Preparing for Proxy Season: Start Now (Annual Program)

Presentation for:
Executive Compensation Webinar Series
September 10, 2020

Presentation by:
Anthony Eppert and Emily Cabrera

Housekeeping: Questions

- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
  - To submit a question, simply type the question in the blank field on the right-hand side of the menu bar and press return
  - 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 after this presentation

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  - This presentation is being recorded for internal purposes only
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  - A purpose of the webinar series is to provide FREE CE credits
  - 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

About Emily Cabrera

Emily Cabrera, Partner
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- Emily practices in the areas of taxation, executive compensation and employee benefits
- Before entering private practice, Emily:
  - Obtained her B.A. at Harvard University
  - Obtained her J.D. from the University of California at Berkeley School of Law
    - Membership Development Editor, California Law Review
    - Law and Economics Fellowship
    - Prosser Prize for Property and Corporate Tax Law
    - Fenwick Tax Award
- Emily is licensed to practice in:
  - Texas
  - California

Upcoming 2020 & 2021 Webinars

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- Upcoming 2020 webinars:
  - 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)

- 2021 webinars:
  - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/7/21)
  - Proxy Disclosure Tips on COVID-Related Compensation Decisions (2/11/21)
  - Executive Compensation Clawbacks: A Robust Analysis of Design Features (3/11/21)
  - Finding Value: How to Negotiate Compensatory Economic Drivers in a Change in Control Transaction (4/8/21)
  - Is a Global Employment Company the Solution to Help Manage Internationally Mobile Employees? (5/13/21)
  - Training Course on Designing an Equity Incentive Plan (6/10/21)
  - Training Course on Stock Option Awards and Stock Appreciation Rights (7/8/21)
  - Training Course on Restricted Stock and Restricted Stock Unit Awards (8/12/21)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
  - How to Properly Hire and Fire an Executive Officer (10/14/21)
  - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
  - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

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

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Our Compensation Practice – What Sets Us Apart

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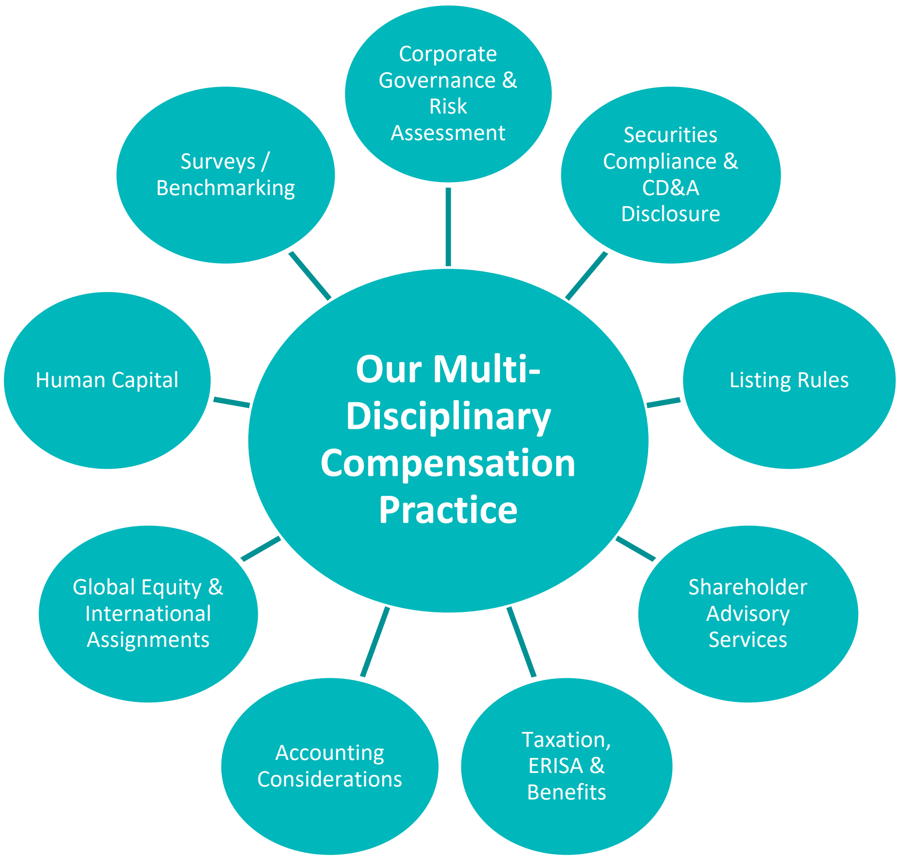
- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



