Upcoming Proxy Season: Compensatory Thoughts from ISS

Presentation for:
Executive Compensation Webinar Series
January 16, 2020

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- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
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  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail shortly after this presentation

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  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
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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

Upcoming 2018 and 2019 Webinars

- 2020 webinars:
  - ABC's in Drafting CD&A Disclosure (Part I of II) (02/13/2020)
  - ABC's in Drafting Proxy Tabular Disclosure (Part II of II) (03/12/2020)
  - Compensation Design: How to Maximize Compensatory Deductions (04/09/2020)
  - Administrative Perspective on Granting Compensatory Equity: A Checklist of Action Items (05/14/2020)
  - Compensatory Ideas in a Partnership Structure (06/11/2020)
  - Public Companies and ESOPs: Check Yes or No (07/09/2020)
  - Compensation Committee Governance (08/13/2020)
  - Preparing for Proxy Season: Start Now (Annual Program) (09/10/2020)
  - How to Design Effective Total Shareholder Return Awards (10/08/2020)
  - Building a Compensatory Peer Group: A Step-by-Step Approach (11/12/2020)
  - Employment Taxes: The 101 Course (12/10/2020)

- Sign up here: https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html

Our Compensation Practice – What Sets Us Apart

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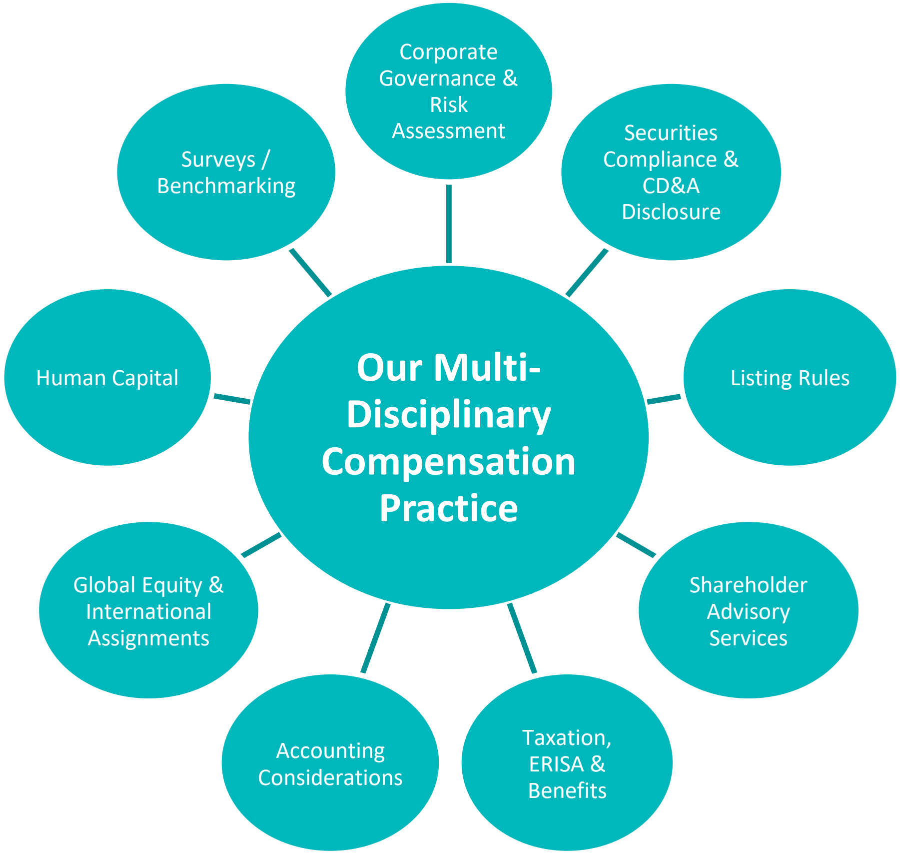
- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- 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.)

