Compensation: ISS Concerns & Mandates (an Annual Program)

Presentation for:
Executive Compensation Webinar Series
January 11, 2018

Presentation by:
Anthony J. Eppert
anthonyeppert@andrewskurth.com
713.220.4276

Housekeeping: Technical Issues and Questions

- Technical issues
  - If you are having difficulty viewing this presentation, please call Cisco WebEx Tech Support toll free at 866.229.3239

- 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 on the right-hand side 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 shortly after this presentation

Housekeeping: Recording, CE Credits and Disclaimer

- Recording
  - This presentation is being recorded for internal purposes only
- Continuing education credits
  - A purpose of the webinar series is to provide FREE CE credits
  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
    - CLE: 1 credit hour (Texas)
    - CPE: 1 credit hour (Texas)
    - HRCI: This activity has been approved for 1 (HR (General)) recertification credit hours toward California, GPHR, PHRi, SPHRi, PHR, and SPHR recertification through the HR Certification Institute
    - SHRM: This program is valid for 1 PDC for the SHRM-CPSM or SHRM-SCPSM
  - If you have any questions relating to CE credits, please direct them to Anthony Eppert at AnthonyEppert@AndrewsKurth.com or 713.220.4276
- Disclaimer
  - This presentation is intended for informational and educational purposes only, and cannot be relied upon as legal advice
  - Any assumptions used in this presentation are for illustrative purposes only
  - No attorney-client relationship is created due to your attending this presentation or due to your receipt of program materials

Housekeeping: About Anthony "Tony" Eppert

Anthony Eppert , Partner
Andrews Kurth Kenyon LLP
Tel: +1.713.220.4276
Email: AnthonyEppert@AndrewsKurth.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

Housekeeping: Upcoming 2018 Webinars

- Upcoming 2018 webinars:
  - Energy Companies: Compensation Governance Survey/Trends (2/15/2018)
  - How to Structure Management Carve-Out and Change-in-Control Plans (3/8/2018)
  - Effective Compensation Governance – The A-Z Course (4/12/2018)
  - Accounting Considerations that Impact 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

Our Compensation Practice – What Sets Us Apart

- 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.)

- 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 discuss Institutional Shareholder Services ("***ISS***") with respect to compensatory matters

- To that end, this presentation covers:
  - Background on the ISS framework,
  - ISS updates for the 2018 proxy season,
  - Our experiences on certain select issues, and
  - Action items to consider

Quick Update

- The Tax Cuts and Jobs Act of 2017 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
  - 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.)
  - 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 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 usage of soft goals is likely to increase (*e.g.*, leadership)
  - There is a potential erosion of performance-based compensation (e.g., Netflix folding its performance-based bonus into its salary structure), but not likely a large deviation given that institutional shareholders demand performance-based compensation
  - Existing binding contracts in effect on 11/2/2017 and not materially modified could have grandfathered treatment. IRS guidance is expected
  - "Who" is a covered employee subject to the $1mm deduction limit was expanded, and too, once a covered employee ALWAYS a covered employee

Quick Update (cont.)

- With respect to non-employee director compensation, the decisions by the Delaware Supreme Court in *Seinfeld* and *Calma* were recently narrowed in *In re Investors Bancorp, Inc. Stockholder Litigation* (December 2017). As a result, outside compensation advisers should be hired to help the board establish the fairness of their compensation
  - As background, actions by non-employee directors with respect to their own compensation is deemed an interested transaction, and as a result, such actions are not afforded the benefit of the "business judgment rule" (instead, such actions are viewed in accordance with the "entire fairness" standard)
  - *Seinfeld* and *Calma* essentially stood for the proposition that the entire fairness standard 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 shareholders. 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 company's shareholders approved the specific equity awards in question or if the awards were pursuant to a self-executing (non-discretionary) equity plan that was approved by the shareholders

- This proxy season, consider whether director compensation, in one form or another, should be presented to the shareholders for their approval

About ISS

- From the compensatory perspective, the framework of ISS is built around the following 5 global principles:
  - Maintain appropriate pay-for-performance alignment, with an emphasis on long-term shareholder value;
  - Avoid pay-for-failure arrangements or risk of such arrangements;
  - Maintain an independent compensation committee;
  - Provide clear and comprehensive compensation disclosures; and
  - Avoid inappropriate pay to non-executive directors (*i.e.*, ensure that pay does not compromise independence)

General Voting Guidelines

- Vote against say-on-pay proposals if:
  - There is a misalignment between CEO pay and performance of the company (*i.e.*, pay-for-performance),
  - The company maintains significant problematic pay practices, or
  - The board exhibits poor communication and responsiveness to its shareholders

- Vote against or withhold from members of the compensation committee (and possibly the full board) if:
  - There is no say-on-pay vote on the ballot and an against vote would have otherwise been warranted due to any of the above,
  - The prior say-on-pay proposal received less than 70% support of the votes cast and the board failed to adequately respond, or
  - The company has recently practiced or approved a problematic pay practice

General Voting Guidelines (cont.)