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 help prepare the Compensation Committee of the Board of Directors for compensatory actions it may need to consider during its November and December meetings

- To that end, this presentation covers:
  - Recap of 2020 proxy season
    - Say on pay
    - Pay ratio
    - Use of virtual meetings
    - COVID-19 disclosure
  - Preparing the Compensation Discussion and Analysis (CD&A)
  - Making and disclosure of discretionary adjustments
  - Compensation Committee Planning
  - Annual grant policies
  - Environmental, social and governance ("***ESG***") proposals
  - Human capital disclosure
  - Director compensation considerations

Item No. 1: 2020 Say-on-Pay – Recap

- The following are the pass rates for the Russell 3000 through mid-July
  - Approximately 74% of the issuers received more than 90% support for their say-on-pay proposals
  - Approximately 19% of the issuers received support that was greater than 70% but less than 90%
  - Approximately 5% of the issuers received support that was greater than 50% but less than 70%
  - Average of approximately 90.6% support
  - The failed rate approximates 2.2% of the issuers

- Approximately 11% of the Russell 3000 received an "against" recommendation from ISS
  - Approximately 94% average support with ISS "For" recommendations
  - Approximately 66% average support with ISS "Against" recommendations

Item No. 1: 2020 Say-on-Pay – Reasons Cited for Failure

- CEO's realizable compensation compared to company's stock return
- Modification of performance targets to make them easier to achieve
- Lack of transparency around performance goals, lack of goal rigor and/or use of discretion
- Lack of quantifiable (vs qualitative) performance metrics
- Time-based equity awards rather than performance-based awards
- One-off equity grants, especially when not sufficiently performance-based
- Mega grants covering current and future years
- Severance and/or change in control arrangements deemed not in the shareholders' interests
- Board exhibits significant level of poor communication and responsiveness to shareholders

Item No. 2: Pay Ratio – Recap

- Median pay ratio so far for 2020 is approximately 75:1
  - 25th percentile is approximately 34:1
  - Average is approximately 172.74
  - 75th percentile is approximately 156:1

- Median ratios vary greatly based on industry
  - Consumer Staples – approximately 192:1
  - Consumer Discretionary – approximately 191:1
  - Materials – approximately 97:1
  - Industrials – approximately 91:1
  - Information Technology – approximately 80:1
  - Energy – approximately 71:1
  - Utilities – approximately 60:1
  - Real Estate – approximately 57:1
  - Healthcare – approximately 56:1
  - Financials – approximately 50:1

Item No. 2: Pay Ratio – Identification of Median Employee for 2020

- Companies will likely have to re-identify median employee for 2020 fiscal year
  - Requirement effective for fiscal years beginning on or after January 1, 2017
  - Companies generally are required to identify its median employee only once every three years, unless there has been a significant change
  - Determination date may be any date within the last 3 months' of fiscal year
- Annually, companies must assess whether there has been a significant change in:
  - Employee population,
  - Employee compensation arrangements, or
  - Median employee's circumstances (such as departure, promotion, or significant change to compensation)
- Actions in 2020, such as workforce reduction and pay reductions, may add complexity to pay ratio calculations
- Furloughs create unique challenges
  - Inclusion of furloughed employees determined based on particular facts and circumstances

Item No. 3: Virtual Shareholder Meetings – Highlights

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- Conducting virtual annual meetings is a complicated subject that is beyond the scope of this presentation
- In 2019, only 8% of Russell 3000 companies held virtual meetings compared with 71% holding either virtual, webcast or hybrid meetings in 2020
  - Shareholder participation was typically higher than in-person meeting held in recent years
  - 80% of shareholder proposals were presented by the proponent live or over a telephone line and others were presented via pre-recorded message or the proposal was read aloud by a company official
- ISS had temporary policy not to recommend votes against companies that hold virtual meetings
  - ISS encourages companies holding a VSM to disclose clearly the reason for their decision (*i.e.*, that it is related to the COVID-19 pandemic) and to strive to provide shareholders with a meaningful opportunity (subject to local laws) to participate as fully as possible, including being able to ask questions of directors and senior management and to engage in dialogue if they wish
  - Boards are encouraged to commit to return to in-person or "hybrid" meetings (or to put that matter to shareholders to decide) as soon as practicable

