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Preparing the Compensation Committee for Proxy Season: Start Now (an Annual Program)

Presentation for:
Executive Compensation Webinar Series
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About Anthony “Tony” Eppert

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- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2018 Webinars

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- Upcoming 2018 webinars:
  - 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.huntonak.com/en/insights/2018-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

Preparing the Compensation Committee

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- The purpose of this presentation is to help prepare the Compensation Committee for actions it may need to take during its November or December meeting
- The point of discussing this topic now is to:
  - Provide content that could be discussed with the Compensation Committee in the next month or so, but well in advance of the November/December meeting
  - Allow sufficient time prior to the November/December meeting to vet concepts

Director Compensation: Background

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- Should stockholders approve all or a portion of director compensation?
  - The answer is not simple and involves a detailed analysis
  - Ultimately, the answer depends upon the issuer's risk tolerance

Director Compensation: Background

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- At a minimum, due to the decisions by the Delaware Supreme Court in *Seinfeld* and *Calma*, as narrowed by *In re Investors Bancorp, Inc. Stockholder Litigation (December 2017)*, outside compensation advisers should be hired to help the committee (*i.e.*, the committee that is setting the non-employee director compensation) establish the fairness of their compensation

- As background:
  - A decisions of non-employee directors with respect to their own compensation can be challenged as self-dealing and thus be subject to the "entire fairness" standard (including both fair dealing and a fair price) rather than the more deferential and director-friendly "business judgment rule" (*i.e.*, a Board's decision will be upheld unless it cannot be attributed to a rational business purpose)
  - An exception to the foregoing applies to compensation decisions that are ratified by the issuer's stockholders, and in such case, the non-employee directors are protected (known as the ratification defense)
  - *Seinfeld* and *Calma* stand for the proposition that the entire fairness standard of review would not apply with respect to equity awards to directors if the equity plan contained sub-limits (applicable to directors) that were both meaningful and approved by the stockholders (*i.e.*, ratification defense). The end result is that the directors would essentially have the benefit of the business judgment rule with respect to the foregoing actions
  - However, *In re Investors Bancorp* held that the business judgment rule would apply only if the issuer's stockholders approved the specific equity awards in question or if the awards were pursuant to a self-executing (non-discretionary) equity plan that was approved by the stockholders

Director Compensation: Background (cont.)

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- As a separate data point, consider the views of ISS with respect to non-employee director compensation

- Beginning in 2019, ISS will evaluate non-employee director compensation
  - A negative recommendation by ISS against the members of the Compensation Committee (or the committee approving non-employee director compensation) could result if there is excess non-employee director compensation in <u>two or more consecutive years</u> without a compelling rationale or mitigating factors
    - Emphasis added because ISS is looking for a pattern of excessive compensation
  - To determine whether compensation is excessive, ISS will compare individual non-employee compensation totals to the median of the non-employee directors at companies in the same index and industry
  - ISS is looking for extreme outliers (meaning non-employee directors are paid above the top 5% of the median non-employee director at peer companies)

Director Compensation: Practical Thoughts

- Consider implementing the following as a result of *Seinfeld* and *Calma*:
  - On an annual basis, review existing compensatory arrangements for non-employee directors, including the processes and practices for determining such compensation
  - Meaningful per-director and annual sub-limits should be contained within equity incentive plans
  - A benchmarking analysis against a peer group should be performed to help determine "meaningful"
  - In accordance with *Seinfeld* and *Calma*, outside compensation advisers should be hired to help the issuer determine the "fairness" of the compensation it pays to its directors
    - Such should include market competitiveness of non-employee director compensation (*i.e.*, the amount, the components, the form, vesting conditions, stock ownership requirements, etc.)

Director Compensation: Practical Thoughts (cont.)

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- For issuers seeking more robust protection, consider implementing the following as a result of *In re Investors Bancorp*, and having stockholders specifically approve:
  - Retainers and meeting fees,
  - Any irregular and unusually large compensatory awards, and/or
  - Formulaic or self-executing cash and/or equity awards
- For example, in light of recent settlements by Clovis Oncology and OvaScience, consider whether stockholders should approve the dollar amount of the retainers and the special retainers (*i.e.*, the latter covering fees to the lead director, fees to the chair of the audit committee, etc.)
  - Consider whether small windows of discretion should be specifically stockholder approved so as to provide the decision makers with the ability make small adjustments (*e.g.*, if the total compensation to a non-employee director was $300,000, then, for example, a window of $15,000 could be applied with respect to the decision makers implementing their discretion)
  - If the dollar values associated with such small windows of discretion are low, then even though the directors' exercise of such discretion might not be subject to the stockholder ratification defense, it could be that plaintiff's won't chase such small dollars
- To the extent applicable, the foregoing should be disclosed in the narrative that directly precedes the Director Compensation Table of the proxy statement

