Current Issues in Executive Compensation

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Your Panelists

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• Evan Farber is General Counsel and Corporate Secretary of The Advisory Board Company. Prior to joining The Advisory Board Company, Evan was a partner at Hogan & Hartson (now Hogan Lovells), where he practiced corporate, securities, transactional, and commercial law.

• Michael Collins is a partner in the Washington, DC office of Gibson, Dunn & Crutcher, where he co-chairs the Executive Compensation and Employee Benefits practice group.
2014 Proxy Season Results & Trends

• Increasing shareholder engagement was a key theme in the 2014 proxy season

• As usual, executive compensation was a focus
  – 4 companies (compared to none in 2013) had shareholder votes in favor of eliminating “single trigger” equity acceleration upon a change in control
  – Close to 10% of “say on pay” votes were negative
    • *Wall Street Journal* suggested that middle-market companies were most likely to have negative outcomes
High MSOP Tide Washes Up More Failures

Support % Votes Cast

Meetings Jan. 1 thru June 30
2014: Say on Pay Support Levels Off

2014 Average MSoP Support at R3K* Firms: 91.7%

ISS Recommends Against 12.4% of 2,227 Proposals

Nearly 8 of 10 proposals drew 90% support or higher

* Based on vote results for 2,227 Russell 3000 firms
<table>
<thead>
<tr>
<th>Company</th>
<th>Investor(s)</th>
<th>Board Issue</th>
<th>Say Nay on Pay</th>
<th>Outcome (Votes Cast For and Against)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burger King</td>
<td>CtW Investment Group</td>
<td>Just Vote No (JNV) on two nominees (Comp Committee)</td>
<td>Yes</td>
<td>Behring (94.4%) and Sicupira (94.4%); MSoP (93.4%)</td>
</tr>
<tr>
<td>Chipotle Mexican Grill</td>
<td>CtW</td>
<td>No</td>
<td>Yes</td>
<td>MSoP (23.4%) and equity comp plan (45%) fail</td>
</tr>
<tr>
<td>Coca-Cola</td>
<td>Wintergreen (David Winters)</td>
<td>Oppose equity plan</td>
<td>No</td>
<td>Equity Plan (83.2%); w/Warren Buffett’s Abstention (72%)</td>
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<tr>
<td>Domino’s Pizza</td>
<td>CtW</td>
<td>JVN on Pay Panel Chair</td>
<td>Yes</td>
<td>Balston (69.3%); MSoP (75.9%)</td>
</tr>
<tr>
<td>McDonald’s</td>
<td>CtW</td>
<td>No</td>
<td>Yes</td>
<td>MSoP (94.2%)</td>
</tr>
<tr>
<td>Wal-Mart</td>
<td>CtW</td>
<td>JVN on Pay Panel Chair</td>
<td>Yes</td>
<td>Wolf (96.3%); MSoP (86.6%)</td>
</tr>
<tr>
<td>Wendy’s</td>
<td>CtW</td>
<td>JVN on Pay Panel Chair</td>
<td>No</td>
<td>Schwab (92.6%)</td>
</tr>
<tr>
<td>Willbros</td>
<td>Laborers’ International Union of North America</td>
<td>JVN on two nominees</td>
<td>No</td>
<td>DiPaolo (85.2%) and Lonergan (91.1%); MSoP (46%); LIUNA didn’t explicitly oppose</td>
</tr>
<tr>
<td>YRC Worldwide</td>
<td>Int’l. Brotherhood of Teamsters</td>
<td>JVN on three nominees (Comp Committee); Oppose equity plan</td>
<td>Yes</td>
<td>Doheny (97.8%), Hoffman (98.1%) and Kneeland (98%); MSoP (85%); Equity plan (89.1%)</td>
</tr>
</tbody>
</table>
Risk Mitigator Trends

Clawback Policy/Malus Provision Disclosed

No Executive or Director Pledged Shares

Policy Prohibiting Hedging

Source: ISS Governance QuickScore
Trends in ClC Vesting Provisions

Source: ISS Governance QuickScore
Use of Compensation Consultants

• Compensation consultants are often criticized for making large pay packages the norm by ratcheting up the average; Warren Buffet has said very unkind things about them

• However, they are critical advisors to the compensation committee in setting executive compensation, especially in light of the enhanced SEC proxy disclosure rules that require detailed descriptions and analysis of named executive officer compensation
Compensation Consultants – Proxy Disclosure Rules

• In addition to the executive compensation disclosure itself, SEC rules require the proxy to disclose any role of compensation consultants in recommending the amount or form of executive or director compensation and any conflict of interest
  – Thus, compensation committees normally distribute questionnaires to their consultants and other advisors in order to determine any conflicts (determined using six factors developed by the SEC)
Compensation Consultants – Proxy Disclosure Rules