Item No. 3: Virtual Shareholder Meetings – 2021 Meetings

- Some shareholders have pushed for a return to in-person meetings
- Other institutional investors have supported holding virtual only shareholder meetings providing that shareholders are afforded the opportunity to meaningfully participate and have active and robust interactions with management and the board at appropriate times
- Virtual shareholder meeting best practices:
  - Prominent, “plain English” instructions in the proxy for how to attend, vote, and ask questions
  - Real-time video of board and management participants
  - Real-time closed captioning
  - Provide option to ask questions in advance of the meeting or live on-air
  - Answer all appropriate questions that are submitted
  - Post all appropriate questions on the company’s website
  - Allow shareholder proponents to present their proposal remotely or send a pre-recorded message

Item No. 4: COVID-19 Disclosure – Recap

- Although proxy disclosure is generally backward-looking, some companies addressed the COVID-19 pandemic in their proxy statements

- However, issuers are also required to disclose actions regarding executive compensation that were taken after its last fiscal year end that could affect a fair understanding of the named executive officer's compensation for the last fiscal year

- There was largely voluntary disclosure, including:
  - Changes to incentive programs for 2020
  - Reductions in executive or board compensation
  - Change in grant dates
  - Delaying setting performance metrics

- ISS recommended that boards of directors provide contemporaneous disclosure to shareholders for their rationales for making change to performance metrics, goals, or targets used in short-term compensation plans in response to economic conditions

Item No. 5: CD&A

- CD&A will be more important than ever in 2021
  - Be transparent and provide clear rational for compensation decisions
  - Consider whether to address COVID-19 in a stand-alone section, within the body of the CD&A or both
  - Address any red flags directly (*e.g.*, use of discretion, one-time grants, changing performance metrics, etc.)

- Be sure to address:
  - How much and how should executives be rewarded for results during the pandemic
  - How is performance measured when the landscaped has changed so dramatically
  - What are the changes in executive pay and what is their justification
  - Impact of economic environment on shareholders and employees

- ISS will look at any in-flight changes made to long-term awards on a case-by-case basis to determine if directors exercised appropriate discretion, and provided an adequate explanation to shareholders of the rationale for changes

- Be wary of disproportionate actions to protect executive in contrast with or at the expense of shareholders and employees

Item No. 6: Discretionary Adjustments

- Discretionary does not mean without a rationale
  - Compensation committees should track and fully understand the performance goals and the impact of the pandemic
  - Assess susceptibility of metrics to economic downturn
  - Caution against simply trying to make executives whole

- Identify factors for board discretion, which can be considered include:
  - Relative vs. absolute performance
  - Evaluate performance for shorter performance periods
  - Reassessment of peer group
  - Employee specific actions
  - Progress against strategic initiatives
  - Customer and workforce satisfaction
  - Attainment of human capital management and ESG governance goals
  - Crises leadership
  - Actions taken to ensure long-term success
  - Competition for talent

Item No. 7: Compensation Committee Planning

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- Revisit stock ownership policy
  - Address executives that are no longer in compliance due to downturn
  - Consider how policy deals with falling share prices
- Reconsider "Good Reason" definition
  - Ensure Cause sufficiently addresses sexual harassment and similar misconduct
  - Address broad-based compensation reductions or other changes in light of extraordinary economic downturns in Good Reason definition
- Assess impact of executive compensation changes on severance and change in control arrangements
- Review equity plan share reserve

Item No. 7: Compensation Committee Planning (cont.)

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- Revisit clawback policies
  - SEC's short-term agenda includes finalization of clawback requirements
  - Strengthen to make sure it has sufficient teeth
- Reconsider "Cause" definition
  - Ensure Cause sufficiently addresses sexual harassment and similar misconduct
- Pay attention to perquisite disclosure
  - SEC continues to institute enforcement actions relating to perquisite disclosure
- Don't forget best practices
  - Make sure to document decision-making
  - Expect increased scrutiny and potentially, shareholder litigation
  - Pay particular attention to Compensation Committee engagement during the hiring/termination process
    - Use tally sheets to preserve defense under the business judgement rule

Item No. 8: Economic Downturn & Annual Grant Policies

- An economic downturn can result in large swings in share price and grant practices
  - Some issuers determine the amount of equity to grant based upon an initial dollar amount, and then convert that dollar amount into a number of shares
  - This approach could create an allegation that the executives timed the market by granting a large number of shares at artificially low fair market value, well knowing that upside will be artificially captured when the stock market rebounds
  - Having a documented annual grant policy could provide a defense to this allegation
- New investor concerns with consistent grant date values
  - Shareholders may expect lower grant date values when stock price is low
  - Granting additional shares has a dilutive effect
  - A short-term stock decline may lead to a windfall for the executives
- Some alternatives
  - For dollar-denominated grants, use average share price over a longer time period
  - Make semi-annual or quarterly grants

