosure and analysis (as opposed to complying with the reduced compensation disclosure requirements that apply to EGCs). As discussed above, EGCs are required to include CEO pay ratio disclosure related to compensation during the first year after exiting EGC status. For example, if a company ceases to be an EGC on December 31, 2022, it will be required to include CEO pay ratio disclosure in its proxy statement filed in 2024 that includes 2023 compensation disclosure. Additionally, a company that loses EGC status will also need to include the new pay versus performance disclosure in its first proxy statement after it ceases to qualify as an EGC.

Proxy Action Item

Companies that are or have been EGCs should reconfirm their current status and potential exit date to ensure timely compliance with rules that apply once EGC status is lost. In addition, companies should reconfirm whether SRC status may be available following a loss of EGC status.

Consider Applicability of Smaller Reporting Company Thresholds

SRCs are eligible for a number of “scaled disclosure” accommodations under Regulations S-K and S-X, including reduced executive compensation disclosure.[4]

However, Glass Lewis may consider a negative recommendation for compensation committee members if it believes the reduced executive compensation disclosure could substantially impact stockholders’ ability to assess executive pay practices. Separately, ISS will continue to require disclosure that provides stockholders with sufficient information to make an informed say-on-pay vote and otherwise evaluate the compensation program.

Proxy Action Item

Companies that qualify as an SRC may wish to consider the advantages of SRC status, including scaled executive compensation disclosure. Companies should consult with corporate counsel on this decision.

Other Proxy Season Housekeeping and Reminders

2022 Say-on-Pay Vote Response

As always, public companies that conducted a say-on-pay vote in 2022 should consider the results and determine what, if any, changes they should make to executive compensation programs and disclosure. Many companies, particularly those that did not receive strong stockholder support on the say-on-pay proposal, have likely been engaging with stockholders and reviewing their compensation programs. ISS recommends full disclosure of the company's response to a say-on-pay vote of less than 70%, including disclosure related to stockholder outreach, concerns voiced by stockholders, and meaningful company actions taken to address stockholder concerns. Glass Lewis considers a negative recommendation for the current proxy's say-on-pay proposal if the company's response to a say-on-pay vote of less than 80% does not include "robust" disclosure of the company's response. Pursuant to SEC rules, all companies must discuss their response to the previous say-on-pay vote in the compensation, discussion, and analysis (CD&A). However, companies with low stockholder support on a prior say-on-pay vote should consider more fulsome or "robust" disclosure of stockholder outreach and communication efforts — describing what they heard from stockholders, how they responded, and why — since ISS and Glass Lewis will be specifically looking for this information and gauging the strength of these efforts as they formulate their 2023 voting recommendations.

Proxy Action Item

Companies should disclose their stockholder outreach and response to the say-on-pay vote. Companies that received weak support in their most recent say-on-pay vote should pay close attention to their disclosure regarding their stockholder outreach and communication efforts, and any compensation-related actions taken in response to those investor discussions.

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, requesting stockholder 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 stockholders in 2017 will need to do so again in 2023. Companies will want to review and confirm whether a say-on-pay or say-when-on-pay proposal is required in this year's proxy. Glass Lewis will recommend voting against all members of a compensation committee if the board of directors adopts a say-on-pay frequency other than the frequency approved by a plurality of the company's stockholders at the annual meeting. ISS views the board's selection of a say-on-pay frequency that is less frequent than that supported by stockholders in the say-on-pay frequency vote as a problematic practice and may recommend against compensation committee members or the full board of directors. New issuers are required to include the say-on-pay and say-when-on-pay frequency votes in the proxy statement for their first annual meeting after an IPO (unless they qualify as an EGC).

Proxy Action Item

Companies should confirm whether a say-on-pay or say-when-on-pay proposal (or both) are required in 2023. If a say-on-pay vote is required, companies should consult with outside advisers regarding the likelihood of adverse recommendations by proxy advisory firms.

Compensation Adviser 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 advises the compensation committee.

Proxy Action Item

Companies should ensure that a compensation adviser independence analysis is undertaken prior to retaining new compensation advisers. The best practice is to perform such analysis on an annual basis.

