

Upcoming Proxy Season: Compensatory Thoughts from ISS

Presentation for:
Executive Compensation Webinar Series
January 17, 2019

Presentation by:
Anthony J. Eppert
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

- 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

- 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

- Compensation issues are complex, especially for publicly-traded issuers, 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 help publicly-traded issuers prepare for the upcoming proxy season with respect to compensation-related matters and ISS

- To that end, this presentation covers:
 - Recent pronouncements from ISS since the last proxy season;
 - Areas where ISS is likely to focus their attention this proxy season; and
 - Action items to consider

Recent ISS Pronouncements

- Problematic pay practices
 - As background, 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
 - Additionally, there are certain problematic pay practices that are deemed “significant,” the presence of which will likely result in an adverse recommendation from ISS, such being:
 - Repricing without stockholder approval,
 - Excessive perquisites or the presence of tax gross-ups,
 - New or extended executive agreements that provide for (i) change in control payments exceeding 3x base and bonus, (ii) single trigger or modified single trigger change in control severance payments without a substantial diminution of duties, or (iii) excise tax gross-ups for change in control payments
 - Noteworthy and new is that ISS added the following to the list of “significant” problematic pay practices:
 - Insufficient executive compensation disclosure by externally-managed issuers, such that a reasonable assessment of the pay programs and practices for such externally-managed issuers is not possible, is the basis for a negative say-on-pay recommendation
 - “Good reason” termination definitions in new or materially amended agreements that are not conducive to an adverse constructive discharge theory and present windfall risk. Definitions that are triggered by the failure of an acquiring entity to assume the agreement in question will no longer trigger the problematic pay practices policy

Recent ISS Pronouncements (cont.)

- Excessive director compensation
 - Last year, ISS announced a policy to issue an adverse vote recommendation for board members responsible for approving non-employee director pay when the issuer exhibited a recurring pattern of excessive pay without a compelling rationale over a two or more consecutive years
 - ISS has updated its methodology to identify pay outliers, and as a result, adverse recommendations will not be issued under this policy until meetings occurring on or after February 1, 2020 (*i.e.*, for issuers where ISS has identified excessive pay without a compelling rationale for both 2019 and 2020)
 - Under the updated methodology, a negative recommendation by ISS against the members of the board responsible for approving the offending pay could result if there is excess non-employee director compensation in two or more consecutive years 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 to pay outliers, representing individual non-employee directors who are paid above the top 2-3% of all comparable directors within the same index and sector
- Front-loaded awards
 - ISS is unlikely to support front-loaded award that are intended to replace grants covering more than 4 future years (*i.e.*, the grant year plus three future years)
 - With respect to front-loaded awards of 4 years or less, ISS requires the issuer to make a firm commitment to not grant additional awards over the covered period

Recent ISS Pronouncements (cont.)

- Smaller reporting company
 - The SEC’s recent change to the definition of a “smaller reporting company” (subject to scaled-back compensation disclosure) will expand the number of issuers subject to smaller reporting company disclosure
 - ISS cautioned that issuers with scaled disclosure should continue to provide sufficient disclosure necessary to enable investors to make an informed say-on-pay vote
- Total shareholder return
 - Even though ISS uses TSR in its quantitative screen, ISS has specifically indicated that it does not endorse or prefer the use of TSR in incentive programs
- Removal of Section 162(m) provisions
 - Removal of Section 162(m) provisions are acceptable, but ISS will view negatively any change that signifies a shift away from performance-based compensation towards discretionary or fixed pay elements
- Equity plan scorecard and change-in-control vesting factor
 - Full points are awarded only if the equity incentive plan contractually provides for the vesting schedule applicable to time- and performance-based awards upon a change-in-control
 - No points if the equity plan is silent or provides for discretionary vesting

Director Compensation: Separate Equity Plan?

- As background, the equity plan scorecard (“EPS”) was adopted by ISS in 2015 and weighs the positive and negative factors around the following 3 pillars:
 - Plan cost,
 - Plan features, and
 - Grant practices
- As part of the “plan features” pillar, a certain number of points are allocated to the issuer if the equity plan has a minimum vesting feature
 - Full points within this bucket are awarded if the equity plan has a 1-year minimum vesting schedule for all equity awards, subject to a 5% carve-out
 - No points within this bucket are awarded if the minimum vesting period is less
- Frequently, non-employee director awards will contain a vesting schedule of less than 1 year (e.g., vest quarterly, etc.)
- As a result, and to help ease the strain on the 5% carve-out otherwise associated with both employees and non-employee directors receiving equity awards with vesting schedules of less than 1 year, consider moving non-employee directors to their own equity incentive plan
 - Noteworthy is that EPS does not apply to a non-employee director equity plan

Director Compensation: Stockholder Approval?

