

Preparing for Proxy Season: Start Now (Annual Program)

Presentation for:
Executive Compensation Webinar 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 2019 Webinars

- Upcoming 2019 webinars:
 - Stock Ownership Policies & Clawback Policies: Design Pointers (10/10/2019)
 - Employee Stock Purchase Plans: The Introductory Course (11/14/2019)
 - How to Design Restrictive Covenants & Economic Forfeitures (12/12/2019)

- 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.)

- 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

- The purpose of this presentation is to help prepare the Compensation Committee of the Board of Directors for compensatory actions it may need to consider during its November and December meetings

- To that end, this presentation covers:
 - Recap of the 2019 proxy season,
 - Issues to consider if there is an economic downturn,
 - Reporting of hedging policies,
 - Whether it makes sense to have a separate non-employee director equity incentive plan,
 - Shareholder approval of non-employee director compensation,
 - Ideas to increase the deductibility of compensation, and
 - Whether to increase the net withholding rate

Item No. 1: 2019 Proxy Season Recap

- The pass rates this past proxy season were comparable to the 2018 proxy season
 - Approximately 78% of the issuers received more than 90% support for their say-on-pay proposals
 - Approximately 15% of the issuers received support that was greater than 70% but less than 90%
 - Approximately 6% of the issuers received support that was greater than 50% but less than 70%
 - The failed rate approximates 2.4% of the issuers

- Approximately 13% of the issuers received an “against” recommendation from ISS
 - Keep in mind that a negative recommendation from ISS still has influence and could downward adjust an issuer’s say-on-pay pass rate by approximately 30%

Item No. 2: Economic Downturn & Annual Grant Policies

- Consider whether an economic downturn could result in large swings in share price and grant practices
 - Some issuers determine the amount of equity to grant based upon an initial dollar amount, and then convert that dollar amount into a number of shares
 - This approach could create an allegation that the executives timed the market by granting a large number of shares at artificially low fair market value, well knowing that upside will be artificially captured when the stock market rebounds
 - Having a documented annual grant policy could provide a defense to this allegation
- Another topic related to an economic downturn is the impact large swings in share price can have on stock options (*i.e.*, causing stock options to become underwater)
 - Underwater stock options (*i.e.*, the exercise price is greater than the fair market value of the underlying stock) do not provide the intended retention value
 - The underwater nature of the stock option might have been avoided if the stock option had a stock-price forfeiture imbedded within the forfeiture provision of the option (*i.e.*, if the stock price falls to a certain price, the option is automatically forfeited and the underlying shares revert to replenish the share reserve of the equity incentive plan)
 - A stock-price forfeiture provision could avoid the time and expense associated with a repricing of the stock option pursuant to the SEC's tender offer rules

Item No. 3: Economic Downturn & Good Reason Definition

- If it is anticipated that an economic downturn could result with the issuer being a possible target in a change-in-control transaction, then consider revisiting the definition of Good Reason that is contained within the executive contracts
- Having such a provision is not a problematic pay practice under ISS policies
- And this type of provision could provide the executive with individual negotiation power vis-à-vis the acquiring entity

Item No. 4: Reporting of Hedging Policies

- The SEC adopted final rules that require issuers to describe their policies regarding hedging, and if an issuer has no such policy, then it must affirmatively state that no such policy exists
- To be clear, hedging is not prohibited, and a hedging policy is not required to be adopted by an issuer
- But disclosure of the issuer's hedging policy (or lack thereof) is required, pursuant to either a full disclosure or a summary of the policy

Item No. 5: Separate Director Equity Plan?

- As background, the equity plan scorecard (“EPS”) was adopted by ISS in 2015 and weighs the positive and negative factors around the following 3 pillars:
 - Plan cost,
 - Plan features, and
 - Grant practices
- As part of the “plan features” pillar, a certain number of points are allocated to the issuer if the equity plan has a minimum vesting feature
 - Full points within this bucket are awarded if the equity plan has a 1-year minimum vesting schedule for all equity awards, subject to a 5% carve-out
 - No points within this bucket are awarded if the minimum vesting period is less
- Frequently, non-employee director awards will contain a vesting schedule of less than 1 year (e.g., vest quarterly, etc.)
- As a result, and to help ease the strain on the 5% carve-out otherwise associated with both employees and non-employee directors receiving equity awards with vesting schedules of less than 1 year, consider moving non-employee directors to their own equity incentive plan

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Item No. 6: Approval of Director Compensation

- Should shareholders approve all or a portion of non-employee director compensation (e.g., compensation caps/limits, fixed formulas, etc.)?
- At a minimum, due to the decisions by the Delaware Supreme Court in *Seinfeld* and *Calma*, and as later narrowed by *In re Investors Bancorp, Inc. Stockholder Litigation* (December 2017), outside compensation advisers should be hired to help the board establish the fairness of their compensation
 - As background, directors' decisions with respect to their own compensation can be challenged as self-dealing and are subject to the "entire fairness" standard (including both fair dealing and a fair price) rather than the more deferential and director-friendly "business judgment rule" (i.e., a board's decision will be upheld unless it cannot be attributed to a rational business purpose). That is, unless such decisions were ratified by the issuer's stockholders
 - *Seinfeld* and *Calma* essentially stood for the proposition that the entire fairness standard of review would not apply with respect to equity awards to directors if the equity plan contained sub-limits (applicable to directors) that were both "meaningful" and approved by the stockholders (i.e., ratification defense). The end result is that the directors would have the benefit of the business judgment rule with respect to their actions
 - However, *In re Investors Bancorp* held that the business judgment rule would apply only if the issuer's stockholders approved the specific equity awards in question or if the awards were pursuant to a self-executing (i.e., non-discretionary) formula in the equity plan that was previously approved by the stockholders

