ALERT

October 31, 2018

GLASS LEWIS RELEASES 2019 VOTING POLICY UPDATES

On October 24, Glass Lewis released U.S. voting policy updates for 2019. There are several key policy changes focused on executive compensation that impact Glass Lewis' vote recommendations on Say-on-Pay and reelection of Compensation Committee members. These policy changes focus on contractual payments and arrangements, front-loaded incentive awards, change in control excise tax gross-ups, recoupment provisions ("clawbacks"), executive compensation disclosures for smaller reporting companies, and other executive compensation clarifications.

Contractual Payments and Arrangements

Glass Lewis expanded its policy on contractual payments and arrangements related to new hires and terminations and provided clarification on the terms that could contribute to an "Against" Say-on-Pay vote recommendation. In its discussion, Glass Lewis emphasized the importance of providing a meaningful explanation for sign-on awards, make-whole awards, and severance payments that exceed the obligations based on employment agreement or policy provisions. Glass Lewis also advised to not exceed the upper limit of general market practice for cash severance multiples (3x salary and bonus) or include long-term incentives in such calculations. Aside from the overall magnitude of contractual payments, Glass Lewis will also consider the design of such entitlements, noting that the following terms could contribute to an "Against" vote recommendation: key man clauses, board continuity conditions, excessively broad change in control triggers, and "poor wording" of employment agreements (e.g., terms that are excessively restrictive in favor of the executive or could potentially incentivize behaviors that diverge from the company's best interest). Glass Lewis also highlighted the inclusion of multiyear bonus guarantees as an entitlement that may drive "Against" recommendations on its own.

These helpful clarifications cover many of the "What We Don't Do" items companies often highlight in their CD&A disclosure to communicate with shareholders that their compensation programs have a strong focus on good governance practices. If a company maintains any of the features referenced above, clear and compelling rationale will be needed to avoid a potential "Against" recommendation.

Grants of Front-Loaded Awards

Glass Lewis added a new section on front-loaded awards (i.e., large upfront grants intended to cover a multiyear period) to its policy guidelines. The guidance indicates careful scrutiny of magnitude, design, and the underlying rationale for making such grants. In particular, Glass Lewis stressed that the award's change in control and termination provisions must ensure that executives do not receive "excessive payouts" that are not aligned with shareholder experience or company performance. Glass Lewis also expects companies to firmly commit to not granting additional awards for a defined period, and if a company should break this commitment, Glass Lewis may recommend "Against" the pay program unless a convincing rationale is provided. Because of the multiyear nature of front-loaded awards, the quantum of awards will be evaluated on an <u>annualized</u> basis.

The new guidelines align with concerns emerging in the investment community related to front-loaded, or special, awards. When considering special awards, we advise Compensation Committees to employ a holistic approach that focuses on the size of the award and impact on competitive posture, the business rationale, key design considerations, and scenario analyses covering potential payouts based on a range of timing/performance and termination assumptions. As part of the evaluation, we believe it is helpful to draft pro forma proxy disclosure and to model a variety of potential payout scenarios. We also note that Glass Lewis' valuation methodology for front-loaded awards differs from ISS' methodology as ISS includes the full value of the special award in the year of grant versus annualized values when calculating proxy officer compensation.

Change in Control Excise Tax Gross-ups

Glass Lewis added change in control excise tax gross-up provisions provided to executives in connection with new/amended agreements to its list of factors that may contribute to an "Against" vote recommendation. The addition of change in control excise tax gross-ups in new or existing agreements may result in Glass Lewis recommending "Against" a company's say-on-pay proposal, the chair of the compensation committee, or all committee members (particularly if the company previously committed to not provide such entitlements in the future). Gross-ups provided on other excise taxes or executive benefits will continue to be reviewed on a case-by-case basis.

While we are aware of situations where change in control excise tax gross-ups have been added to employment agreements in connection with a transaction, the vast majority of companies understand the strong investor sentiment in opposition to excise tax gross-ups and have avoided adding unlimited gross-up protection to new/amended executive agreements.

