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Preparing for Proxy Season: Start Now (Annual Program)

Presentation for:
Executive Compensation Academy – (Monthly Training Series)
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- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
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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

- 2022 webinars:
  - 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

Prior Proxy Season Recap

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- Through June 2022, there were approximately
  - 72 companies that failed their say-on-pay vote (only 60 failures in prior year around the same time frame)
  - Approximately 20 of those that failed involved multi-year failures (i.e., more than 1 year of failure), typically surrounding the same issues each year such as:
    - Pay v. performance disconnects (most common reason for a negative recommendation from ISS),
    - Problematic compensation practices, and
    - Mega grants
  - The number of companies with low say-on-pay results (less than 70% pass rate) also rose by 30% compared to 2021. Keep in mind that an issuer with less than a 70% pass rate is expected by ISS to disclose in the next proxy:
    - Efforts that the Board took with respect to shareholder engagement
    - The specific feedback the issuer received from dissenting shareholders, and
    - What actions or changes the issuer made to its pay programs and practices to address concerns of its shareholders
- The statistics support that an “Against” recommendation from ISS creates a drop in the pass rate by approximately 32% or more

Prior Proxy Season Recap: Compensation Proposals

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- Shareholder resolutions on compensation-related items moved from primarily focusing on ESG topics (as in prior years) to a focus on severance pay proposals
  - Most (approximately 2/3rd) of the severance pay proposals came from Chevedden Group
- Chevedden Group proposals included:
  - 18 proposals seeking shareholder ratification of severance payment multiples in excess of 2.99x base salary and annual bonus

Possible Items of Interest for Fall 2022

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- Some of the more highlighted points are contained on the following slides

- But overall, Compensation Committee concerns will be very similar to its concerns in prior years, such including:
  - Volatility of stock price and its impact on compensation arrangements such as conversion ratios, stock ownership policies, relative total shareholder return and similar performance metrics;
  - Addressing underwater stock options;
  - Addressing long-term performance metrics that are not likely to pay out;
  - Addressing retention issues for executives who otherwise could receive a "fresh grant" of equity if he or she took employment with another entity;
  - Planning for an exit strategy; and
  - Disclosure

- AND . . . Pay versus Performance disclosure rules are going to be a hot topic

Annual Grant Policy

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- This topic is not new. Having a documented annual grant policy could provide an affirmative defense to an allegation that the equity grant was intended to time the market
  - 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 grants to coincide with low stock price, thus resulting in a higher share award than if the stock retained a higher stock price
- And too, the SEC's guidance on spring-loaded equity awards is yet another reason why issuers should consider adding an annual grant policy. Under such 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 grants. 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 more shares than he or she would have received if the grant occurred after the public announcement
  - The SEC guidance differentiates between routine and non-routine grants, and implies that routine grants might not be subject to the guidance. Thus, a routine grant pursuant to an annual grant policy may avoid the issue of spring-loaded equity awards

Shrinking Labor Market – Succession Strategy Thought

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- The cost of retaining key employees may increase as the baby boomers continue to exit the workforce
- It is anticipated that a thinning labor market will become the norm even in the face of, or during, an economic downturn
- Consider performing an assessment to determine whether retention gaps exist within the issuer's compensation structure. For example:
  - Consider adding a "retirement" provision within equity award agreements and key employee employment agreements that allow for accelerated vesting (all or some) if the key employee terminates his or her employment due to retirement
  - BUT . . . Require advance notice (e.g., 6 months, 12 months) advance written notice before the key employee can effectuate such retirement
  - Such advance notice could help an issuer with its succession strategies by providing the issuer with time to find and train a successor key employee

Stock Price Volatility: Underwater Stock Options

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- This slide sets up the factual problem:

- Outstanding stock options run the risk of becoming underwater and a drag on the share reserve of the equity incentive plan

- If the Compensation Committee desires to reprice underwater stock options, the issuer would have to file a Schedule TO with the SEC unless:
  - The repricing is conducted on an individually negotiated basis with a small number of key executives (*see* March 21, 2001 SEC Exemptive Order); or
  - A repricing is permitted unilaterally (*i.e.*, without optionee consent), thus negating the Schedule TO rules because there is no "offer" and the optionee would not have to make an investment decision
    - However, a significant drawback to a unilateral repricing is that incremental compensation expense could be significant since a "value-for-value" exchange cannot be effectuated (such requires optionee consent because a lesser number of shares generally results under the amended award)

  - And too, other issues must be considered when repricing stock options, such as:
    - Whether the cancelled shares return to the share reserve under the equity plan;
    - Whether shareholder approval is required under the terms of the equity plan and under applicable NYSE/NASDAQ listing rules (answer is most likely yes that such approval is required); and
    - Whether adverse tax and accounting consequences could be avoided

Stock Price Volatility: Underwater Stock Options (cont.)

