

Key Compensation Items for the 2019 Proxy Season and Beyond

Public companies should consider a number of items for 2019, including recent SEC and proxy advisory developments and other perennial executive compensation considerations.

Even as the US government shutdown continues to create complexities for many companies,¹ it is business as usual for US public companies that are continuing their annual planning for the upcoming proxy season. Although 2019 introduces fewer significant changes than 2018 to the executive compensation landscape, this *Client Alert* offers a brief summary of the key executive compensation-related reminders and considerations that public companies should continue to prioritize early in 2019 and in the course of their preparations for the proxy season.

New Requirement to Disclose Hedging Practices and Policies

As mandated under the Dodd-Frank Act, the Securities and Exchange Commission (SEC) has adopted a new disclosure requirement under which US public companies must disclose their hedging practices or policies in their annual proxies or information statements. Specifically, Item 407(i) of Regulation S-K will require 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. 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 proxy or information statement relating to the election of directors. The requirement becomes effective for fiscal years beginning on or after July 1, 2019; though smaller reporting companies and emerging growth companies (EGCs) may delay compliance until 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 now 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 towards reducing the magnitude of pledging over time.

Proxy Action Item

Companies 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 2019 voting policies (along with corresponding ISS FAQs), effective for all companies with annual meetings on or after February 1, 2019. Set forth below is a summary of certain compensation-related policy changes and updates that companies should consider while preparing for the 2019 proxy season.

Consequences for Excessive Non-Employee Director Pay

In 2018, ISS introduced a new policy that will provide for 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. ISS has confirmed that application of this policy will not trigger a negative recommendation until meetings occurring on or after February 1, 2020 (*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 further confirmed that it will compare individual non-employee director pay totals to the median of all non-employee directors at companies in the same index and sector (within the same two-digit Global Industry Classification Standard group). Any non-employee directors paid at the top 2-3% 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. Mitigating factors may include one-time awards, special payments related to unusual transactions or circumstances or payments in consideration of special expertise. If any of these factors exist, companies should consider expanding their disclosure to address them.

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 2-3% of directors as compared to the median director may be considered a mitigating factor.

Equity Plan Proposals

ISS made some minor adjustments to its methodology for the review of equity plan proposals for the 2019 proxy season. The passing score for companies under the ISS equity plan scorecard (EPSC) will remain at the same levels in effect for 2018 (53 points out of 100 (increased to 55 points out of 100 for those

companies subject to the S&P 500 scoring model)), but ISS implemented the following changes to its equity plan scoring model:

- ISS revised the change in control vesting factor to focus on the quality of the disclosure of change in control vesting, rather than evaluating the treatment of awards upon a change in control. ISS now provides that full credit will only be awarded with respect to the change in control vesting factor if the plan specifically discloses the vesting treatment for both time- and performance-based awards. Points will not be awarded if the plan provides for discretionary vesting or is silent as to the change in control vesting treatment for either time- or performance-based awards. ISS has increased the weighting of the plan duration factor, and will only award full points where the proposed share reserve should last five to six years or less (based on the company's three-year annual average burn rate).
- ISS has confirmed that it will consider equity plan amendments involving removal of general references to Section 162(m) as administrative and neutral. However, ISS will view the removal of individual award limits in an equity plan as a negative change, as ISS considers such limits to be a good governance practice and a stockholder-favorable practice. Additionally, ISS' 2019 policies specifically note that shifts away from performance-based compensation to discretionary or fixed pay elements will be viewed negatively by ISS.
- ISS has also provided that, while it will generally follow its EPSC model in evaluating equity plan proposals, ISS may recommend against the proposal despite a passing score if it is deemed "excessively dilutive." ISS considers a proposal excessively dilutive if the proposal is estimated to cause share capital dilution² of more than 20% (for S&P 500 model) or 25% (for Russell 3000 model). This new policy does not apply to companies that are covered by a model other than the S&P 500 model or Russell 3000 model.

Front-Loaded Awards

ISS' 2019 policies specifically address "front-loaded" awards intended to cover multiple future years, which awards have become more prevalent in the last several years. ISS is unlikely to support any such grants that cover more than four years (calculated as the grant year plus three future years). ISS will also look for specific and firm commitments not to grant additional awards over the period covered by the grant. The presence of these types of awards will also receive more scrutiny with respect to ISS' usual pay-for-performance considerations and companies will want to ensure they provide complete disclosure, especially around the vesting and performance conditions and the rigor of any performance criteria.

Decreased Disclosure for Smaller Reporting Companies

In connection with the SEC's recent change to expand the definition of "smaller reporting company" (SRC), which is further discussed below under [Other Proxy Season Reminders](#), Glass Lewis has updated its voting guidelines to clarify that it will consider the impact of materially decreased executive compensation disclosures in the proxy statement. If Glass Lewis determines that the reduced executive compensation disclosures substantially impacts a stockholder's ability to assess the company's executive pay practices, then Glass Lewis may recommend against compensation committee members. Similarly, ISS notes that companies with scaled compensation disclosure will need to provide sufficient disclosure to allow stockholders to meaningfully assess the board's compensation philosophy and practices and make an informed decision on any say-on-pay vote.

