2019 Proxy Season Hot Topics: Part 4 – Diversity disclosure and executive compensation

2019 PROXY SEASON HOT TOPICS
Corporate Governance Alert

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As we enter the 2019 proxy season, we want to bring your attention to a few topics that are likely to play a prominent role in the coming months. In our first alert, we discussed changes in the voting policies of ISS, the SEC’s continued focus on non-GAAP measures and the SEC’s proxy plumbing roundtable. In our second alert, we took a deeper dive into issues directly impacting the 2019 proxy season to discuss changes in the voting policies of Glass Lewis, virtual-only shareholder meetings, issues regarding board refreshment, composition and diversity, say-on-pay, CEO pay ratio and director compensation arrangements. In our third alert, we discussed some issues beyond proxy-related matters that are likely to impact public companies in general, including the new SEC hedging rules, changes to the independent auditor’s report, changes to the Form 10-K cover pages and exhibit hyperlinks.

In this alert, we discuss the SEC staff’s latest C&DIs on diversity disclosure, issues related to director compensation, section 162(m), perquisite disclosure, a registrant’s graduation from being an Emerging Growth Company and the need to perform an equity incentive plan and ESPP checkup.

We are excited about our new format for this series and invite you to call the authors of this alert or your DLA Piper contact if you have any questions or would like to discuss any of the issues reviewed in the series.
1. **DIVERSITY DISCLOSURE**

Earlier this month, the SEC Division of Corporation Finance issued new Item 401 and 407 C&DIs (Q116.11 and Q133.13, which are identical) concerning director self-identified diversity characteristics and Board diversity policy disclosures.

Pursuant to Item 401(e) of Regulation S-K, a registrant is required to discuss the background of its directors, including their business experience, qualifications, attributes and skills that led to the director’s nomination as a director. And, pursuant to Item 407(c)(2)(vi) of Regulation S-K, a registrant is required to discuss the nominating committee’s process for identifying and evaluating director nominees, including a discussion regarding any director diversity policy and the manner in which its effectiveness is assessed.

The C&DIs clarify that if a board or nominating committee considered diversity characteristics of a Board candidate (e.g., race, gender, ethnicity, religion, nationality, disability, sexual orientation or cultural background), and if the candidate consents to the disclosure of these self-identified diversity characteristics in the issuer’s proxy statement, the SEC staff would expect that the issuer’s discussion of director qualifications include such diversity characteristics and how they were considered. The C&DI also clarifies that the SEC staff expects that any description of diversity policies to include a discussion of how the registrant considers the diversity attributes of nominees as well as any other qualifications the diversity policy takes into account, such as diverse work experience, military service, or socioeconomic or demographic characteristics.

**DLA Piper action items**

The new C&DIs address disclosure of self-identified director diversity characteristics under Item 401 and under Item 407 of Regulation S-K.

- Review the registrants’ current charters and guidelines to identify instances where “diversity” is specifically noted.
- Undertake a review of existing proxy disclosure to determine whether to enhance disclosure regarding director qualification and nomination process.
- Given the timing of the new interpretive advice, it is possible that some registrants may conclude that additional disclosure is not required.

2. **DIRECTOR COMPENSATION MATTERS – STILL ON THE RADAR**

Director compensation continues to be a common source of shareholder litigation exposure for boards of directors. The Delaware Supreme Court’s decision in *In Re Investors Bancorp, Inc. Stockholder Litigation, Case No. 169 (In Re Investors Bancorp)* from late 2017 should remain at the forefront of compensation committee considerations as they set director compensation for the year.

In this case, the Delaware Supreme Court rejected the long-held presumption that including meaningful limits in shareholder-approved equity plans is sufficient to demonstrate shareholder ratification. Instead, the court reasoned that a different standard of review should apply when boards are issuing equity grants under plans that do not meaningfully limit director discretion. The decision emphasized that when directors have more discretion over their awards and the terms of those awards, such decisions are not entitled to a deferential standard of review.