Item No. 9: ESG

- ESG issues continue to gain more prominence
  - Requests to tie compensation to ESG increased a percentage of compensation-related shareholder proposals

- Approximately 51% of S&P 500 companies incorporate ESG metrics in their incentive plans
  - Approximately 50% include ESG metrics in annual incentive programs
  - Approximately 4% include ESG metrics into long-term incentive program

- ESG measures are incorporated into annual incentive programs of the S&P 500 in the following ways:
  - Weighted metric (approximately 35%)
  - Qualitative component (approximately 32%)
  - Individual component (approximately 49%)

- The most common ESG metrics used in annual incentive compensation plans include:
  - Human capital (people & HR, diversity and inclusion, employee health and safety)
  - Customer service
  - Governance
  - Environmental & sustainability

Item No. 10: Human Capital Disclosure – New Rules

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- SEC adopted amendments to Regulation S-K requiring the following human capital disclosure, to the extent material to an understanding of the company's business as a whole
  - "A description of the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel)"
  - Replaces existing requirement to disclose only number of employees

- Rules do not define human capital, but what is it?
  - Human capital addresses management of a company's human resources and includes issues such as diversity and inclusion, labor practices, corporate culture, employee health and safety, and compensation

- Disclosure is principles-based and does not require any particular framework
  - SEC Chairman publicly stated he expects to see meaningful qualitative and quantitative disclosure, including, as appropriate disclosure of metrics that companies use in managing their affairs
  - Disclosure will vary industry to industry

- Boards of directors must consider assignment of oversight of human capital

Item No. 10: Human Capital Disclosure – Shareholder Push

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- New SEC rule comes after several years of push from institutional investors
  - Human capital is the primary source of value for many companies
- What disclosure have institutional shareholders requested the following information on the workforce:
  - Demographics (number of full-time, part-time, contingent, subcontracted and outsourced workers)
  - Stability (turnover, internal hire rate)
  - Composition (diversity, pay equity)
  - Skills and capabilities (training, alignment with business strategy, skill gaps)
  - Compensation and incentives (bonus metrics, measures to counterbalance risks created by incentives)
  - Productivity (return on cost of workforce, profit/revenue per full-time employee)
- Institutional shareholders have also requested broader disclosure on:
  - Culture and empowerment (engagement, union representation, work-life initiatives)
  - Health and safety (injuries, fatalities, lost day rate)
  - Oversight of policies meant to protect employees
  - Link between human capital management performance and executive compensation
  - Risk management processes

Item No. 10: Human Capital Disclosure – Current Landscape

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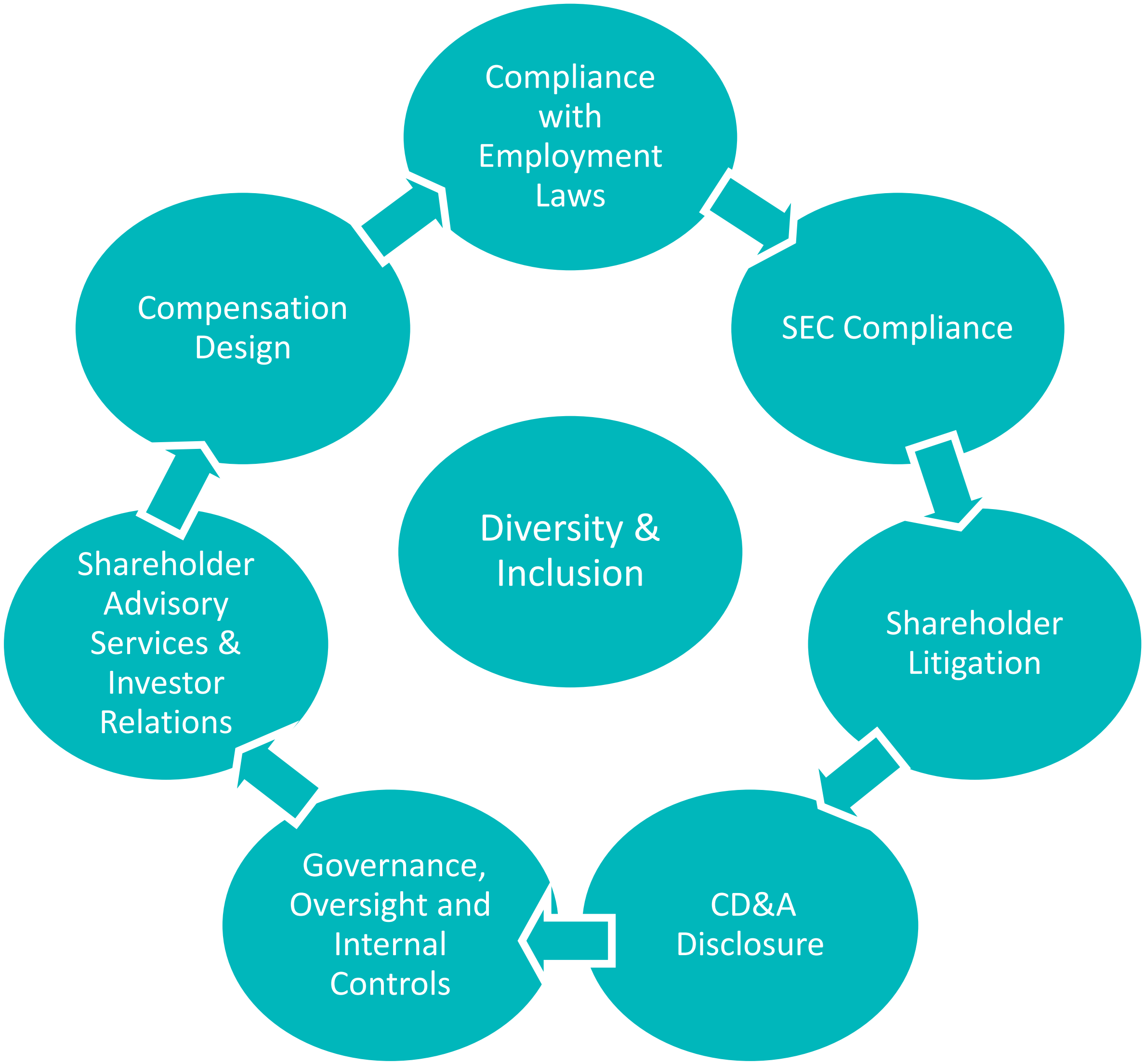
- In 2020, companies received shareholder proposals on various human capital topics such as:
  - Reports on gender and racial pay gaps
  - Reports on workplace diversity and policies
  - Voluntary reporting regarding sexual harassment and policies regarding prevention

