Social Science Knowledge & Executive Compensation

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HARVARD BUSINESS SCHOOL

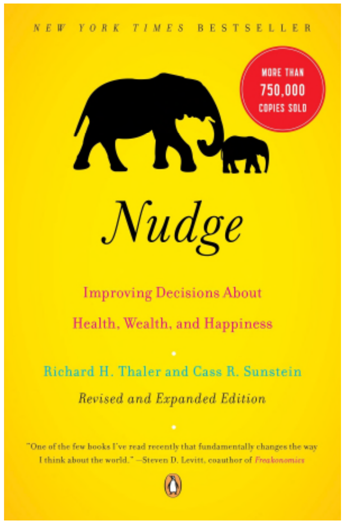
DIRECTOR'S ROUNDTABLE

OCTOBER 25, 2017

Big News from Academia

Behavioral Economics!

- Multiple articles in Academic Journals
- Nudge - Richard Thaler & Cass Sunstein (2009)
- Misbehaving – Richard Thaler (2015)
- Thaler elected President of the American Economic Association
- Thaler wins the 2017 Nobel Prize in Economics



What’s New about Compensation

1. Individuals dislike losses more than they like equivalent gains
(Kahneman & Tversky)

- Implication:
  - Instead of rewarding with bonuses, penalize managers if they don’t make targets!
  - A “rebate” instead of a bonus

What’s New about Compensation

2. Individuals value immediate payoffs more than those in the future (e.g. $10 today instead of $12 tomorrow)

Implications:

- Immediate payments are a more powerful incentive
- Can also use this principle to incentivize long-term focus by an executive: focus on long-term paybacks for meeting short-term goals – distancing the reward from these goals decreases the incentive to prioritize short-term profit margins over long-term strategic vision

*for more ideas, feel free to dig into the academic journals (*Journal of Economic Behavior & Organization*, *Journal of Behavioral and Experiment Economics*)

My Perspective

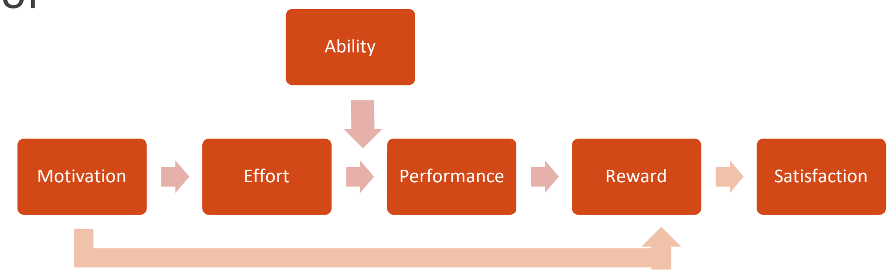
As a longtime scholar, consultant, and board member concerned with the human aspects of organizations, I have two reactions to all this excitement:

1. Great to see the economists waking up!
2. Are these ideas really new?

Yes, BUT…

Expectancy-Theory Model

- There are *existing* ideas which can be better utilized than they have been
- For example : Lawler's "Expectancy-Theory Model" (1973) for thinking about compensation and performance :
  - An individual's motivation is a function of
    1. Effort-to-performance expectancies
    2. Performance-to-reward expectancies
    3. Perceived attractiveness of reward



Expectancy-Theory Model

- While these ideas are useful in thinking about compensation for situations in which the connection between effort and performance can be understood, their application to senior executives is difficult because:
  1. Senior executives can only produce results through and with others
  2. Multiple forces out of their control affect outcomes (e.g. macroeconomic forces)

Unique Challenges of Executive Compensation

- There is no “silver-bullet” to solving compensation issues at the executive level - but there are some important specifics to keep in mind:
  - The importance of working with other executives vs. focusing on individual efforts
  - The length of time between effort and performance results
  - Many variables which are not in the control of the executive

The Whole Fuss

So who is concerned?

- Certain institutional investors
  - e.g., Calpers
  - Calstirs
  - Union Pension Funds
  - Etc
- Media and Politicians
  - It “sizzles”
- The Public
  - Reflects skewed income distribution
    - Rich getting more
    - Average citizen falling back
    - Disappearing middle class

Conventional Concerns

What are the main concerns?

- CEOs earn too much*
  - In absolute terms
  - Compared to other named officers
  - Compared to the average employee/citizen
- In incentive plans (which are the bulk of executive compensation) the link between pay and performance is often not clear

*CEOs are the focus because they get the most!

Conventional Concerns (cont'd)

- Too many large payments with no intended connection to performance
  - e.g., Golden Parachutes
  - No-fault departures
    - Big Settlements

Fundamental Matters

- Motivational impact is limited
  - Line of sight not obvious
    (*Efforts* x *Value of Rewards* x *Visible Connection to Results* = *Power of Incentives*)
  - Corporate results are largely group or organizational efforts – limit power of individual incentives
- Are plans based on right goals? Focus on TSR
  - Management does not control TSR
  - Management has more control over company economic results
  - Yet too many plans focus on TSR

Fundamental Matters (cont'd)

- Do plans use right time horizons?
  - Long-term usually means 3 years
  - Industry defines "long-term"
  - What proportion of top management compensation should be LTIP?
- What about non-financial rewards?
  - Company success
  - Promotion
  - Personal reputation

Fundamental Matters (cont'd)

- Are comparisons with other company CEOs meaningful?
  - Is there a market for CEOs?
  - Are comparisons by company size and industry valid?
  - The matter of negotiation
  - The ratcheting effect of surveys
- What are the root causes of the continuing concern?
  - Executive compensation is usually a fraction of a percent of company profits
- What are the root causes of public concern?
  - Skewed income distribution
  - Negative view of business

Korn Ferry Hay Group Top 300 CEO Compensation Study

Performance equity emerges as king, while cash-based pay raises hit new low

Theo Sharp, Senior Client Partner – Executive Pay & Governance

October 2017

KORN FERRY | HayGroup

Boards turn to longer-term CEO compensation vehicles instead of more immediate salary and bonus increases

Agenda
Presentation overview

1

Overview of Findings

Overview of findings
About this study

- Korn Ferry Hay Group's tenth annual CEO pay study
- 300 U.S. public companies:
  - Median FY 2016 revenues of $17.2 billion
- Proxy filings between May 1, 2016 – April 30, 2017
- CEO pay for FY 2016

Overview of findings
2016 study methodology

Base pay
- As disclosed in the Summary Compensation Table (SCT), not annualized for new executives

Annual incentives / bonus
- Bonus + annual non-equity incentive plan compensation

Long-term incentives
- Grant value as disclosed in the SCT
- Option awards + stock awards (restricted stock + performance equity) + cash LTIP payouts
- May include stock or options if deferred from a bonus

All other compensation & change in pension value / NQ deferred comp earnings
- As disclosed in the SCT

Performance data (source: S&P Capital IQ)
- 2016 Net Income and total shareholder return, 2014-2016 annualized total shareholder return

Together, these pay elements make up total compensation

Overview of findings
Headlines

Companies continue to exercise caution as financial performance improves and market conditions rebound

- After a year when total shareholder return only increased from 0.1%, the market improved to a solid 12.0%
- Company profitability grew 2.6% after last year’s growth of 5.3%

Flat salary increases and modest bonus gains as companies continue to put their emphasis on long-term incentives, particularly performance equity

- Salary increases were flat and bonuses grew just 0.8% as total pay grew 4.2%, driven by long-term incentive increases of 4.4%
- With increased scrutiny from governance watchdogs, investors and the media, companies continue to show restraint even after the market improved

Overview of findings
Headlines

Realized gains from long-term incentives grow as stock market performance improves

- Stock market growth in 2016 translated to increased gains in realized pay from stock option exercises and the vesting of restricted stock and performance equity, all granted a number of years ago

