Equity Awards:
Design Tips for Navigating Blackout Periods

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About Anthony “Tony” Eppert

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- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

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- Upcoming 2019 webinars:
  - Golden Parachutes & 280G: Design Pointers on Being a Winner (3/14/2019)
  - Best Practices for Conducting the Compensation Committee Meeting (4/11/2019)
  - Anatomy of ISS (5/9/2019)
  - Tips to Increase the Longevity of the Equity Plan's Share Reserve (6/13/2019)
  - Multi-Disciplinary Facets to Net Withholding: It Ain't Boring (7/11/2019)
  - Everything Perquisites: The 101 Training Course (8/8/2019)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/12/2019)
  - Stock Ownership Policies & Clawback Policies: Design Pointers (10/10/2019)
  - Employee Stock Purchase Plans: The Introductory Course (11/14/2019)
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Our Compensation Practice – What Sets Us Apart

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- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

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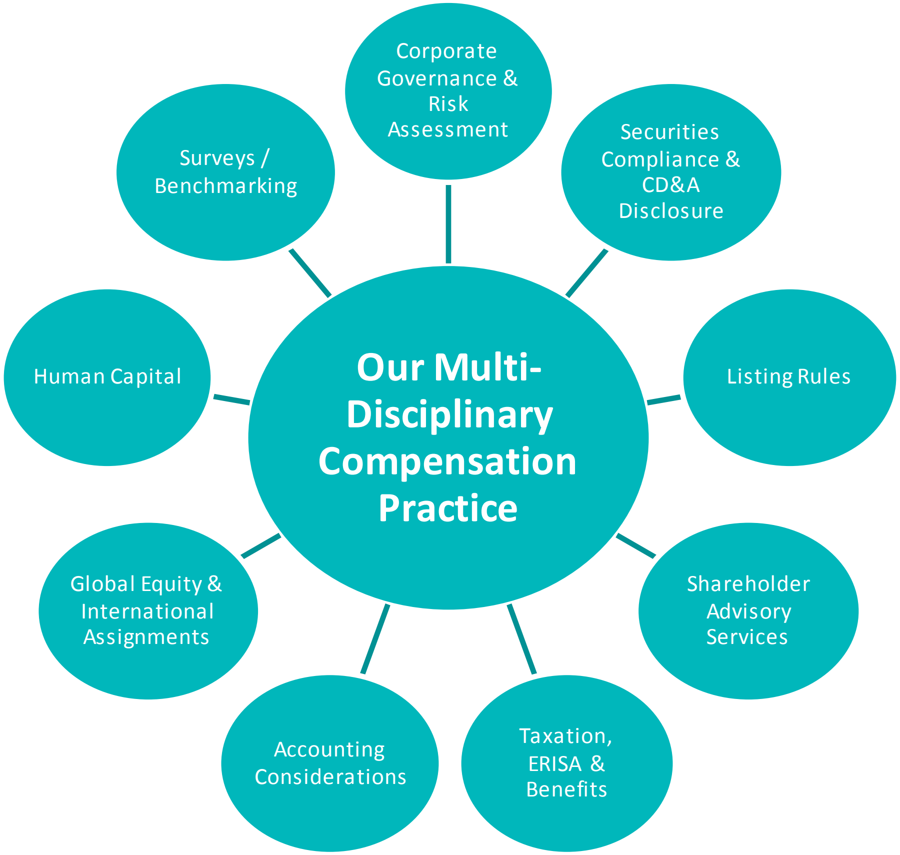
- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

- The purpose of this presentation is to discuss various techniques for navigating blackout periods

- To that end, this presentation covers:
  - Background on liability under Section 16,
  - Background on liability under Rule 10b-5,
  - 10b5-1 trading plans, and
  - A discussion of various scenarios

Background: Section 16(b) Liability

- As background, Section 16(b) is a provision of the Securities Exchange Act of 1934 that imposes reporting requirements and trading restrictions on “insiders” of publicly-traded issuers
  - For purposes of Section 16, the term “insider” includes:
    - A director;
    - An officer (defines as the president, principal financial officer, principal accounting officer, any VP in charge of a principle business unit/division/function, and any other person who performs a policy-making function for the issuer); and
    - Any 10% beneficial owner

- A purpose of Section 16 is to deter insiders from using confidential information for personal gain. To that end, Section 16(b) generally requires insiders to:
  - File public reports relating to the insider’s transactions with equity of the issuer; and
  - Disgorge profits realized on “short-swing transaction” (i.e., any purchase and sale, or vice versa, of the issuer’s equity within a period of less than 6 months)
    - Generally, a purchase or sale occurs when the insider makes an irrevocable commitment
    - Interesting is that “less than 6 months” begins on the date of the transaction and ends 2 days prior to the end of the 6 month period
    - The disgorged “profits” is computed by matching the highest sale price to the lowest purchase price during the 6-month period, and so on, irrespective of the dates on which the transactions occurred
    - Therefore, it is possible to have a “profit” under Section 16(b) even though the transactions resulted in an actual net loss to the insider