The court decided that the entire fairness standard is the appropriate standard of review for analyzing board decisions about director compensation issued under a plan that is neither self-executing nor formula-based. The entire fairness standard places the burden on boards to demonstrate that their compensation decisions were entirely fair to companies.

Practically, compensation committees should factor in the burden to demonstrate fairness in the process used to set award sizes and terms as they design equity plans and grant director awards. Challenges to director compensation issued under equity plans that do not sufficiently limit board discretion are expected to be difficult to dismiss at the pleading phase. Of course, any such shareholder suits that are not dismissed at the pleading phase can prove to be costly and could damage public perception of a company and its board.

**DLA Piper action items**

DLA Piper is a global law firm operating through various separate and distinct legal entities. Further details of these entities can be found at www.dlapiper.com. This may qualify as
In the post-In Re Investors Bancorp landscape, we recommend compensation committees employ a few best practices to mitigate shareholder litigation exposure. These best practices include:

- Enlisting a compensation consultant to provide peer reviews and closely reviewing the criterion used to identify peers.
- Documenting the philosophy underlying the award sizes and terms to demonstrate how the compensation committee used the peer review and historical grant history to set amounts.
- Reviewing proxy disclosure to ensure that the communications to shareholders clearly reflect a process that is fair and balanced.
- Evaluating whether to add formulaic provisions to equity plans to determine the size of director awards to limit board discretion.
- Making certain that the reasoning behind any significant departures from past grant cycles is clearly outlined in all shareholder communications, including the company’s proxy disclosure.
- Considering including grant-date dollar limitations in lieu of limits expressed as a number of shares. Because fluctuating share prices will not affect a grant-date dollar limitation, such limitations may be a more objective expression of value.

3. **SECTION 162(m) – ONGOING ISSUES**

In August 2018, the Internal Revenue Service (IRS) issued Notice 2018-68 clarifying certain changes to Section 162(m) of the Internal Revenue Code which was amended by the Tax Cuts and Jobs Act of 2017 (TCJA). As a result of the TCJA, certain existing executive compensation arrangements will now be subject to the Section 162(m) deduction limitation. The Notice provided limited transition (grandfather) relief to certain existing arrangements.

The grandfather rule set forth in the Notice, which many employers were hopeful would provide the opportunity to preserve the performance-based exemption for many existing arrangements, unfortunately provides limited relief. The Notice provides that compensation offered under a "written binding contract" in effect on and that is not "materially modified" after November 2, 2017 will be subject to the old Section 162(m) rules (ie, prior to the enactment of the TCJA).

However, determining whether an agreement constitutes a "written binding contract" and what is a material modification continue require careful and detailed analysis. Please see our alert on this topic. The following are a few important considerations followed by action items for employers.

A. **Equity grants made after November 2, 2017**

In general, new compensation arrangements and new equity awards made after November 2, 2017 will be subject to the new Section 162(m) regime. Although the performance-based exemption under 162(m) may no longer be available, this change could provide compensation committees with some flexibility in determining how best to design compensation programs by moving compensation from variable to fixed or vice versa and reviewing "negative discretion" clauses in new awards. The influence of institutional shareholders, however, on the design of these performance-based compensation will be an important part of this analysis.

B. **Analyzing written binding contracts in effect as of November 2, 2017**

For purposes of the transition rule, only a "written binding contract" as determined under applicable state law will be considered "grandfathered." If an agreement includes "negative discretion" by the employer to either clawback, reduce or eliminate an award in part or its entirety, this may result in an agreement failing to meet the "grandfather" requirements in the Notice and therefore being subject to the new Section 162(m) rules.

C. **Renewals/modification**

The Notice provides some relief to a written binding contract in effect on November 2, 2017 that continues and is not renewed or materially modified after that date. However, if that contract is terminable or cancellable by the employer without the employee's consent after November 2, 2017, the contract is treated as renewed as of the date that any such termination or cancellation, if made, would be effective.