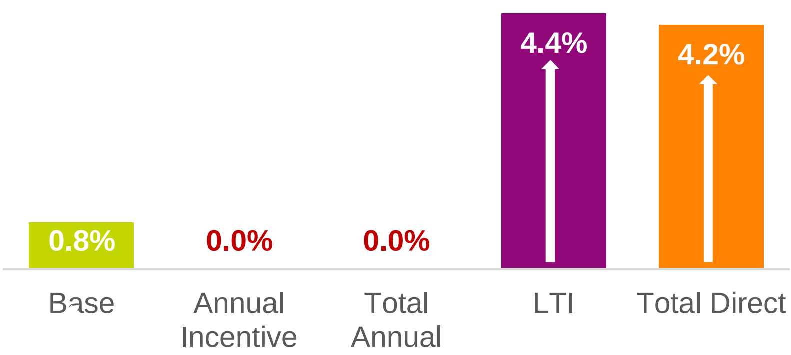
As companies put more of their incentive dollars into long-term performance-based equity programs

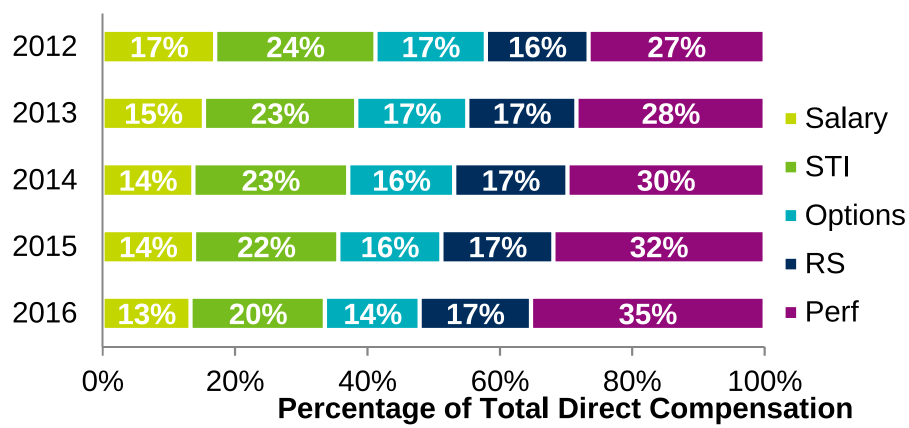
- Over the past five years, performance-based awards have increased form 43.7% of the long-term incentive plan pay mix to 54.7%
- Few companies put all of their long-term incentive pay into performance-based awards. At most companies, the remaining awards were split almost equally between stock options and restricted stock grants

Overview of findings
Headlines

Flat salary increases and modest bonus gains as companies continue to put their emphasis on long-term incentives, particularly performance equity

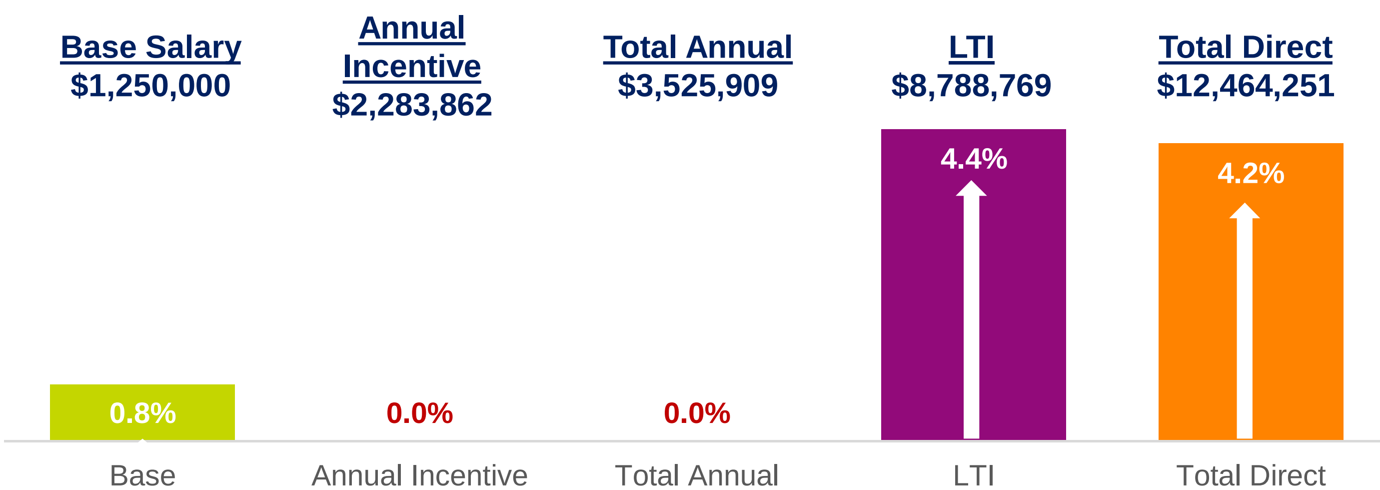
- Salary and target bonuses pretty flat as total pay grew 4.2%, driven by long-term incentive increases of 4.4%
- With increased scrutiny from governance watchdogs, investors and the media, companies continue to show restraint even after the market improved
- This continues a long trend…increases are generally realized through incentive compensation, not base salary….mostly LTI….mostly performance LTI





Overview of findings
Headlines

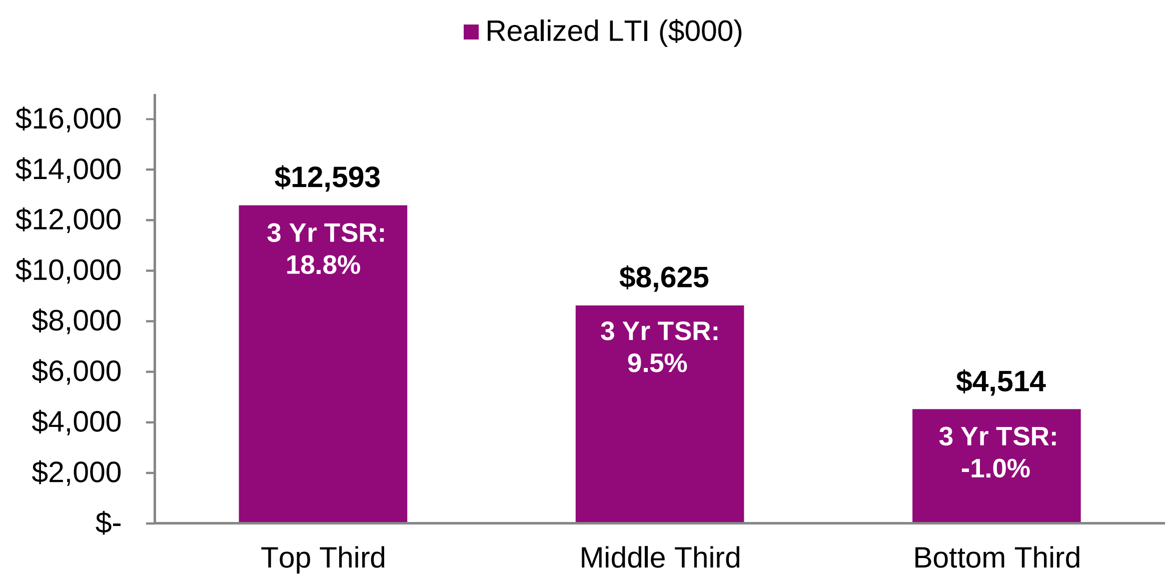
- Let's add the numbers
- It's a lot of money reported as compensation, but again realized is the key
- The base salary number won't move much in the future, nor will the annual incentive
- Query: when is enough LTI enough? Or STI? Does risk get become a problem?
- Two issues: 1) awkward conversations in a down market and 2) duplication of metrics creates high volatility and high risk