Background: Rule 10b-5 Liability

- Generally, insider trading is prohibited under Rule 10b-5
- Rule 10b-5 imposes a presumption in favor of liability, such that if a person is "aware" of material non-public information at the time a security is bought or sold, such person is then presumed to be trading based upon such material non-public information
  - In practice, this rule puts many insiders in a difficult position because they almost always find themselves possessing material, non-public information
- But a properly designed 10b5-1 trading plan would shift the focus:
  - From whether an insider had material, non-public information at the time of a trade;
  - To whether that insider had material, non-public information at the time he or she became committed to the trade

Problem No. 1 – Vests During Blackout Period

- Possible Solution No. 1
  - Under Section 83, a substantial risk of forfeiture is automatically presumed to continue to exist to the extent that a sale of the underlying shares would subject the insider to liability under the short-swing transaction rules of Section 16(b)
  - However, the foregoing does not apply to the extent the transaction is permitted under Section 16(b) but is otherwise prohibited under some other provision, such as the issuer's insider trading policy

- Possible Solution No. 2
  - Draft a provision in the award agreement to provide that if vesting occurs during a blackout period, that the award shall continue to remain unvested until the first date of an open window
  - However, the risk of forfeiture would be extended in this scenario, which means real risk of loss

Problem No. 1 – Vests During Blackout Period (cont.)

- Possible Solution No. 3 is to implement a net withholding (*i.e.*, issuer finances withholding)
  - Such would have no open market transaction element
  - However, the issuer would have to finance the related cash to remit to the U.S. treasury
  - Keep in mind that some equity incentive plans do not contain liberal share counting provisions (*i.e.*, provisions that would allow the netted out shares to return to and replenish the equity plan's share reserve)
  - And at what rate should the issuer withhold?
    - The minimum supplemental rate?
    - The maximum individual rate?

- Possible Solution No. 4 – incorporate a trading plan into the net withholding provision (*i.e.*, market finances withholding)
  - Consider that the issuer might desire a net withholding, but might lack the cash flow to effectuate the IRS remittance
  - The market could pay the withholding dollars if:
    - The award agreement provided for such a sale in the market pursuant to a formula that otherwise satisfied the rules for a trading plan
    - Such could be contained within the tax withholding section of the award agreement

Problem No. 1 – Vests During Blackout Period (cont.)

- Possible Solution No. 5 is to, on the front end, design all of the equity awards to become vested during pre-designed open windows

- Possible Solution No. 6 is to have the equity awards covered by a trading plan

Problem No. 2 – Expiring Term of Stock Option

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- Assume that the insider is holding a stock option with a 10-year term, however, the 10-year term is expiring while the insider has material, non-public information

- Possible Solution No. 1
  - Allow the insider to exercise the stock option with his or her own cash and hold the underlying shares

- Possible Solution No. 2
  - Allow for a net exercise, which is economically similar to a broker assisted sale in the open market but with no open market transaction
  - Much of the analysis contained within Problem No. 1 applies equally here
  - Need to verify that the equity plan permits a net exercise so as to avoid "modification" issues (which is an issue under the ISO rules if such modification is not already expressly permitted under the equity incentive plan)

- Possible Solution No. 3 is to adopt a trading plan

- Possible Solution No. 4
  - Ensure that on the front end, the award agreements are drafted to require an automatic exercise, an automatic net-exercise or automatic trading plan-compliant open market exercise/sale on the day immediately preceding the expiration of the 10-year life, and only if the option is in-the-money at the time

Trading Plans: Background

- Trading plans are a common method for directors and officers to trade without incurring insider trading liability
  - It allows insiders to buy and sell their issuer's stock even if they are in possession of material, non-public information, but only if the trading takes place pursuant to a plan the insider entered into at a time when he or she did not possess material, non-public information
  - The trading plan must either:
    - Specify the amount of securities to be traded and the price and date on which the stock is to be purchased or sold; or
    - Include a written formula for determining the amount, price and date of the transaction
  - A trading plan provides an affirmative defense against an allegation that the insider's purchase or sale was made on the basis of inside information
  - But the key is for the insider to have no future discretion over future trades
  - Plus, the existence of such a plan could preempt a perception in the market that the insider's selling is associated with a loss of confidence in the issuer
- Absent a trading plan, it is often difficult for insiders who are frequently in possession of material, non-public information to trade without incurring the risk of insider trading liability
  - Insider trading policies of issuers will typically prohibit the insider from trading except during "open windows" (*e.g.*, a specified number of days immediately following the issuer's release of its quarterly earnings data)

Trading Plans: Reasons to Adopt

- Some of the reasons to adopt a trading plan include:
  - For those who often possess material non-public information, the trading plan provides more trading opportunities
  - Facilitates financial planning for the individual
  - Minimizes investor criticism that the trade was conducted on the basis of the individual holding material non-public information
  - Ensures the exercise of stock options that would have otherwise expired due to a lapse in the term
  - Facilitates the attainment of stock ownership guidelines

