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Effective Compensation Governance (the A-Z Course)

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About Anthony "Tony" Eppert

HUNTON ANDREWS KURTH

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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 2018 Webinars

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- Upcoming 2018 webinars:
  - Effective Compensation Governance – The A-Z Course (4/12/2018)
  - Accounting Considerations that Shape Equity Compensation Design (5/17/2018)
  - Training Course on Forms 3, 4 and 5 (6/14/2018)
  - Pay Ratio: Developments from Last Proxy Season (7/12/2018)
  - Preparing for Proxy Season: Start Now (Annual Program) (8/9/2018)
  - Planning for an IPO: Compensation Considerations (Part 1 of 2) (9/13/2018)
  - Compensation Changes Due to Loss of EGC Status (Part 2 of 2) (10/11/2018)
  - Taxation of Equity Awards: The 101 Training Course (11/8/2018)
  - How to Negotiate Executive Employment Contracts (12/13/2018)
- Upcoming 2019 webinars:
  - List will be created around September 2018
- Sign up here: https://www.andrewskurth.com/ExecCompWebinar

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.)

- 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 compensation discussion strategies, including:
  - Authority of the Compensation Committee,
  - Compensation Committee action items,
  - Tally sheets,
  - Wealth accumulation tables,
  - Date of grant,
  - Delegations of authority to grant equity,
  - Avoid equity grants to an entity,
  - Documentation of acceptance of an award,
  - Share counting provisions,
  - Inducement grants,
  - Accelerated vesting due to retirement,
  - Trading plans,
  - Employer stock and S-8,
  - Stock ownership policies,
  - Clawbacks, and
  - Risk assessments

Authority of the Compensation Committee

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- The governance process associated with director compensation is generally as follows:
  - The nominating and corporate governance committee makes recommendations to the full board
  - Compensation decisions are made by the full Board

- In contrast, it is the Compensation Committee that typically has the authority to make compensation decisions for the NEOs and other employees of the Company
  - This means that pursuant to the Compensation Committee Charter, the Board of Directors delegated such responsibility to the Compensation Committee
  - Alternatively, the Board could have only delegated the ability to make recommendations, which means the Compensation Committee can only make recommendations and compensatory decisions can only be made by the full Board

Compensation Committee Action Items

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- At least annually, the Charter should be reviewed and reassessed by the Committee
  - Any proposed changes to the Charter must be submitted to the full Board for their approval

- At least annually (or more frequently), the Committee should review and approve the compensation goals and objectives that cover the management team, to include:
  - Balance between short-term and long-term compensation,
  - The performance of each member of the management team, and
  - The compensation levels of each member of the management team
  - NOTE: Provide the committee with tally sheets and wealth accumulation tables so they are informed in accomplishing the above, thus bolstering their use of the business judgment rule defense if there is ever, for example, a shareholder derivative lawsuit

Compensation Committee Action Items (cont.)

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- With the help of HR, legal and possibly finance, the committee should oversee the process of determining whether any of its compensation policies and practices (for any group of employees, not just NEOs) create material risk
  - If a compensation policy is "reasonably likely to have a material adverse effect" on the Company, then a stand-alone discussion of this risk must be present in the proxy
  - This discussion, if present, should be outside of the CD&A because it covers more than just the NEOs
  - Many companies provide affirmative disclosure
- HR/legal must develop a process to determine the above by:
  - Identifying all plans,
  - Assessing risk, and
  - Making a determination
- Important to the foregoing is the "process"

Tally Sheets

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- If the business judgment rule is applied:
  - Then the decisions of a director will be presumed to have been informed, made in good faith, and accomplished with the belief that such was in the best interests of the company; the presumption makes it more difficult for a plaintiff to prove such director breached his/her fiduciary duties
- Tally sheets
  - Tally sheets can be a key for a director to preserve the defense of the business judgment rule because tally sheets act as proof that the director made an "informed" decision, even if the wrong decision
  - A tally sheet lists each component of an executive's compensation and tallies it up (*i.e.*, a placemat)
  - Compensation committees should require a tally sheet showing range of potential payments in alternative scenarios
  - It should be prepared and explained by a compensation expert
  - It should be attached to minutes
- Amounts to tally
  - Income for the year
  - Projected values under different performance and termination scenarios
  - Realized option and stock gains (last 5 years)
  - Total wealth accumulation