- For equity-based compensation plan proposals, vote against the proposal if certain conditions exist, including:
  - There is a liberal change-in-control definition,
  - The plan is a vehicle for problematic pay practices,
  - The plan creates a significant pay-for-performance disconnect,
  - The plan allows for repricing without shareholder approval, or
  - Any other features are present that are determined to have a significant negative impact on the interests of the shareholders

Board Communications

- In evaluating an item on a ballot, ISS will consider the board's responsiveness to investor input and engagement on compensation issues

- Bad facts include:
  - Failure to respond to a majority-supported shareholder proposal on executive pay;
  - Failure to "adequately" respond to a prior say-on-pay proposal that received less than 70% of the votes cast

- Addressing this latter point, ISS will evaluate:
  - The company's response, including:
    - Whether the company adequately addressed and disclosed engagement efforts with major institutional shareholders on issues giving rise to the low support,
    - Whether specific actions were taken to address the issue, and
    - Whether any other actions were taken by the board
  - Whether the issues raised are recurring or isolated;
  - The company's ownership structure; and
  - Whether support was less than 50% (which would require the highest degree of responsiveness)

Problematic Pay Practices

- There are numerous problematic pay practices that ISS will evaluate on a case-by-case basis to determine whether such are contrary to a performance-based pay philosophy, including:
  - Multi-year guarantees of pay,
  - Excessive new-hire packages,
  - Incentives that motivate excessive risk-taking (discussed on next slide),
  - Abnormally large bonus payouts without performance linkage or proper disclosure,
  - Excessive perquisites,
  - Excessive severance and/or change in control provisions (*e.g.*, single triggers, new or materially amended agreements containing excise tax gross-ups, etc.),
  - Dividends or dividend equivalents paid on unvested performance shares or units,
  - Internal pay disparity (*i.e.*, excessive differential between CEO total pay and that of the next highest paid NEO), and
  - Repricings without prior shareholder approval

Problematic Pay Practices (cont.)

- However, the following problematic pay practices are deemed "significant," the presence of which will likely result in an adverse recommendation from ISS:
  - Repricing without shareholder approval,
  - Excessive perquisites or tax gross-ups,
  - New or extended executive agreements that provide for:
    - Change-in-control payments exceeding 3x [base + average/target/most recent bonus]
    - Single trigger or modified single trigger change-in-control severance payments (unless there was at least a substantial diminution of duties), and
    - Excise tax gross-ups for change-in-control payments
- The following are examples of incentives that could motivate excessive risk-taking:
  - A single or common performance metric used for both short- and long-term plans,
  - Multi-year guaranteed bonuses,
  - Mega annual grants providing unlimited upside and no downside risk, and
  - High pay opportunities relative to industry peers
- ISS acknowledges that risky incentives can be mitigated with rigorous clawback provisions and rigorous stock ownership/holding guidelines

Equity Plan Scorecard

- The equity plan scorecard ("***EPS***") was adopted by ISS in 2015 and weighs positive and negative factors around the following 3 pillars:
  - Plan cost,
  - Plan features, and
  - Grant practices

- "Plan cost" means the total estimated cost of the company's equity plans relative to industry/market cap peers, measured by the company's estimated Shareholder Value Transfer ("***SVT***") in relation to peers. Plan cost considers both:
  - SVT on new shares requested, plus outstanding unvested/unexercised grants; and
  - SVT on new shares requested, plus shares remaining for future grants

  (Note: SVT = the estimated cost of shares used under a company's equity plans, differentiating between full value awards and stock options, where applicable. An ISS proprietary model is used)

Equity Plan Scorecard (cont.)

