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# Compensation Changes Due to Loss of EGC Status (Part 2 of 2)

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**Presentation by:**  
Anthony J. Eppert  
[AnthonyEppert@HuntonAK.com](mailto:AnthonyEppert@HuntonAK.com)  
713.220.4276

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## About Anthony “Tony” Eppert



Anthony Eppert , Partner  
Hunton Andrews Kurth LLP

Tel: +1.713.220.4276

Email: [AnthonyEppert@HuntonAK.com](mailto:AnthonyEppert@HuntonAK.com)

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

## Upcoming 2018 and 2019 Webinars

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- Upcoming 2018 webinars:
  - Taxation of Equity Awards: The 101 Training Course (11/8/2018)
  - How to Negotiate Executive Employment Contracts (12/13/2018)
  
- Upcoming 2019 webinars:
  - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/17/2019)
  - Equity Awards: Design Tips for Navigating Blackout Periods (2/14/2019)
  - Golden Parachutes & 280G: Design Pointers on Being a Winner (3/14/2019)
  - Best Practices for Conducting the Compensation Committee Meeting (4/11/2019)
  - Anatomy of ISS (5/9/2019)
  - Tips to Increase the Longevity of the Equity Plan's Share Reserve (6/13/2019)
  - Multi-Disciplinary Facets to Net Withholding: It Ain't Boring (7/11/2019)
  - Everything Perquisites: The 101 Training Course (8/8/2019)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/12/2019)
  - Stock Ownership Policies & Clawback Policies: Design Pointers (10/10/2019)
  - Employee Stock Purchase Plans: The Introductory Course (11/14/2019)
  - How to Design Restrictive Covenants & Economic Forfeitures (12/12/2019)
  
- 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.)

- 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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- An issuer that is no longer eligible for “emerging growth company” (“**EGC**”) status must comply with certain additional requirements that are not otherwise applicable to EGCs, including:
  - A requirement to make substantial new executive compensation disclosures in the issuer’s proxy statement, and
  - A requirement to have a say-on-pay vote, which is an advisory vote by the issuer’s stockholders on the executive compensation programs of the issuer’s named executive officers (“**NEOs**”)
- With respect to NEO compensation, the expanded disclosure requirement will include a compensation discussion and analysis (the “**CD&A**”), which requires:
  - Expanded disclosure of the issuer’s executive compensation program,
  - Disclosure of the issuer’s executive compensation **philosophy**, and
  - Additional tabular disclosure
- The expanded disclosure requirements, coupled with the issuer having to adopt say-on-pay, requires a thorough review of the issuer’s compensation programs for its NEOs, and a determination of whether changes are necessary
  - Put another way, compensation disclosure often drives design. As a result, an enhanced disclosure requirement is likely to drive compensatory design changes
- The purpose of this presentation is to highlight such design changes that should be considered

## Background: Loss of EGC Status

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- An issuer qualifying as an emerging growth company (“**EGC**”) at the time of its IPO is treated differently from other publicly-traded companies and enjoys limited compensation disclosure
  - Exempt from say-on-pay, say-on-frequency and say-on-golden parachute shareholder votes;
  - Exempt from pay ratio disclosure;
  - Exempt from having to file a CD&A within its proxy statement;
  - The NEO determination is limited to the CEO and two other executive officers;
  - The only required tabular disclosure is the Summary Compensation Table, the Outstanding Equity Awards Table, and the Director Compensation Table
  
- An issuer will retain EGC status until the earlier of:
  - The last day of the issuer’s fiscal year that contains the 5<sup>th</sup> anniversary of the issuer’s IPO,
  - The last day of the first fiscal year in which the issuer has annual gross revenues of \$1.07bb or more,
  - The date the issuer becomes a large accelerated filer, and
  - The date the issuer issued more than \$1bb in non-convertible debt during the preceding 3-year period

## Background: Exiting EGC Status & Item 402

- The following compares EGC and non-EGC requirements under Item 402 of Regulation S-K (and assumes the latter is not a smaller reporting company)

