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Client Alert
Commentary

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Key Compensation Items for the 2020 Proxy Season and Beyond

Public companies should consider recent SEC and proxy advisory developments and other perennial executive compensation matters.

This *Client Alert* offers a summary of the key executive compensation related reminders and considerations that public companies should continue to prioritize early in 2020 and in the course of their preparations for the 2020 proxy season.

New Requirement to Disclose Hedging Practices and Policies

As mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the US Securities and Exchange Commission (SEC) has adopted a disclosure requirement under which US public companies must disclose their hedging practices or policies in their annual proxies or information statements.

Disclosure of hedging practices or policies has existed in annual proxies for some time, but only with respect to named executive officers (NEOs) and to the extent material to the understanding of named executive officer compensation. The new disclosure requirements broaden the scope to expand the (i) persons covered by hedging practices or policies, (ii) type of equity securities held, regardless of how obtained, and (iii) category of transactions allowed. Specifically, Item 407(i) of Regulation S-K now requires a company 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.

The disclosure is required in any annual proxy or information statement relating to the election of directors. The requirement became effective for fiscal years beginning on or after July 1, 2019, though smaller reporting companies (SRCs) and emerging growth companies (EGCs) may delay compliance until

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fiscal years beginning on or after July 1, 2020. Foreign private issuers are exempt from this disclosure requirement, and the disclosure is not required to appear in an initial public offering (IPO) prospectus.

As a reminder, proxy advisory firm Institutional Shareholder Services (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. Proxy advisory firm Glass Lewis also disfavors hedging and prefers to see anti-hedging policies.

The SEC does not provide where the hedging disclosure should be located within the annual proxy or information statement. It may be appropriate to include the disclosure in the Corporate Governance or Compensation Discussion and Analysis (CD&A) sections. However, if the hedging disclosure is included in the CD&A, then it is subject to the company's say-on-pay vote. As a result, companies may want to include the full hedging disclosure in the Corporate Governance section and include a more tailored disclosure in the CD&A to satisfy the CD&A disclosure requirement with respect to NEOs.

Proxy Action Item

Companies other than SRCs and EGCs must disclose their hedging practices or policies in any annual proxy or consent solicitation material relating to the election of directors or information statements filed on Schedule 14C. All companies that are or will be subject to this requirement should review their existing practices and policies that address hedging transactions and prepare any necessary disclosure in advance of the implementation date. 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.

Proxy Advisory Policy Updates

ISS and Glass Lewis recently released updates to their 2020 voting policies (along with corresponding ISS FAQs). The Glass Lewis voting guidelines are effective for all companies with annual meetings on or after January 1, 2020, and the ISS voting guidelines are effective for all companies with annual meetings on or after February 1, 2020. Below is a summary of certain compensation-related policy changes and updates that companies should consider while preparing for the 2020 proxy season.

Key ISS Updates

ISS Policy on Excessive Director Compensation	ISS will provide negative vote recommendations for any compensation committee members or other board members who are responsible for setting or approving director compensation if ISS establishes a "pattern of excessive non-employee director pay" in two or more consecutive years without a compelling rationale or other mitigating factors for such excessive pay (*i.e.*, for companies with respect to which ISS identified a pattern of excessive non-employee director pay in its review in both 2019 and 2020). To determine whether non-employee director compensation is excessive, ISS will compare individual non-employee director pay totals to those of all non-employee directors at companies in the same index (S&P 500, combined S&P 400 and S&P 600, remainder of the Russell 3000 Index, and the Russell 3000-Extended) and in the same sector (within the same two-digit Global Industry Classification Standard group). Any non-employee directors paid at the top 2% of all comparable directors (ISS deems these to be the "extreme outliers") may be found to have received excessive compensation. Following ISS's identification of a director pay outlier using these measures, a qualitative evaluation of the company's disclosure will determine if concerns are adequately mitigated or if there is an appropriate rationale for the compensation. Director pay outliers may be an unintended consequence for some companies where, for example, a company is characterized by more than one industry group and ISS has compared the company's non-employee director pay with the median of an industry different from the industry group the company may have used in determining its peer group. Additionally, one-time awards due to special committee service or interim roles with the company may also increase non-employee director compensation such that it is deemed excessive by ISS. Plan design can also impact the analysis if a director compensation program includes per meeting fees and there are a large number of meetings in one fiscal year, or if equity awards are based on a fixed number of shares instead of a dollar-denominated value at grant, as discussed below under Director Compensation Litigation Risk — Potential Mitigation Efforts. Mitigating factors may include one-time awards (*e.g.*, on-boarding awards for new directors), special payments related to corporate transactions or special circumstances (*e.g.*, transaction committee fees), or payments in consideration of specialized scientific expertise. If any of these factors exist, or if companies think they could have directors that are extreme outliers, companies should consider expanding their disclosure to address them. Payments in connection with separate consulting/service agreements will be assessed case-by-case, and ISS will be looking for disclosure of the services provided under the agreement that go beyond typical director responsibilities and whether the agreement has a set term.