Overview of findings
Headlines

Realized gains from long-term incentives grow as stock market performance improves

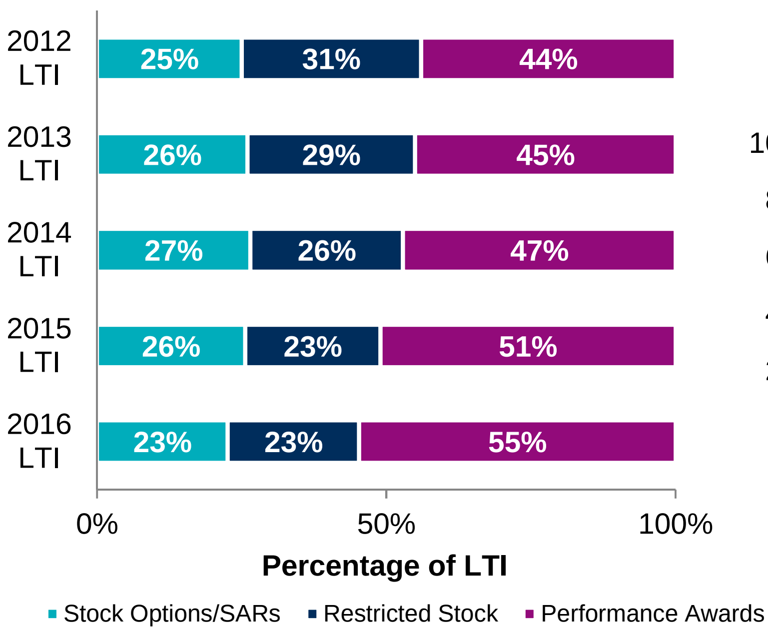
- Stock market growth in 2016 translated to increased gains in realized pay from stock option exercises and the vesting of restricted stock and performance equity, all granted a number of years ago
- The media might finally be right about increasing compensation as LTI has translated into realizable pay
- However, holding periods and ownership requirements keep much of this at risk
- Again, do these levels of incentive payouts create an issue in future years?

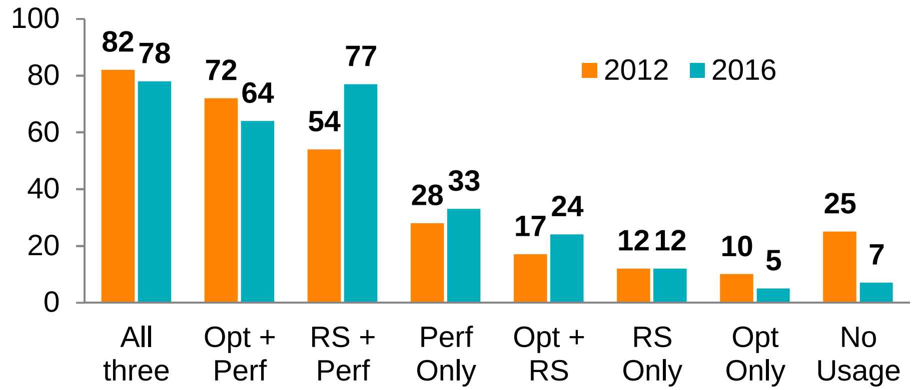


Overview of findings
***Headlines** cont'd*

As companies put less emphasis on cash-based salary and bonus payments, they put more of their incentive dollars into long-term performance-based equity programs

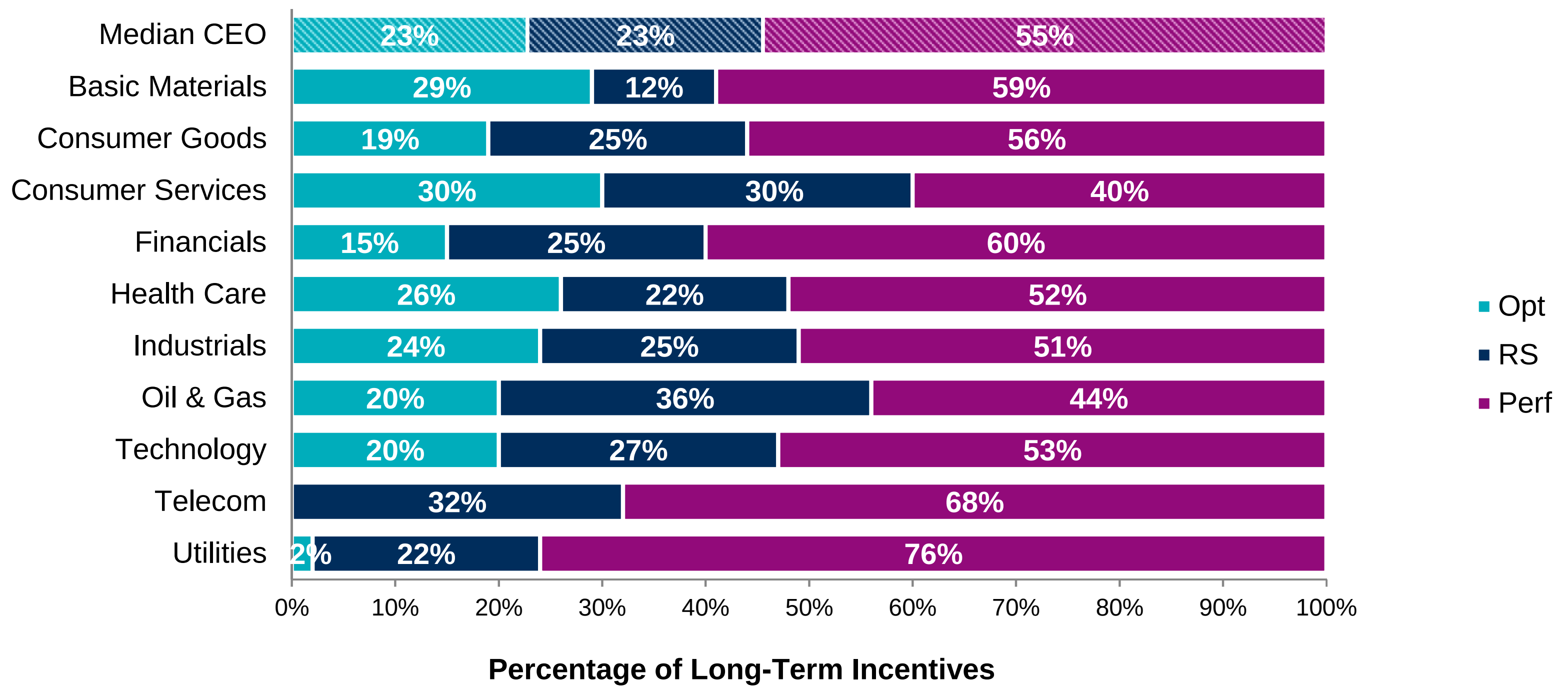
- Over the past five years, performance-based awards have increased form 43.7% of the long-term incentive plan pay mix to 54.7%
- But a portfolio approach continues to be seen as a good balance to retention and performance





Overview of findings
Mix of long-term elements – industry CEOs

- Almost every sector continues to emphasize performance plans over any other vehicle



Overview of findings
Headlines *cont'd*

Top 10 CEOs' pay increases substantially in 2016 after declining similarly in 2015

- Year-over-year median and average top 10 CEO pay increases 17.6% and 26.3%, respectively
- CBS's CEO came in second place in 2016 after topping the list in 2015; this year's highest-paid was the CEO at Charter Communications
- Much of this compensation is "reported" compensation but the most important measure won't come for a few years when it turn up in our realized pay slide…maybe more, maybe less