Proxy Action Item

Companies should consider how ISS' and Glass Lewis' voting policies may affect companies' proxy proposals. 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

Directors have historically avoided the compensation scrutiny applied to executives; however, there has been increased attention towards director compensation in recent years. In late 2017, the Delaware Supreme Court issued an opinion that continued the trend of enabling plaintiffs to sue companies for director compensation. The decision in *In re Investors Bancorp, Inc. Stockholder Litigation*, Case No. 1693,³ found that equity awards granted to Investors Bancorp's directors were "self-interested decisions" and must be reviewed under the "entire fairness" standard (as opposed to the business judgment rule).⁴ 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.⁵

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.⁶ 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:

Reviewing Existing Director Compensation Arrangements

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, a comparison of director compensation (both cash and equity) against the company's compensation peer group, and proxy disclosure regarding the process for determining and amounts of director compensation. 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 will also want to ensure their public disclosure does not indicate unreasonable benchmarking practices.

Considering Potential Plan Changes

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 standalone directors' plan may provide certain benefits, including (1) maintaining a distinct framework for a company's director compensation, and (2) allowing for clear and distinct proxy disclosure and a more straightforward process for stockholder approval of director compensation.⁷ 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.⁸ 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.

Reviewing Director Compensation Disclosure

In light of the increased focus on 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. 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 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.

Proxy Action Item

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 2019 proxy season likely will bring additional examples of companies proposing formulaic director plans or programs within broader equity plans for stockholder approval. The *Investors Bancorp* decision was decided late in 2017, too late for most companies to take its findings into account in making decisions with respect to the proposals for their 2018 proxies. Companies not incorporated in Delaware may have particular incentive to take a wait-and-see approach to see whether courts in other states adopt the reasoning employed in the *Investors Bancorp* decision. However, decisions about director compensation in light of *Investors Bancorp* must be made on a company-by-company basis.

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, the CEO pay ratio disclosure was required for most proxies filed in 2018 and most issuers have already performed these calculations and disclosed the resulting ratio.

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 or employee compensation arrangements that the company reasonably believes would result in a significant change to its pay ratio disclosure. 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 requirement⁹ 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:

<p>Step 1 ▼</p>	<p><i>Has the company previously disclosed a CEO pay ratio?</i> If a company has previously disclosed its CEO pay ratio, move to Step 2.</p> <p>For companies required to disclose their CEO pay ratio for the first time during 2019, 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.</p>
<p>Step 2 ▼</p>	<p><i>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?</i> If the answer is no, move to Step 3.</p> <p>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.</p>
<p>Step 3 ▼</p>	<p><i>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?</i> If the answer is no, move to Step 4.</p> <p>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.</p>

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.

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.

CEO Pay Ratio — Consider Capturing Additional Disclosures

In 2018, S&P 500 companies received a form letter signed on behalf of a number of investors, including the New York City Comptroller and the New York State Comptroller, as well as a number of advocacy groups (including the AFL-CIO, the International Brotherhood of Electrical Workers, and the International Brotherhood of Teamsters), regarding the CEO pay ratio disclosures in last year's proxy statement. The letter provides a list of supplemental disclosures that the letter's signatories believe will be helpful to investors, by providing additional context and requesting that the company consider including them in next year's proxy statement. The requested supplemental disclosures include, as examples only: identification of the median employee's job function, geographic location of the median employee, a breakdown of full time vs. part time employment status, and use of temporary or seasonal employees or of subcontracted workers, amongst other disclosures.

Many companies already voluntarily provide supplemental disclosures on their CEO pay ratio. In preparing for the 2019 proxy statement, companies may consider including additional 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.

Other Proxy Season Reminders**2018 Say-on-Pay Vote Response**

As always, public companies that conducted a say-on-pay vote in 2018 should consider the results and determine what, if any, changes they should make to executive compensation programs and disclosure. Many companies, particularly those that received less than 70% support, have likely been engaging with stockholders and reviewing their compensation programs. ISS recommends full disclosure of the company's response to a say-on-vote of less than 70%, including disclosure related to stockholder outreach, concerns voiced by stockholders, and meaningful company actions taken to address stockholder concerns. In most cases, companies in this situation will be able to address the ISS

recommendations in the context of their disclosure — describing what they heard from stockholders, how they responded, and why.

Proxy Action Item

Companies — particularly those that received less than 70% support in their most recent say-on-pay vote — should disclose their stockholder outreach and response to this vote.

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 2013 will need to do so again in 2019. 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.

Proxy Action Item

Confirm whether one or both proposals are required in 2019. If a say-on-pay vote is required, companies should consult with outside advisors regarding the likelihood of adverse recommendations by proxy advisory firms.

EGCs Must Confirm Continuing EGC Status and Potential New Requirements if Exiting EGC Status

An EGC generally must hold a say-on-pay vote no later than one year after it ceases to qualify as an EGC. However, if a company has been an EGC for less than two years after its IPO, the company has up to three years after the IPO to hold the vote, though a say-when-on-pay vote may need to occur earlier. For EGCs, the say-when-on-pay vote is required as early as the first annual meeting after the company ceases to be an EGC, regardless of when the company ceased being an EGC following its IPO.