	Additionally, in recognition of the pay premium often associated with non-executive chairs and lead independent directors, non-employee directors in these roles will be compared against other directors in such leadership positions in the same index and sector. With respect to narrow distributions of non-employee director pay within any specific index and sector grouping, the lack of a pronounced difference in pay of the top 2% of directors as compared to the median director may be considered a mitigating factor.
ISS Evaluation of Equity Plan Proposals — Evergreen Provisions	For the 2020 proxy season, ISS clarified that it will consider an evergreen provision (*i.e.*, "auto-replenishment of share reserves") in an equity plan as an overriding factor in its Equity Plan Score Card, and will recommend a negative vote against any plan containing such provision.
ISS ESG Governance QualityScore	Effective November 2019, ISS announced updates to its ESG Governance QualityScore methodology, which now includes two Compensation/Remuneration factors that evaluate whether companies disclose any environmental and social performance measures for their short-term incentive plan for executives, and for any long-term incentive plan for executives granted in the last fiscal year. The new factors capture the level of disclosure companies provide around these measures and whether companies are aligning executive compensation with sustainability goals. They will not impact a company's QualityScore during the first year of inclusion (*i.e.*, until November 2020).
ISS Quantitative Pay-for-Performance Assessment	For annual meetings held on or after February 1, 2020, ISS will use Economic Value Added (EVA) metrics, as opposed to GAAP measures, in its Financial Performance Assessment (FPA). The FPA is the fourth and secondary screen used by ISS in its quantitative pay-for-performance assessment. The FPA may affect the overall quantitative concern level only if a company is (i) a "Medium" concern under any of the three primary screens or (ii) a "Low" concern but bordering the "Medium" concern threshold under any of the primary screens. The FPA is a relative measure that compares the percentile ranks of a company's CEO pay and financial performance across four EVA metrics — EVA Margin, EVA Spread, EVA Momentum vs. Sales, and EVA Momentum vs. Capital — relative to an ISS-developed comparison group over the prior two- or three-year period. EVA metrics will be calculated by ISS and are based on audited financial data reported in annual and quarterly public filings. ISS notes that while GAAP metrics will not be used in the quantitative pay-for-performance assessment, they may be used in ISS's evaluation of long-term pay and performance alignment.

Termination and Severance Payments	ISS is looking for clear, forthright disclosure around the nature of an executive's termination and how the board determined to pay severance (*e.g.*, "the board determined the termination to be 'without cause' as defined in the executive's employment agreement and paid the severance amount provided under the agreement"). ISS has stated that disclosure indicating that an executive "stepped down" does not clearly indicate an involuntary termination — companies should identify in such cases the type of termination (*e.g.*, termination without cause or resignation for good reason) and the provision by which severance payments were made under the agreement.

Key Glass Lewis Updates

Say-on-Pay Frequency	Glass Lewis updated its 2020 voting guidelines to 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 already considers this a problematic item that will generally result in a negative recommendation against compensation committee members (as is the failure to include a say-on-pay vote or say-on-pay frequency vote when one would otherwise be expected if there is no explanation for the omission).

Stockholder Feedback and Company Responsiveness	The 2020 Glass Lewis guidelines specify factors that Glass Lewis will consider in assessing whether a company has appropriately responded to a low (*i.e.*, 80% or below under the Glass Lewis guidelines) say-on-pay stockholder vote at the prior fiscal year annual meeting, which is generally discussed under Other Proxy Season Reminders. The guidelines specify that companies should include a "robust" disclosure, which may vary depending on the severity and persistence of stockholder opposition, and such disclosure should include stockholder engagement initiatives and specific changes made in response to stockholder feedback. Absent an appropriate response to stockholder feedback, Glass Lewis will recommend voting against a company's upcoming say-on-pay proposal.