2015		
Company	**Executive**	**TDC**
CBS	Leslie Moonves	$55,199,918
Viacom	Philippe P. Dauman	$53,876,984
Oracle	Mark V. Hurd	$53,222,875
Oracle	Safra A. Catz	$53,222,875
Disney	Robert A. Iger	$42,170,641
Honeywell	David M. Cote	$32,178,000
Time Warner	Jeffrey L. Bewkes	$31,242,578
AON	Gregory C. Case	$29,002,082
General Motors	Mary T. Barra	$27,979,533
Liberty Global	Michael T. Fries	$26,451,649
	Median	$37,174,321
	Average	$40,454,714

2016		
Company	**Executive**	**TDC**
Charter Communications	Thomas M. Rutledge	$97,728,795
CBS	Leslie Moonves	$67,446,942
Valeant Pharmaceuticals	Joseph C. Papa	$62,100,182
Estee Lauder	Fabrizio Freda	$47,607,282
NIKE	Mark G. Parker	$46,535,494
Oracle	Safra A. Catz	$40,923,275
Oracle	Mark V. Hurd	$40,923,275
Disney (Walt)	Robert A. Iger	$39,782,791
Hewlett Packard	Margaret C. Whitman	$35,280,830
Johnson Controls	Alex A. Molinaroli	$32,609,142
	Median	$43,729,385
	Average	$51,093,801

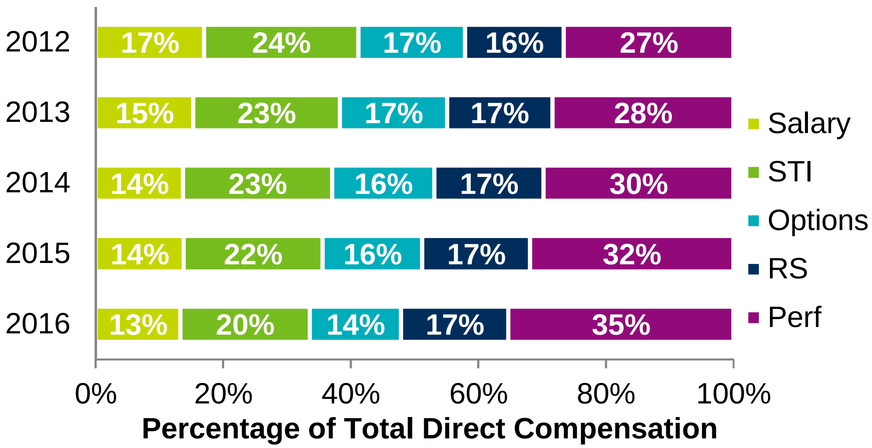
Overview of findings
Headlines *cont'd*

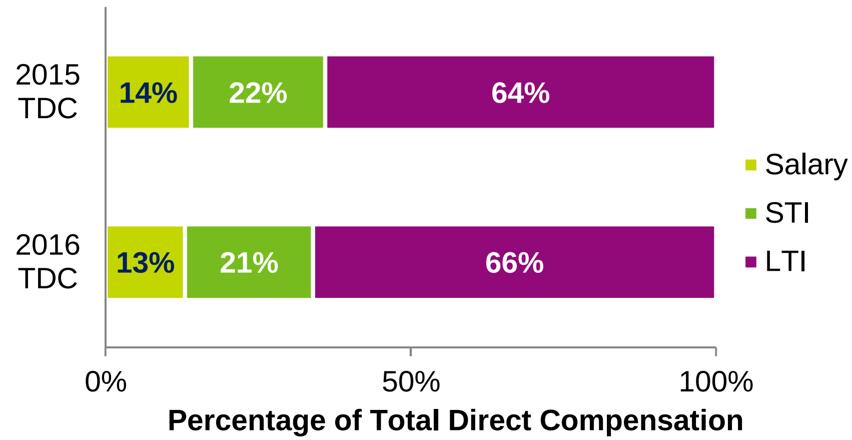
Most companies conduct extensive outreach with their stockholders leading up to the 2016 annual meeting

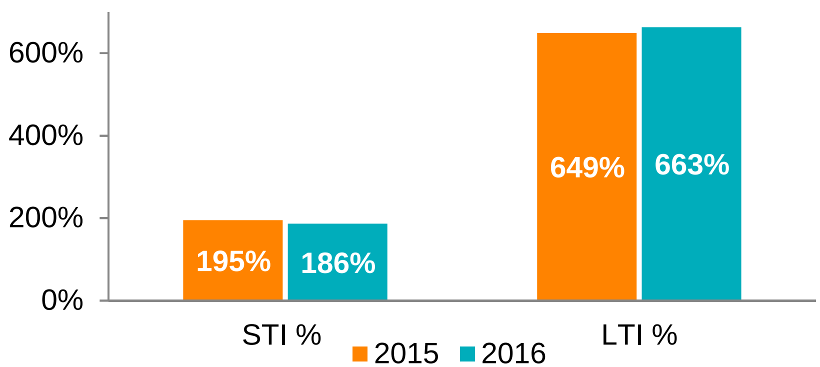
- Outreach meetings are conducted to solicit feedback from their shareholders in an effort to engage them, listen to what they have to say and respond to their concerns
- Shareholder outreach isn't just a trend, its becoming a necessity
- If a company waits until there is a problem, the outcome won't be as positive
- ISS meetings are becoming more prevalent
- **Company spokespeople are becoming more conversant in executive compensation, or at least they should be**
    - **Query as to whether Compensation Committee Chairs should be have a specific background in HR or Compensation?**
    - **Is there a move to broadening the Compensation Committee mandate?**
- Companies continue to make changes, such as pay mix and performance metrics revisions, in response to the feedback that they have received in 2016

Overview of findings
***Non-Headlines** cont'd*

A couple interesting things we know, but should keep in mind







2

Paying for performance

Paying for performance

Cash Compensation

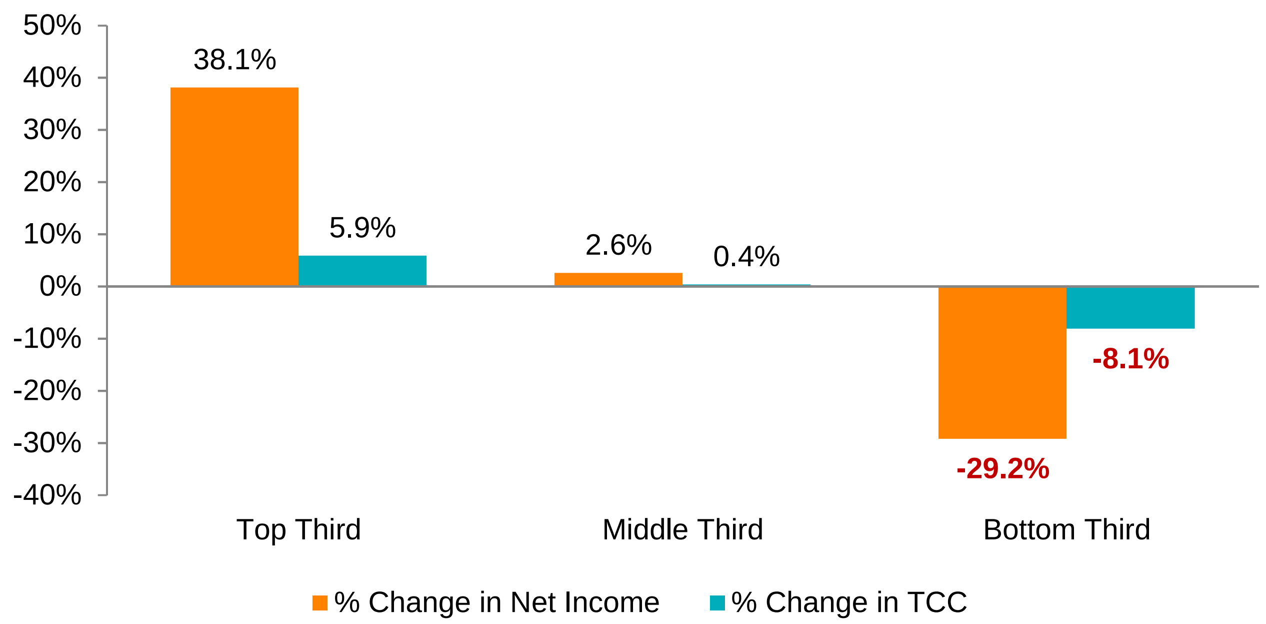
How much did annual performance drive total cash pay outcomes in 2016?