Wealth Accumulation Tables

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- Wealth accumulation analyses focus on how much wealth the executive will accumulate at various career points
  - Includes realized and unrealized equity value, plus deferred income (*e.g.*, retirement plans)

- Used to determine "how much is enough"
  - Determine wealth accumulation targets
  - Determine a reasonable minimum guaranteed wealth and from what sources
  - Determine how performance metrics figure into the analyses
  - Determine whether accumulation is appropriate in context of overall compensation
  - Determine whether shareholders should fund this level of accumulation
  - Determine whether improved long-term incentive plans could improve alignment with shareholders

Date of Grant

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- An accurate date of grant is important to support accurate accounting charges and to avoid adverse tax consequences under Section 409A

- The date of grant is generally the date the Board or the Compensation Committee (or delegates) "approves" a grant containing "definitive terms"
  - If the Board or the Compensation Committee acts prior to knowing the definitive terms, then the date of grant would typically be the date all definitive terms become known
  - Generally, "definitive terms" means the identity of the recipient, the number of shares subject to the award, the vesting schedule and the exercise price (if applicable)

- Keep in mind that the grant is "approved" on the date the Board or the Compensation Committee acts pursuant to written minutes (though such could contain a later effective date for the grant)
  - This means that if the action is pursuant to unanimous written consent resolutions, then the date of grant is deemed to be on the date of the last signature

Delegations of Authority to Grant Equity

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- Absent a valid delegation, only the Board has the authority to grant equity
  - The Compensation Committee Charter is typically the vehicle that delegates such authority to the Compensation Committee
  - Such Charter may allow for a further downward delegation from the Compensation Committee to a sub-committee (*e.g*., an inside director or a non-director officer), but typically such downward delegations are implemented (if at all) only in situations where there are administrative burdens associated with the Compensation Committee acting through unanimous written consent

- Typically, downward delegations from the Compensation Committee are used (if at all) to facilitate the company's need to react quickly in new hire situations

Delegations of Authority to Grant Equity (cont.)

- Assuming a downward delegation from the Compensation Committee is appropriate, then the following points should be considered:
  - Delegations must comply with applicable state law (*e.g*., DGCL 157(c))
  - Delegations 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. This will help to thwart arguments that delegated awards contained terms not previously approved by the Board or the Compensation Committee
  - The Policy should specify the total number of awards (individually and collectively) that may be made pursuant to the delegation
  - Delegations should exclude the ability to make grants to those who are Section 16 insiders as of the date of grant (*e.g*., 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)

Avoid Equity Grants to an Entity

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- Compensatory equity should NOT be granted to an "entity" because rules relating to both Form S-8 (for publicly-held companies) and Rule 701 (for private companies) require that equity be granted to a "natural person" in order to gain the protection of those rules

- So how does an issuer grant equity to a consultant that has taken the form of an LLC or S corporation?

- The SEC has clarified that in the context of a Form S-8, an issuer may contract with a consulting entity so long as the securities are issued to a natural person working for that consulting entity (*see* SEC Release No. 33-7646)
  - The IRS has a similar rule (i.e., the individual is holding the award as an agent or pursuant to a constructive trust)

- These arrangements should always be in writing

Documenting Acceptance of Equity Awards

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- Be sure to document acceptance of equity award agreements, especially if restrictive covenants are contained within the award agreements

- Noteworthy is that electronic acceptance is permitted in Texas

- Example:
  - Electronic Signature. Participant acknowledges and agrees that by clicking the "Accept Grant Online" button on the "Notice and Award Agreement" page of the XYZ Corp website (https://XYZCorp.com), it will act as the Participant's electronic signature to this Agreement and will constitute Participant's acceptance of and agreement with all of the terms and conditions of the Award, as set forth in the Notice, the Award Agreement and the Plan

Share Counting Provisions: S-8 v. Equity Plan

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- This slide is intended to be a reminder that the calculation of expended shares under an equity incentive plan is different from the calculation of expended shares under Form S-8 rules
  - Equity incentive plans with liberal share counting provisions (*e.g.*, provisions that allow for forfeited shares to revert to, and replenish, the share reserve) are counted or depleted on a net basis, and
  - In contrast, shares registered under a Form S-8 are counted or depleted on a gross basis (*e.g.*, shares that are forfeited reduce the number of registered shares that remain available)
    - A related concept is that share counting provisions under a Form S-8 do not take into account any fungible share counting provisions otherwise contained within an equity incentive plan (*e.g.*, shares under the Form S-8 are reduced on a 1 for 1 basis even though the equity plan has a provision that reduces the shares remaining for issuance at a rate of 1.6x for non-option and non-SAR awards)

- As a result of the above, an issuer should:
  - Not rely upon its equity plan's capitalization table as a determination of how many shares remain registered under the related Form S-8, and
  - Always register more shares than are then available under the equity incentive plan when determining how many shares to register under a Form S-8

Share Counting Provisions: S-8 v. Equity Plan (cont.)