Contractual Payments and Arrangements With Executives	The 2020 Glass Lewis guidelines clarify Glass Lewis' position with respect to certain executive-friendly terms contained in new, renewed, or amended executive contractual payments and arrangements, including, but not limited to (i) excessively broad change in control triggers, (ii) inappropriate severance entitlements, (iii) inadequately explained or excessive sign-on arrangements, (iv) guaranteed bonuses (especially multi-year guaranteed awards), and (v) failure to address any concerning practices in amended employment agreements. With respect to change in control payments, Glass Lewis also clarified that it considers double-trigger change in control arrangements to be best practice, and any change in control payments or arrangements that are not explicitly double-trigger may be considered a single-trigger or modified single-trigger arrangement. Finally, Glass Lewis indicated that in reviewing a company's say-on-pay proposal, it will take into account any significant changes or modifications to executive compensation, including any post-fiscal year end changes and one-time awards, particularly if the changes touch upon issues that are material to Glass Lewis' recommendations.

Short-Term Incentives	The 2020 Glass Lewis guidelines clarify Glass Lewis' position regarding short-term bonuses and incentives and state that if a company has applied upward discretion in determining short-term bonus and incentive awards, which includes lowering goals mid-year or increasing calculated payouts, Glass Lewis will expect a robust discussion of why such decision was necessary.

Proxy Action Item
Companies should consider how ISS's and Glass Lewis' voting policies, as well as ISS's updates to its Quantitative Pay-for Performance Assessment and QualityScore, may affect companies' 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.

Director Compensation Litigation Risk — Potential Mitigation Efforts

Director compensation has faced increased attention and scrutiny in the past several years. Since the Delaware Supreme Court decision in late 2017 in *In re Investors Bancorp, Inc. Stockholder Litigation*,[1] plaintiffs have continued to seek to sue companies based on perceived director compensation abuses. The decision in *Investors Bancorp* found that equity awards granted to Investors Bancorp's directors were "self-interested decisions" and must be reviewed under the "entire fairness" standard, the highest level of review under Delaware corporate law (as opposed to the business judgment rule).[2] The court found that director awards were self-interested decisions and must be reviewed under the entire fairness standard because the directors retained discretion to determine the specific awards to directors under the

stockholder-approved equity plan, even within the confines of a stockholder-approved limit on the aggregate awards that could be made to directors under the plan.[3]

More recently, in 2019, in a case challenging the Goldman Sachs' board of directors' compensation,[4] the Delaware Court of Chancery reiterated that director compensation should be reviewed under the entire fairness standard unless stockholders have previously approved a plan that does not involve future director discretion in setting director compensation. The court also noted that to bring an entire fairness challenge, in addition to alleging the directors were self-interested, plaintiffs must also plead facts indicating that the director compensation is unfair, as shown by excessive compensation in relation to the company's compensation peer group.

Delaware courts have consistently refused to treat stockholder approval of an equity plan as ratification of director equity awards if the challenged equity plan did not include "meaningful" limits on the director awards. However, courts have historically failed to define what constituted meaningful for this purpose.[5] The *Investors Bancorp* opinion clarified that even meaningful limits on awards to directors alone may not be sufficient to ensure application of the business judgment rule to director equity award decisions. The safest approach under Delaware law is stockholder approval of specific awards or a self-executing stockholder-approved formula plan if there is no director discretion over individual awards.

While each company's situation will be unique, companies may take a number of possible actions to mitigate the risk of potential claims alleging breaches of fiduciary duty in connection with director compensation, including one or more of the following:

Proactive Review and Disclosure of Director Compensation Arrangements

- **Review Programs and Process.** At a minimum, companies should review their director compensation program and practices, including the process for determining director compensation, any applicable limits on director compensation, and a comparison of director compensation (both cash and equity) against the company's compensation peer group. In particular, companies should review whether any current director equity compensation limits consist of fixed-share limits, which are less effective at maintaining predictable compensation limits, because the dollar amount of such equity compensation can increase over time if the share value increases, as opposed to fixed-dollar denominated limits. Benchmarking non-employee director compensation annually to ensure consistency with the company's peer group is also advisable. By proactively reviewing current director compensation practices on an annual basis, a company will be best-positioned to determine what, if any, modifications to its director compensation practices and governing documents may be appropriate in light of the current litigation environment. Companies should consult with the company's compensation consultant to complete this review. Companies should also ensure that their public disclosure does not indicate unreasonable benchmarking practices.