Weaker performance drove lower bonuses, but strong performance didn’t necessarily translate into meaningful increases to cash compensation

- In 2016, significant increases in profitability for top-performing CEOs only translated into a 5.9% rise in cash compensation levels
- To a lesser degree, companies that lost money did not necessarily see a proportional drop in cash compensation levels

Paying for performance
Change in CEO TCC vs. change in net income

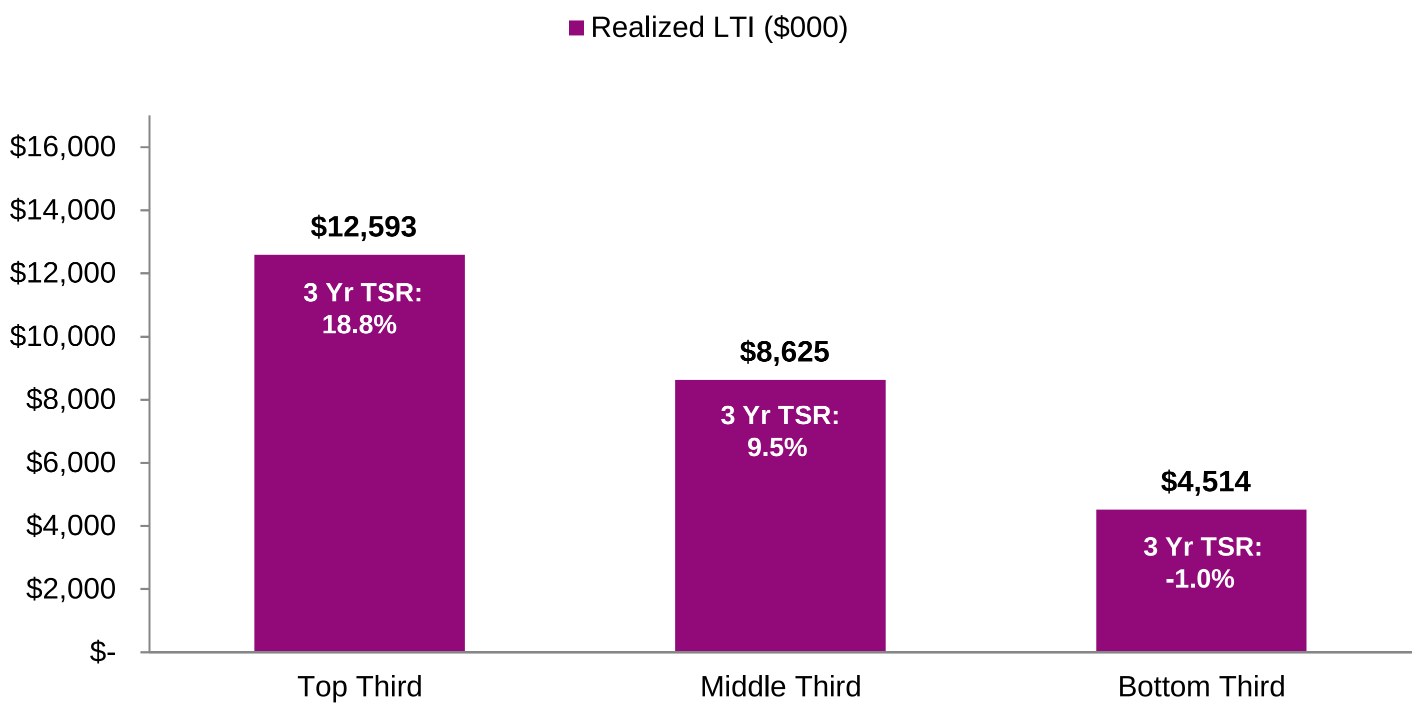
- While bottom-third performers were somewhat penalized, top-third performers weren't necessarily rewarded for strong performance as companies remain cautious about paying executives for short-term results



Paying for performance
Long-Term Compensation

How much did long-term performance drive pay outcomes in 2016

Despite market and political uncertainty in 2016, TSR performance in 2016 returned to double-digit growth levels, driving evident long-term pay differentiation between the various levels of performers



Paying for performance
What does this tell us?

In 2016, companies considered a more holistic and longer-term view of performance rather than rewarding executives immediately with larger bonuses for near-term results

- Compensation Committees are demonstrating restraint and approaching pay decisions based on sustained performance, leveraging the long-term pay element now more than ever

Given the continued emphasis on performance-based LTI grants and a more volatile LTI portfolio, significant realized pay gaps between top, middle and low performers should continue to be exhibited

- More volatile TSR performance over the past three years somewhat tempered realized LTI in 2016, in part because many performance plans use a relative TSR metric

Enhanced efforts to align pay and performance continues to be top of mind for Compensation Committees as pay outcomes shouldn't solely be influenced by TSR, but rather broader organizational and performance context over near and longer-term periods

3

Examples of changing programs

Examples of changing programs
Companies respond to Say-on-Pay votes

In 2016, shareholder outreach continued as companies engaged investors throughout the year to discuss pay issues within the context of economic uncertainty

- Following those meetings, companies often listened to the expressed concerns and recommendations of shareholders, with many continuing to recalibrate their pay programs to better align with he business strategy and horizon
- Companies that have held-out on a TSR metric over the last several years are introducing TSR as a plan modifier rather than overhauling pay-for-performance plans to solely focus on a TSR metric

The most common types of changes seen in 2016 involved the following areas:

- Continued enhancement of performance-based equity vehicles at the expense of time vested equity vehicles
- Redesigned STI and LTI programs with new performance metrics
- Extension of LTI performance periods to better align with the time horizon to execute on the intended business strategy
- Simplification of STI and LTI designs to enhance transparency and perceived value

As shareholders and proxy advisors continue to redefine what an “ideal” pay program consists of, companies will continue to face more pressure to balance shareholder expectations with paying for actual performance

Examples of changing programs

***Companies respond to Say-on-Pay votes** cont'd*

- In response to shareholder outreach discussions, most pay program changes in 2016 included: adopting a new LTI vehicle with increased emphasis on performance-based incentives; and continued redesign of the STI and LTI programs, with a new or revised LTI mix, and evolving performance metrics.

Company	New LTI Vehicle	Increased Emphasis on Perf-Based LTI	New LTI Mix / Redesign	New / Revised Performance Metrics	New / Revised Incentive Caps	Perf Period / Goal-Setting Adjustment	STI Redesign	Enhanced Proxy Disclosure / Transparency
Applied Materials	✓	✓	✓				✓	✓
BB&T Corp	✓	✓	✓	✓				
BorgWarner						✓	✓	✓
Chevron	✓	✓	✓	✓	✓			✓
Chubb		✓			✓			
CVS Health				✓	✓			✓
Exelon				✓	✓	✓		
YUM! Brands		✓	✓	✓				

Examples of changing programs

Companies respond to Say-on-Pay votes *cont'd*

Company	SOP Support	Pay Program Change	Shareholder Engagement?
Applied Materials	2016: 84% 2017: 98%	• Improved **transparency of STI program** and reduced discretionary elements • Wholesale redesign of LTI program to **include two LTI vehicles** instead of one	✓
BB&T Corporation	2016: 55% 2017: 95%	• **Introduced PSUs** as a new LTI vehicle • **Introduced TSR** as an LTIP / PSU modifier • Recalibrated the LTI program to **enhance performance emphasis**	✓
BorgWarner	2016: 40% 2017: 94%	• **Reduced CEO's actual and annual target STI award** • **Provided clarity** on economic value calculation and **eliminated "carry-over" feature** for senior executives • **Limit one-time restricted stock awards**	✓
Chevron	2016: 54% 2017: 94%	• Recalibrated LTI mix to **enhance emphasis on performance shares** and introduction of RSUs • **Capped STI awards** at 200% of target • **Provide more transparency** in the determination of STI awards • Added S&P 500 index as an **additional comparator group to determine PS payouts**	✓