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- For example, assume that an equity plan with liberal share counting
  - Has a share reserve of 100,000 shares,
  - Registers only 100,000 shares under a Form S-8,
  - The employer grants an award covering 60,000 shares, and
  - 20,000 of such award becomes forfeited and reverts back to replenish the share reserve pursuant to the liberal share counting provision

- Results of the above example:
  - Only 40,000 shares remain available under the Form S-8 (100,000 minus 60,000 granted = gross counting)
  - In contrast, 60,000 shares remain available for future issuance under the equity incentive plan (100,000 minus 60,000, plus 20,000 = net counting)

Share Counting Provisions: Performance Awards

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- Equity-based performance awards that have maximum payout modifiers (*e.g.*, 200% of target) will draw from the share reserve of the 2016 Equity Plan at the maximum amount on the date of grant

- The above poses design issues for companies who struggle with an insufficient share reserve caused by failure of their stockholders to increase the share reserve
  - And this problem is exacerbated when the maximum payout is really an unrealistic stretch goal
  - And the problem is even further exacerbated when the unrealistic stretch goal covers a performance period of more than one year (*e.g.*, a 3-year TSR performance period)

- For the above reasons, some companies have partially moved to a cash-settled performance award program
  - For example, a company could settle the award in equity up to the target level, and then settle any payout above the target level in cash (thus hoping to eliminate the share reserve issue with respect to unrealistic stretch goals over multiple performance years)

Inducement Grants to Protect Share Reserve

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- Under applicable NYSE and NASDAQ listing rules, shareholder approval is not required for “inducement grants”
- To qualify as an inducement grant, the grant of restricted stock or stock options must act as a material inducement to the person being hired as an employee (or such person being rehired following a bona fide period of interruption of employment)
  - Inducement awards include grants to new employees in connection with an M&A transaction
- Inducement grants must be approved by the Compensation Committee or a majority of the Company’s independent directors
- An additional qualification requirement is that promptly (generally within 4 business days) following the grant of an inducement award, the Company must disclose in a press release the material terms of the award, including the identity of the recipient(s) and the number of shares involved, and make certain other filings with the applicable listing agency

Inducement Grants to Protect Share Reserve (cont.)

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- In terms of the "form" of award, some companies provide inducement grants as stand-alone awards, whereas others will have an inducement plan from which to make grants
  - The latter is particularly prevalent in M&A transactions

- Important to note is that inducement grants are "outside" of the shareholder approved equity incentive plan
  - Therefore, inducement grants would have to comply with an applicable securities exemption or be covered pursuant to a Form S-8 or other securities registration

Inducement Grants to Protect Share Reserve (cont.)

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- Our thoughts generally:
  - Depending on the extent a company grants equity to new hires, compliance with the inducement grant exception could substantially increase the life expectancy of a stockholder-approved share reserve (*i.e*., equity grants tend to be larger in new hire situations)
  - Inducement grants could be used in the M&A context where a buyer offers equity to the employees of the target
  - However, burn rate and dilution profiles relative to industry peers could be negatively impacted, thus making it more likely that ISS would recommend "against" to any future request to increase the share reserve for the Company's equity incentive plan (*i.e*., an inducement plan essentially borrows from the share reserve of a future shareholder-approved equity incentive plan)

- Our thoughts for any company considering implementation of an inducement program:
  - Consider the structure of any inducement program
    - Create an inducement pool within the current stockholder-approved equity incentive plan (not recommended, but doable)
    - Draft an inducement plan (recommended if inducement grants will be frequent)
    - Approve stand-alone inducement grants on an ad hoc basis (recommended if inducement grants will be infrequent)
  - Have the inducement grant (or plan) be covered by a Form S-8, except in ad hoc situations involving restricted stock, then the bonus stock exemption could be a viable alternative in many situations where no par value is required

