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Navigating Compensation Rules Applicable to Financial Institutions

Presentation for:
Executive Compensation Academy –
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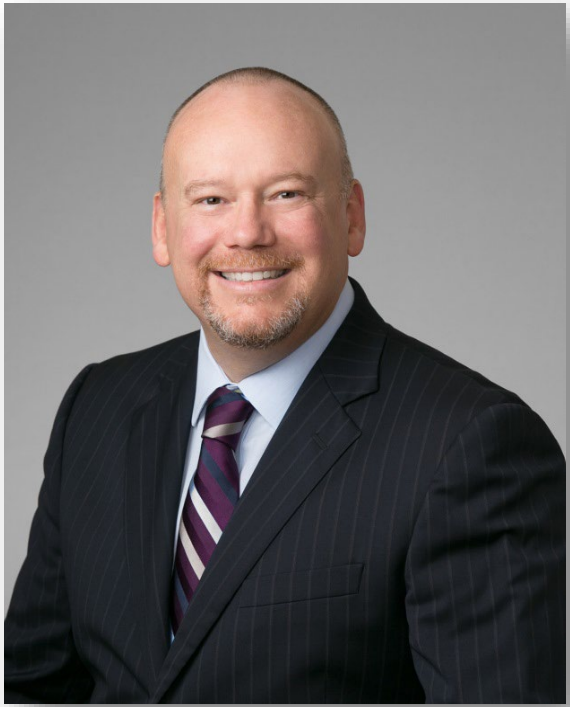
About Anthony "Tony" Eppert



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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 2022 Webinars

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- 2022 webinars:
  - Preparing for Proxy Season: Start Now (Annual Program) (9/8/22)
  - Compensation Considerations Due to Upcoming Loss of EGC Status (10/13/22)
  - Aging Executives: 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

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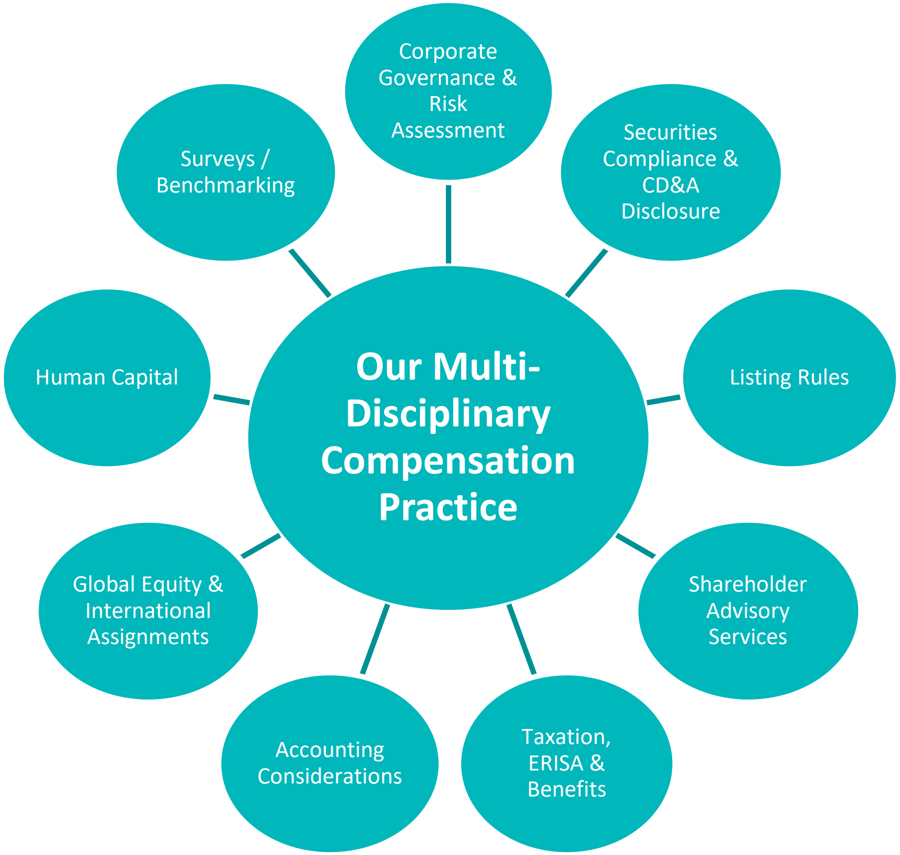
- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