Examples of changing programs

Companies respond to Say-on-Pay votes *cont'd*

Company	SOP Support	Pay Program Change	Shareholder Engagement?
Chubb	2016: 59% 2017: 96%	• **Eliminated second-chance vesting** opportunities for PS awards • Added vesting criteria to PS awards with a **TSR modifier** • **Reduced upside leverage** on PS payouts from 200% to 165% of target • **Increased emphasis of PS** from 50% to 60%	✓
CVS Health	2015: 95% 2016: 80% 2017: 61%	• **Reduced maximum STI awards** • **Improved disclosure of performance metrics** in the incentive program • **Discontinue dividend equivalents on unvested RSUs** until vesting occurs • **Revised TSR modifier** on performance-based LTIP	✓
Exelon	2016: 38% 2017: 87%	• **Extended PS performance period** from 1 to 3 years • **Recalibrated performance metrics and weightings** to better align with strategic initiatives and value proposition • **Reduced CEO's STI payout** from 143% to 100% of target	✓
YUM! Brands	2016: 92% 2017: 90%	• **Increased emphasis of PS** from 25% to 50% • PSU awards **transitioned to two performance metrics** – rTSR and CAGR EPS • Shifting competitive **CEO pay positioning toward market median**	✓

4

What's next?

What's next?
Looking back at 2016

Most companies continue to receive strong shareholder support for their pay programs, but more effort was likely required

- Most companies have a respectable 90%+ Say-on-Pay voting outcome – however, shareholder outreach meetings continue to provide them with recommendations on how to improve their pay programs. Listening and responding to such discussions may enable companies to avoid a lower Say-on-Pay vote in future years
- Pay programs continue to evolve as companies enhance their pay for performance reinforcement – it's a tricky balance to do what's ideal for shareholders while also being right for the business

Proxy advisor outreach is also becoming more common

- Outreach activity continues to intensify and should carry into 2017 as companies rationalize pay decisions that balance performance alignment and retention
- Capacity is an issue at the advisors, so plan early

Companies are working to refine pay program disclosures

- More explanation, rationale, and clarity on current and prospective pay decisions and structure are becoming the norm within the CD&A – it's a marketing tool for corporate issuers to make their case to shareholders
- More depth can be found today with respect to annual incentive and performance-based LTI disclosures to educate shareholders and score points with proxy advisors
- But think about a very succinct Executive Summary

What's next?
ISS

ISS continues to be the dominant proxy advisory firm, but consideration of Glass Lewis has slowly emerged

- While the majority of large institutional shareholders continue to follow ISS, some have developed their own pay 'playbooks' with ISS and Glass Lewis' vote recommendations as secondary considerations

While ISS has become more flexible and continues to improve its approach, their "playbook" has also become more challenging to navigate and their voting recommendations are more difficult to predict

- ISS's quantitative pay-for-performance test will continue to be the driver of its SOP vote recommendation, but broader financial performance will also be considered from a qualitative perspective
- Companies may spend ample energy gaining feedback from shareholders to ensure alignment of their program with its business and shareholder desires, but unique or challenging business situations will never fit their model

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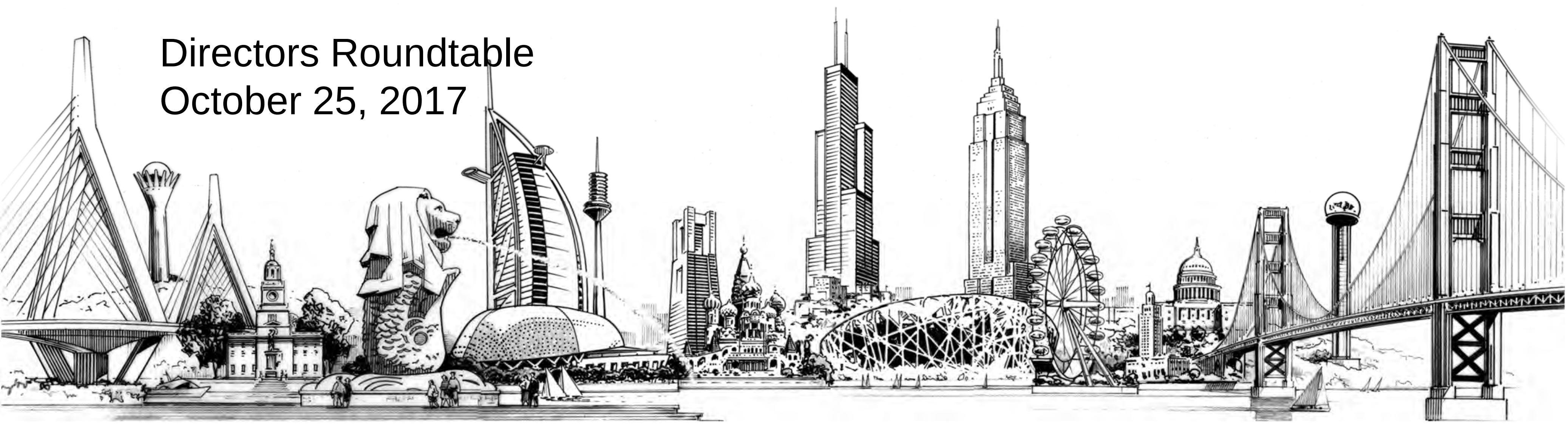
Questions?

Morgan Lewis

STRATEGIES FOR EXECUTIVE COMPENSATION IN TODAY'S "PAY FOR PERFORMANCE" ENVIRONMENT

Laurie A. Cerveny

Directors Roundtable
October 25, 2017



Agenda

- 2017 Proxy Season Update
- 2017 Proxy Disclosure Trends
- Developments in Shareholder Litigation
- Increased Focus on Board Composition and Diversity
- Pay Ratio Update
- Updated SEC Agenda

2017 Proxy Season Update

Say-on-Pay 2017 Results – Russell 3000 Companies

- Similar results to 2016 with vast majority of companies achieving high levels of support
- As of June 30, 2017, 25 companies, or under 1%, had reported a failed Say-on-Pay vote, down slightly from 2016, which had a total of 2%
- 94% of companies received more than 70% support in 2017, generally consistent with 2016
- Of the 22 companies that failed in 2016 and have had their 2017 votes, 17 received majority support and 14 greater than 70% support
- Of the 25 companies that failed this year, only 5 had failed in 2016 and 8 had support over 70% in 2016
- The message: Results in one year are not necessarily predictive of results in future years

2017 Proxy Season Update

Say-on-Pay 2017 Results – Russell 3000 Companies

- Generally low rate of negative results is due to the shareholder engagement efforts that companies, in particular large companies, have undertaken in recent years
- Companies are addressing concerns through changes in compensation programs and through better disclosure
- But efforts must be constant; no resting on prior year's results
- ISS recommended "Against" at 12% of companies so far and 11% total in 2016
- Average support with ISS "Against" is 70%, up from 67% in 2016
- Off-season engagement with ISS and Glass Lewis becoming more common

2017 Proxy Season Update

Say-on-Frequency 2017 Results – Russell 3000 Companies

- In 2011, unclear where market practice would settle
- Some companies, institutions and commentators espoused triennial votes to allow review over longer periods
- But management largely recommended annual votes and shareholders agreed
- 2017 showed that practice solidifying – non-annual votes are now unusual
- Management recommendation and shareholder preference for annual votes at 95% of S&P 500 in 2017
- BlackRock continues to support triennial except where company has failed to align pay with performance