Trading Plan Reqs: Adoption

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- Material non-public information cannot be a factor when setting up the trades (otherwise the affirmative defense is negated). This means that:
  - The individual cannot have material non-public information at the time of adopting the plan; and
  - Additionally, the broker (or other third party delegatee) cannot be aware of material non-public information when applying any discretion to set up the future trades
- The issuer's insider trading policy could help ensure compliance with the foregoing by:
  - Limiting the timing on which trading plans may be adopted to open trading windows, and
  - Prohibit any adoption of a trading plan during blackout periods
- And too, the person should indicate in writing at the time of the adoption of the plan that he or she does not possess material non-public information
  - In other words, the existence of an open trading window does not guarantee that the individual has no material non-public information

Trading Plan Reqs: No Discretion & Good Faith

- The affirmative defense is lost if the individual retains any discretion over the "whether," "when" and "how" to effectuate any trades

- This means the terms of the trading plan must:
  - Contain a written formula or algorithm that specifies the amount (share number or dollar value), date and price of securities to be purchased/sold; and
  - The individual cannot exercise any discretion or influence over such number, date or price

- The trading plan must be entered into in "good faith" and not as part of a plan or scheme to evade the rule
  - This good faith standard is applied using hindsight facts and circumstances

Trading Plan Reqs: Waiting Period/Pre-Clearance

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- As a technical matter, waiting periods from the date the plan is entered into and the date the first trade is effectuated are not required (but are recommended)
  - The delay from the date of entering into the trading plan and conducting the first transaction <u>should</u> be at least 30 days
  - It is recommended that any adoption of a trading plan be pre-cleared under the issuer's pre-clearance procedures
  - Usually one person would be appointed to handle pre-clearance procedures (as opposed to multiple persons or a committee)

- Any modification to a trading plan is deemed to be a new trading plan
  - Thus, any modification must be at a time when the person has no material non-public information and the other requirements of the trading plan rules are satisfied
  - For this reason, modifications should be limited to be allowed only in extreme circumstances

- Multiple concurrent plans
  - Having a new plan take effect after an existing plan expires is an acceptable practice
  - Though multiple concurrent plans are technically permitted, such is not recommended because it could be argued that such is an attempt to evade 10b-5, thus voiding the affirmative defense otherwise provided by the trading plan
  - And a person should never have multiple plans covering the <u>same</u> shares

Trading Plans: Best Practices

- The trading plan is an affirmative defense, not a shield. Such affirmative defense can be bolstered if the issuer follows best practices, which can include:
  - Ensure a trading plan is permitted under the issuer's insider trading policy
  - Consider whether to voluntarily disclose the trading plan in a Form 8-K (such is not required, but if disclosing, then be sure to avoid disclosing details about the plan other than the aggregate number of shares)
  - Require any new trading plan or amendment to an existing plan to be subject to pre-clearance procedures under the issuer's insider trading policy
  - Only adopt the trading plan when the insider is not aware of material, non-public information. If the issuer has open window periods, adopt the plan only during an open window immediately after announce of the quarterly earnings
  - Require a lag time for the first trade (*e.g.*, 30 days). There is no legal requirement to provide a lag time, but the purpose of a lag time is to decrease public scrutiny if trading activity begins right before announcement of material news
  - Keep the trading plan design simple
  - Limit the length of the trading plan to a date between 6 months and 18 months

Trading Plans: Best Practices (cont.)

- [Continued from prior slide]
  - Only allow amendments to the trading plan when the insider does not possess material, non-public information, and subject amendments to pre-clearance (*i.e.*, the SEC considers amendments to be the same as entering into a new plan)
  - In situations where multiple awards to multiple recipients are likely to vest at the same time (*i.e.*, because the issuer grants awards on the same day to all recipients pursuant to a comparable vesting schedule), consider adding a provision to the insider trading policy or pre-clearance procedures that limits sales to a percentage per day
    - Alternatively, such provision could be added to the award agreement

Beware Open Market Purchases and Trading Plans

- To the extent trading plans are being used to facilitate open market sale transactions upon vesting of an equity award (e.g., to fund the payment of withholding taxes), care should be taken to the extent the issuer is also encouraging insider to make open market purchase transactions
  - Reason: the short-swing profit rule under Section 16 requires that profits realized by Section 16 insiders from the purchase and sale of equity securities of the issuer within a period of less than 6 months may be disgorged by the issuer or other shareholders of the issuer
- To highlight the problem, assume that an issuer is encouraging open market purchases by its Section 16 insiders, however:
  - Such insiders adopted a trading plan to fund withholding obligations that are triggered when the compensatory equity award vests, and
  - Such equity award has 6-month vesting tranches so equity is always vesting within a 6 month period
- The result – potential disgorgement of profits under the short-swing profit rule creates a disincentive for insiders to purchase company stock in the open market
- The better way to design around the issue is to remove 6-month vesting tranches and replace them with 1 year vesting. Then the insider can at least make open market purchases during 6 months of the year

Don’t Forget Next Month’s Webinar

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- Title:
  - Golden Parachutes & 280G: Design Pointers on Being a Winner
- When:
  - 10:00 am to 11:00 am Central
  - March 14, 2019