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

Typical Bank Compensation Designs

- Compensation designs include:
  - Base salary,
  - Annual incentives,
  - Performance-based incentives (typically pursuant to long-term equity plans),
  - Time-based incentives (typically pursuant to long-term equity plans),
  - Bank-owned life insurance policies,
  - Perquisites (golf membership, car allowance, etc., and
  - Employee stock ownership plans (non-discriminatory programs)

Typical Annual Incentive Performance Metrics

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- Earnings tends to be financial metrics. Such include:
  - Operating income
  - Net income
  - Earnings per share
- Returns and Growth metrics tend to be the next most used. Such include:
  - Returns: ROTE, ROE and ROA
  - Growth: Asset growth, loan growth and deposit growth
- Asset quality metrics tend to be the next most used. Such include:
  - Net charge-offs
  - Classified assets
  - Non-performing assets or assets

Typical Long-Term Incentive Performance Metrics

- Return based metrics include:
  - ROTE
  - ROA
  - ROE
- TSR based metrics include:
  - Relative TSR (being the more dominate)
  - Absolute TSR
- Earnings metrics include:
  - EPS
  - Pre-Tax net income
- Asset quality is also used as a metric, and include:
  - Non-performing assets
  - Net charge-offs

Stock Options v. Restricted Stock – A Comparison

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EVENT	ISO	NSO	Restricted Stock
Date of Grant (Employee)	No federal income tax consequence to the optionee or the company	No federal income tax consequence to the optionee or the company	No federal income tax consequence to the participant or the company unless the participant timely filed an 83(b) election If the participant timely filed an 83(b) election, then the participant would recognize ordinary taxable income equal to the difference between the FMV of the shares on the date of grant and the price paid. The company would have a corresponding withholding obligation and compensation deduction
Date of Vesting (Employee)	No federal income tax consequence to the optionee or the company	No federal income tax consequence to the optionee or the company	If no 83(b) election was filed, then the participant would have compensation income (taxed at ordinary rates) equal to the difference between the FMV of the shares on the date of vesting and the price paid, if any. The company would have a corresponding withholding obligation and compensation deduction If instead the participant timely filed an 83(b) election, then vesting would trigger no federal income tax consequence to the participant or the company

Stock Options v. Restricted Stock – A Comparison

EVENT	ISO	NSO	Restricted Stock
Date of Exercise (Employee)	No federal income tax consequence to the optionee or the company However, the "spread" under an ISO – *i.e.*, the difference between the FMV of the shares at exercise and the exercise price – would be classified as an item of adjustment in the year of exercise for purposes of AMT. In order to avoid the application of AMT, the optionee would have to sell the shares within the same calendar year in which the ISOs were exercised. However, such a sale within the same calendar year would constitute a "disqualifying disposition" (see next slide) The company would have no withholding obligation and would not be entitled to any deduction	Optionee would have compensation income (taxed at ordinary rates) equal to the difference between the option's exercise price and the FMV of the underlying shares on the date of exercise The company would have a corresponding withholding obligation The company would generally be entitled to a compensation deduction equal to the amount the optionee included as ordinary income	Not applicable