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- A possible idea to fix the prior problem could be to insert a stock-price forfeiture
- The stock option award agreement would provide that if the stock option ever becomes underwater by $x.00 (or the stock price ever falls by $y.00), then both the vested and unvested portions of the stock option are automatically and immediately forfeited for no consideration
  - Depending on the equity plan's terms, the forfeited shares would return to, and act to replenish, the share reserve of the equity plan
- The goal is avoid the time, expense and shareholder relationship issues associated with repricings and compliance with the SEC's tender offer rules
- Risk to be vetted
  - Under NYSE and NASDAQ listing rules, a cancellation followed by a **required** regrant is deemed to be a repricing, which generally would require shareholder approval
  - This "cancellation" issue will need to be vetted by legal counsel
  - A possible solution to consider is whether a cancellation followed by a **voluntary** grant (the latter of which would be pursuant to a written or operational annual grant policy) would sufficiently negate the nexus between a cancellation and regrant, thus negating the repricing characterization

Insufficient Shares: Inducement Grants

- Under applicable NYSE and NASDAQ listing rules, shareholder approval is not required for "inducement grants"

- To qualify as an inducement grant, the grant of restricted stock or stock options must act as a material inducement to the person being hired as an employee (or such person being rehired following a bona fide period of interruption of employment)
  - Inducement awards include grants of equity to new employees in connection with an M&A transaction

- Inducement grants must be approved by the Compensation Committee or a majority of the company's independent directors

- An additional qualification requirement is that promptly (generally within 4 business days) following the grant of an inducement award, the company must disclose in a press release the material terms of the award, including the identity of the recipient(s) and the number of shares involved, and make certain other filings with the applicable listing agency

Insufficient Shares: Inducement Grants (cont.)

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- In terms of the "form" of award, some companies provide inducement grants as stand-alone awards, whereas others will have an inducement plan from which to make grants
  - The latter is particularly prevalent in M&A transactions
- Important to note is that inducement grants are "outside" of the shareholder approved equity incentive plan
  - Therefore, inducement grants would have to comply with an applicable securities exemption or be covered pursuant to a Form S-8 or other securities registration

Insufficient Shares: Inducement Grants (cont.)

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- Our thoughts generally:
  - Depending on the extent a company grants equity to new hires, compliance with the inducement grant exception could substantially increase the life expectancy of a shareholder-approved share reserve (*i.e*., equity grants tend to be larger in new hire situations)
  - Inducement grants could be used in the M&A context where a buyer offers equity to the key employees of the target entity
  - However, burn rate and dilution profiles relative to industry peers could be negatively impacted, thus making it more likely that ISS would recommend "against" to any future request to increase the share reserve for the company's equity incentive plan (*i.e*., an inducement plan essentially borrows from the share reserve of a future shareholder-approved equity incentive plan)

- Our thoughts for any company considering implementation of an inducement program:
  - Consider the structure of any inducement program
    - If inducement grants will be frequent, then draft an inducement plan
    - But if inducement grants will be infrequent, then approve stand-alone inducement grants on an ad hoc basis

  - Have an inducement grant (or plan) be covered by a Form S-8

Pay v. Performance: Overview

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- On August 25, 2022, the SEC adopted long-awaited rules addressing pay v. performance disclosure requirements, as required pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act

- Purpose of the rule is to include information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions

- Here is an OVERVIEW of the final rules:
  - Issuers with fiscal years ending on or after December 16, 2022 will be required to include pay v. performance disclosures within the proxy and information statements they file in March – June 2023
  - Rules do not apply to EGCs, foreign private issuers and registered investment companies
  - Scaled disclosure is permitted for Smaller Reporting Companies
  - The new disclosure table covers the PEO individually, and an average for the other NEOs
  - A new disclosure table measures total compensation in the SCT, the compensation actually paid to the executives, and the financial performance of the issuer
  - Financial performance measures include: TSR, peer group TSR, net income and a financial performance measure as chosen by the issuer that represents the most important financial measure the issuer uses to link pay v. performance

