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Public Company Governance & Internal Controls: A Compensatory Perspective

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Executive Compensation Webinar Series
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- 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 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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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:
  - Keep It Boring: Drafting Miscellaneous Provisions in a Contract (11/9/23)
  - [Topic TBD] (12/14/23)

- 2024 webinars:
  - [Announced next month]

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 companies, 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 Presentation

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- The purpose of this presentation is to cover the certain governance issues that should be considered from a compensatory perspective, including (in no particular order):
  - Design of Compensation Committee Charters,
  - Performing risk assessments to mitigate risky behavior,
  - Recoupment policies,
  - Perquisite disclosures, and
  - Designing equity compensation trading windows within an insider trading policy

Compensation Committee Charters

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- What is the authority of the Compensation Committee, and has any of such authority been delegated? For example:
  - Absent a valid delegation, only the Board of Directors has the authority to effectuate grants of equity
  - Such delegation is typically contained within the Compensation Committee Charter, thus providing the Compensation Committee with the requisite authority

- And too, does the Compensation Committee Charter allow for an additional downward delegation? For example, downward delegations to an executive officer could be helpful in non-executive officer new hire situations where, to attract the prospective employee, reaction time on behalf of the issuer must be quick

Compensation Committee Charters (cont.)

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- Assuming a downward delegation from the Compensation Committee to an executive is permitted within the Charter, then consider that:
  - Delegations must comply with applicable state law (*e.g.*, DGCL 152(b) and 157(c))
  - Delegations of authority to grant equity should be governed by a written equity grant policy (the "***Policy***") that was approved by the Compensation Committee and/or the Board
  - The Policy should include a reporting mechanism to the Compensation Committee of all equity grants. To avoid "date of grant" issues, the Policy should clearly state that only a "reporting" to the compensation committee is required (*i.e.*, no ratification or approval by the Compensation Committee is required)
  - Award agreements that were pre-approved by the Board or the Compensation Committee should be attached as exhibits to the Policy (*i.e.*, to address minimum vesting schedules, whether par value is required, etc.)
  - The Policy should specify the total number of awards (individually and collectively) that may be made pursuant to the delegation
  - The Policy should specify the time period within which shares can be issued pursuant to the delegation AND the time period within which the Policy is effective
  - The Policy should specify whether any minimum consideration is required (*e.g.*, par value – a remnant carryover of past practices)
  - Delegations should exclude the ability to make grants to those who are Section 16 insiders as of the date of grant
    - Compliance with Rule 16b-3 requires the full board of directors or a committee of 2 or more non-employee directors to approve, in advance, all grants to Section 16 insiders

Compensation Committee Charters (cont.)

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- Our thoughts:
  - Delegations of authority can simplify the process of granting equity in situations where non-executive officers are being hired (*i.e.*, quick reaction)
  - Delegations of authority should be effectuated pursuant to a written document (*i.e.*, a policy) that addresses many of the points on the prior Slides
  - Verify that the Charter of the Compensation Committee allows for a downward delegation of authority to grant equity
  - An amendment to the equity incentive plan might be needed if the terms of such plan provide that only the Compensation Committee has the authority to effectuate grants. Any such amendment would not likely require shareholder approval (*i.e.*, the amendment is not likely to be a "material revision" under NYSE and NASDAQ listing rules), but this issue should be vetted
    - To this point, review the administrative powers section of the equity plan and determine whether, within the plan document, the issuer reserved the right to delegate its authority

Risk Assessments

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- Proxy disclosure is required to the extent an issuer's compensation policies or practices (for both executives and non-executives) are reasonably likely to have a material adverse effect on the issuer
  - Disclosure is only required if such risk is present
  - However, even in situations where no such risk is present, consideration should be given to whether positive disclosure should be implemented within the proxy statement (*i.e.*, affirmatively state that there are no such risks)
- As a result, the issuer must perform a risk assessment every year
- This issue is more about "process"
  - Assemble the team
  - Review existing compensation policies, programs and arrangements
  - Look for arrangements that could incentivize individuals to take great risks, which in turn could threaten the value of the issuer
  - Analyze the results
  - Change or modify any policies, programs or arrangements that create such risks

Recoupment Policies

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- Issuers have until December 1, 2023, to adopt Dodd-Frank compliant clawback policies to be effective on October 2, 2023
  - Board approval is required (unless such was previously delegated to a committee of the Board)

- 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
    - And too, 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)
    - Plus, 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)

Recoupment Policies (cont.)