Perquisites: Background

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- The item in question is a perquisite if:
  - The item is NOT "integrally and directly related to the performance of the executive's duties" AND
    - Note that the foregoing is not a business purpose test
    - Put another way, whether the foregoing qualifies as a "ordinary" and "necessary" business expense for tax purposes is NOT determinative as to whether the item qualifies as a perquisite for SEC rules
  - The item confers a direct or indirect benefit on the executive that is personal in nature, regardless of whether a business purpose exists or if the item was provided for the convenience of the issuer
- Notwithstanding the above, if the item is made available to all employees on a non-discriminatory basis, then the item is not a perquisite
- Proxy disclosure rules surrounding perquisites
  - No disclosure is required if the value of all perquisites provided to the individual is less than $10,000
  - If perquisites to an individual is greater than $10,000, then the value of all perquisites must be disclosed in the All Other Compensation column of the SCT and the type of perquisite must be footnoted
  - Additionally, if perquisites to an individual is greater than $10,000, then the value of any perquisite that exceeds the greater of $25,000 or 10% of the value of all the perquisites to that individual must be quantified and disclosed in a footnote to the All Other Compensation column of the SCT

Perquisites: Recent SEC Activity

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- July 2018: An issuer settled an allegation by the SEC that the issuer failed to properly disclose approximately $3mm of perquisites over a 4-year period
  - As background, the issuer applied the wrong standard in its determination of whether an item is a perquisite (*i.e.*, it appeared to have applied a business purpose standard to the job of the individual, which is an incorrect standard)
  - The perquisites in question consisted of:
    - Travel to outside board meetings,
    - Sporting events,
    - Club memberships,
    - Use of a personal assistant’s time
    - Board membership fees to a charitable organization
  - According to the SEC, the issuer failed:
    - To have adequate processes and procedures in place so as to ensure proper reporting
    - To adequately train employees responsible for drafting the CD&A
  - As a result, the issuer entered into a settlement offer with the SEC that:
    - Fined the issuer $1.75mm (a high amount relative to the value of $3mm in perquisites)
    - Ordered the issuer to retain an independent consultant for a 1-year period in order to assess the issuer’s policies and procedures for complying with SEC compensatory securities laws (and the issuer must implement any recommended changes)
    - Ordered the issuer to be subject to compliance monitoring for 2 years

Perquisites: Recent SEC Activity (cont.)

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- July 2018: The SEC alleges that, over a 5-year period, the former CEO of an issuer failed to properly disclose certain personal loans provided to him by vendors and failed to disclose as perquisites certain reimbursements he received
  - With respect to the loans, the SEC alleges that:
    - Outside vendors provided the CEO with approximately $7.5mm in personal loans, and the issuer failed to properly report these loans as related party transactions
    - The issuer failed to disclose in a Form 8-K that its CEO was loaned approximately $3mm by an individual who was a candidate to become a member of the issuer's Board of Directors, and who at that time was also a portfolio manager at the issuer's largest shareholder
  - With respect to the reimbursements, the SEC alleges that such reimbursements were not reasonable, were personal, lacked sufficient documentation and were not properly disclosed as perquisites within the issuer's proxy statement. The reimbursements in question related to:
    - A charitable donation to his child's school in the amount of $15,000
    - $323,000 in costs associated with alcohol and cigars to stock a bar at the office for the benefit of the issuer's executives,
    - A highly expensive bottle of wine that was purchased at a charity action, and
    - First class plane tickets for his wife and child to travel to a meeting of the Board of Directors in London (*i.e.*, spouses were invited)

Perquisites: Practical Thoughts

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- To ensure current and on-going compliance, issuers should self-assess whether sufficient control measures exist

- For example, issuers should consider:
  - Whether advanced approval by the Compensation Committee is required before any perquisites may be provided to executives
  - Whether the folks responsible for tracking perquisites need additional training or whether such folks should have frequent training on what is a perquisite, calculating the aggregate incremental cost of such perquisites, tracking perquisites and disclosing the same
    - Plug coming . . . wait for it . . . wait for it . . . our Firm can provide such training onsite or remotely via a webinar
  - Whether to revise D&O questionnaires so that perquisite-orientated questions are written to be over-inclusive (thus allowing the issuer's trained individuals to make the determination of whether an item is a perquisite or not)
  - Whether a pre-clearance procedure should apply before an officer or director is reimbursed for certain items that arguably could be a perquisite
  - Whether executive-only facilities constitute a perquisite

Pay Ratio: Background

- Effective for fiscal years beginning on or after January 1, 2017, the pay ratio rule requires most public issuers to disclose:
  - The annual total compensation of their CEO,
  - The annual total compensation of the median employee of the issuer (excluding the CEO) and its consolidated subsidiaries,
  - A reasonable estimate of the ratio of the amount determined in the above two items,
  - The date the above was determined (which must be within the last 3 months of the last completed fiscal year), and
  - The methodologies the issuer used to identify the median employee and to calculate total compensation, including:
    - All material assumptions, COLAs and consistently applied compensation measures (a.k.a., “CACMs”) used to identify the median employee or to determine total compensation
    - Any estimates must be clearly disclosed