- 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 help publicly-traded issuers prepare for the upcoming proxy season with respect to compensation-related matters covered by ISS

- To that end, this presentation covers:
  - Recent pronouncements from ISS since the last proxy season;
  - Areas where ISS is likely to focus their attention this proxy season;
  - The impact the foregoing could have on compensation design; and
  - Practical compensatory thoughts for issuers preparing for the 2020 annual shareholders'' meeting

Background: 5 Global Compensation Principles of ISS

- From the compensatory perspective, the framework of ISS is built around the following 5 global principles:
  - Maintain appropriate pay-for-performance alignment, with an emphasis on long-term shareholder value,
  - Avoid say-for-failure arrangements or risk of such arrangements,
  - Maintain an independent Compensation Committee,
  - Provide clear and comprehensive compensation disclosures, and
  - Avoid inappropriate pay for non-executive directors (*i.e.*, do not allow pay to compromise independence)

What's New – Proxy Voting Guidelines

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- ISS Proxy Voting Guidelines Updates for 2020 (published on November 11, 2019, and effective for annual meetings on or after February 1, 2020)

- Equity incentive plans that have evergreen provisions within the share reserve
  - ISS noted that, prior to the elimination of the performance-based exemption to the $1mm deduction limitation, issuers had to have the performance metrics within their equity incentive plan reapproved by the shareholders at least 1x every 5 years
  - ISS further noted that the Tax Cuts and Jobs Act of 2017 eliminated the performance-based exception to the $1mm deduction limit, and therefore, essentially eliminated the requirement for issuers to obtain regular re-approval of their equity incentive plans
  - ISS believes that the foregoing caused a significant drop in the number of equity plans brought to a shareholder vote (*i.e.*, a 27% year-over-year drop from 2017 to 2018)
  - As a result, the existence of an evergreen provision within the share reserve of an equity incentive plan will be considered an egregious factor by ISS that overrides the Equity Plan Scorecard analysis (regardless of its score), rationale being that the existence of the evergreen provision eliminates/decreases the regular re-approval of the equity incentive plan
  - Therefore, if an evergreen provision is present, then ISS will recommend "against" <u>any</u> shareholder approval of the equity incentive plan proposal

What's New – Excessive Director Pay – 2nd Year

- Background
  - In 2018, ISS announced a policy to issue an adverse vote recommendation for board members responsible for approving non-employee director pay when the issuer exhibited a recurring pattern of excessive pay without a compelling rationale over <u>two or more</u> consecutive years
    - Emphasis added because ISS is looking for a <u>pattern</u> of excessive compensation
  - As a result, adverse recommendations will not be issued under this policy until meetings occurring on or after February 1, 2020
  - To determine whether compensation is excessive, ISS will compare individual non-employee compensation to pay outliers, representing individual non-employee directors who are paid above the top 2-3% of all comparable directors within the same index and sector
- Due to the 2-year requirement, the 2020 proxy season is the first time that ISS could issue an adverse recommendation under this policy

What's New – Use of EVA in Pay-for-Performance

- The purpose of the pay-for-performance analysis is to identify strong or satisfactory alignment between pay and performance over a sustained period
  - If a misalignment exists and a say-on-pay vote is on the ballot, then ISS will recommend against the say-on-pay vote
  - But if misalignment exists and there is no say-on-pay vote on the ballot, then ISS will recommend against the re-election of Compensation Committee members

- Beginning in 2020, ISS will use EVA-based metrics (instead of GAAP metrics) in the secondary FPA screen of its quantitative pay-for-performance model

- As background, the quantitative pay-for-performance methodology involves:
  - Relative Degree of Alignment (RDA – a relative measure)
    - Seeks to determine if the pay opportunity delivered to the CEO is commensurate with the performance achieved by shareholders, relative to a comparable group of issuers
    - It does this by comparing the percentile rank of an issuer's CEO pay and TSR performance, relative to an ISS-developed peer group, over the prior 3-year period (a relative measure)

  - Multiple of Median (MOM – a relative measure)
    - Independent of issuer performance, this measure seeks to identify instances where CEO pay is significantly higher than amounts paid to CEOs of a comparison group
    - Calculated as the issuer's 1-year CEO pay, divided by the median pay for the comparison group

What's New – Use of EVA in Pay-for-Performance (cont.)

- Pay-TSR Alignment (PTA – an absolute measure)
  - Seeks to determine the degree to which CEO pay has changed more or less rapidly than shareholder returns over a 5-year period

- Financial Performance Assessment (FPA – a relative measure)
  - This is a secondary measure applied after RDA, MOM and PTA are calculated
  - Seeks to compare the issuer's financial and operational performance over a 3-year period (in most instances) against the ISS peer group
  - Comparison is performed utilizing EVA-based metrics
  - New for 2020, the EVA-based metrics replace the GAAP metrics of ROE, ROA, ROIC and EBITDA growth
  - EVA represents the economic profit an issuer earns after meeting all of its obligations, including the demands of capital providers
  - ISS determined that incorporating EVA would improve comparisons between issuers with different capital structures, different operating leverage levels, different operating models in terms of assets, etc.