D. **Acceleration of payments**
The Notice clarifies that in certain circumstances, the acceleration of a payment under a contract would not be a "material modification." This relief is limited, however. With regard to deferrals of compensation, the Notice provides that it is not a material modification under Section 162(m) to increase (or decrease) in the amount payable on a deferred basis is based on either a reasonable rate of interest or a predetermined actual investment. Other types of deferral arrangements which provide for other rates or means of determining earnings may not be covered by the transition relief.

**DLA Piper action items**

- To the extent that an employer has not analyzed existing arrangements and is expecting to rely on the TCJAs, such agreements should be carefully reviewed in light of the new guidance in Notice 2018-68.
- Employers will need to identify who are "covered employees" and should maintain a database to keep track of all covered employees for tax years beginning after December 31, 2016, particularly in connection with corporate transactions.
- Employers should consult with executive compensation counsel as part of 2019 compensation committee discussions on Compensation Discussion & Analysis (CD&A) disclosure related to executive compensation and changes to any arrangements in light of the changes to Section 162(m).
- As part of 2019 compensation planning, employers may want to consider restructuring their compensation arrangements to avoid the $1 million deduction cap of Section 162(m) and whether to adopt new or amended and restated equity plans.
- In 2019, prior to making any changes to employment agreements with "covered employees," employers should carefully review any such changes and taking into account any potential impact of Section 162(m) on such arrangements.
- Foreign private issuers, recent IPO companies who are relying on the "IPO transition" rule under the old 162(m) rules, and entities involved in M&A corporate transactions affecting compensation paid to "covered employees" should be on the watch in 2019 hopefully for additional guidance from the IRS.

4. **FOCUS ON PERQUISITE DISCLOSURE**

The SEC recently targeted a registrant for not adequately training employees in key roles, including those tasked with drafting and compiling the executive compensation tables required by Item 402 of Regulation S-K. In that case, the enforcement action alleged that the registrant failed to ensure that the proper standard was applied for perquisites disclosure and failed to implement adequate processes and procedures to ensure proper reporting of perquisites. The registrant also agreed to pay a civil money penalty and agreed to retain for one year an independent consultant approved by the SEC to conduct a review of the registrant’s policies, procedures, controls and training relating to executive compensation disclosure.

**DLA Piper action item**

- Review and ensure compensation-related disclosures are correct, especially with respect to perquisites.

5. **ARE YOU AN EMERGING GROWTH COMPANY? WHY DOES IT MATTER?**

Generally, a registrant’s emerging growth company (EGC) status terminates on the earliest of:

- the last day of the first fiscal year in which the registrant’s annual gross revenues exceed $1 billion
- the date on which the registrant is deemed to be a large accelerated filer
- the date on which the registrant has, during the previous 3-year period, issued more than $1 billion in non-convertible debt and
- the last day of the fiscal year in which the 5th anniversary of the registrant’s first sale of equity securities pursuant to an effective registration statement occurs.

If a registrant’s status as an EGC will terminate as of the end of its current fiscal year, then the proxy statement for the next year will need to include comprehensive compensation disclosure for all named executive officers (NEOs), not just the principal executive officer and the two highest paid other executive officers.

In addition, the next proxy statement also will need to include a full compensation discussion and analysis (CD&A) section that describes in narrative form the rationale underlying compensation-related decisions for NEOs. A registrant also is required to hold a “say-when-on-pay” vote the first year in which it is no longer an EGC and the
CEO pay ratio disclosure will apply for the first full fiscal year that a registrant ceases to be an EGC.

**DLA Piper action item**
- Keep track of the different metrics which may result in a registrant losing its EGC status.

6. **TIME FOR A CHECKUP?**

We recommend that a registrant (and their stock administration department) perform a check up on their equity incentive plans and employee stock purchase plans from time to time.

**DLA Piper action item**
- Are there are sufficient shares for equity grants in 2019 and the near future?
- Review Form S-8 registration statements (and other appropriate filings) to ensure they are up to date.
- Confirm if a registrant has an employer stock fund within its retirement plan, that registration statements are up to date and that appropriate SEC Form 11-K filings are being made, if required.

Learn more about these issues by contacting any of the authors, and see the entire 2019 Proxy Season Hot Topics Series here.

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