Results of 2017 Equity Compensation Plan Votes – Russell 3000 Companies

- 721 proposals voted on (760 in 2016)
- 20% with ISS “Against” recommendation (24% in 2016)
- Average level of support with ISS “For” recommendation was 93% (92% in 2016)
- Average level of support with ISS “Against” recommendation was 77% (80% in 2016)
- Number of failed proposals (less than 50% support) was 3 (4 in 2016)

2017 Proxy Season Update

Compensation-Related Shareholder Proposals – Russell 3000 (as of June 30, 2017)

- Continued steep decline overall in compensation-related proposals; 29 submitted in 2017 compared to 58 in 2016
- Low support and rarely pass (none this year to date); say-on-pay continues to be the primary way shareholders express compensation concerns
- ISS supported 59% of compensation proposals and support averaged 28% with ISS recommendation; 10% where ISS recommended against
- Most common proposals and support:
  - 7 social compensation issues – 18% support
  - 6 to limit golden parachutes – 32% support
  - 6 to implement clawbacks – 14% support
  - 3 regarding stock retention policies – 30% support
  - 7 “other” – 19% support

2017 Proxy Season Update

Targets of Shareholder Proposals – Large-Cap Focus Continues

- Predictions were that mid-cap companies would come under pressure to adopt governance changes
- But so far generally not the case – Shareholder proposals remain largely targeted at S&P 500 companies
- In 2017 to date, 80% of all proposals voted on were at S&P 500 companies, even higher than in prior years
- Has resulted in a bifurcated corporate governance system with shareholder-friendly governance being much more common at large cap companies than at smaller cap companies
- Most common proposals to go to vote remain Governance, with Social/Political, then Compensation following

2017 Proxy Season Update

Top Shareholder Proposals That Went to Vote

1. Political Issues – 60 (73 in 2016)
2. Environmental Issues – 59 (67 in 2016)
3. Appoint Independent Board Chair – 40 (47 in 2016)
4. Anti-Discrimination – 28 (23 in 2016)
5. Proxy Access – 27 (76 in 2016)
6. Human Rights Issues – 23 (21 in 2016)
7. Lower % of Shareholders to Call Special Meeting – 19 (15 in 2016)
8. Right to Act by Written Consent – 14 (16 in 2017)
9. Adopt Majority Vote to Elect Directors – 14 (19 in 2016)
10. Eliminate Supermajority Thresholds – 14 (16 in 2016)
11. Increase Board Diversity – 8 (8 in 2016)
12. Declassify Board – 6 (6 in 2016)

Shareholder Proposals - Thinking ahead to 2018:

- Most 2017 proxy season shareholder proposals were filed prior to the November 2016 elections
- Expect shareholders to step up their 2018 campaigns on issues they care about, where they run contrary to the Trump administration
- Environmental and Climate Change
- Social Concerns
- Workforce Diversity

2017 Proxy Disclosure Trends

- Continued emphasis on Shareholder Engagement and telling the story in the proxy statement; how many shareholders were contacted and responded, types of feedback received, changes made in response
- Ongoing use of proxy summary and CD&A summary
- Increased use of graphical presentations to show formulas and trends (often in color)
- Compensation checklists (what we do, and what we don't do)
- Increased use of alternative pay measures like realized and realizable pay

2017 Proxy Disclosure Trends

- Focus on the integration of the compensation committee's work with the company's strategic plan – investors care so tell your story
- Continued increase in use of Board skills matrices – more expected in 2018
- Sustainability and commitment to the environment disclosure continues to increase
- Increased use of color
- Increased use of CD&A table of contents and navigational technology
- Many changes have resulted in general improvement in readability and usability, in particular in CD&A (but not shorter disclosure)

Developments in Shareholder Litigation

Alleged Violations of Proxy Disclosure Rules and Plan

Intel Litigation

- In May 2017, an Intel shareholder filed a complaint alleging that Intel failed to comply with SEC disclosure requirements for proxy statements relating to the amendment and restatement of its equity plan
- The complaint sought to enjoin the company from submitting the proposal to a shareholder vote
- Specifically, the complaint alleged that the proxy disclosure failed to specify “the classes of eligible participants, their approximate number, and the basis of their participation” in the Intel equity plan

Developments in Shareholder Litigation

Director Compensation Litigation

- Lawsuits continue to challenge director compensation under Delaware law at several public companies (claiming breach of fiduciary duty, unjust enrichment, corporate waste)
  - Core issue is that outside directors are viewed as interested with respect to their own compensation
  - Directors received equity grants under a plan that did not specify the amount or the form of compensation to be granted to non-employee directors, and the non-employee directors who received the grants also approved them
- Recently, a shareholder lawsuit was brought alleging that Sorrento Therapeutics Inc. directors improperly granted themselves subsidiary stock options
  - Summary judgment was denied for the defendants
  - Court rejected the board's argument that the compensation was shielded by the business judgment rule
  - Instead, the case must be reviewed under the more rigorous "entire fairness" standard, as the shareholder sufficiently pleaded that the transactions were unfair
  - *Williams v. Ji* , Del. Ch., No. 12729-VCMR

Developments in Shareholder Litigation

- Most companies do not want to subject their compensation arrangements to that scrutiny and have settled
- Recent settlements indicate where the trend may go; sample size is very small, but the following may be part of the mix:
  - Dollar amount cap on director equity (not share cap)
  - Submission of cap to shareholder vote
  - Compensation committee commitment and charter amendment to hire independent consultant to advise annually on cash and noncash director compensation
  - Enhanced disclosure of outside director compensation, including philosophy and process

Developments in Shareholder Litigation

Recommendations:

- Review how outside director compensation practices compare to peer practices
- Hard cap on director equity that is submitted for shareholder approval
  - Implement through a plan amendment and express as a dollar amount limit, not as a number of shares
- Enhanced disclosure of outside director compensation
  - Proxy disclosure should include: (a) philosophy on outside director compensation, (b) process used to arrive at the amounts, and (c) the specific annual award limit for each outside director

Increased Focus on Board Composition and Diversity

NYC Comptroller Boardroom Accountability Project

- NYC Comptroller recently launched its second “Boardroom Accountability Project Campaign” focused on board diversity
- The Comptroller is calling on the boards of 151 U.S. public companies to disclose the race and gender of their directors, along with board members’ skills, in a standardized “matrix” format and to enter into a dialogue regarding their board’s “refreshment” process
- Requests in-depth engagement with one or more members of Nominating Committee
- Likely to result in increased disclosure regarding diversity, skills and refreshment, though much resistance to the comptroller’s “matrix” format in lieu of company’s format

Increased Focus on Board Composition and Diversity

- Institutional investors and other stakeholders have increasingly focused on board diversity in recent months
  - State legislatures also have gotten involved in targeting a minimum percentage of boards that should be women
- SSGA announced that it intended to focus on gender diversity and would vote against governance committee chairs at companies that fail to take action to promote gender diversity on boards of directors
  - This was reported in September 2017 to have occurred at 400 companies
- Vanguard also states that gender diversity is one element of board composition that it will continue to focus on over coming years
- ISS survey results show 2/3 of investor respondents find it problematic if no women served on a public company board; engagement important to understand why

Pay Ratio Update

CEO Pay Ratio Disclosure

- The disclosure is effective for most companies in the 2018 proxy season
- The rule generally requires proxy disclosure of:
  - The total annual compensation of all “employees,” other than the CEO
  - The total annual compensation of the CEO
  - The ratio of the CEO’s total pay to the median total pay of all employees
- Companies must also disclose:
  - Methodology for determining the median employee
  - The date chosen for identifying the median employee (which must be in the last three months of the year)
- SEC recently provided helpful guidance
- Companies have latitude to select the methodology for identifying the median employee - company’s size, structure and compensation methods
- SEC has attempted to address issues facing multinational and/or multi-business line companies