- **Review Director Compensation Disclosure.** In light of the increased focus on director compensation, including ISS's policy on excessive director compensation, and regardless of whether any plan changes are determined to be advisable, companies should — more so than ever — clearly disclose their director compensation and the process for setting that compensation. Companies should consider providing their reasoning in establishing the programs and amounts, as well as the relationship of such director compensation to that of the company's peers and any material variances from the median of such peers, in their proxy statement and other filings. Also, any mitigating factors that will help explain director compensation that may be out of line with peers or possibly considered

"excessive" by ISS should be disclosed. While disclosure alone will not ensure the application of the business judgment rule to director compensation decisions, fulsome and thoughtful disclosure may help deter claims by plaintiffs or, in the event a claim is brought, rebut allegations from plaintiffs.

Drafting Director Compensation Arrangements

If a company determines that changes to its director compensation program are warranted, the company may wish to consider:

- **Stockholder Approval of Formulaic Director Awards.** The most protective measure a company may take to insulate itself and its directors from attacks on director compensation practices is to have its stockholders approve a director compensation plan prescribing the precise terms of formulaic cash and equity awards, or to include such formulaic cash and equity awards in the company's omnibus equity plan. A stand-alone directors' plan may provide certain benefits, including (i) maintaining a distinct framework for a company's director compensation and (ii) allowing for clear and distinct proxy disclosure and a more straightforward process for stockholder approval of director compensation.[6] However, including director compensation in the company's equity compensation plan is also a feasible approach, and avoids the need to submit director compensation for stockholder approval separately from the equity plan. Companies can adopt various structures to implement a stockholder-approved formulaic director compensation program, while still retaining some flexibility for future decisions. Companies should consult with outside counsel and compensation consultants if they are interested in pursuing this approach.

- **Stockholder Approval of Specific Director Compensation Limit.** Companies may alternatively consider adding (or continuing to include) specific meaningful annual limits on total director compensation under stockholder-approved compensation plans, most typically their equity compensation plans. Companies can usually amend such plans to include director limits without obtaining stockholder approval.[7] While these limits may not provide absolute protection against stockholder claims in Delaware, they may help to deter claims. Companies may wish to consider seeking such approval in conjunction with other amendments, such as an increase in the share pool, as opposed to seeking approval separately from other amendments.

Proxy Action Item

Companies should review their director compensation policies and practices, and to the extent director compensation is aligned with or is below the average of the applicable peer group, companies may determine that immediate action is unwarranted. The 2020 proxy season likely will bring additional examples of companies proposing formulaic director plans or programs within broader equity plans for stockholder approval, as well as the inclusion of maximum dollar-denominated limits for director compensation in such plans and programs.

CEO Pay Ratio — Annual Key Steps Companies Should Take to Comply

The SEC's final rules requiring companies to disclose their CEO and median-compensated employee pay ratio were effective for compensation paid in fiscal years beginning on or after January 1, 2017. As a result, most issuers have already performed these calculations and disclosed the resulting ratio for the past two proxy seasons.

Pursuant to the SEC rule, 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[8] 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 a company has previously disclosed its CEO pay ratio, move to Step 2.

For companies required to disclose their CEO pay ratio for the first time during 2020, please refer to the discussion of the rules governing the calculation of the ratio in Latham's January 17, 2018, *Client Alert*. Companies should also note that once the same median employee has been used for three years, the company will need to re-identify its 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, and there has been a significant change in the company's employee population or compensation arrangements that would result in a significant change to the pay ratio disclosure, 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 re-identify a new median employee.

Step 4	***Has there been no significant change to the company's employee population or compensation arrangements and the median employee's circumstances have not changed?*** 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 2020 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.

Equity Plan Matters

While some companies are already planning to include equity plan proposals on their annual meeting agendas during 2020, 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 2020 annual meeting to extend the plan or adopt a new plan prior to any such expiration. 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 their burn rate analysis.

Companies that are already planning to include equity plan proposals on their annual meeting agendas during 2020 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), companies will want to include a specific cross-reference to the public filing of the existing plan or include 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.** As discussed above under Drafting Director Compensation Arrangements, 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.