Compensation Risk Assessment

Compensation committees should annually review:

- Management's evaluation of the company's compensation policies and practices
- 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
- The company's proxy disclosure regarding such "pay risk"

In the current environment, management and committees undertaking these pay-risk assessments and reviews should keep in mind that pay plans for rank-and-file employees and senior employees need to be reviewed, and that risks to a company's reputation can have a material adverse effect.

Proxy Action Item

Companies should ensure that a compensation risk assessment is undertaken on an annual basis and review SEC disclosures, if any.

Compensation Committee Charter and Compliance

Companies should review the qualifications of their compensation committee members under stock exchange and securities law requirements and reconfirm that their committee membership complies with the requirements under their compensation committee charter and that their proxy disclosure on such points is still accurate.

Companies should also review the duties enumerated in the compensation committee charter to ensure the terms of the charter line up with the committee's actual calendar and responsibilities. Proxy disclosure should be carefully reviewed to ensure it accurately describes the terms of the charter and the compensation committee's activities in setting executive compensation.

Proxy Action Item

Companies should review their compensation committee charter and proxy disclosure to confirm that they appropriately reflect committee membership, the terms of the charter, and the compensation committee's activities.

Hedging Practices and Policies

US public companies must disclose their hedging practices or policies in their annual proxies or information statements. Foreign private issuers are exempt from this requirement.

A public company is required to describe "any practices or policies it has adopted regarding the ability of its directors, officers and employees to purchase securities or other financial instruments, or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of equity securities granted as compensation, or held directly or indirectly by the employee or director." This requirement extends to policies relating to equity securities of the company, any parent company, and any subsidiary of the company or the parent company, and to equity securities whether granted as compensation or otherwise held by such persons. Alternatively, a company can provide the full text of its hedging policy.

If a company does not have any hedging practices or policies, the rule generally requires disclosure of the absence of such practices or policies or a statement that hedging transactions are generally permitted.

As a reminder, ISS will recommend against members of a board committee that oversees risks related to pledging, or against the full board, if ISS determines that a significant level of pledged company stock by executives or directors raises concerns. ISS will consider factors such as a disclosed anti-pledging policy, the magnitude of the pledged stock, disclosure that ownership or holding requirements do not include pledged stock, and progress toward reducing the magnitude of pledging over time. Glass Lewis also disfavors hedging and prefers to see anti-hedging policies.

We recommend that companies include the mandated hedging disclosure in the Corporate Governance section of the proxy or information statement and include a more tailored disclosure in the CD&A to satisfy the CD&A disclosure requirement with respect to its named executive officers.

Proxy Action Item

Companies should review their existing practices and policies that address hedging transactions and prepare any necessary disclosure. If a company does not maintain such practices and policies, it may wish to consider adopting a hedging practice or policy in order to avoid the requirement to disclose the absence of such practices and policies.

Endnotes

1 The CEO pay ratio rules apply to all issuers other than EGCs, SRCs, foreign private issuers, Multijurisdictional Disclosure System filers, and registered investment companies. Companies exiting EGC and/or SRC status have the benefit of a one-year transition period. For example, if a company with a fiscal year ending December 31 loses its EGC status on December 31, 2021, its first pay ratio will appear in the 2023 proxy in which 2022 compensation is disclosed.

2 The SEC permits a company to calculate CEO pay when there are two CEOs in one year. The company may either (1) calculate each CEO's compensation during the time period of the relevant year and combine the amounts, or (2) determine the CEO serving on the date of selection of its median employee and annualize this amount. The method used must be disclosed.

3 However, the issuance in any three-year period of more than $1.0 billion in non-convertible debt securities would cause an issuer to lose its EGC status immediately. Note, however, that EGC status will be extended during the registration process even if the registrant's revenues exceed $1.235 billion or the registrant issues in excess of $1.0 billion of debt securities during the registration process. Any confidential submission or public filing by an EGC will lock in EGC status through the earlier of (i) the IPO date or (ii) one year after the issuer would have otherwise lost EGC status.

4 A company will qualify as an SRC where its public float is below $250 million. In addition, companies with annual revenues of less than $100 million will also qualify as an SRC if they have no public float or a public float of less than $700 million. For more information, see this Latham Client Alert.

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