Pay Ratio Update

Summary of new SEC guidance:

- Describes companies' ability to combine the use of reasonable estimates with other reasonable methodologies, including statistical sampling
- Clarifies that consistently applied compensation methodologies can be formulated with internal records that reasonably reflect annual compensation, even if the records do not include every pay element, such as widely distributed equity
- Allows companies to refer to a pay ratio as an "estimate"
- Guidance withdrawn regarding classification of a worker as an independent contractor versus an employee

Pay Ratio Update

The SEC provided the following examples of the sampling methods (depending on the company):

- **Simple random sampling** (drawing at random a certain number or proportion of employees from the entire employee population)
- **Stratified sampling** (dividing the employee population into strata, e.g., based on location, business unit, type of employee, collective bargaining agreement, or functional role and sampling within each strata)
- **Cluster sampling** (dividing the employee population into clusters based on some criterion, drawing a subset of clusters, and sampling observations within appropriately selected clusters, which may be conducted in one stage or multiple stages)
- **Systematic sampling** (the sample is drawn according to a random starting point and a fixed sampling interval, every nth employee is drawn from a listing of employees sorted on the basis of some criterion)

Pay Ratio Update

- The new guidance clarifies various “reasonable methods” that a company may utilize, including those applicable to multi-national corporations
- For example, a company that has employees both in and outside of the U.S. with three business units and 21 geographical units may perform sampling from each of the three business units
  - In obtaining samples of compensation data from each of the three business units, the company could select samples from the geographic locations whose employee pay is generally representative of employee pay within the entire business unit

Pay Ratio Update

- No Enforcement action unless bad faith or no reasonable basis
- Use of internal records
  - Companies may use existing internal records, such as tax or payroll records, to determine the “median” employee
  - Companies may also use internal tax or payroll records to help determine whether it may except non-U.S. employees that account for 5% or less of its total employee population
  - Companies may use internal records that “reasonably reflect” annual compensation to identify the median employee, even if not all elements of compensation, such as equity awards, are widely distributed to employees
- Anomalous results
  - If the use of a consistently applied methodology based on internal records gives the company a median employee with “anomalous” compensation characteristics, which, in turn, significantly impact the resultant pay ratio, the company may substitute another “median employee” with substantially similar compensation
- Use of IRS and other guidance for determination of “employees”
  - Prior confusion regarding whether independent contractors may be deemed “employees” for pay ratio disclosure has been eliminated
  - Companies may apply a widely-recognized test under another area of law (such as IRS guidance) to determine whether its workers are “employees” under the rule

Pay Ratio Update

Supplemental Pay Ratio Disclosure

- Companies may provide “supplemental” disclosure to offset a particularly skewed pay ratio
- For example, companies are considering including a pay ratio disclosure showing CEO pay as compared to the median of U.S. full-time employees only and/or the executive team only
- The supplemental disclosure may not be more prominent than the required pay ratio disclosure

Mitigating Negative Reaction

- Ensure that competitive compensation opportunity levels are monitored annually against the median of an appropriate peer group
- Ensure the company is prepared for internal and external messaging
- More than ¾ of respondents to ISS Survey indicate they intend to compare pay ratio information across companies and industries or analyze year over year changes, or both
- Responses also indicated that pay ratio disclosure is likely to influence voting on compensation-related matters
- Apply “best practice” compensation and governance policies, including robust stock ownership guidelines, clawbacks, policies, and prohibit hedging and pledging in company stock

Pay Ratio Update

Where is Everyone in the Process? As of July 2017 based on survey by *The Corporate Counsel* (128 respondents)

Stage of Progress	Percentage of Respondents
"Barely Prepared" (i.e. still assessing the workforce population	~56%
"Somewhat Prepared" (i.e. running calculations and statistical sampling)	~20%
"Very Prepared" (i.e. all calculations have been run, but draft disclosure not prepared	~13%
"Fully Prepared" (i.e. draft disclosure prepared)	~2%
Other	~8%

Updated SEC Agenda

- The SEC recently published its semiannual regulatory agenda
- Notably, the following have been removed from the prior year's agenda:
  - Universal Proxy
  - Corporate Board Diversity
  - Clawbacks
  - Pay for Performance
  - Hedging
- The following issues remain on the agenda for 2018 (more business friendly):
  - Regulation S-K Business and Financial Disclosure
  - Disclosure Update and Simplification
  - Emerging Growth Company Simplification
  - Audit Committee Disclosure
  - Mining Disclosure Modernization

Updated SEC Agenda

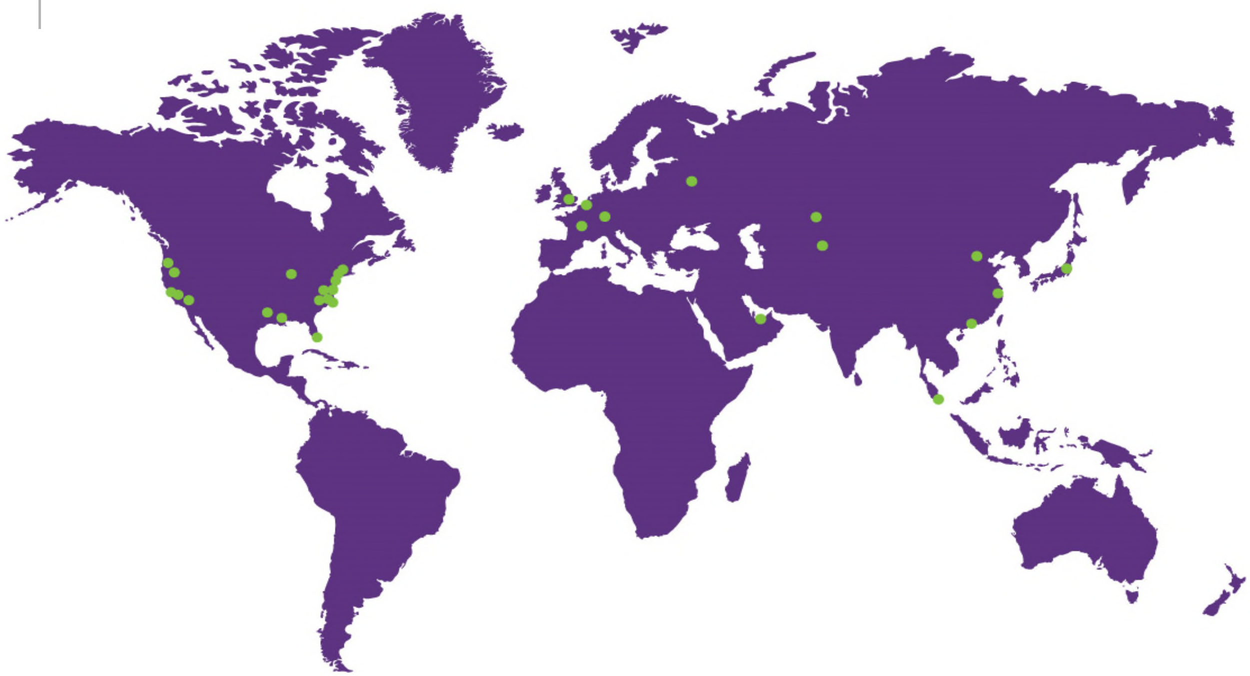
- Comments to the SEC regarding the updated agenda were due September 25, 2017
- CII calls on the SEC to complete its Dodd-Frank rulemaking mandates, which include Universal Proxy, clawbacks, and hedging disclosures
- Each of these were re-classified in the current agenda as “long term” in favor of the identified initiatives relating to capital formation and disclosure effectiveness

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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THANK YOU