Accelerated Vesting Due to Retirement

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- There are two types of vesting schedules containing "retirement" provisions that act to accelerate vesting:
  - Those with performance-based vesting provisions, and
  - Those with time-based vesting provisions
- For agreements with performance-based vesting provisions that provide for accelerated vesting upon retirement:
  - The continued application of the performance-based metrics within the award agreement should act as a substantial risk of forfeiture under Section 83 of the Code. Such is the answer even though the employee has a "contractual" right to benefits (to the extent the performance condition is satisfied) due to his or her attaining retirement age
  - For the above reasons, there is no taxation to the employee due to his or her attaining retirement age. This means no withholding obligation and no FICA/FUTA is triggered at retirement age or upon a termination of employment on or after attaining retirement age
  - Instead, taxation (both withholding and FICA/FUTA) would be triggered when the performance condition becomes satisfied

Accelerated Vesting Due to Retirement (cont.)

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- In contrast, for agreements with only time-based vesting provisions that provide for accelerated vesting upon retirement BUT payout only upon a separation from service:
  - The substantial risk of forfeiture under Section 83 is eliminated when the employee attains retirement age
  - Absent the agreement being designed to comply with Section 409A, the employee would have taxable income (subject to employment taxes, income tax withholding, etc.) when he or she attains retirement age WITHOUT regard to whether he or she terminates employment at such time
- If the agreement is designed to comply with Section 409A, *e.g.*, having the award payout upon his or her separation from service even though he or she previously attained retirement age, then:
  - FICA/FUTA is still triggered upon the employee attaining retirement age, and
  - Income tax withholding would be deferred until the employee incurred a separation from service
- If retirement provisions are going to be used within equity awards, then consider only using RSU and PSU awards because it is easier to facilitate deferral opportunities within these types of awards

Trading Plans: Background

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- Generally, insider trading is prohibited under Rule 10b-5
- Rule 10b-5 imposes a <u>presumption in favor of liability</u>, 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 a lot of insiders in a difficult position because they almost always find themselves possessing material, non-public information
- But a properly designed 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

Trading Plans: Background (cont.)

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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 company'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 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 made on the basis of 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 company
- Absent a trading plan, it is often difficult for insiders who are frequently in possession of material, non-public information to trade without incurring the risk of insider trading liability
  - Insider trading policies of companies will typically prohibit the insider from trading except during "open windows" (*e.g.*, a specified number of days immediately following the company's release of its quarterly earnings data)

Trading Plans: Reasons to Adopt

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- Some of the reasons to adopt a trading plan include:
  - For those who often possess material non-public information, the trading plan provides more trading opportunities
  - Facilitates financial planning for the individual
  - Minimizes investor criticism that the trade was conducted on the basis of the individual holding material non-public information
  - Ensures the exercise of stock options that would have otherwise expired due to a lapse in the term
  - Facilitates the attainment of stock ownership guidelines

Trading Plan Reqs: 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 company's insider trading policy could help ensure compliance with the foregoing by:
  - Limiting the timing on which trading plans may be adopted to open trading windows, and
  - Prohibit any adoption of a trading plans during blackout periods
- And too, the person should indicate in writing at the time of the adoption of the plan that he or she does not possess material non-public information
  - In other words, the existence of an open trading window does not guarantee that the individual has no material non-public information

Trading Plan Reqs: 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 an 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

- 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 Plan Reqs: Waiting Period/Pre-Clearance/Other

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- As a technical matter, waiting periods from the date the plan is entered into and the date the first trade is effectuated are not required (but are recommended)
  - The delay from the date of entering into the trading plan and conducting the first transaction should be at least 30 days
  - It is recommended that any adoption of a trading plan be pre-cleared under the company's pre-clearance procedures
  - Usually 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
  - Thus, any modification must be at a time when the person has no material nonpublic information and the other requirements of the trading plan rules are satisfied
  - For this reason, modifications should be limited to be allowed only in extreme circumstances
- Multiple concurrent plans
  - Having a new plan take effect after an existing plan expires is an acceptable practice
  - Though multiple concurrent plans are technically permitted, such is not recommended because it could be argued that such is an attempt to evade 10b-5, thus voiding the affirmative defense otherwise provided by the trading plan
  - And a person should never have multiple plans covering the same shares

