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Compensatory Thoughts on Navigating Blackout Periods

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Executive Compensation Webinar Series
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Housekeeping: Questions

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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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  - A purpose of the webinar series is to provide FREE CE credits
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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 2024 Webinars

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- 2024 webinars:
  - Preparing for Proxy Season: Start Now (Annual Program) (9/12/24)
  - Governance: Properly Hiring and Terminating an Executive Officer (10/10/24)
  - Introduction Course on Employment Taxes (11/14/24)
  - What Happened in 2024: Year-End Review of Compensatory Items(12/12/24)

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 this Presentation

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- The purpose of this presentation is to discuss various techniques for navigating blackout periods

- To that end, this presentation covers:
  - Background on liability under Section 16,
  - Background on liability under Rule 10b-5,
  - 10b5-1 trading plans, and
  - A discussion of various scenarios

Background: Section 16(b) Liability

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- As background, Section 16(b) is a provision of the Securities Exchange Act of 1934 that imposes reporting requirements and trading restrictions on "insiders" of publicly-traded issuers
  - For purposes of Section 16, the term "insider" includes:
    - A director;
    - An officer (defines as the president, principal financial officer, principal accounting officer, any VP in charge of a principle business unit/division/function, and any other person who performs a policy-making function for the issuer); and
    - Any 10% beneficial owner

- A purpose of Section 16 is to deter insiders from using confidential information for personal gain. To that end, Section 16(b) generally requires insiders to:
  - File public reports relating to the insider's transactions with equity of the issuer; and
  - Disgorge profits realized on "short-swing transaction" (i.e., any purchase and sale, or vice versa, of the issuer's equity within a period of less than 6 months)
    - Generally, a purchase or sale occurs when the insider makes an irrevocable commitment
    - Interesting is that "less than 6 months" begins on the date of the transaction and ends 2 days prior to the end of the 6 month period
    - The disgorged "profits" is computed by matching the highest sale price to the lowest purchase price during the 6-month period, and so on, irrespective of the dates on which the transactions occurred
    - Therefore, it is possible to have a "profit" under Section 16(b) even though the transactions resulted in an actual net loss to the insider

Background: Section 16(b) Liability (cont.)

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- There are a few exemptions from Section 16(b) liability, including:
  - Gifts,
  - Inheritances, and
  - Transactions with the issuer under Rule 16b-3

- Pursuant to Rule 16b-3, transactions with the issuer relating to equity compensation are generally exempt from Section 16(b) liability if the plan/transaction is approved by:
  - The issuer's Board of Directors,
  - A committee of the Board of Directors comprised solely of two or more independent non-employee directors, or
  - The issuer's stockholders

- Equity incentive plans are designed to comply with Rule 16b-3, which means acquisitions and dispositions under the plan should not be subject to the short-swing liability rules
  - Acquisitions from the issuer are exempt under Rule 16b-3(d)
  - Dispositions to the issuer are exempt under Rule 16b-3(e)

Background: Rule 10b-5 Liability

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- Generally, 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 puts many insiders in a difficult position because they almost always find themselves possessing material, non-public information

- But a properly designed 10b5-1 trading plan would shift the focus:
  - From whether an insider had material, non-public information at the time of a trade;
  - To whether that insider had material, non-public information at the time he or she became committed to the trade

Background: Rule 10b5-1 Trading Plans

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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

Background: Rule 10b5-1 Trading Plans (cont.)

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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

Background: Rule 10b5-1 Trading Plans (cont.)

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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

Background: Rule 10b5-1 Trading Plans (cont.)

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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

Background: Rule 10b5-1 Trading Plans (cont.)