- The ratio may be presented numerically (*e.g.*, 75:1) or in narrative form
  - Disclosure in the form of a percentage is not permitted as the sole form of disclosure

Pay Ratio: Practical Thoughts

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- The Compensation Committee is likely to ask how the issuer's pay ratio stacked up compared to the compensatory peer group. Be ready to explain:
  - That deviations in the median employee is likely the strongest driver as to why two issuers within a peer group have substantially different pay ratios (*i.e.*, CEO pay within a peer group is typically uniform)
  - A pay ratio comparison group should be comprised of issuers with similar employee demographics (*i.e.*, not similar market cap)
- If the pay ratio vis-à-vis the issuer's peer group was not favorable, then consider whether a supplemental pay ratio should be calculated for next proxy season
  - Supplemental ratios are permitted so long as the supplemental disclosure is not as prominent as the required disclosure
  - Last proxy season some issuers provided a supplemental pay ratio for the purpose of increasing the median employee's pay level (which correspondingly lowers the ratio). For example:
    - Some issuers excluded non-U.S. employees from the supplemental ratio, and
    - Some issuers excluded part-time and temporary employees from the supplemental ratio calculation

Time for CE Code

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- Code: HAK8482

Section 162(m): Background

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

Section 162(m): Background (cont.)

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- [Continued from prior slide]
  - Existing written binding contracts in effect on 11/2/2017 and not materially modified or renewed on or after such date could have grandfathered treatment, however:
    - The contract cannot be modified on or after 11/2/2017
    - IRS guidance is expected
    - It is unknown whether the presence of negative discretion would void grandfathered treatment, but the majority of the practicing community does agree that the exercise of negative discretion would destroy grandfathered treatment
    - A written "binding" contract is not likely to exist if the Compensation Committee has the discretion to terminate or materially modify such contract

Section 162(m): Practical Thoughts

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- Consider advising the Compensation Committee on whether the issuer should seek periodic stockholder approval of the performance criteria under the equity and non-equity incentive plans
  - The requirement to seek a stockholder vote at least 1x every 5 years was eliminated with the repeal of the Exception
  - We think most issuers will abandon the practice of seeking stockholder approval every 5 years

- The use of Incentive Stock Options ("***ISOs***") will increase because:
  - Though ISOs are not tax deductible to the issuer, the tax effect of such lost deduction is less onerous with the reduction of the corporate tax rate from 35% to 21% in the Tax Reform Act
  - The spread between the exercise price of an ISO and the fair market value of its underlying stock on the date of exercise is an item of adjustment for Alternative Minimum Tax ("***AMT***") purposes, and was often cited as an impediment to the use of ISOs, however, the Tax Reform Act reduced the negative effect of AMT on an ISO holder
  - ISOs provide favorable tax treatment to the holder
    - An ISO holder has the ability to avoid taxation at the time of exercise (in contrast, NSOs are taxed at exercise), and if the underlying shares are held for the longer of 2 years from the date of grant and 1 year from the date of exercise, then the spread between the exercise price and the resulting sale price is all captured at favorable long-term capital gains rates

Section 162(m): Practical Thoughts (cont.)

- Compensation Committee charters should be reviewed to determine whether any revisions are required
- The use of positive discretion by the Compensation Committee is allowed with respect to bonuses that are not intended to be grandfathered:
  - Use of positive discretion by the Compensation Committee will convert a performance-based award that is otherwise reported in the non-equity incentive column of the SCT, to an award that is reported as a discretionary bonus in the SCT (*i.e.*, not likely a data point of concern to the Compensation Committee)
  - Any exercise of positive discretion will need to be disclosed in the CD&A
- If the Compensation Committee is concerned with preserving the deductibility of compensation that otherwise exceeds $1mm, consider:
  - Replacing the standard 3-year vesting schedule with a longer vesting schedule
  - Pay severance in installments instead of a lump sum payment

Performance Metrics: Practical Thoughts

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- Semi-related to the foregoing slides, the Tax Reform Act reduced the corporate tax rate, which could have an impact on any multi-year performance-based compensation arrangement that ends in 2018 or later

- If the performance metric is a financial performance metric, then should the Compensation Committee consider adjusting the metric if the executives were otherwise to receive a windfall caused solely by the change in the issuer's corporate tax rate?

Don’t Forget Next Month’s Webinar

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- Title:
  - Planning for an IPO: Compensation Considerations (Part 1 of 2)
- When:
  - 10:00 am to 11:00 am Central
  - September 13, 2018