Trading Plans: Best Practices

- Important to keep in mind is that a trading plan is an affirmative defense, not a shield. The affirmative defense is bolstered if the company follows best practices, which can include:
  - Ensure a trading plan is permitted under the company's insider trading policy
  - Consider whether to voluntarily disclose the trading plan in a Form 8-K (*i.e*., disclosure is not required except in a Form 4)? If yes, consider avoiding disclosure of plan details except the aggregate number of shares involved
  - Require any new trading plan or amendment to an existing plan to be subject to pre-clearance procedures under the company's insider trading policy
  - Only adopt the trading plan when the insider is not aware of material, non-public information. If the company has window periods, adopt the plan only during an open window immediately after announcement of the quarterly earnings
  - Require a lag time for the first trade (*e.g*., 30 days). There is no legal requirement to provide a lag time, but the purpose of a lag time is to decrease public scrutiny if trading activity begins right before announcement of material news
  - Keep the trading plan design simple
  - Limit the length of the trading plan to a date between 6 and 18 months

Trading Plans: Best Practices (cont.)

- [Cont. from prior Slide]:
  - Only allow amendments to the trading plan when the insider does not possess material, non-public information, subject to pre-clearance (*i.e.*, the SEC considers amendments to be the same as entering into a new plan)
  - Attempt to avoid termination of the trading plan in order to avoid allegations that the trading plan was not entered into in good faith, and alternatively, allow terminations only during an open window
  - Attempt to avoid multiple concurrent trading plan, especially for the same stock
  - In situations where multiple awards to multiple recipients are likely to vest at the same time (i.e., the company grants awards on the same day to all recipients pursuant to a comparable vesting schedule), consider adding a provision to the insider trading policy or pre-clearance procedures that limits sales to a percentage per day
    - Alternatively, such a provision could also be added to the grant award agreement

Open Market Purchases and 10b5-1 Trading Plans

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- 10b5-1 trading plans provide an affirmative defense against allegations of Rule 10b-5 and Section 10(b) violations (the latter two prohibit the purchase or sale of a security on the basis of material nonpublic information)
  - For this reason, 10b5-1 trading plans are commonly used by Section 16 insiders
- To the extent 10b5-1 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 company is encouraging open market purchases by its insiders
  - Reason: the short-swing profit rule under Section 16 of the Exchange Act requires that profits realized by Section 16 insiders from the purchase and sale of equity securities of the company within a period of less than 6 months may be disgorged by the company or other shareholders of the company
- To highlight the problem, assume that a company is encouraging open market purchases by its Section 16 insiders, however:
  - Such insiders adopted 10b5-1 trading plans to fund withholding obligations that are triggered when the compensatory equity award vests, and
  - Such equity award has 6-month vesting tranches
- 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

Employer Stock, 401(k), Form S-8 Prospectus & SPD

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- For qualified retirement plans that have an employer stock fund:
  - Form S-8 registration is required only if the 401(k) plan has an employer stock fund AND the participant may use his or her own funds to invest in such fund
  - Such registration is not required if the presence of employer stock within the qualified plan is the result of employer matching contributions or employer contributions of stock to the 401(k). And no registration is required even if the participant is permitted to diversify his or her account
- A Form S-8 is typically used when registration is required. Such form consists of two parts:
  - A prospectus which must be provided to eligible employees, but not filed with the SEC, and
  - A short-form registration statement filed with the SEC, but not provided to employees, that registers an indeterminate number of plan interests
- Question
  - Should the prospectus and summary plan description for a 401(k) plan be combined?
  - Due to ambiguity by the courts, the better answer is “no”

Employer Stock, 401(k), Form S-8 Prospectus & SPD

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- As background, if an SPD and prospectus are combined, then the SEC filings that are incorporated into the prospectus become incorporated into the SPD
  - If later, the SEC filing is found to be misleading or inaccurate, then the SPD will have also incorporated misleading or inaccurate information
  - Such allows plaintiff lawyers to expand the scope of their securities claims to include breaches of fiduciary duty under ERISA (*i.e.*, alleging that the plan fiduciary distributed ERISA documents to participants, that participants relied to their detriment, and that the company's continued investment in the stock fund caused the breach)
- Important to the above point is that:
  - Plan fiduciaries are personally liable for ERISA breaches of fiduciary duty;
  - Companies typically carry ERISA insurance in addition to D&O insurance; and
  - Plaintiffs view ERISA insurance as a deep pocket
- Again, the goal of not combining the two documents is to avoid converting an SEC filing that discusses the company's financial condition into an ERISA fiduciary communication issue
- Answer
  - To conclude, separate documents with no incorporation are the safest from a litigation perspective, and if any incorporation is desired, then:
    - The prospectus may incorporate the SPD since the prospectus is not an ERISA document, and
    - The SPD should NOT incorporate the prospectus