- **Share Withholding Under Equity Awards.** US accounting rules now 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 with equity plan proposals going before stockholders for other reasons 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. Companies without other equity plan proposals in 2020 generally may undertake amendments to provide for share withholding in excess of the minimum statutory rates without stockholder approval — unless plan language provides otherwise.

- **Clawbacks.** The SEC's proposed rules on clawbacks under Dodd-Frank have still not been finalized (and it does not appear that they will be finalized anytime soon). In order to allow companies to claw back compensation under possible 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 consider adding provisions in their incentive compensation plans and agreements providing that all awards made thereunder are subject to such clawback policies.

- **Potential Removal of Section 162(m) Provisions.** Equity and incentive plans adopted prior to the adoption of the Tax Cuts and Jobs Act (the TCJA)[9] typically contain extensive provisions designed to

ensure that awards were eligible to qualify as performance-based compensation for Section 162(m) purposes prior to the repeal of those provisions by the TCJA. Companies may choose to amend equity and incentive plans to streamline or remove extensive provisions as a housekeeping matter to bring the plans into line with the TCJA. Whether stockholder approval of any such amendments is required will depend largely on the equity plan's amendment language and applicable national stock exchange rules on equity plans, though many amendments should not require stockholder approval. Companies should also review and potentially update equity plan prospectuses if the prospectuses include tax disclosure regarding Section 162(m).

When evaluating whether to amend or remove Section 162(m) provisions in an existing equity plan, companies will also want to be mindful that certain amendments may cause a loss of the ability to rely on the transition relief under the TCJA.[10] Companies should take care to analyze the potential impact amendments may have on any "grandfathered" awards outstanding under the plan in order to avoid inadvertently jeopardizing their grandfathered status. For further details regarding the transition relief under the TCJA, please refer to Latham's August 29, 2018, *Client Alert*.[11] As an alternative, companies looking to update their equity plan may wish to consider adopting a new plan that does not contain Section 162(m) provisions to govern future awards, while leaving the existing plan(s) in place with respect to outstanding grandfathered awards.

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.

Other Proxy Season Reminders

2019 Say-on-Pay Vote Response

As always, public companies that conducted a say-on-pay vote in 2019 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. As discussed above under Proxy Advisory Policy Updates, Glass Lewis will now consider 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 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 — as ISS and Glass Lewis will be specifically looking for this information and gauging the strength of these efforts as they formulate their 2020 voting recommendations.

Proxy Action Item

Companies should disclose their stockholder outreach and response to this vote. Those companies that received weak support in their most recent say-on-pay vote should pay particularly 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 2014 will need to do so again in 2020. 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. As discussed under Proxy Advisory Policy Updates, companies holding a say-when-on-pay proposal in this year's proxy should keep in mind that Glass Lewis will now 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 also 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-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

Confirm whether one or both proposals are required in 2020. If a say-on-pay vote is required, companies should consult with outside advisers regarding the likelihood of adverse recommendations by proxy advisory firms.

Confirm Continuing EGC Status and Potential New Requirements if Exiting That 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). In addition, 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, 2019, it will be required to include CEO pay ratio disclosure in its proxy statement filed in 2021 that includes 2020 compensation disclosure.

Proxy Action Item

Companies that are or have been EGCs should reconfirm current status and potential exit date to ensure timely compliance with rules that apply once EGC status is lost.

Consider Applicability of New Increased Smaller Reporting Company Thresholds

In 2018, the SEC adopted amendments to the definition of SRC, raising the public float threshold at which a company will qualify as an SRC to US$250 million. In addition, under the amendments, companies with annual revenues of less than US$100 million will also qualify as an SRC if they have no public float or a public float of less than US$700 million. SRCs are eligible for a number of "scaled disclosure" accommodations under Regulations S-K and S-X, including reduced executive compensation disclosure.

However, Glass Lewis may consider a negative recommendation for compensation committee members if it considers the reduced executive compensation disclosure to substantially impact stockholders' ability to assess executive pay practices, and 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.

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

Ensure compensation adviser independence analysis is undertaken prior to retention of new compensation advisers. 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
Ensure compensation risk assessment is undertaken on an annual basis and review SEC disclosures, if any.

