Compensation committees: Best practices for paying it right

This is the second part of a series of client alerts for public companies and their boards and compensation committees, covering key considerations for equity grant practices.

Overview

The compensation committee plays a crucial role in overseeing the design, administration, and disclosure of the company's executive compensation program, including equity grants. As part of its role, the compensation committee is responsible for ensuring that equity grant practices are consistent with the company's compensation philosophy.

Below, we outline key steps that compensation committees may consider when defining their equity grant practices.

Compensation committee organization: Chartering the course

Review and maintain a thoughtful written charter

Periodically review the compensation committee's charter to ensure that, in defining the committee's authority, responsibilities, and procedures, it reflects updates to both US Securities and Exchange Commission (SEC) rules and the listing standards of the applicable stock exchange, as well as market practices.

For example, the charter can specify the committee's role not just in approving equity compensation plans and equity awards for the board, executives, and other employees, but also in regard to clawbacks of erroneously awarded incentive compensation and insider trading risks associated with compensatory awards.

Develop a compensation philosophy

Establish and articulate a clear compensation philosophy that reflects the company's values, goals, and strategy to guide the design of the company's equity grant program. The company's compensation philosophy can be reviewed periodically to ensure that it remains responsive to changing business and market conditions, as well as to the expectations and feedback of shareholders, proxy advisory firms, and other stakeholders.

Implement a formal equity grant policy

Adopt a written equity grant policy that outlines the terms and procedures that must be followed when making an equity grant, including authority and delegations, timing, and communication of awards. This should be considered comprehensively with other policies and procedures, such as the insider trading policy and nonemployee director compensation policy, to ensure such policies work together properly and can be disclosed in a clear and consistent manner.

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Delegate authority responsibly

To optimize the impact of awards and ease administration, the compensation committee may wish to delegate certain authority to subcommittees, management, or third parties to administer or implement equity grants. Because the purpose of compensation committees, however, is to provide independent oversight of management and compensation programs, any such delegation should be formally approved by the committee and subject to appropriate oversight, limits, and reporting. Confirm that any such delegation is permitted by the compensation committee's charter, the plan itself, and any applicable laws or regulations.

Equity grant provisions: The path to success

Mitigate insider trading risks with timing of grant or settlement of awards

Consider utilizing pre-established grant dates that coincide with regular board or committee meetings, or occur shortly after the release of quarterly or annual financial results, to avoid concerns that the company misused material nonpublic information (MNPI) that is not reflected in the grant date fair value of the award. A "spring-loaded" award that enjoys an immediate lift in value when earnings are announced may frustrate investors, create accounting complexity, and prompt legal challenges, while an award that immediately decreases in value after earnings may lose its intended incentivization effect.

Additionally, consider whether the future vesting and settlement of the award could create insider trading considerations. It is common for tax withholding obligations to be funded by "sell to cover" transactions into the open markets, which generally should not occur when there is MNPI. However, companies can develop strategies in advance to address such situations, such as the use of Rule 10b5-1 trading plans, automatic withholding of shares upon vesting with a value equal to the amount of withholding taxes, timing vesting schedules to align with "open" windows, or deferring settlement of vested awards subject to limitations under Section 409A.

Limit discretionary or one-time equity awards

Unless there is a clear and articulable rationale for doing so, seek to limit the use of discretionary or one-time equity awards, or equity awards with special or unusual features, to avoid the appearance of opportunistic or discretionary timing of equity grants.

Assess risks and rewards

Assess the potential risks and rewards with equity grants and implement risk mitigation measures, such as diversifying award types, imposing holding periods, and setting ownership guidelines.

Integrate metrics that align with company strategy

Align performance-based incentives with the company's long-term goals and shareholder expectations. While those vary across companies, and even among functional units within companies, take care to consider whether incentives are being created to spur behavior the company desires. For example, if the company's strategy is to launch new products, expand internationally, or even to meet specific ESG targets, consider linking equity awards to these strategic goals.

Equity grant impacts: Assessing effectiveness

Analysis of compensation

Regularly compile and update comprehensive compensation data into structured tally sheets that can be used as a decision-making tool by the compensation committee and inform equity grant practices.

Evaluate performance and vesting outcomes

Evaluate the performance and vesting outcomes of the equity grants, and assess the effectiveness of the company's clawback and forfeiture policies. By gaining insights, the compensation committee can refine the terms of future awards and its implementation and administration of policies to better align with the company's strategic goals and desired outcomes.

Maintain strategic oversight of equity grants

Exercise appropriate oversight and discretion in approving and ratifying equity grants to ensure that equity grants are aligned with the company's equity compensation plan, equity grant policy, and compensation philosophy, particularly with respect to equity grants made near the release of MNPI or those that may result in excessive dilution or burn rate.

Monitor market practices and developments

Stay up to date on changes in the business and regulatory landscape by observing peer companies, shareholder expectations, and proxy advisors. In addition to gaining insight on how to structure equity-based compensation to reward performance in line with market expectations, companies should also be aware of what constitutes a problematic equity grant practice.

Equity grant disclosure: Communicating clearly and effectively

Oversee executive compensation disclosure

Carefully review any compensation-related disclosure included in the company's proxy statement and other filings to ensure accuracy and completeness, and obtain briefings as to how disclosure complies with SEC rules and applicable listing standards.

For example, as previously discussed in the first part of this series, new disclosure requirements under Item 402(x) of Regulation S-K mandate detailed reporting on the timing of stock options and similar awards in relation to the release of MNPI. Clear communication of the company's policy ensures compliance and transparency – and, for most companies, this will be disclosed in the upcoming proxy statement.

Ensure regular reporting

Regularly communicate with, and deliver reports to, the board of directors summarizing the activities, recommendations, and other decisions of the compensation committee. Ensure the committee receives the appropriate input it needs from management and outside advisors to make those decisions. Effective reporting can ensure transparency and accountability in the committee's oversight of executive compensation and equity grant practices.

Engage an independent compensation consultant

Consider engaging an independent compensation consultant to advise the compensation committee on the design, valuation, and disclosure of equity grants based on an analysis of the company, its industry, its peers, and the company's compensation philosophy.

Engage with shareholders and proxy advisors

Communicate and engage with shareholders and proxy advisors on the company's equity grant practices and consider their feedback. Good working relationships with shareholders and proxy advisors can help the company avoid activist attention and obtain favorable votes on say-on-pay, new equity incentive plan approvals, and other compensation-related matters.

Conclusion

Equity grants are a significant component of executive compensation for public companies and require careful oversight and governance by the compensation committee. By following these key steps, compensation committees can enhance their oversight of executive compensation and equity grant practices, better align incentives with performance and shareholder value, and mitigate potential risks and challenges.

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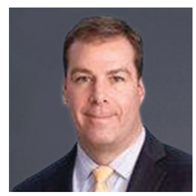

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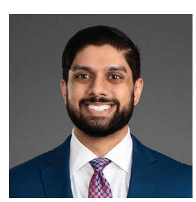

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