Stock Options v. Restricted Stock – A Comparison

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EVENT	ISO	NSO	Restricted Stock
Date of Sale (Employee)	The tax consequences depend on whether the sale is a "disqualifying disposition" (*i.e.*, no disqualifying disposition if the stock is held for at least: (i) 2 years from the date of grant AND (ii) 1 year from the date of exercise) If the sale is not a disqualifying disposition, then the optionee would recognize long-term capital gain (or loss) equal to the difference between the sale price of the shares and the exercise price. The company would be entitled to no corresponding deduction If instead the sale is a disqualifying disposition, the optionee generally would have compensation income (taxed at ordinary rates) equal to the difference between the exercise price and the FMV of the underlying stock at the time of exercise (the company would be entitled to a corresponding deduction). Such compensation income would be added to the stock's basis to determine any capital gain that would have to be recognized on the disqualifying disposition	Any gain or loss would be short- or long-term capital gain or loss, depending on whether the shares were held for one year following exercise The company would not receive a compensation deduction for any such gain or loss	Same as NSOs

Internal Liquid Market – A Repurchase Program

- The purpose of an internal liquid program is to provide key employees of a bank with an opportunity to achieve full or partial liquidity in what is otherwise illiquid stock, and at values reasonably determined by the Board

- An internal liquidity program generally has the following characteristics:
  - At the end of each fiscal year, the Board will determine (<u>in its sole discretion</u>) how much (if any) cash should be set aside to fund the program for the next repurchase period (the next repurchase period typically being a 1-year period)
  - On an annual basis, the Board may impose minimum and maximum limits on the number or value of shares that may be repurchased from a key employee
  - Key employees who are interested in having shares repurchased under the program would provide notice to the bank
  - After applying the foregoing, repurchases could be orderly (*i.e.*, think of a government-issued bread line):
    - First, to current key employees who provided notice for a prior repurchase period, but whose shares were not fully repurchased due to the foregoing limitations;
    - Second, to current key employees who provided notice for the current repurchase period (and if over-subscribed, then on a first-come first-serve basis in the order that the bank received notices from key employees);
    - Third, to former key employees who provided notice for a prior repurchase period, but whose shares were not fully repurchased due to the above limitations; and
    - Fourth, to former key employees who provided notice for the current repurchase period (and if over-subscribed, then on a first-come first-serve basis in the order that the bank received notices from such key employees)

Facilitate Capital Raise with an ESOP

- Conceptually, implementation of an ESOP can help a bank with its capital raising endeavors as follows:
  - The bank creates a newly-formed ESOP, which is a qualified retirement plan that works in conjunction with the Bank's existing 401(k) plan;
  - Participants in the 401(k) plan are permitted to use dollars within their 401(k) accounts to direct investments into the ESOP trust;
  - The ESOP trust would enter into a stock purchase agreement with the bank to acquire newly issued shares of bank common stock;
  - Such stock would then be beneficially allocated to the respective participants' ESOP accounts; and
  - The bank uses the cash to help fund operational endeavors for which it otherwise was seeking a capital raise

- Documents and actions required to implement an ESOP transaction include:
  - ESOP plan document and trust agreement;
  - Summary plan description;
  - Stock purchase agreement;
  - A private placement memorandum so that 401(k) participants are able to make an informed decision with respect to their investing 401(k) monies into Bank common stock;
  - Appointment of a trustee;
  - Participant election forms, and too, possibly amend the 401(k) plan to allow for certain percentages of a participant's account balance to be invested in the ESOP

Facilitate Capital Raise with an ESOP (cont.)

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- Possible advantages to a bank for sponsoring an ESOP include:
  - Helps create/foster an employee-ownership culture, which should increase employee moral and profitability, and help retain and attract key employees;
  - When used in conjunction with an internal liquid market for the trading of the bank's common stock, the bank should realize substantial tax savings without cash outlay, which should increase the bank's cash flow;
  - All allocations to participant accounts are tax deferred and distributions from participant accounts could be rolled over into an IRA;
  - Provides liquidity for shareholders at objectively-determined fair market value;
  - An ESOP is permitted to use debt from a third party to purchase bank common stock and cash dividends/distributions can be used to service such debt; and
  - Dividends paid to an ESOP are tax deductible (*i.e.*, otherwise, dividends are not deductible)