Pay v. Performance: Rules

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- New proxy disclosure table
  - Table must cover the 5 most recently completed fiscal years
  - Table must cover the PEO (individually) and the other NEOs as an average
  - Table must disclose Total Compensation (as disclosed in the SCT) and "compensation actually paid"
  - Additional disclosure in the table includes:
    - Issuer's TSR,
    - TSR of the issuer's peer group,
    - Issuer's net income, and
    - A tabular list of at least 3 (and up to 7) financial performance metrics that were used by the issuer in determining compensation actually paid

- Narrative text following the table must include:
  - A description of the relationship between "compensation actually paid" and each of the above performance measures, and
  - A description of the relationship between the issuer's TSR and the weighted TSR of the issuer's peer group

- The first proxy statement will only require disclosure for 3 years, and each of the two years thereafter will add another year, such that eventually 5 years of disclosure will be required (with scaled back disclosure for EGCs and SRCs)

Sample Tabular Presentation

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Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO NEOs	Average Compensation Actually Paid to Non-NEO PEOs	Value of Initial Fixed $100 Investment Based On:		Net Income	[Company-Selected Measure]
					Total Shareholder Return	Peer Group Total Shareholder Return		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Y1								
Y2								
Y3								
Y4								
Y5								

Pay v. Performance: Rules (cont.)

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- New methodology - Compensation Actually Paid
  - Calculating “compensation actually paid” could become complex because it substantially differs from the determination of compensation under the SCT rules
  - With respect to equity awards, “compensation actually paid” means value is determined as follows:
    - If equity was granted in a covered year and remains outstanding and unvested as of the last day of such year, then value is determined using the fair value of the awards as of the end of such year
    - If equity was granted in a prior covered year and are outstanding and unvested as of the end of the covered year, then value is determined using the change in fair value from the prior year end to this year end
    - If the equity was granted in a prior or same fiscal year and becomes vested as of the end of a covered year, then value is determined using the change in fair value as of the vesting date
    - And if the equity was granted in a prior covered year and does not later vest, then a deduction for the amount of fair value at the end of the prior fiscal year is required
  - Key is that fair value determinations will have to be determined at the end of each fiscal year (whereas the status quo prior to the final rules only necessitated a determination of fair value in connection with the grant of the award). Thus, there will be advanced Monte Carlo simulations and Black-Scholes calculations

Pay v. Performance: Rules (cont.)

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- Additionally, the issue must describe in a narrative or graphically (or both):
  - The relationship between each of the performance metrics set forth in the table and compensation "actually paid"
  - The relationship between the TSR of the issuer and the TSR of the issuer's peer group

- The issuer must report 3-7 financial measures that it deems are its most important financial measures in linking executive compensation to issuer performance for the recently completed fiscal year
  - If less than 3 financial measures were used, then all such measures must be listed irrespective of importance
  - Non-financial measures may be used if such are among the "most important" and at least 3 (or less if the issue used less than 3) "most important" financial performance measures were disclosed
  - No ranking or weighting of the measures is required

- Supplemental disclosure is permitted
  - Same rules apply with respect to supplemental disclosure of the SCT
  - The use of supplemental disclosure to address realizable or actual pay will likely increase due to the pay v performance disclosure rules

Pay v. Performance: Rules (cont.)

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- Issuers are provided flexibility on the placement of the pay v performance disclosure
  - Placement could be outside or inside the CD&A
- If placed outside the CD&A, then consider having its placement after the typical required tabular disclosure so that the pay v performance disclosure is not covered by the Compensation Committee report and not covered by the say-on-pay vote
- However, what is more likely is that the issuer already addresses pay v performance in its executive summary to the CD&A or within the CD&A itself. As a result, certain aspects of the pay v performance disclosure should be woven into the CD&A, with the required table being disclosed after the typical required tabular disclosure

Don’t Forget Next Month’s Webinar

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- Title:
  - Compensation Considerations Due to Upcoming Loss of EGC Status
- When:
  - 10:00 am to 11:00 am Central
  - October 13, 2022