- The deadline for companies to have compensation committees that meet new, heightened stock exchange independence criteria were effective the earlier of the first annual meeting after January 15, 2014 or October 31, 2014
- Boards will need to add an independence assessment for compensation committee members to their annual director independence assessments.
- In making an affirmative determination that compensation committee members are independent, boards at both NYSE and NASDAQ companies must consider all relevant factors, including whether a compensation committee member receives any consulting, advisory or other compensatory fees from the company, and whether the committee member has any affiliate relationships with the company, its subsidiaries or any affiliate of a subsidiary.
  - As a result of recent rule changes, NASDAQ will not prohibit directors from serving on the compensation committee if they receive fees from the company. Instead, the board need only consider any such fees as part of the independence assessment.
Practical Issues with Compensation Consultants

• Finding the right consultant
  – Knowledge of the industry/type of talent the company competes for
  – Right “fit” for the compensation committee

• How much engagement with the committee?
  – How much with management?

• How much should compensation committees rely on consultants?
  – Role of legal counsel: consultants sometimes not as sensitive to ISS, disclosure and other issues
Proxy Solicitors

• Consider role of proxy solicitors with material executive compensation decisions
  – Especially equity plans

• Critical to understand how shareholders will vote
  – Internal proxy voting guidelines?
  – Rely heavily on ISS or Glass Lewis?
Severance Packages

• Severance packages have changed substantially in the past decade
  – Equity is much more often “double trigger”
    • Shareholder advisory votes this year
  – Lower severance multiples – “three times” is much less common
Severance Packages

• Few Internal Revenue Code section 280G “gross-ups”
  – ISS started this trend
  – “Best net” and “cutback” are the alternatives
  – Should be reflected in employment agreements, severance plans, etc.
• Shorter-term employment/severance protection agreements
  – Some companies enter into contracts with fixed terms (e.g., two years) that do not automatically renew
  – There are potential benefits with reevaluating periodically, but also some downsides
• Say on pay/say on golden parachute rules have impacted what companies do, even though they are just advisory votes (don’t tell that to the plaintiffs’ lawyers)
Director Compensation

• Traditionally, director equity plans have allowed discretion to the board or the compensation committee to specify grants

• *Seinfeld* decision in Delaware highlighted the risk of breach of fiduciary duty/self-dealing lawsuits for directors setting their own compensation
  – Increased use of “director only” plans rather than granting director awards through omnibus plans
  – Trend is for new director plans to specify the annual awards (e.g., $100,000 of options) at the time shareholder approval is sought, to mitigate this risk
Likely Hot Button
Issues/Developments

• Issues likely to arise in 2015 proxy season and beyond
  – ISS considering policy standards
  – Burn rate issues
    • Some companies (e.g., relatively recent IPOs where pre-IPO plans reserved a lot of shares) will have to deal with these issues for the first time
  – Change in control benefit votes
    • The four votes in favor of double-trigger/pro-rata vesting this year may embolden others
      – Companies should evaluate best practices
Likely Hot Button
Issues/Developments

• Pending SEC guidance that may impact corporate governance/proxy disclosure includes:
  – Dodd-Frank "clawback" policies
  – Disclosures about whether companies permit employees and directors to engage in hedging; and
  – Disclosures about the relationship between compensation "actually paid" to executives and a company's financial performance.

• SEC Chair Mary Jo White has indicated that completing these rules is a high priority
Tax Changes on the Horizon

• Executive compensation tax changes on the way?
• Representative Camp has introduced a major tax reform bill that would have a number of impacts on executive compensation
• Unlikely these provisions will be enacted this year, but executive compensation changes often are introduced and then used a few years later when a revenue-raiser is needed (e.g., section 409A)
Tax Changes on the Horizon

• Internal Revenue Code section 162(m)
  – Currently limits to $1 million the deduction that public companies may take for compensation paid to “covered employees”
    • Covered employees include the CEO and the three other most highly-compensated executive officers (other than the CFO) from the proxy
  – Key exception is for “performance-based compensation”
    • There are a number of requirements; keys include shareholder approval of performance goals, payment must be contingent on goal achievement, and plan must be administered by compensation committee consisting solely of outside directors
  – Only applies to compensation paid in a year in which an individual is a covered employee
  – Camp bill would make major changes:
    • Would add back the CFO as a “covered employee”
    • Would eliminate the “performance-based compensation” exception so that all compensation in excess of $1 million paid to a covered employee would be nondeductible
    • “Once a covered employee, always a covered employee”
Tax Changes on the Horizon

• Internal Revenue Code section 409A
  – Currently imposes a number of requirements that “deferred compensation” must satisfy
  – If violated, penalties include taxation upon vesting, a 20% additional tax and, in some cases, an interest charge
  – Key exception from 409A coverage is “short-term deferral”, commonly-referred to as “vest and pay”

• Camp bill would effectively eliminate deferred compensation as tax matter
  – Amounts would be taxed as they vest
  – This would likely make unfunded deferred compensation a thing of the past
  – Would place increased pressure on short-term deferral determinations
Questions?