- In 2020, 77% of Fortune 100 had proxy disclosure relating to human capital as compared with 32% in 2017

- The most typical voluntary human capital disclosures related to:
  - Workplace diversity
  - Workforce competition
  - Health, wellness and safety
  - Compensation
  - Culture initiatives
  - Workforce skills and capabilities
  - Workforce stability

Bonus: Diversity & Inclusion Webinar to come!



Item No. 11: Director Compensation – Thoughts to Consider

- Adopt a stand-alone, non-employee director equity compensation plan
  - Since the ISS Equity Plan Scorecard doesn't apply to a non-employee director equity plan, a separate plan would make it easier for the company to meet the minimum vesting requirements for its employee plan

- Ask shareholders to approve non-employee directors' compensation (*e.g.*, annual fees, compensation caps/limits, fixed formulas, etc.) in order to help protect the decisions of the non-employee directors with respect to their own compensation

- Bulk up proxy's "director pay" disclosure – the narrative that proceeds the non-employee director compensation table
  - Can discuss the pay philosophy, how pay is assessed, and benchmarking efforts

- Re-evaluate equity grant policies

Employee Benefits Academy

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Hunton Andrews Kurth is excited to announce the launch of Employee Benefits Academy, a monthly webinar series that provides training on all facets of employee benefits, including qualified retirement plans, health and welfare arrangements, fringe benefits, and more. Free continuing education in the forms of CLE, CPE (certain states), HRCI and SHRM credits will be provided.

Join us on Thursday, September 24 for our inaugural employee benefits webinar, *ERISA Fiduciary Standards: Identifying and Mitigating Risks.*

ERISA's fiduciary standards are among the most rigorous and complex in the law. In light of increasing and expanding litigation, benefit plan fiduciaries must be aware, and take appropriate action, to fulfill their responsibilities. This webinar, which is geared to human resources professionals, employee benefit plan administrators and in-house legal counsel advising on employee benefits issues, will cover the basics of the ERISA fiduciary rules and deal with key risks and lessons learned from ERISA litigation and steps to help mitigate those risks.

Thursday, September 24, 2020 10:00 a.m. – 11:00 a.m. CT | 11:00 a.m. – 12:00 p.m. ET

Speakers: Scott Austin, Partner and Jessica Agostinho, Partner

www.huntonak.com/employee-benefits-academy.html

Don’t Forget Next Month’s Webinar

- Title:
  - How to Design Effective Total Shareholder Return Awards
- When:
  - 10:00 am to 11:00 am Central
  - October 8, 2020