- "Plan features" considers:
  - The presence of any single-trigger awards (though performance-based awards could have its vesting schedule adjusted to reflect actual or pro rata performance), and full points only where plan expressly prohibits single trigger or board discretion,
  - Discretionary vesting authority (full points only if discretion can be used in cases of disability or death),
  - Liberal share recycling,
  - Lack of minimum vesting periods (*i.e.*, full points if 1 year minimum vesting schedule for all awards, subject to a 5% carveout; and no points if otherwise), and
  - Dividends payable prior to vesting (*i.e.*, full points if the equity plan expressly prohibits dividends prior to vesting, and no points if there is no express prohibition)
- "Grant practices" considers:
  - The company's 3-year burn rate relative to its industry/market cap peers;
  - Vesting provisions in the most recent CEO equity grants (with a 3-year look-back);
  - The estimated duration of the plan (based on the sum of the shares remaining available and the new shares requested, divided by the average annual shares granted during the prior 3 years);
  - The proportion of the CEO's most recent equity grants/awards subject to performance conditions;
  - The existence of any clawback policy; and
  - The existence of any post-exercise or post-vesting share-holding provisions

Equity Plan Scorecard (cont.)

- For S&P and Russell 3,000 issuers, each of the above 3 pillars have the following scoring, with 53 points out of 100 points required to “pass” (though in practice ISS pushes 56 or 57 points as a recommended pass):
  - Plan cost = 45 potential points
  - Plan features = 20 potential points
  - Grant practices = 35 potential points

Pay-for-Performance

- The purpose of the pay-for-performance analysis is to identify strong/satisfactory alignment between pay and performance over a sustained period. For Russell 3,000 issuers, the requisite inquiry begins with a quantitative test, and if any portion of the quantitative test indicates a pay-for-performance misalignment, then ISS will use a qualitative test (*i.e.*, to determine whether mitigating factors exist) before making a voting recommendation

- 1st part – Quantitative – Peer group alignment
  - Addresses the degree of alignment between the company's annualized TSR rank and the CEO's annualized total pay rank within a peer group, measured on a relative basis over a 3-year period
  - For purposes of the above, the peer group will generally consist of 12-24 companies, organized by market cap, revenue, GICS industry group, and certain of the company's self-selected peer group companies

- 2nd part – Quantitative – CEO peer group alignment
  - Analyzes the multiple of the CEO's total compensation relative to the peer group median of CEO total compensation
  - The Relative Pay and Financial Performance Assessment was added as part of this test (see Slide 13)

Pay-for-Performance (cont.)

- 3rd part – Quantitative – Absolute alignment
  - Addresses the degree of alignment between the trend in CEO pay and the company's TSR over the prior 5 fiscal years

- If ISS believes the peer group alignment or absolute alignment demonstrates the existence of significant misalignment of long-term pay-for-performance, then it will analyze the following 11 non-weighted qualitative factors:
  - The ratio of performance-based to time-based equity awards;
  - The overall ratio of performance-based compensation;
  - The completeness of disclosure;
  - Whether performance targets are easily achievable;
  - The application of the compensation committee's use of discretion in determining whether performance metrics are otherwise satisfied;
  - The magnitude of pay opportunities;
  - The company's peer group benchmarking practices;
  - Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
  - Special circumstances relating to attrition or anomalous equity grant practices (e.g., special one-time grants);
  - Realizable and realized pay compared to grant pay; or
  - Any other factors deemed relevant

Pay-for-Performance (cont.)

- Notwithstanding the foregoing, ISS FAQ 21 provides that even in situations where a company received a "low" concern in the quantitative analysis, that ISS will still evaluate such company's incentive programs for problematic incentive designs (*e.g*., tax gross-ups, etc.)

- Relative Pay and Financial Performance Assessment – Addressing pay-for-performance and whether there is potential for pay-for-performance misalignment, ISS added the following financial metrics (in addition to the TSR metric):
  - Return on equity,
  - Return on assets,
  - Return on invested capital,
  - Revenue growth,
  - EBITDA growth, and
  - Growth in cash flow from operations

- Financial performance will be measured by a weighted average of the above 7 financial metrics, and weightings will vary depending on the company's GICS code

- This means that a company's CEO pay will be compared to the 3-year financial performance of the weighted average of the above 7 financial metrics

Non-Employee Director Compensation

- ISS has a policy with respect to evaluating proposals seeking shareholder ratification of non-employee director cash and equity compensation

- Qualitative factors that will be considered include:
  - Director compensation compared to companies with a similar corporate profile,
  - Any problematic pay practices with respect to non-employee director compensation,
  - 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,
  - Presence of any meaningful limits on director compensation (*i.e.*, likely a result from *Seinfeld* and *Calma*),
  - Presence of retirement benefits and/or perquisites, and
  - The quality of the disclosure address non-employee director compensation

ISS Updates

- Evaluations of non-employee director pay (beginning in 2019)
  - A negative recommendation by ISS against the members of the committee could result if there is excess non-employee director compensation in two or more consecutive years without a compelling rationale or mitigating factors
  - ISS will compare the non-employee compensation against those within the peer group and look for outliers

- Pay ratio
  - Pay ratio will be included in ISS' proxy research reports, but such will not be factored into the ISS recommendation with respect to say-on-pay
  - And too, ISS asked companies and investors to consider the following 3 questions:
    - How does the ratio compare with peer companies
    - Is it the CEO's pay or the median employee's pay that is driving the ratio
    - Whether there are mitigating circumstances such as low cost labor, etc.