- Should stockholders approve all or a portion of non-employee director compensation (e.g., compensation caps, fixed formulas, etc.)?
- At a minimum, due to the decisions by the Delaware Supreme Court in *Seinfeld* and *Calma*, and as later narrowed by *In re Investors Bancorp, Inc. Stockholder Litigation* (December 2017), outside compensation advisers should be hired to help the board establish the fairness of their compensation
 - As background, directors’ decisions with respect to their own compensation can be challenged as self-dealing and are 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). That is, unless such decisions were ratified by the issuer’s stockholders
 - *Seinfeld* and *Calma* essentially stood 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 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 issuer’s stockholders approved the specific equity awards in question or if the awards were pursuant to a self-executing (i.e., non-discretionary) formula in the equity plan that was previously approved by the stockholders

Director Compensation: ISS

- ISS has a policy with respect to evaluating proposals seeking stockholder ratification of non-employee director cash or equity compensation
- Qualitative factors that will be considered include:
 - Director compensation compared to issuers with a similar corporate profile,
 - Any problematic pay practices with respect to non-employee director compensation,
 - The 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,
 - The presence of any meaningful limits on director compensation (*i.e.*, likely a result from *Seinfeld* and *Calma*),
 - The presence of retirement benefits or perquisites, and
 - The quality of the disclosure addressing non-employee director compensation
- The above last bullet is yet another reason why robust disclosure should be included within the narrative that directly precedes the Director Compensation Table of the proxy statement

Pay Ratio – Year 2

- Pay ratio disclosure in 2019 is likely to be compared to the issuer’s disclosure in 2018, and compared to pay ratio disclosures from the issuer’s peer group
- If the issuer had changes to its employee population or its operations since last proxy season, consider whether it makes sense to change the methodology for determining the “median employee”
- Consider introducing a supplemental pay ratio disclosure

Action Items to Consider

- Courting the say-on-pay vote
 - The most common reason for a negative recommendation from ISS is a pay-for-performance disconnect in the compensation of executive officers
 - Robust disclosure on this point can help, especially disclosure that specifically addresses why certain performance criteria were used and the degree of difficulty in attaining such criteria
 - Stockholder outreach programs are important towards achieving a passing say-on-pay vote

- Large swings in share price and grant practices
 - For some sectors, this issue is a repeat of 2008 and 2009
 - A common concern for issuers granting equity based on a dollar amount that is then converted into a number of shares, is whether stockholders might allege that the executives took advantage of the downward slide in stock price by awarding themselves a larger number of shares than in prior years
 - Having a documented annual grant policy could provide an affirmative defense to an allegation that the equity grant is otherwise timing the market (as would an issuer's practice over the prior years if consistent with the current grant)

- Large swings in share price and underwater stock options
 - Underwater stock options do not provide the intended retention value
 - Issue may have been avoided if the stock option had a stock-price forfeiture imbedded within the forfeiture provision of the option (*i.e.*, if the stock price falls to a certain price, the option is automatically forfeited and the underlying shares revert to replenish the share reserve of the equity incentive plan)

Action Items to Consider (cont.)

- Impact of Section 162(m)
 - If the equity incentive plan is being restated or a new equity incentive plan is being proposed to the issuer's stockholders, consider streamlining the administrative design that was otherwise complex due to the performance-based exception to the \$1mm deduction limit under Section 162(m)
- Director pay disclosure
 - Be robust (more than prior years)
 - What is the philosophy associated with director compensation? How is the pay assessed? What is the frequency of the assessment? What is the process associated with any benchmarking?
- Benchmarking director pay and revisiting the form and amount of such pay
- Whether director pay should be submitted to the stockholders for ratification

Action Items to Consider (cont.)

- Net withholding
 - Whether to revise the net withholding rate within the equity incentive plan from the supplemental rate of 22% to the highest marginal rate

- Shrinking labor market
 - The cost of retaining key employees may increase as the baby boomers exit the workforce (a thinning labor market will become the norm even if there is an economic downturn over the next 12 months or so)
 - Perform an assessment to determine whether retention gaps exist within the compensatory structure

Don't Forget Next Month's Webinar

- Title:
 - Equity Awards: Design Tips for Navigating Blackout Periods

- When:
 - 10:00 am to 11:00 am Central
 - February 14, 2019