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Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program)

Presentation for:
Executive Compensation Academy - (Monthly Training Series)
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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 2021 Webinars

- 2022 webinars:
  - Hot Compensation Topics (2/10/22)
  - Solving for the Tug-of-War Between Deferred Taxation and Long-Term Capital Gains (3/10/22)
  - Remote Workers: Analysis of Applicable State & International Tax Issues (4/14/22)
  - Current Compensation Designs within Partnership Entities (5/12/22)
  - Granting Equity Abroad: Applicable Tax Considerations (6/9/22)
  - How to Effectively Vet and Hire a Compensation Consultant (7/14/22)
  - Navigating Compensation Rules Applicable to Financial Institutions (8/11/22)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/8/22)
  - Compensation Considerations Due to Upcoming Loss of EGC Status (10/13/22)
  - Aging Executive: Thoughts on Designing Succession Strategies (11/10/22)
  - [Topic TBD] (12/8/22)

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

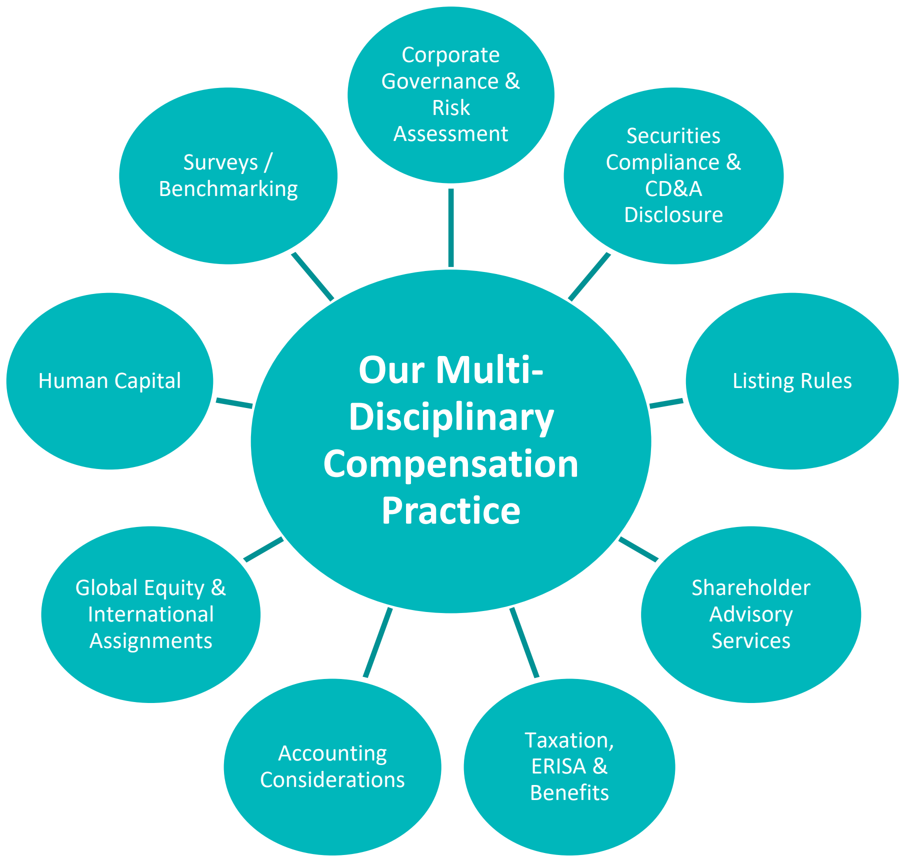
Our Compensation Practice – What Sets Us Apart

- 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.)

- 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 Program

- The purpose of this program is to discuss recent pronouncements from ISS and other institutional advisory services, including:
  - Areas where ISS and other institutional shareholder advisory services are likely to focus their attention this proxy season,
  - The impact of the foregoing on compensation design, and
  - Practical compensatory thoughts as issuers begin preparing for the 2022 annual shareholders' meeting

- Worth noting is that the 2022 proxy season will be the 3rd proxy season during COVID-19 pandemic conditions, and the second year of executive pay disclosure during such conditions

Background: 5 Global Compensation Principles of ISS

- With respect to compensation matters, ISS has a framework that is built around the following 5 global principles:
  - Maintain appropriate pay-for-performance alignment, with an emphasis on long-term shareholder value,
  - Avoid pay-for-failure arrangements or risk the existence 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

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- On December 7, 2021, ISS updated its FAQs for pandemic-related U.S. compensation decisions, applicable for the 2022 proxy season. Generally, the FAQs cover:
  - ISS has indicated that the “surprise” element of COVID-19 is no longer applicable, and that generally compensation programs should return (or begin returning) back to pre-pandemic structures
  - As a result, mid-year changes to performance metrics or targets, and programs that heavily emphasize discretionary or subjective criteria, will be viewed negatively by ISS. The foregoing is especially important for issuers who ISS believes have a quantitative pay-for-performance misalignment
    - Though with respect to an issuer that continues to be negatively impacted by the pandemic, ISS may consider it reasonable to lower pre-set performance targets (compared to 2020) and/or provide modest year-over-year increases in the weighting of subjective or discretionary factors
    - As a result, such issuers will want to clearly explain their rationale for target setting and any mid-year changes to existing compensatory programs (e.g., why was the change necessary, what were the pandemic-related challenges, and how did those challenges render the original program or targets impossible to achieve)
  - Issuers that grant a pandemic-related one-time award should be prepared to disclose the rationale for such award, as well as describe how such award advances the shareholders’ interests
    - Repeated use of one-time awards in consecutive years will be viewed by ISS as problematic
    - Vesting conditions should be performance based and the vesting period should be long-term

What's New (cont.)

