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New SEC Rules:
Navigating Clawback and Pay vs Performance

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 2023 Webinars

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- 2023 webinars:
  - New Compensatory Thoughts & Practices from ISS (Annual Program) (1/12/23)
  - Start-Up Compensation Designs: Focus on Founders (Part 1 of 2) (2/9/23)
  - Start-Up Compensation Designs: Focus on Key Employees (Part 2 of 2) (3/9/23)
  - Current 280G Mitigation Techniques (4/13/23)
  - Private Equity Compensatory Design Trends & Practices (5/11/23)
  - Equity Awards & Employment Taxes: Design Considerations (6/8/23)
  - Form 4 Training Course (7/13/23)
  - Anatomy of ISS: A Current Compensatory Perspective (8/10/23)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/14/23)
  - PubCo Governance & Internal Controls: A Compensatory Perspective (10/12/23)
  - Keep It Boring: Drafting Miscellaneous Provisions in a Contract (11/9/23)
  - [Topic TBD] (12/14/23)

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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

Purpose of this Presentation

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- The purpose of this discuss is to cover:
  - The upcoming pay versus performance rule that many issuers are currently implementing, and
  - Clawback requirements

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

- 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 (using either the industry comparators set forth in the performance graph of the Form 10-K or the peer group used within benchmarking disclosure within the proxy statement),
    - Issuer's net income, and
    - An unranked tabular list of at least 3 (and up to 7) financial performance metrics that were used by the issuer in determining compensation actually paid - neither the target nor actual performance levels need be disclose – non-financial measures may be used if 3 (or less if use less) financial measures have already been disclosed
- 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: Total Shareholder Return	Peer Group Total Shareholder Return	Net Income	[Company-Selected Measure]
(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 issuer 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.)

- 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

New Clawback Requirements

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- On October 26, 2022, the SEC adopted new clawback rules pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act

- National stock exchanges (i.e., NASDAQ and NYSE) are now required to establish listing standards to comply with the new rules

- Once the applicable listing standards become effective, issuers will be required to file their clawback policies as exhibits to, and provide disclosures within, their annual reports

- Deadline to comply:
  - We await implementing rules from stock exchanges
  - Stock exchanges are permitted to provide for an effective date of up to one year
  - An issuer then has up to 60 days to implement a compliant clawback policy

New Clawback Requirements (cont.)

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- As a quick review, the current requirements of the Dodd-Frank Act clawback include:
  - Compensation clawback policy must apply at least to current and former executive officers
    - In contrast, Section 304 of SOX applies only to the CEO and CFO
  - The clawback policy must be triggered any time the issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws
    - In contrast, Section 304 of SOX applies only when a restatement of financial statements is "required" and is the result of "misconduct". Thus, Section 304 of SOX contains a fault requirement and Dodd-Frank does not
    - Dodd-Frank clawback applies to "Little r" restatements (*i.e*., financial restatements that are not deemed material errors and do not require a full restatement of previously issued financial statements)
    - Dodd-Frank clawback applies to "Big R" restatements (*i.e*., financial restatements that are deemed material errors and do require a full restatement of previously issued financial statements)
  - Once the clawback is triggered, it would apply to all "incentive-based" compensation that is "received" based on financial information required to be reported under the securities laws
    - In contrast, the look back period under Section 304 of SOX is 12 months
    - For this purpose, compensation is "received" in the fiscal year during which the relevant goal in question is satisfied (even if payment or grant occurs after the end of such period)

New Clawback Requirements (cont.)

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- [Continued List from Prior Slide]:
  - The look back period for which incentive-based compensation is subject to clawback is the 3-year period preceding the date on which the restatement is required
    - In contrast, the look back period under Section 304 of SOX is 12 months
  - The amount subject to the clawback is the difference between the amount paid and the amount that should have been paid under the accounting restatement
    - To the extent the financial metrics involve stock price and TSR, reasonable estimates may be used to determine the impact of the restatement
    - Such amount to be recovered must be calculated without respect to taxes paid by the executive officer
  - No discretion not to pursue recovery except in 3 situations:
    - If enforcement costs of recovery would exceed the amount to be recovered,
    - If recovery would violate the home country laws, or
    - If recovery would violate rules governing tax-qualified retirement plans

What Are Companies Doing?

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- To date, companies have been applying a variety of approaches while they awaited finalization of the clawback requirements under the Dodd-Frank Act. These approaches included:
  - Do nothing and wait
  - Adopt a “loose” policy that is expected to be amended in a more robust way once final rules are issued
  - Have executive officers sign a contractual arrangement whereby each such executive agrees to comply with the Dodd-Frank Act clawback requirements (when effective) and any clawback policy adopted by the company, as such is amended from time to time
  - Adopt a very formal and robust clawback policy
    - Encompass other “triggers” (*e.g.*, violations of corporate ethics codes, “fitness to serve” standards, and restrictive covenants)
    - Increase the risk of forfeiture of certain benefits should an executive be terminated for ethical or compliance lapses

Covered Executives

- Section 954 of the Dodd-Frank Act applies to "any current or former executive officer of the issuer who received incentive-based compensation"

- The group of covered individuals should be broad enough to cover at least those individuals who influence decision-making with respect to critical business issues. Currently, issuers who have adopted clawback policies generally cover one or more of the following groups:
  - Named executive officers
  - Current key executive officers (*e.g.*, Section 16 officers)
  - Current and former key executive officers (*e.g.*, Section 16 officers)
  - Incentive pay recipients (annual and/or equity plan participants)

Compensation Components Covered

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- Dodd-Frank only applies to incentive-based compensation
- However, clawback policies could cover several forms of compensation paid to an individual, including:
  - Annual cash bonuses
  - Long-term cash incentive awards
  - Equity awards (both full-value awards, such as restricted stock or restricted stock units, and appreciation-only awards, such as stock options and stock appreciation rights)
  - Gains from the sale or exercise of equity-based compensation
  - Nonqualified deferred compensation
- Fixed pay is typically not included (*e.g.*, salary, retention bonuses, etc.)

What Are Next Steps

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- 1st – Review the issuer's current clawback policy (if any) to determine whether changes are required
- 2nd – Review existing contractual arrangements to determine whether the issuer has the authority under such arrangements to implement a clawback
  - The Board or Compensation Committee should then review and discuss
- 3rd – Revisit any situation where the issuer incorporates a financial performance-based measure as a modifier to an otherwise non-financial performance-based measure
- 4th – With respect to severance pay, consider whether any multiple of severance that is based upon performance-based incentive pay should instead be denominated as a flat dollar amount
- 5th – Review form separation agreements and mutual releases to ensure the possibility of a clawback is not thwarted
- 6th – Determine the enforcement mechanism and whether a claims procedure should apply

Don’t Forget Next Month’s Webinar

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- Title:
  - New Compensatory Thoughts & Practices from ISS (Annual Program)
- When:
  - 10:00 am to 11:00 am Central
  - January 12, 2023

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