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- [Continued List from Prior Slide]:
  - 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)
  - 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

Perquisites: Rule

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- As background, a perquisite exists if:
  - The item in question is NOT "integrally and directly related to the performance of the executive's duties," and
  - The item in question confers a direct or indirect benefit on the executive that is personal in nature, regardless of whether a business purpose exists or if the item was provided for the convenience of the issuer, UNLESS it is generally available on a non-discriminatory basis

- A few things to keep in mind when applying the above tests:
  - Whether an item qualifies as an "ordinary" and "necessary" business expense for tax purposes is NOT determinative as to whether the item qualifies as a perk under SEC rules
    - The perquisite standard is more stringent than the business purpose test
    - And too, the perquisite analysis draws a distinction between an item that an issuer provides because the executive needs it to do the job (*i.e.*, integrally and directly related to the performance of duties), and an item provided for some other reason (even when that other reason involves both issuer benefit and personal benefit, *e.g.*, corporate aircraft)
  - An item is considered non-discriminatory if it is generally available to all employees on a non-discriminatory basis to those who may lawfully receive it (*e.g.*, available to all domestic employees with "accredited investor) status)
    - In contrast, an item is discriminatory if it is only available to employees in the same job category or at the same pay scale

Perquisites: Examples

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- Car Allowance
- Car Insurance
- Club Dues
- Club Initiation Fee
- Commission for Sale of Home
- Commuting Expenses
- Computer Equipment
- Corporate Residence
- Costs Associated with Expatriate Work Assignment
- Currency Exchange Arrangements
- Discounts on Company's Products/Services Not Generally Available to All Employees
- Excess Liability Insurance
- Executive Office Benefits
- Financial Consulting/Planning Services
- Gas Allowance
- Goods and Services Differential (For Foreign Service)
- Home Office Costs
- Home Security
- Housing Allowance
- Legal Expenses
- Life Insurance Premiums
- Living Expenses
- Long Term Disability Insurance
- Medical and Dental Claims/Premiums
- Parking Fees
- Payments for Staying in Personal Residence while on Business Travel
- Personal Liability Insurance
- Personal Travel on Corporate Aircraft
- Personal Use of Company-Provided Administrative Support
- Physical Exam/Voluntary Health Screening
- Relocation Allowance
- School Tuition
- Secured Parking
- Security Concerning Fraudulent Data Access
- Spouse/Family Member Tag-Along on Business Travel
- Spouse Attendance at Company Events
- Stipend for Effective Company Representation in the Community
- Supplemental Accidental Death and Dismemberment Insurance
- Tax Equalization Payments
- Tax Gross-Ups
- Tax Return Preparation
- Telephone Services
- Trips Awarded to Top Sales Performers
- Use of Company Products and Services
- Use of Corporate Travel Agency for Personal Travel
- Use of Executive Dining Room
- Wellness Reimbursement (For Fitness Related Activities)
- Wireless Network for Computer Use

Perquisites: Disclosure

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- Perquisites are reported in the "All Other Compensation" column of the SCT
  - No disclosure is required if the aggregate value of all perks provided to a named executive officer is less than $10,000
  - If the aggregate value of all perks provided to a named executive officer is greater than $10,000:
    - The value of all perks must be disclosed in the table;
    - Each type of perk must be identified by type in a footnote (general categories such as travel and entertainment are not sufficient);
    - The value of any perk that exceeds the greater of $25,000 or 10% of the aggregate value of all of the perks must be quantified and disclosed in a footnote;
    - Value of a perk is determined on the basis of the incremental cost of the perk;
    - If footnote quantification is required, the methodology to compute the aggregate incremental cost should be included in a footnote; and
    - The requirement for identification and quantification applies only to the last fiscal year

- Issuers may include a separate table for all items under "All Other Compensation" or specifically for perks to more clearly present the required disclosures