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- [Cont. – ISS updated FAQs]
  - Responsiveness - ISS is returning to pre-pandemic policies with respect to issuers who receive less than 70% support on their say-on-pay proposal. As a result, issuers who receive less than 70% say-on-pay support should, according to ISS, be responsive in the following three ways:
    - Disclose in the proxy efforts that the Board took with respect to shareholder engagement;
    - Disclose in the proxy the specific feedback the issuer received from dissenting shareholders; and
    - Disclose in the proxy what actions or changes the issuer made to its pay programs and practices to address concerns of its shareholders

Proxy Season: Action Items to Consider

- Courting the say-on-pay vote
  - The most common reason for a negative recommendation from ISS is a pay-for-performance disconnect in the issuer's compensation of its 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 certain stock grant practices
  - It is common practice that grants of equity awards are first denominated in dollars (e.g., 100% of base salary), and then converted into a number of shares
  - An issue with the foregoing is whether shareholders might allege that the executives took advantage of a downward slide in stock price by timing dollar denominated equity award to coincide with low stock price, thus resulting in a higher share award than if the stock had a higher stock price
  - Having a documented annual grant policy could provide an affirmative defense to an allegation that the equity grant was intended to time the market (and too, an issuer's consistent grant practice over the prior years could have the same effect)

Proxy Season: Action Items to Consider (cont.)

- Consider increasing compensatory deductions by limiting executive officer status

- As background:
  - Beginning January 1, 2018, all compensation (unless grandfathered under the Tax Cuts and Jobs Act of 2017) paid to a “covered employee” that exceeds $1mm will not be deductible
  - Beginning January 1, 2018, 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, and too, once an individual is considered to be a covered employee, then he or she will always remain a covered employee for purposes of these rules even if he or she is no longer the CEO, CFO or the next 3 most highly compensated executive officer

- So does it make sense for an issuer to consider protecting the deductibility of compensation by limiting “executive officer” status? As background:
  - Only an executive officer is eligible to be a named executive officer as 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
  - 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 payout would be deductible)

- Shrinking labor market
  - The cost of retaining key employees may increase as the baby boomer exit the workforce (a thinning market will become the norm even if there is an economic downturn over the next 12 months or so)
  - Consider performing an assessment to determine whether retention gaps exist within the compensation structure. For example:
    - Consider adding a “retirement” provision within equity awards and other long-term incentive awards that allow for accelerated vesting of some sort if the key employee terminates his or her employment due to retirement, BUT . . . require 6 months, 12 months, etc. advance written notice before the key employee can effectuate such retirement
    - Such advance written notice will help smooth transitions and provide the issuer with time to find or train up a successor

Practical Compensatory Thoughts

- According to an FW Cook report:
  - An increased number of issuers are evaluating financial metrics on a relative basis (as opposed to an absolute basis) due to market volatility
  - An increasing number of issuers using relative TSR performance metrics are setting targets above median (likely in response to institutional shareholder view that target earnout should require above-median performance

- The increasing trend of remote working will likely continue throughout 2022. As a result, be sure to analyze perquisite disclosure with respect to any work flexibility provided to an issuer's NEOs
  - Perquisite disclosure continues to be a hot topic for the SEC's Division of Enforcement

Practical Compensatory Thoughts (cont.)

- Equity grant policies – should issuers have them?
  - Issuers with volatile stock price should consider having an annual (or more frequently, *e.g.*, quarterly, monthly, etc.) equity grant policy. Reason is that with respect to dollar-denominated awards that are then converted into equity based upon such dollar amount, and assuming there is no such equity grant policy, such issuers could be susceptible to claims that the executives (or the Board) was timing the market price
  - This topic is not new. Having an equity grant policy became a hot topic during the financial crisis in '08ish
  - Volatile stock prices in the current pandemic has breathed new life into topic
  - And too, the SEC guidance on spring-loaded equity awards is yet another reason why issuers should consider whether it makes sense to have an equity grant policy. Under such SEC guidance:
    - Spring-loading occurs when an equity award is granted just prior to a public announcement that the issuer expects will increase its stock price
    - There are two issues with spring-loaded awards. First, the compensation expense will be lower than it would have been had the award been granted immediately following such public announcement. Second, for issuers with dollar-denominated grants, the executive will have received many more shares than he or she would have received had the award been granted after the public announcement when the issuer's stock price would have been higher
    - The SEC guidance differentiates between routine and non-routine grants, and as a result, such implies that routine grants would not be subject to this guidance. Can having an equity grant policy create "routine"? Such policy could, by example, reflect that grants will only occur on the 10th day of each quarter

Don’t Forget Next Month’s Webinar

- Title:
  - Hot Compensation Topics
- When:
  - 10:00 am to 11:00 am Central
  - February 10, 2022