Action Items to Consider

- When setting financial goals under a company's annual incentive program or equity incentive plan for 2018, compensation committees should consider the 6 new ISS financial metrics
  - Especially since such new financial metrics, based on investor feedback to ISS, reflect investor views on how compensation should be analyzed vis-à-vis company performance

- Consider whether to amend the equity incentive plan to:
  - Eliminate Section 162(m) designs,
  - Require a minimum 1-year vesting schedule applicable to all awards under the equity plan (with a carve out up to 5%),
  - Expressly prohibit the payment of dividends on unvested awards,
  - Create a stand-alone equity plan for non-employee directors,
  - To seek shareholder ratification of a self-executing formula awards for non-employee director compensation (see *In re Investors Bancorp*)

Don’t Forget Next Month’s Webinar

- Title:
  - Energy Companies: Compensation Governance Survey/Trends
- When:
  - 10:00 am to 11:00 am Central
  - February 15, 2018

FIRM LOCATIONS

AUSTIN
111 Congress Avenue
Suite 1700
Austin, TX 78701
P +1.512.320.9200
F +1.512.320.9292

BEIJING
Room 2007, Capital Mansion
No. 6 Xin Yuan Nan Lu
Chao Yang District
Beijing, China 100004
P +86.10.8486.2699
F +86.10.8486.8565

DALLAS
1717 Main Street
Suite 3700
Dallas, TX 75201
P +1.214.659.4400
F +1.214.659.4401

DUBAI
Andrews Kurth Kenyon DMCC
45th Floor
Mazaya Business Avenue, BB2
Jumeirah Lakes Towers
P.O. Box 118273
Dubai, UAE
P +971.4.567.0767
F +971.4.567.0768

HOUSTON
600 Travis Street
Suite 4200
Houston, TX 77002
P +1.713.220.4200
F +1.713.220.4285

LONDON
Andrews Kurth Kenyon (UK) LLP
16 Old Bailey
London EC4M 7EG
United Kingdom
P +44.20.3053.8300
F +44.20.3053.8299

NEW YORK – BATTERY PARK
One Broadway
New York, NY 10004
P +1.212.425.7200
F +1.212.425.5288

NEW YORK – MIDTOWN
450 Lexington Avenue
New York, NY 10017
P +1.212.850.2800
F +1.212.850.2929

RESEARCH TRIANGLE PARK
4505 Emperor Boulevard Suite
330 Durham, NC 27703 P
+1.919.864.7200

SILICON VALLEY
1801 Page Mill Road
Suite 210
Palo Alto, CA 94304
P +1.650.384.4700
F +1.650.384.4701

THE WOODLANDS
Waterway Plaza Two
10001 Woodloch Forest Dr.
Suite 200
The Woodlands, TX 77380
P +1.713.220.4800
F +1.713.220.4815

WASHINGTON, DC
1350 I Street, NW
Suite 1100
Washington, DC 20005
P +1.202.662.2700
F +1.202.662.2739

Copyright © 2017 Andrews Kurth Kenyon LLP. Andrews Kurth, the Andrews Kurth logo, Straight Talk Is Good Business and Intelligent Energy are registered service marks of Andrews Kurth Kenyon LLP. Andrews Kurth Kenyon and the Andrews Kurth Kenyon logo are service marks of Andrews Kurth Kenyon LLP. All Rights Reserved. This presentation has been prepared for informational purposes only and does not constitute legal counsel. This information is not intended to create (and receipt of it does not constitute) an attorney-client relationship. Readers should not act on this information without seeking professional counsel. A past performance or prior result is no guarantee of a similar future result in another case or matter. Andrews Kurth Kenyon LLP is a Texas limited liability partnership. Andrews Kurth Kenyon (UK) LLP is authorized and regulated by the Solicitors Regulation Authority of England and Wales (SRA Registration No.598542). Andrews Kurth Kenyon DMCC is registered and licensed as a Free Zone company under the rules and regulations of DMCCA. Attorney Advertising.

ANDREWSKURTH
KENYON
andrewskurthkenyon.com