

Building a Compensatory Peer Group: A Step-by-Step Approach

Presentation for:
Executive Compensation Webinar Series
November 12, 2020

Presentation by:
Anthony Eppert

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About Anthony “Tony” Eppert



Anthony Eppert , Partner
Hunton Andrews Kurth LLP

Tel: +1.713.220.4276

Email: AnthonyEppert@HuntonAK.com

- 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 2020 & 2021 Webinars

- Upcoming 2020 webinars:
 - Employment Taxes: The 101 Course (12/10/2020)

- 2021 webinars:
 - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/7/21)
 - Proxy Disclosure Tips on COVID-Related Compensation Decisions (2/11/21)
 - Executive Compensation Clawbacks: A Robust Analysis of Design Features (3/11/21)
 - Finding Value: How to Negotiate Compensatory Economic Drivers in a Change in Control Transaction (4/8/21)
 - Is a Global Employment Company the Solution to Help Manage Internationally Mobile Employees? (5/13/21)
 - Training Course on Designing an Equity Incentive Plan (6/10/21)
 - Training Course on Stock Option Awards and Stock Appreciation Rights (7/8/21)
 - Training Course on Restricted Stock and Restricted Stock Unit Awards (8/12/21)
 - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
 - How to Properly Hire and Fire an Executive Officer (10/14/21)
 - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
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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

Introduction

- The purpose of this presentation is to discuss how to effectively build a peer group for purposes of executive compensation analyses
- To that end, this presentation is intended to provide a step-by-step approach to building a peer group, including:
 - The general purpose of a peer group and how it is used;
 - Governance concerns in selecting a peer group, including the role of the Compensation Committee;
 - Criteria used to select peer members; and
 - Use of multiple peer groups
- Additionally, this presentation covers related specific issues, including:
 - SEC disclosure issues;
 - Peer group selection for purposes of total shareholder return calculations; and
 - Thoughts from institutional shareholder advisory services such as ISS

Background

- To properly conduct an analysis of competitive pay, an issuer should:
 - Step 1 – Design a compensation philosophy
 - Step 2 – Develop a peer group of similarly-situated issuers in the marketplace
 - Step 3 – Collect market data for the executive positions from peers
 - Step 4 – Analyze the collected market data for pay levels and delivery methods

- Addressing Step 2, peer group development is the process of developing a list of issuers to serve as the “market” or “benchmark” for evaluating compensation levels for the executive officers

- An effective peer group should, to the extent possible, represent the organizations that make up the talent pool against which the issuer competes for talent

Background (cont.)

- Specifically, the peer group should shed light on an issuer's competitiveness of pay opportunities for certain executive officers, both total compensation and the various elements of compensation, including:
 - Base salary;
 - Annual bonus opportunity;
 - Equity incentive opportunity;
 - Percentage of pay subject to performance;
 - Mix between cash and equity;
 - Mix between short-term and long-term cash/equity opportunities;
 - Change-in-control transaction pay;
 - Severance pay;
 - Perquisites; and
 - Appropriateness of governance measures such as clawbacks, stock ownership policies and guidelines, restrictive covenants, employment agreements, etc.

Background (cont.)

- Key considerations in developing a peer group for an issuer generally include (among others):
 - Industry (e.g., issuers providing similar services);
 - Size (e.g., issuers with similar annual revenue, market value, total assets, employee population, etc.);
 - Location (e.g., issuers in large metro regions);
 - Market data sources available; and
 - Number of peers (typically 15-20 issuers)

- Of the above, industry, revenue and market cap are the most often used metrics for determining a peer group
 - Though the financial services sector tends to focus on assets instead of revenue

- The Compensation Committee needs to be engaged in the process
- The Compensation Committee should document:
 - Its review and approval of the process,
 - Its review and approval of the criteria that was used to select the peer members,
 - Whether the data and analysis was objective, and
 - Any supporting rationale and third party opinions (*i.e.*, typically, the compensation consultants report would be attached as an exhibit to the minutes of the Compensation Committee meeting where the peer group was approved)
- Addressing third-party opinions, the guidelines of many institutional investors require that third-party vendors conduct the peer group analyses
- Avoid using aspirational peer group members because:
 - A shareholder derivative action or specific shareholders could allege that the pay in question was excessive;
 - A common response to the foregoing by the Compensation Committee would be that such pay was consistent with market practice (*i.e.*, the peer group); and
 - The response from plaintiff shareholders would be that the peer group was aspirational (or certain of its peer issuers were aspirational peers), and therefore, the benchmarking was not accurate and was ill-informed

Governance (cont.)