Stock Ownership Policies

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- A stock ownership policy sets the parameters on the level of stock that must be owned
  - Such a policy increases the message to the company's shareholders that the latter can rely on the commitment of the executives to the company's long-term success (*i.e.*, there is a direct alignment of interest with the company's long-term shareholders)
  - Helps bolster performance pay
  - Could act as a mitigating factor to negate risk assessment disclosure. Remember that companies must disclose the relationship between their compensation practices (for all employees) and their risk management philosophy, BUT ONLY IF such compensation programs are "reasonably likely to have a material adverse effect"
- Though a multiple of salary (*i.e.*, a fixed value) is a most common stock ownership policy, consider using a fixed percentage/number of shares because the former is difficult to satisfy if the underlying stock price is volatile

Stock Ownership Policies (cont.)

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- The length of the accumulation period within which executives must attain their ownership levels must be determined
  - A five year accumulation period is a most common time frame

- In conjunction with the above (or in lieu of the above), consider whether to also implement a holding requirement, which is another share retention tool:
  - For an indefinite period of time, require the executives to retain a certain percentage of his/her net profit shares until the required ownership levels are attained (in contrast to a term of years requirement within which the ownership percentage must be satisfied)
    - Net profit shares refers to the shares remaining after payment of any exercise price and/or taxes owed
    - Holding period could be indefinite; OR
  - Require the CEO to hold a percentage of net profit shares for a certain period of time (*i.e.*, a one-year holding period is common)

Stock Ownership Policies (cont.)

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- The “stick” or penalty for failing to satisfy a given stock ownership policy is not typically disclosed in a proxy statement. Such penalties can include:
  - Increased holding requirements,
  - Prohibiting sales of equity, and
  - Paying annual incentives in equity and not cash
- And where satisfying a stock ownership policy would otherwise create undue hardship on an executive, a company could modify the stock ownership policy to incorporate hardship provisions
  - Question is whether to incorporate the hardship terms into the stock ownership policy, or instead to simply provide the Board or the compensation committee with the discretion to deviate from the requirement if a hardship is present

Stock Ownership Policies

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- Stock ownership policies of public companies
  - Assuming deemed investments in employer stock are permitted within a non-qualified deferred compensation arrangment, should any such deemed investments count towards the employee satisfying the employer's stock ownership policies

Clawbacks

- To date companies have been applying a variety of approaches while they await finalization of the clawback requirements under Dodd-Frank. These approaches include:
  - 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 clawback requirements (when effective) and any clawback policy adopted by the company as such is amended from time to time, and
  - Adopt a very formal and robust clawback policy

Clawbacks (cont.)

- As a quick review, the current requirements of the Dodd-Frank clawback include:
  - The clawback policy must be triggered any time the company is required to prepare an accounting restatement resulting from "material" noncompliance with any financial reporting requirement under the securities laws
    - In contrast, Section 304 applies only when a restatement of financial statements is "required" and is the result of "misconduct"
  - Once the clawback is triggered, it would apply to all "incentive-based" compensation paid to current and former executive officers
    - In contrast, Section 304 applies only to the CEO and CFO
  - 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 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 statement

Risk Assessments

- Disclosure continues to be required to the extent the Company’s compensation policies or practices (for both executive and non-executives) are reasonably likely to have a material adverse effect on the Company
  - Disclosure is only required if risk is present
  - However, consideration should be given to whether positive disclosure should be implemented even if such risk is not present
- Thus, every year the Company must perform a risk assessment
- 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 that could threaten the value of the Company
  - Analyze the results
  - Change any policies, programs or arrangements that create such risk

Don’t Forget Next Month’s Webinar

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- Title:
  - Accounting Considerations that Shape Equity Compensation Design
- When:
  - 10:00 am to 11:00 am Central
  - May 17, 2018