Perquisites: Example of SEC Enforcement

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- An issuer settled an allegation by the SEC that the issuer failed to properly disclose approximately $3mm of perks over a 4-year period
  - As background, the issuer applied the wrong standard in its determination of whether an item is a perk (*i.e.*, it appeared to have applied a business purpose standard to the job of the individual, which is an incorrect standard)
  - The perks in question consisted of:
    - Personal use of issuer aircraft,
    - Sporting events,
    - Club memberships,
    - Use of a personal assistant's time, and
    - Board membership fees to a charitable organization
  - According to the SEC, the issuer failed to:
    - Have adequate processes and procedures in place so as to ensure proper reporting
    - Adequately train employees responsible for drafting the CD&A
  - As a result, the issuer entered into a settlement offer with the SEC that:
    - Fined the issuer $1.75mm (a high amount relative to the value of $3mm in perks)
    - Ordered the issuer to retain an independent consultant for a 1-year period in order to assess the issuer's policies and procedures for complying with SEC compensatory securities laws (and the issuer must implement any recommended changes)
    - Ordered the issuer to be subject to compliance monitoring for 2 years

Perquisites: Example of SEC Enforcement (cont.)

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- In June 2023, the SEC found that an issuer's "system for identifying, tracking and calculating perquisites did not apply an integrally-and-directly-related standard when characterizing certain" perquisites. In this matter:
  - The issuer disclosed perquisites for its executive officers, but failed to report in the All Other Compensation column of the proxy statement a total of $1,300,000 per year relating to corporate aircraft usage
  - The issuer self-reported the problem and cooperated with the SEC, resulting in a settlement with the SEC that included no financial penalties
  - However, it was also learned that one of the executives had failed to report on his or her D&O questionnaire over $600,000 of perquisites relating to car and driver services, car repairs, meals, travel, etc., as well as issuer-approved use of corporate aircraft
  - Such D&O failure caused an underreporting of compensation in the All Other Compensation of the Summary Compensation Table
  - As part of the above settlement, the executive in question agreed to pay a $75,000 civil penalty (and too, such executive had already reimbursed the issuer for most of the under-reported expenses)

Practical Thoughts

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- To ensure current and on-going compliance, issuers should assess whether sufficient control measures exist
  - Individuals responsible for preparing executive compensation disclosure should be
    - Familiar with the SEC's perk disclosure standards, and
    - Empowered to find the information within the issuer to provide accurate disclosure
  - Develop steps to identify perks and procedures for tracking personal usage
  - Review reimbursement policies and procedures with the SEC's disclosure standard in mind
  - Provide additional training on identifying perks, calculating the aggregate incremental cost of such perks, tracking perks and disclosing the same
    - Plug coming . . . wait for it . . . wait for it . . . our Firm can provide such training onsite or remotely via webinar
- Review D&O questionnaires
  - Regularly update questionnaire to elicit information about possible perks
  - Include expansive perk-orientated questions
  - Provide examples of what might constitute a perk
  - Leave time for reviewers to analyze the responses and prepare the appropriate disclosures

Practical Thoughts (cont.)

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- Consider whether the following procedures should be implemented:
  - Pre-approval of the Compensation Committee prior to any perks being provided to executive officers or, alternatively, approval of a perk policy
  - Pre-clearance procedure before an officer or director is reimbursed for certain items that arguably could be a perk

Insiders Selling/Trading Plans/Insider Policies

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- As background, insider trading is prohibited under Rule 10b-5
  - Rule 10b-5 imposes a presumption in favor of liability, such that if a person is "aware" of material non-public information at the time a security is bought or sold, such person is then presumed to be trading based upon such material non-public information
    - In practice this rule places insiders in a difficult position because many find themselves almost always possessing material, non-public information
  - But a properly designed 10b5-1 trading plan would shift the focus:
    - From whether the insider had material, non-public information at the time of the trade;
    - To whether the insider had material, non-public information at the time he or she became committed to the trade