Item No. 7: ISS & Director Compensation

- ISS has a policy with respect to evaluating proposals by issuers seeking shareholder ratification of non-employee director cash or equity compensation
- Qualitative factors that will be considered include:
 - Director compensation compared to issuers with a similar corporate profile,
 - Any problematic pay practices with respect to non-employee director compensation,
 - The presence of any stock ownership guidelines (*i.e.*, at least 4x the annual cash retainer) or hold requirements applicable to non-employee directors,
 - Vesting schedules with respect to equity awards,
 - The mix between cash and equity compensation,
 - The presence of any meaningful limits on director compensation (*i.e.*, likely a result from *Seinfeld* and *Calma*),
 - The presence of retirement benefits or perquisites, and
 - The quality of the disclosure addressing non-employee director compensation
- The above last bullet is yet another reason why robust disclosure should be included within the narrative that directly precedes the Director Compensation Table of the proxy statement

Item No. 8: Disclosure of Director Compensation

- Consider having substantially more robust narrative disclosure preceding the non-employee director compensation table of the proxy statement

- To that end, discussions with the Compensation Committee should include:
 - What is the philosophy associated with non-employee director compensation
 - How is pay assessed
 - What is the frequency of the assessment
 - What is the process associated with any benchmarking of non-employee director compensation

Item No. 9: Consider Increasing Deductibility

- As background, the Tax Cuts and Jobs Act of 2017 (the “Act”) eliminated the performance-based exception to the \$1mm deduction limit (the “Exception”) and expanded the definition of “who” is subject to the \$1mm deduction limit
 - This means that, starting January 1, 2018, all compensation paid to a covered employee that exceeds \$1mm will not be deductible unless the compensation is covered by the grandfathered rules
 - With the exception of grandfathered awards, equity incentive and annual bonus plans should be reviewed to reduce restrictions related to the Exception (e.g., setting performance goals within a certain period of time, certifying the achievement of goals, etc.)
 - With respect to the foregoing, issuers should review and update equity plan prospectuses to the extent Section 162(m) tax disclosure is contained therein
 - Annual grant sub-limits within a plan could be removed (though retaining sub-limits could be a form of good compensation governance) and any removal will likely require shareholder approval under NYSE and NASDAQ listing rules (i.e., removal of a sub-limit enlarges a possible benefit to a participant)
 - Severance provisions within executive contracts could be amended because, with the elimination of the Exception, performance conditions no longer have to be satisfied in order to receive severance pay (i.e., compliance with Rev. Rul. 2008-13 is no longer necessary)
 - The prevalence of soft goals is likely to increase (e.g., leadership)

Item No. 9: Consider Increasing Deductibility (cont.)

- As more background, “who” is a covered employee subject to the \$1mm deduction limit was expanded under the Act to include the CFO, and too, once a covered employee ALWAYS a covered employee
 - Covered employee now includes the CEO, CFO and the next 3 most highly compensated executive officers for the tax year whose compensation is required to be disclosed in the Summary Compensation Table
 - Any individual who is a covered employee on or after January 1, 2017, will always remain a covered employee (e.g., even years after termination of employment)

- Consider taking action to reduce the number of “covered employees”
 - Only an “executive officer” can become a covered employee
 - The term “executive officer” is defined by the SEC to include (i) any president, (ii) any vice president in charge of a principal business unit, division or function, and (iii) any other officer who performs a policy-making function for the issuer
 - Unless otherwise delegated, it is the Board of Directors that makes the determination of whether an individual is an executive officer

Item No. 9: Consider Increasing Deductibility (cont.)

- Other ideas to increase compensatory deductions include:
 - Implement deferral programs with future annual payouts to be less than \$1mm
 - Replace the standard 3-year vesting schedule with a longer vesting schedule
 - Create time windows within which stock option exercises must occur (if at all), and create an annual ceiling on the dollar value of any spread (*i.e.*, the difference between the exercise price and the then fair market value of the underlying stock) that may be subject to exercise per calendar year, or if grant is denominated in stock, then an annual ceiling on the dollar value that may become vested per calendar year
 - Move lump-sum severance arrangements to installment payouts
 - Whether such installment is greater than or less than \$1mm, the result is that a larger portion of the compensation is deductible

Item No. 10: Increase Net Withholding

- The Financial Accounting Standards Board (“**FASB**”) allows employers to effectuate tax withholding of equity awards up to the maximum individual statutory rate WITHOUT triggering liability classification for accounting purposes
 - Prior to the foregoing change, stock-based awards withheld at or less than the minimum statutory rate would be classified as equity awards (*i.e.*, accounting expenses is measured at the date of grant), and stock-based awards withheld at a rate above the minimum statutory rate would be classified as liability awards (*i.e.*, accounting expense is re-measured each reporting period settled)

- The change creates a real solution to the problem of holding illiquid stock (because the recipient has material non-public information at the time of vesting or exercise of stock options)
 - The minimum federal supplement withholding rate is generally 22%, and
 - The maximum federal individual tax rate is 35%

Don't Forget Next Month's Webinar

- Title:
 - Stock Ownership Policies & Clawback Policies: Design Pointers

- When:
 - 10:00 am to 11:00 am Central
 - October 10, 2019