Requirement under Item 402	EGC	Non-EGC Issuers
<b>Officers Included as NEOs:</b>	PEO  Next 2 most highly paid executive officers	PEO  PFO  Next 3 highest paid executive officers  An additional two individuals for whom disclosure would have been required but for the fact they were not serving as an executive officer at the end of the last completed fiscal year
<b>CD&amp;A:</b>	Essentially not required	Required
<b>Summary Compensation Table:</b>	Required, but only cover last two fiscal years	Required and cover last three fiscal years
<b>Grants of Plans-Based Awards Table:</b>	Not required	Required
<b>Option Exercises and Stock Vested Table:</b>	Not required	Required
<b>Pension Benefits and Non-Qualified Deferred Compensation:</b>	Not required	Required
<b>Potential Payments upon Termination or Change-in-Control:</b>	Not required	Required
<b>Say-on-Pay:</b>	Not required	Required
<b>Say-on-Frequency Vote:</b>	Not required	Required
<b>Golden Parachute Advisory Vote:</b>	Not required	Required
<b>Pay Ratio Disclosure:</b>	Not required	Required

## Compensation Committee Charter

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- Will the Board of Directors or a committee oversee the additional disclosure requirements and compensatory changes?
- Under the Compensation Committee Charter, does the Compensation Committee have the requisite authority to address the additional disclosure requirements and any changes to NEO compensation
  - This question is an important first step because many EGCs (though not a majority) retain such authority within the Board (*i.e.*, the Compensation Committee can only make recommendations to the full Board of Directors with respect to NEO compensation)
  - If such authority does not reside with the Compensation Committee, then determine whether changes should be recommended such that the Board of Directors delegates this responsibility to the Compensation Committee and such is appropriately reflected in the Compensation Committee Charter

## CD&A – Compensation Philosophy

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- A compensation philosophy is a formal view of the issuer’s position regarding the compensation of its NEOs
  - It explains the “why” behind NEO pay,
  - It creates a framework for consistency, and
  - It is based upon both internal and external factors that affect NEO retention, performance, tenure and alignment (the latter addressing the alignment of the NEOs’ interests with those of the issuer’s long-term stockholders)
  
- An issuer’s compensation philosophy is the starting point of any CD&A and permeates the entire CD&A
  
- Determinations to consider include:
  - Should base salaries be targeted to the competitive market and/or to a percentile of a designated peer group
  - Should short-term annual incentives approximate a certain percentage or multiple of base salary, or a certain percentage of long-term incentives
  - If long-term incentives should be designed to focus NEOs on the long-term financial performance of the issuer, along with achieving certain designated strategic objectives, then should long-term incentives be targeted to:
    - The competitive market,
    - A percentile of the designated peer group, and/or
    - A multiple of base salary and annual incentives

## CD&A – Formal or Informal Peer Group

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- The Compensation Committee Charter might reference (or require) NEO pay packages to be competitive to a peer group (the latter to be identified by the Compensation Committee)
  - As background, peer group development is the process of developing a list of issuers to serve as the market or benchmark for evaluating NEO compensation levels on either a formal or informal basis
  - An effective peer group includes the issuer's competition
  
- Questions to consider include:
  - Should a formal peer group be developed to be disclosed in the CD&A, along with an explanation on how the issuer's NEOs compare to the NEOs of the issuer's peer group
  - Should the compensation of the NEOs be set in whole or part by benchmarking against the issuer's peer group (e.g., we target total compensation at the 60<sup>th</sup> percentile)



## CD&A – Base Salaries

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- How did the Compensation Committee determine the base salaries of its NEOs
  - This must be disclosed
  - For example:
    - Were base salaries based upon a formal or informal peer group review
    - Did the Compensation Committee attempt to set base salary as a percentage of Total Compensation or in connection with any other metric
  
- Discussion points within the CD&A should include:
  - How base salaries were determined
  - How the issuer's decisions with respect to base salaries of the NEOs fit into the issuer's overall compensation objectives
  - Whether the foregoing affects decisions with respect to other elements of pay packages for the issuer's NEOs

## CD&A – Short-Term Incentives

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- The CD&A must indicate how the Compensation Committee determined the short-term incentives of its NEOs
  
- Questions to answer include:
  - Was the determination by the Compensation Committee based upon a formal peer group review
  - How did the Compensation Committee determine the minimum, threshold and maximum payout levels
  - How were the performance metrics determined
  - Was short-term incentive set as a percentage of base salary