Trading Plans: Background

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- Trading plans are a common method for directors and officers to trade without incurring insider trading liability
  - It allows insiders to buy and sell their issuer's stock even if they are in possession of material, non-public information, but only if the trading takes place pursuant to a plan the insider entered into at a time he or she did not possess such material, non-public information
  - The trading plan must either:
    - Specify the amount of securities to be traded and the price and date on which the stock is to be purchased or sold; or
    - Include a written formula for determining the amount, price and date of the transaction
  - A trading plan provides an affirmative defense against an allegation that the insider's purchase or sale was based upon inside information
  - But the key is for the insider to have no future discretion over future trades
  - Plus, the existence of such a plan could preempt a perception in the market that the insider's selling is associated with a loss of confidence in the issuer

Trading Plans: Adoption

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- Material non-public information cannot be a factor when setting up the trades (otherwise the affirmative defense is negated). This means that:
  - The individual cannot have material non-public information at the time of adopting the plan; and
  - Additionally, the broker (or other third-party delegatee) cannot be aware of material non-public information when applying any discretion to set up the future trades

- The issuer's insider trading policy could help ensure compliance with the foregoing by:
  - Limiting the timing on which trading plans may be adopted to only being adopted during open trading windows, and
  - Prohibit any adoption of trading plans during blackout periods

- Effective for trading plans entered into or modified on or after February 27, 2023, a written certification is required from the insider when adopting or modifying a trading plan. Such must include a statement that:
  - The insider is not aware of material non-public information about the issuer or its securities, and
  - That the insider is adopting or modifying the trading plan in good faith and not as a part of a plan or scheme to evade the prohibitions of Rule 10b-5

Trading Plans: Retain No Discretion/Good Faith

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- To be clear, the affirmative defense is lost if the individual retains any discretion over the "whether," "when" and "how" to effectuate any trades

- This means the terms of the trading plan must:
  - Contain a written formula or algorithm that;
  - Specifies the amount (share number or dollar value), date and price of securities to be purchased/sold; and
  - The individual cannot exercise any discretion or influence over such number, date or price

- The trading plan must be entered into in "good faith" and not part of a plan or scheme to evade the rule
  - This good faith standard is applied using hindsight facts and circumstances
  - And too, effective February 27, 2023, this good faith requirement extends throughout the duration of the trading plan

- Any change or deviation from the terms of the trading plan would destroy the affirmative defense

- Consider limiting the use of a broker to just one broker

Trading Plans: Waiting Period/Pre-Clearance/Other

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- It used to be that waiting periods from the date the plan is entered into and the date the first trade is effectuated was not required; however, for new or modified plans on or after February 27, 2023, a waiting period is required until the later of:
  - 90 days after the adoption or modification of the plan, and
  - Two business days after the issuer files a quarterly or annual financial report with the SEC covering the quarter in which the plan was adopted or modified
- Thus, it is recommended that any adoption of a trading plan be pre-cleared under the issuer's pre-clearance procedures
  - Typically, one person would be appointed to handle pre-clearance procedures (as opposed to multiple persons or a committee)
- Any modification to a trading plan is deemed to be a new trading plan
- Multiple concurrent plans are no longer permitted for new plans or modified plans, starting February 27, 2023
  - However, an individual could have two separate trading plans if trading under one does not commence until all trades under the other have completed
  - The exception to the above limit is if the plan covers sales needed to satisfy tax withholding obligations due to compensatory equity becoming vested

Trading Plans: Disclosures

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- Issuers must disclose on an annual basis whether they have trading plans, and too, they must disclose the procedures governing such
  - Such must be included as an exhibit to the issuer's annual financial report filed with the SEC
  - Additionally, issuers are required to quarterly disclose whether any insider has adopted or modified or terminated a trading plan, AND describe the material terms of each, including the name of the insider, the date it was adopted/modified/terminated, the duration of the trading plan, and the amount of securities to be purchased or sold thereunder
- Thus, it is recommended that any adoption of a trading plan be pre-cleared under the issuer's pre-clearance procedures
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Don’t Forget Next Month’s Webinar

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- Title:
  - Keep It Boring: Drafting Miscellaneous Provisions in a Contract
- When:
  - 10:00 am to 11:00 am Central
  - November 9, 2023