Review Compensation Committee Charter and Compliance

Many companies include a requirement that compensation committee members qualify as "outside directors" for purposes of Section 162(m) in their committee charters. Compensation committee members may no longer need to qualify as outside directors for purposes of Section 162(m), although the national stock exchanges and securities laws still impose requirements on compensation committee member qualifications. Companies may be able to remove from their committee charters the requirement that compensation committee members qualify as outside directors for purposes of Section 162(m). However, compliance with the Section 162(m) transition relief under the TCJA may require ensuring compensation committee members satisfy the Section 162(m) requirements until any grandfathered awards are certified and paid may be necessary. Companies should review the qualifications of their compensation committee members under stock exchange and securities law requirements and reconfirm 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
Review compensation committee charter and proxy disclosure to confirm that it appropriately reflects any changes to a company's compensation committee member requirements in light of Section 162(m) changes under the TCJA and that proxy disclosure matches the terms of the charter and the compensation committee's activities.

ESG Matters and HCM Disclosure

Environmental, social, and governance (ESG) disclosures have increasingly become a top priority of stockholders, asset managers, and proxy advisers. In particular, human capital management (HCM), which is included in the "social" component of ESG, has become an emerging topic. Broadly speaking, HCM focuses on a company's employee base and culture beyond senior-level executive officers and focuses on certain employee-related metrics, such as diversity and inclusion, talent management and development, employee turnover, and organization culture and ethics.

In August 2019, the SEC proposed including HCM as a new disclosure topic, making HCM even more relevant for upcoming proxy seasons. Such HCM disclosure would be principles-based and include a description of a company's human capital resources, to the extent material, including descriptions of any human capital measures or objectives that company management focuses on in managing the business.

While shareholder interest in HCM is high, there are no mandatory or prescriptive SEC disclosure requirements for HCM disclosure at this time.

Proxy Action Item
Companies should review their current human capital measures or objectives that management focuses on in managing the business, to the extent material, and address any concerns now should the SEC's proposed human capital disclosure measures be approved.

The Bottom Line

Each year brings new executive compensation rules and considerations, whether based on 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. 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 2020 and beyond.

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Endnotes

[1]177 A.3d 1208 (Del. 2017).

[2] Under Delaware law, a decision of a board of directors generally receives the protection of the business judgment rule and will be subject to challenge only if a plaintiff can show that the decision had no rational business purpose. If, however, a stockholder rebuts the business judgment standard by, for example, alleging facts that lead to a reasonable inference that the directors breached their fiduciary duties in granting director equity awards, then the court will review such decision under the higher standard of "entire fairness." The higher standard means the court will determine whether the decision was made based on fair dealing and at a fair price, unless the company's stockholders "ratified" the decision.

[3] For a more complete discussion of the *Investors Bancorp* decision, please refer to Latham's January 17, 2018, *Client Alert*.

[4] *Stein v. Blankfein*, C.A. No. 2017-0354-SG (Del. Ch. May 31, 2019).

[5] *Calma v. Templeton*, 114 A.3d 563 (Del. Ch. 2015); *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012); *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007).

[6] Equity plans solely for non-employee directors will generally not be subject to the Equity Plan Score Card analysis utilized by ISS for "omnibus" equity plans. See ISS's 2020 US Proxy Voting Guidelines for more information regarding the plan features necessary to receive a positive ISS recommendation for a stand-alone non-employee director equity plan.

[7] The authors of this *Client Alert* recommend that the structure and amount of such limit be carefully reviewed with the company's compensation consultants and legal counsel to assure it is a meaningful limitation on director awards. Specific consideration should be given to the scope of such limit (*e.g.*, whether it takes into account both cash and equity compensation) and the method of calculating compensation for purposes of such limit (*e.g.*, a specific number of shares or specified dollar amount). The authors of this *Client Alert* generally recommend that the limits encompass both equity and cash compensation.

[8] 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 in 2019, its first pay ratio will appear in the 2021 proxy in which 2020 compensation is disclosed.

[9] The TCJA is Public Law No. 115-97. Shortly before final Congressional approval of the TCJA, the Senate parliamentarian ruled that the previously attached short title, the "Tax Cuts and Jobs Act," violated procedural rules governing the Senate's consideration of the legislation. Accordingly, the TCJA no longer bears a short title, although commentators continue to refer to it as the Tax Cuts and Jobs Act.

[10] The TCJA contains transition relief for certain Section 162(m) performance-based compensation arrangements pursuant to "written binding contracts" in effect as of November 2, 2017, so long as such arrangements are not "modified in any material respect."

[11] In addition, state law may vary from federal law on the deductibility of executive compensation. Companies should consider any continuing rules under state law before they adjust existing executive compensation arrangements.