## CD&A – Long-Term Incentives

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- Same questions on the prior slide apply equally to the disclosure associated with long-term incentives
- Additional questions to answer include:
  - How did the Compensation Committee determine the split between time-based and performance-based awards, and was there a weighting of one over the other, and if yes, what was the weighting
  - Was the amount of the long-term incentives set as a percentage of the NEO's total compensation
  - With respect to equity awards, why did the Compensation Committee choose one form over another (e.g., why was restricted stock chosen over stock options)
  - With respect to time-based vesting awards, how and why was the vesting schedule chosen
  - With respect to performance-based vesting criteria, how was the performance measure chosen and what is the rigor associated with the threshold, target and maximum performance levels

## CD&A – Supplemental Material

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- Consider whether to highlight what “we do and don’t do”
  - Issuers will often highlight programs that mitigate compensation risk and that are considered “best practices” and good compensation governance. Such programs include:
    - Stock ownership policies
    - Any clawback policies (policies in addition to Section 304 of SOX)
    - Anti-hedging policies
    - Anti-pledging policies
  
- Should the issuer include other supplemental material such as:
  - An executive summary
  - A realized or realizable pay table
  - Graphics to demonstrate the issuer’s performance versus the performance of the peer group

## Pay Ratio Disclosure

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- The pay ratio disclosure rule requires most 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 (“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 Disclosure (cont.)

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- Disclosure of additional ratios are permitted. However, the additional ratios:
  - Must be clearly identified,
  - Cannot be misleading, and
  - Cannot be presented with greater prominence when compared to the required pay ratios (*i.e.*, this portion of the rule is similar to the rule applicable for any supplemental table to the Summary Compensation Table)
  
- In designing the calculations and drafting the disclosure, issuers should expect that questions will be asked with respect to the disclosure of the median employee's total compensation
  
- To that end, consider adding explanatory language. For example, consider:
  - Proactively addressing differences in ratios between the issuer and its peers (*e.g.*, employees in low cost jurisdictions, seasonal and part-time employees, and differences between an issuer that both manufactures and sells a product compared to an issuer that only sells such product)
  - Providing explanatory disclosure geared towards the viewpoint of the issuer's other employees that may view the median employee's total compensation
  
- In terms of placement, consider having it appear immediately after the Summary Compensation Table or immediately after the Potential Payments upon Termination or Change in Control discussion/table because such placement avoids the disclosure being part of the CD&A and subject to the Compensation Committee's certification



## Say-on-Pay and Frequency Say-on-Pay

- Say-on-pay is a non-binding, advisory vote on the compensation of the issuer's NEOs, as disclosed in the proxy statement
  - Without a stockholder communication initiative, beneficial owners typically do not provide voting instructions to brokers. Brokers are not permitted to vote without voting instructions from the beneficial owners. As a result, if broker votes are subtracted from the denominator, then institutional shareholder advisory services such as ISS have a disproportionately higher voting influence
- Frequency addresses how often the say-on-pay vote must occur.
  - The issuer may choose every year, every 2 years or every 3 years (though 1 year is the most common)
    - The goal of a 1 year frequency is to make the say-on-pay vote routine
    - An additional benefit of a 1 year frequency is as follows: If ISS identifies a pay-for-performance disconnect or discovers a problematic pay practice and no say-on-pay vote is on the ballot, then ISS may recommend an “against” on the re-election of the members of the Compensation Committee. However, if a say-on-pay vote is on the ballot, then ISS is likely to limit its adverse actions to the say-on-pay vote. For this reason, an annual say-on-pay vote can be protective
  - The frequency must be voted upon at least every 6 years
- The timing of when the first say-on-pay vote must occur depends upon how long the issuer was an EGC. Depending on the facts, the answer will either be 2 years from the issuer's IPO or 1 year from the date the issuer lost EGC status

## Tabular Disclosure

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- Verify whether any additional NEOs need to be disclosed
- Prepare to include the following:
  - The Summary Compensation Table will include the last 3 fiscal years of the issuer,
  - A Grants of Plan-Based Awards Table,
  - A Option Exercises and Stock Vested Table,
  - If applicable, a Pension Benefits and Nonqualified Deferred Compensation Table, and
  - A Potential Payments upon Termination or Change in Control
    - Disclosed as either a table or in narrative format
- Consider whether to include more narrative disclosure with respect to the Director Compensation Table
  - Especially in light of the recent focus on director compensation and the inability of directors to qualify for the business judgment rule defense with respect to their own compensation

## Don't Forget Next Month's Webinar

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- Title:
  - Taxation of Equity Awards: The 101 Training Course
  
- When:
  - 10:00 am to 11:00 am Central
  - November 8, 2018