- How should replacement peer issuers be chosen if a peer member ceases to exist prior to the formal selection of a new peer member? Alternatives include:
 - Do nothing and have the defunct/acquired issuer removed from the peer group;
 - Have a replacement named by the Compensation Committee at its discretion;
 - Use the average of an index (e.g., the S&P 500); or
 - Use a “dummy” peer member that represents the average of the remaining peers

- It is good practice to review the peer group on an annual basis for the following reasons:
 - M&A activity and spin-offs,
 - Bankruptcies,
 - Going private transactions,
 - Peer group member is acquired, and
 - New public issuers becoming an available peer

Selection Criteria - Size

- Size of the peer group
 - Determining the appropriate size involves a balance between having a large enough number of peers to draw comparisons and relevancy
 - A common range for the size of a peer group is 15-20 issuers (with 15 being the more common range)
 - Those issuers with more than 20 peers typically come from niche industries where there are only a few issuers of comparable size

- It is not uncommon for an issuer to have multiple peer groups for compensatory purposes
 - According to one study, approximately 11% of the S&P 500 disclosed in their proxy statement the use of more than one compensation peer group
 - For example, an issuer might use a comparative group for purposes of total shareholder return calculations, and then use another comparative group for all other purposes
 - As another example, an issuer might have a core compensatory peer group, but then use a much broader peer group for additional insight on pay practices

Selection Criteria – Size (cont.)

- Key considerations in selecting peer issuers include:
 - Industry (“GICS” is most common, Global Industry Classification Standard),
 - Revenue,
 - Market cap,
 - Number of employees,
 - Assets,
 - Geography, and
 - Other (e.g., maturity of the issuer)

- The three criteria that are most often used, and typically such three are used at the same time through a funnel or filter approach, are:
 - Industry,
 - Revenue,
 - Market cap (accounting for similar performance characterizations), and
 - Business specific characteristics

- The use of “industry” as one of the selection criteria should be favored to maintain the accuracy of the benchmarking during unusual market conditions impacting that industry (e.g., energy sector)

Selection Criteria – Key Considerations (cont.)

- Addressing market cap:
 - It is inherently volatile, and therefore, consideration should be given to using market cap in conjunction with revenue (*i.e.*, shy away from using market cap as the sole criteria except possibly for 280G calculations)
- For market cap and revenue, issuers typically look at 0.5x to 2x their size, positioning the issuer at the median
- If the foregoing selection criteria produces too many comparable issuers, then either:
 - The revenue or market cap scope is narrowed, and
 - Limitations such as geography and number of employees could be considered

TSR – Background on Absolute TSR

- TSR is simply stock price appreciation/depreciation, plus reinvestment of dividends, over a measurement period
 - Another way to look at it, is that TSR measures the return an investor would receive if he or she bought one share of common stock at the beginning of the measurement period, accumulated dividends during the measurement period, and then sold the common stock at the end of the measurement period
- An absolute TS formula is calculated as follows:

$$\text{TSR} = \frac{\text{Ending Price} - \text{Beginning Price} + \text{Dividends}}{\text{Beginning Price}}$$

- The payout is then determined as a function of the company's TSR compared to predetermined goals (*i.e.*, it is not compared to the TSR of the peer group)

TSR – Background on Relative TSR

- A relative TSR program has the same math formula as an absolute TSR program, however, with a relative TSR program the payout is determined as a function of the company's TSR ranking/ratio compared to the TSR ranking/ratio of its peer group
- The following represents a hypothetical (though typical) relative TSR program:

	Relative TSR Rank	Payout %
Maximum:	75 th percentile	200%
Target:	50 th percentile	100%
Threshold:	25 th percentile	50%
Below:	Less than 25 th percentile	0%

- In the above example, if the company's TSR rank relative to its peer group is at the 25th percentile, then the payout would be 50% of the target shares
- The following steps are typically employed when computing relative TSR:
 - Calculate TSR for the company and each member of its peer group,
 - Determine the sequential rank/ratio for each company in the peer group according to its TSR performance, and
 - Determine the corresponding portion of the award that should vest or payout

Picking a Relative TSR Peer Group

- Generally, it is desirable to pick peer group companies that have strong correlation in stock price
- Addressing volatility, care should be taken to avoid matching a company with low volatility to a peer group containing high volatility (and vice versa)
- How should a relative TSR program address changes to members of the peer group of companies that occur during the measurement period due to bankruptcy, M&A activity or going private transactions?
 - Should it be fixed (*i.e.*, the number of peer group companies could then decrease over the measurement period due to, for example, an M&A event),
 - Prior to the end of the measurement period, should there be a determination as to how replacement peer group companies will be chosen (*e.g.*, use a stand-in dummy entity with TSR that is deemed equal to the average TSR of all remaining peers), or
 - Should the choosing of a replacement peer group member be left to the discretion of the compensation committee of the Board of Directors

ISS Methodology on Peer Group Selection

- The size of the peer group is generally between 12 and 24 issuers based upon the following factors:
 - GICS classification of the subject issuer,
 - GICS classification of the subject issuer's disclosed peer group members, and
 - Certain size restraints relating to revenue (or assets for financial issuers) and market value

- With a focus on choosing issuers that push the subject issuer to the median of the peer group, ISS will typically pick peers in the following order:
 - From the subject issuer's own 8-digit GICS group,
 - From the subject issuer's peers' 8-digit GICS group,
 - From the subject issuer's 6-digit GICS group,
 - From the subject issuer's peers' 6-digit GICS group, and
 - From the subject issuer's 4-digit GICS group

- ISS gives priority to those peers the subject issuer has chosen and to those issuers that have chosen the subject issuer as a peer

ISS Methodology on Peer Group Selection (cont.)

- ISS applies two size constraints in selecting a peer:
 - Revenue (or assets for financial institutions) within the range of 0.4x to 2.5x the subject issuer's revenue, though the range is expanded for issuers with revenue (or assets for financial institutions) of at least \$10bb or small than \$200mm
 - Market cap (within the range of 0.25x to 4x the subject issuer's market cap, depending upon whether the subject issuer in question is a micro, small, mid or large cap issuer)

- If the subject issuer used multiple peer groups, then ISS will apply the peer group that the subject issuer used to benchmark the CEO's pay

- Most issuers disclose a compensation peer group
- What is “benchmarking”?
 - According to the SEC, it’s the use of compensation data of other issuers as a reference point to justify (wholly or partially) compensation decisions
 - However, the SEC has accepted the argument that using comparative issuers as a “market check” would not constitute “benchmarking”
 - The question is “How is the issuer using the data?”
- Under Item 402, if the issuer benchmarks, then the CD&A must:
 - Identify the peer issuers by name;
 - Explain how and why these issuers were selected for comparative purposes;
 - Identify any indexes that were used (*e.g.*, S&P 500), and why;
 - Identify the desired benchmark percentage, if any (*e.g.*, 50%);
 - And if there is a desired benchmark percentage/range, then the SEC Staff expects the issuer to disclose where the actual compensation fell relative to the targeted percentile/range; and
 - If the issuer benchmarks to a range, or retains discretion to not benchmark, then it must disclose the extent of the discretion, and whether/how it was exercised

Don't Forget Next Month's Webinar

- Title:
 - Employment Taxes: The 101 Course

- When:
 - 10:00 am to 11:00 am Central
 - December 10, 2020

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