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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
  - 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
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Beware Open Market Purchases and Trading Plans

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- To the extent trading plans are being used to facilitate open market sale transactions upon vesting of an equity award (e.g., to fund the payment of withholding taxes), care should be taken to the extent the issuer is also encouraging insider to make open market purchase transactions
  - Reason: the short-swing profit rule under Section 16 requires that profits realized by Section 16 insiders from the purchase and sale of equity securities of the issuer within a period of less than 6 months may be disgorged by the issuer or other shareholders of the issuer
- To highlight the problem, assume that an issuer is encouraging open market purchases by its Section 16 insiders, however:
  - Such insiders adopted a trading plan to fund withholding obligations that are triggered when the compensatory equity award vests, and
  - Such equity award has 6-month vesting tranches so equity is always vesting within a 6 month period
- The result – potential disgorgement of profits under the short-swing profit rule creates a disincentive for insiders to purchase company stock in the open market
- The better way to design around the issue is to remove 6-month vesting tranches and replace them with 1 year vesting. Then the insider can at least make open market purchases during 6 months of the year (assuming annual equity grants are timed to vest on the same day each year)

Problem No. 1 – Vests During Blackout Period

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- Under Section 83, a substantial risk of forfeiture is automatically presumed to continue to exist to the extent that a sale of the underlying shares would subject the insider to liability under the short-swing transaction rules of Section 16(b)
  - However, the foregoing does not apply to the extent the transaction is permitted under Section 16(b) but is otherwise prohibited under some other provision, such as the issuer's insider trading policy

- Possible Solution No. 1
  - Draft a provision in the award agreement to provide, that if vesting occurs during a blackout period, then the award shall continue to remain unvested until the first date of an open window
  - However, the risk of forfeiture would be extended in this scenario, which means real risk of loss. Such might not be appealing to the equity holder

Problem No. 1 – Vests During Blackout Period (cont.)

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- Possible Solution No. 2 is to implement a net withholding (*i.e.*, issuer finances withholding)
  - Such would have no open market transaction element, and therefore, Section 16 would not apply
  - However, the issuer would have to finance the related cash to remit to the U.S. treasury
  - Keep in mind that some equity incentive plans do not contain liberal share counting provisions (*i.e.*, provisions that would allow the netted out shares to return to and replenish the equity plan's share reserve)
  - And at what rate should the issuer withhold?
    - The minimum supplemental rate?
    - The maximum individual rate?

- Possible Solution No. 3 – incorporate a trading plan into the net withholding provision (*i.e.*, public market finances withholding)
  - Consider that the issuer might desire a net withholding, but might also lack the cash flow to effectuate the IRS remittance
  - The market could pay the withholding dollars if:
    - The award agreement provided for such a sale in the open market pursuant to a formula that otherwise satisfied the rules for a 10b5-1 trading plan
    - Such could be contained within the tax withholding section of the award agreement

Problem No. 1 – Vests During Blackout Period (cont.)

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- Possible Solution No. 4 is to, on the front end, design all equity awards to become vested during pre-designed open windows
- Possible Solution No. 5 is to have the equity awards covered by a 10b5-1 trading plan
- Possible Solution No. 6 is to delay the settlement of the award (if dealing with RSUs, PSUs, etc.). So long as the award becomes actually settled by March 15th of the calendar year that immediately follows the calendar year within which the award vested, then such delay should remain 409A compliant
  - And too, Treas. Reg. 31.3121(v)(2)-(1)(b)(3)(iii) also permits for FICA taxes to be delayed until the shares are release

Problem No. 2 – Expiring Term of Stock Option

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- Assume that the insider is holding a stock option with a 10-year term, however, the 10-year term is expiring while the insider has material, non-public information

- Possible Solution No. 1
  - Allow the insider to exercise the stock option with his or her own cash and hold the underlying shares

- Possible Solution No. 2
  - Allow for a net exercise, which is economically similar to a broker assisted sale in the open market but with no open market transaction
  - Much of the analysis contained within Problem No. 1 applies equally here
  - Need to verify that the equity plan permits a net exercise so as to avoid "modification" issues (which is an issue under the ISO rules if such modification is not already expressly permitted under the equity incentive plan)

- Possible Solution No. 3 is to adopt a 10b5-1 trading plan

- Possible Solution No. 4
  - Ensure that on the front end, the award agreements are drafted to require an automatic exercise, an automatic net-exercise or automatic trading plan-compliant open market exercise/sale on the day immediately preceding the expiration of the 10-year life, and only if the option is in-the-money at the time

Don’t Forget Next Month’s Webinar

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- Title:
  - Preparing for Proxy Season: Start Now (Annual Program)
- When:
  - 10:00 am to 11:00 am Central
  - September 12, 2024