Recoupment Provisions ("Clawbacks")

Glass Lewis clarified their policy on clawbacks to consider specific provisions as opposed to solely the presence of a policy based on the minimum legal requirements under Section 304 of the Sarbanes-Oxley Act. Glass Lewis believes clawback policies should be designed to be triggered, at a minimum, in the event of financial restatement *or a similar revision of performance indicators* upon which bonuses were based. Glass Lewis stated that the absence of a more expansive clawback policy would "inform" their overall view on the compensation program, but not necessarily result in an "Against" recommendation on its own.

In keeping with evolving corporate governance practices, most companies have already expanded their clawback policies to cover officers other than the CEO and CFO, as required under Sarbanes-Oxley, and some have expanded the basis under which clawbacks may occur to include events other than financial restatements. We note that companies will likely need to revise recoupment provisions if Dodd-Frank requirements are finalized and there may be increasing pressure from investors to expand clawback policies in the interim.

Executive Compensation Disclosure for Smaller Reporting Companies

Glass Lewis will consider the impact of materially reduced CD&A disclosures for companies that now qualify as a "smaller reporting company" (SRC) according to the SEC's recently amended definition, which significantly expanded the number of companies that would qualify for reduced disclosure requirements. Glass Lewis may consider recommending "Against" committee members where a reduction in disclosure "substantially impacts shareholders' ability to make an informed assessment of the company's executive pay practices." Additional details on the SRC modifications can be found here.

Other Executive Compensation Clarifications:

Glass Lewis has also clarified and formalized several other aspects of their executive compensation policy guidelines, including the following:

- Updated language on how peer groups and benchmarking contribute to an "Against" Say-on-Pay vote recommendation, adding "outsized" to discussion of "inappropriate" peers and benchmarking compensation targets set "well-above" peers
    - "Outsized" is not defined, but will likely reflect companies that fall well above the range of Glass Lewis selected peers
    - Benchmarking "well-above" peers is also undefined, but we assume targeting above median will raise Glass Lewis' concern level
- Revised the description of their pay-for-performance model, explicitly stating that companies that receive a "D" or "F" grade are more likely to receive an "Against" Say-on-Pay vote recommendation, absent other ameliorating qualitative factors
- Added to the discussion on the consideration of discretion in incentive plans, affirming that Glass Lewis will not automatically recommend "Against" a pay program that maintains a discretionary short-term incentive program, but will look for "substantial and satisfactory" disclosures as to the rationale for determining the bonuses paid
    - In conjunction with a discretionary short-term program, Glass Lewis notes the following significant issues in a program's design or operation that may contribute to an "Against" recommendation
        - A disconnect between pay and performance
        - The absence of a cap on payouts
        - The absence of performance-based long-term awards
- Added an explanation of the structure and disclosure ratings in Glass Lewis' Proxy Papers noting that most companies will fall within the "Fair" range for both structure and disclosure, and that the "Good" and "Poor" ratings are mainly used to highlight outliers
- In keeping with their previously disclosed guideline that equity grants to non-employee directors should not be performance-based, Glass Lewis added language stating equity plans that exclusively or

primarily cover non-employee directors as participants should not provide for performance-based awards in any capacity

- If an equity plan broadly allows for performance-based awards to non-employee directors or explicitly provides for such grants, Glass Lewis may recommend "Against" the overall plan, particularly if the company has granted performance-based awards to directors in the past
- To protect against this risk, companies may add specific language prohibiting the grant of performance-based awards to directors in shareholder-approved equity plans that cover multiple participant classes

The full Glass Lewis U.S. policy can be accessed here. Note that ISS is expected to release complete updates to its executive compensation policy in mid-November, and we will provide a comprehensive Alert letter at that time.

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General questions about this summary can be addressed to Caroline Cubberly in our Houston office at 713-427-8303 or by email at caroline.cubberly@fwcook.com or to Joe Sorrentino in our New York office at 212-299- 3659 or by email at joe.sorrentino@fwcook.com. Copies of this summary and other published materials are available on our website at www.fwcook.com.