What's New – Termination & Severance Disclosure

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- With respect to the Compensation Policies FAQs that were updated December 6, 2019, ISS add a new FAQ 46 to indicate that clear and forthright disclosure should be made with respect to the nature of an executive's termination and how the board determined severance

- Personal note is that from a practical perspective, such is difficult when the executive is being terminated for cause

Proxy Season: Action Items to Consider

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- Courting the say-on-pay vote
  - The most common reason for a negative recommendation from ISS is a pay-for-performance disconnect in the compensation of executive officers
  - Robust disclosure on this point can help, especially disclosure that specifically addresses why certain performance criteria were used and the degree of difficulty in attaining such criteria
  - Shareholder outreach programs are important towards achieving a passing say-on-pay vote
- Large swings in share price and grant practices
  - For some sectors, this issue is a repeat of 2008 and 2009
  - A common concern for issuers granting equity based on a dollar amount that is then converted into a number of shares, is whether shareholders might allege that the executives took advantage of the downward slide in stock price by awarding themselves a larger number of shares than in prior years
  - Having a documented annual grant policy could provide an affirmative defense to an allegation that the equity grant is otherwise timing the market (as would an issuer's practice over the prior years if consistent with the current grant)
- Large swings in share price and underwater stock options
  - Underwater stock options do not provide the intended retention value
  - Issue may have been avoided if the stock option had a stock-price forfeiture imbedded within the forfeiture provision of the option (*i.e.*, if the stock price falls to a certain price, the option is automatically forfeited and the underlying shares revert to replenish the share reserve of the equity incentive plan)

Proxy Season: Action Items to Consider (cont.)

- Impact of Section 162(m)
  - If the equity incentive plan is being restated or a new equity incentive plan is being proposed to the issuer’s shareholders, consider streamlining the administrative design that was otherwise complex due to the performance-based exception to the $1mm deduction limit under Section 162(m)
  - Keep in mind that removal of Section 162(m) provisions is acceptable to ISS, but that ISS will negatively view any change that signifies a shift away from performance-based compensation towards discretionary or fixed pay elements

- Director pay disclosure
  - Be robust (more than prior years)
  - What is the philosophy associated with director compensation? How is the pay assessed? What is the frequency of the assessment? What is the process associated with any benchmarking?

- Benchmark director pay and revisit the form and amount of such pay

Proxy Season: Action Items to Consider (cont.)

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- Consider increasing the deductibility of compensation. As background:
  - The Tax Cuts and Jobs Act of 2017 eliminated the performance-based exception to the $1mm deduction limit and expanded the definition of "who" is subject to such $1mm deduction limit
  - Which means that, starting January 1, 2018, all compensation (unless grandfathered) paid to a "covered employee" that exceeds $1mm will not be deductible
  - And too, covered employee status was expanded to include the CEO, the CFO and the next 3 most highly compensated executive officers who are disclosed in the issuer's Summary Compensation Table
  - Additionally, covered employee status was expanded because, under the new rules, "once a covered employee always a covered employee" (*i.e.*, it now includes severance payments to a terminated individual who was a covered employee)
- Does it makes sense to increase compensatory deductions by limiting "executive officer" status? As background:
  - Only an executive officer is eligible to be an officer disclosed in the Summary Compensation Table
  - The Board could revisit which individuals are executive officers of the issuer, and thereby mitigate covered employee status

Proxy Season: Action Items to Consider (cont.)

- Other ideas to increase compensatory deductions include:
  - Implement a deferral program with future annual payouts to be less than $1mm
  - Replace the standard 3- and 4-year vesting schedules with a longer vesting schedule (not likely practical)
  - Move lump-sum severance obligations to installment payouts (*e.g.*, only $1mm of a $4mm lump sum payout would be deductible if paid to a covered employee in one calendar year, but if the payout was structured over three calendar years, then $3mm of the $4mm would be deductible)

Proxy Season: Action Items to Consider (cont.)

- Net withholding
  - Whether to revise the net withholding rate within the equity incentive plan from the supplemental rate of 22% to the highest marginal rate
- Shrinking labor market
  - The cost of retaining key employees may increase as the baby boomers exit the workforce (a thinning labor market will become the norm even if there is an economic downturn over the next 12 months or so)
  - Perform an assessment to determine whether retention gaps exist within the compensatory structure

Don’t Forget Next Month’s Webinar

- Title:
  - The ABC’s in Drafting CD&A Disclosure (Part I of II)

- When:
  - 10:00 am to 11:00 am Central
  - February 13, 2020