- Possible disadvantages of the bank sponsoring an ESOP include:
  - Existing shareholders of the bank are diluted to the extent stock is purchase from the bank and not from existing shareholders of the Bank;
  - Certain ERISA fiduciary duties apply to an ESOP;
  - Control issues can arise under federal banking laws (but only if the ownership level of the ESOP is 10% or more of the bank's outstanding common stock); and
  - Costs associated with setting up an ESOP and ongoing maintenance costs (including legal fees, employee communications, participant recordkeeping and annual valuation)

Designs to Avoid Excessive Risk Taking

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- Within the banking industry and due to regulatory interests on sound banking practices, banks tend to not provide robust stretch goals to reward outperformers (especially when compared to non-bank employers). By way of example:
  - For non-bank employers it is common to have a stretch goal attached to the performance metric, such that the individual could earn up to 2x target amount if he or she outperforms
  - As applied to banks, large payouts above target can be viewed by regulators as encouraging excessive risk. As a result, bank compensation programs tend to not pay as well (when compared to non-bank employers) when stretch goals are satisfied
- Bank pay programs should be designed to make sure that key employees are not incentivized to take excessive risk. Such design features to help avoid excessive risk include:
  - Add stock ownership policies and post-vesting hold policies
  - Add clawback policies on performance-based compensation. What should be the term for the lookback?
  - Require a deferral of a certain percentage of performance-based compensation
    - 60%, 40%, 30%?
    - Some or all of the deferred monies would be subject to clawback if certain enumerated safety and soundness factors were not satisfied
    - The deferred monies could also be used to enforce restrictive covenants (e.g., non-competes, non-solicitations, confidentiality provisions, invention assignment provisions, etc.)

Stock Ownership Policy Design Considerations

- A stock ownership policy sets the parameters on the level of stock that must be owned. Such can be structured as either a stock ownership guideline or a hold/retention guideline

- Why adopt a stock ownership policy?
  - Discourages excessive risk taking
  - Minimizes the focus on short-term gains at the expense of long-term gains
  - Aligns the executive's interest with those of the long-term shareholders
  - Signals to shareholders that the executives are committed to long-term success
  - Best practice
  - Helps to further create a link between pay and performance

- Drawbacks of a stock ownership policy?
  - Too large of an equity concentration by an executive is also not good
  - The lack of diversification with respect to an executive's wealth could make the executive risk adverse in a way that could impact the corporate strategy

Stock Ownership Policy Design Considerations (cont.)

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- Stock ownership policies typically cover executives and key employees
- These policies are typically denominated in dollars, either a fixed dollar amount of a multiple of compensation (e.g., 3x base salary), and a lesser number of policies are denominated in shares
  - In an effort to address volatile stock performance, many policies are structured to provide that once the policy is satisfied, it is always satisfied (i.e., future declines in share price will not impact the individual's compliance so long as the individual maintains the same number of shares as when compliance with the policy was achieved)
    - Essentially, a dollar-denominated guideline turns into a share-denominated guideline once the required stock ownership level is satisfied
  - Using a "trailing average" over multiple periods of time could also be used to mitigate stock price volatility
- Ownership targets are typically varied depending upon the position of the individual
- A design issue is whether unvested and vested equity awards should count towards compliance with the stock ownership policy

Stock Ownership Policy Design Considerations (cont.)

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- What should be the time period within which an individual has to comply with the policy? 1 year, 2 years, 3 years, etc.?
  - Alternatively, the bank could provide that NO specific time period will apply, and instead, a stock holding requirement will apply until the policy guidelines are satisfied

- How should compliance be tracked? And what should be the frequency of verifying compliance?

- What are the penalties for non-compliance? Such can include:
  - Prohibit sales,
  - Require other forms of compensation to be taken into stock, and
  - Disqualify the employee from receiving future equity awards

- Common exceptions applied to stock ownership policies include:
  - Financial hardship
  - Divorce
  - Extreme market conditions
  - Tuition or educational needs

Don’t Forget Next Month’s Webinar

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- Title:
  - Preparing for Proxy Season: Start Now (Annual Program)

- When:
  - 10:00 am to 11:00 am Central
  - September 8, 2022