Notably, companies that lose EGC status (and do not qualify as a SRC) also will 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, 2018, it will be required to include CEO pay ratio disclosure in its proxy statement filed in 2020 that includes 2019 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, as discussed above under [Proxy Advisory Policy Updates](#), 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 programs.

Proxy Action Item

Companies that previously were not eligible for SRC status but that could now qualify as an SRC under the new increased thresholds may wish to consider the advantages of SRC status, including scaled executive compensation disclosure. Companies should consult with corporate counsel on this decision.

Compensation Advisor 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 advisor independence analysis is undertaken prior to retention of new compensation advisors. Best practice is to perform such analysis on an annual basis.

Compensation Risk Assessment

Compensation committees should 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 and in view of recent events, 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 Membership

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 Tax Cuts and Jobs Act¹⁰ (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.

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.

Equity Plan Matters

Companies that are already planning to include equity plan proposals on their annual meeting agendas during 2019 to 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:

- **Director Compensation Provisions.** As discussed above under [Considering Potential Plan Changes](#), companies may wish to include specific 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 2019 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 any time 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.
- **Plan Expiration Dates.** Companies should review their equity plans to determine whether the plans are subject to expiration in the coming year, and whether they should take action at the 2019 annual meeting to extend the plan or adopt a new plan prior to any such expiration.
- **Potential Removal of Section 162(m) Provisions.** Equity and incentive plans typically contain extensive provisions designed to ensure that awards were eligible 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 (generally material) amendments may cause a loss of the ability to rely on the transition relief under the TCJA.¹¹ 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](#).¹² 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 if an equity plan proposal is on their annual meeting agenda.

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, 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 advisors to confirm compliance with disclosure requirements, tax law developments, recent litigation trends, and other considerations that will require continued attention in 2019 and beyond.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Holly M. Bauer

holly.bauer@lw.com
+1.858.523.5482
San Diego

David T. Della Rocca

david.dellarocca@lw.com
+1.202.637.1050
Washington, D.C.

Maj Vaseghi

maj.vaseghi@lw.com
+1.650.470.4852
Silicon Valley

Bradd L. Williamson

bradd.williamson@lw.com
+1.212.906.1826
New York

Stephanie Jeane*

stephanie.jeane@lw.com
+1.415.395.8089
San Francisco

**Admitted to practice in DC and Texas only. All work supervised by a member of the California bar.*

You Might Also Be Interested In

[Reminder: Employers Must Report 2018 ISO and ESPP Transactions](#)

[IRS Provides Initial Guidance on Section 162\(m\) Tax Reform Changes](#)

[Compensation in the 2018 Proxy Season: Recent Shakeups Create New Challenges](#)

[We've Got Washington Covered](#)

[US Tax Reform Resource Center](#)

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit <https://www.sites.lwcommunicate.com/5/178/forms-english/subscribe.asp> to subscribe to the firm's global client mailings program.

Endnotes

- ¹ In general, we do not expect the US government shutdown will have a significant effect on most issuers this proxy season. While the US government shutdown remains in effect, those companies that are required to file a preliminary proxy this year (for matters outside of the normal annual meeting items described in Rule 14a-6 of the Securities Exchange Act of 1934 (Exchange Act)) may simply file the preliminary proxy, wait ten days and file the definitive proxy without further action as the rule is self-executing and the staff of the Securities and Exchange Commission (SEC) will not be on duty to review the preliminary proxy. When the US government shutdown ends, there will be a significant backlog of requests under Rule 14a-8 of the Exchange Act, so the no-action process for stockholder proposals will likely see additional delays; therefore, companies should plan accordingly if they will have a Rule 14a-8 request this year.
- ² Dilution for this purpose is calculated using the following formula: $(A + B + C) \div \text{CSO}$, where: A = the number of new shares requested; B = the number of shares that remain available for issuance; C = the number of unexercised or unvested outstanding awards; and CSO = the number of common shares outstanding.
- ³ 2017 WL 1277672 (Del. Sup. Ct. Dec. 13, 2017).
- ⁴ 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.
- ⁵ For a more complete discussion of the *Investors Bancorp* decision, please refer to [Latham's January 17, 2018 Client Alert](#). For a discussion of Delaware cases addressing director compensation prior to the *Investors Bancorp* decision, please refer to [Latham's May 28, 2015 Client Alert](#).
- ⁶ *Calma v. Templeton*, C.A. No. 9579-CB (Del. Ch. April 30, 2015); *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012); *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007).
- ⁷ Equity plans solely for non-employee directors will generally not be subject to the EPSC analysis utilized by ISS for “omnibus” equity plans. See [ISS' 2019 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.
- ⁸ 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.
- ⁹ 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 2018, its first pay ratio will appear in the 2020 proxy in which 2019 compensation is disclosed.
- ¹⁰ 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.
- ¹¹ 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.”
- ¹² 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.