HUNTON ANDREWS KURTH

Preparing for Proxy Season: Start Now (Annual Program)

Presentation for:
Executive Compensation Webinar Series
September 14, 2023

Presentation by:
Anthony J. Eppert
AnthonyEppert@HuntonAK.com
512.542.5013

Housekeeping: Questions

HUNTON ANDREWS KURTH

- 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 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 (CA, FL, GA, NC, NY, TX and VA)
    - 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@HuntonAK.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

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 2023 Webinars

- 2023 webinars:
  - PubCo Governance & Internal Controls: A Compensatory Perspective (10/12/23)
  - Keep It Boring: Drafting Miscellaneous Provisions in a Contract (11/9/23)
  - [Topic TBD] (12/14/23)

- 2024 webinars:
  - [Announced next month]

Sign up here: https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html

Our Compensation Practice – What Sets Us Apart

HUNTON ANDREWS KURTH

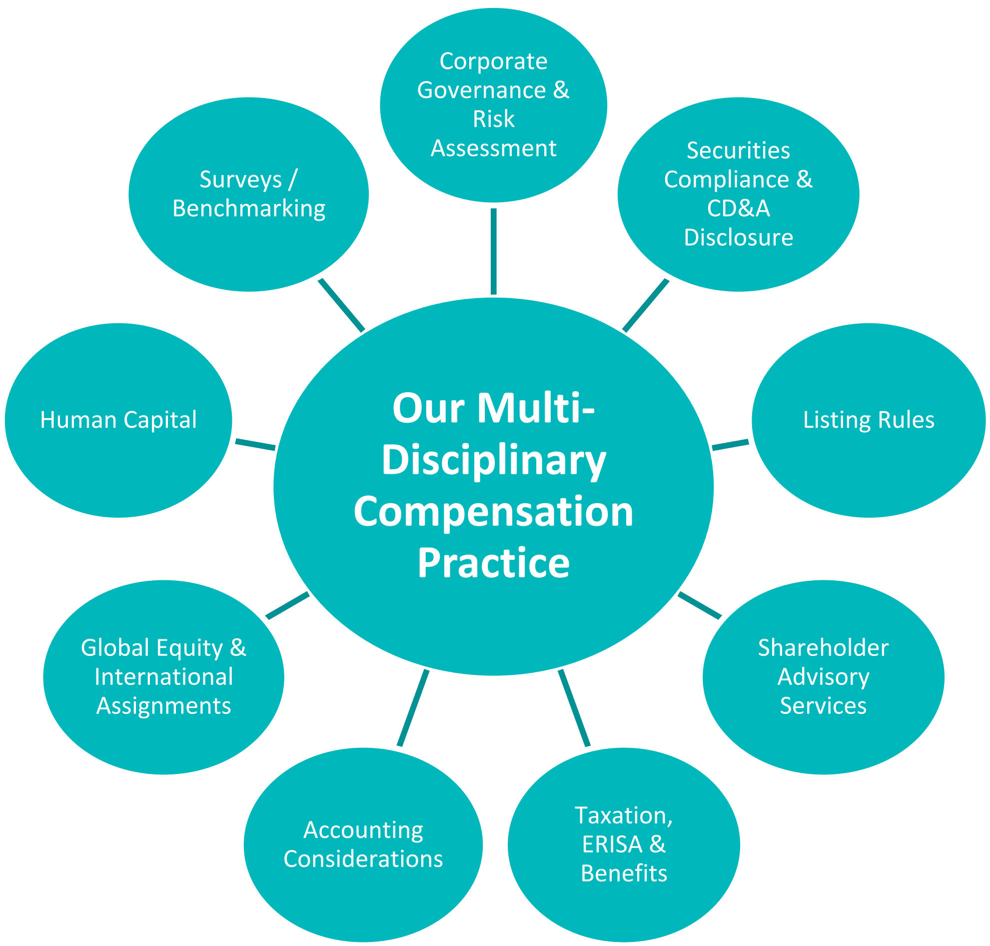
- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- 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.)

HUNTON ANDREWS KURTH

- 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.)

HUNTON ANDREWS KURTH

- 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

2023 Proxy Season Recap

HUNTON ANDREWS KURTH

- Through June 2023, approximately
  - 47 companies failed their say-on-pay vote, compared to 72 companies that failed their say-on-pay vote last year around the same time frame
  - Approximately 16 of those that failed involved multi-year failures (*i.e.*, more than 1 year of failure)
  - Reasons for the failures include (ordered most frequent to less frequent):
    - Pay v. performance disconnects (most common reason for a negative recommendation from ISS),
    - Problematic compensation practices,
    - Rigor of performance goals,
    - Non-performance based equity,
    - Mega grants, and
    - Inadequate disclosure of shareholder outreach
  - The number of companies with low say-on-pay results (less than 70% pass rate) also decreased compared to 2022

2023 Proxy Season Recap (cont.)

HUNTON ANDREWS KURTH

- Noteworthy is that an issuer with less than a 70% pass rate is expected by ISS to disclose in the next proxy:
  - Efforts that the Board took with respect to shareholder engagement
  - The specific feedback the issuer received from dissenting shareholders, and
  - What actions or changes the issuer made to its pay programs and practices to address concerns of its shareholders

- ISS will recommend an Against vote on the Company's say-on-pay proposal if any of the following are present:
  - Significant misalignment between CEO pay and company performance;
  - Problematic pay practices exist such as excessive change-in-control pay or severance pay, repricing of options, tax gross-ups or perquisites; or
  - Board's responsiveness to shareholders is poor

- And too, statistics support that an "Against" recommendation from ISS creates a drop in the pass rate by approximately 20% or more
  - 12.2% of Russell 3000 companies received an Against recommendation, and
  - 9.0% of S&P 500 companies received an Against recommendation

- Median support by shareholders for social and environmental proposals has decreased compared to last season around this time (decrease of approximately 7% for social proposals and 9% for environmental proposals)

2023 Proxy Season Recap (cont.)

HUNTON ANDREWS KURTH

- Voting behavior on equity plan proposals included:
  - Approximately 60% of the equity plan proposals received a 90% or greater favorable vote,
  - Approximately 29% of the equity plan proposals received a 70% - 90% favorable vote,
  - Approximately 10% of the equity plan proposals received a 50% - 70% favorable vote, and
  - Approximately 1% of the equity plan proposals received less than a 50% favorable vote

- Among the Russell 3000, shareholder support for equity plan proposals decreased slightly compared to 2022 (*i.e.*, 5 failed votes in 2023, compared to 2 failed votes in 2022)

Possible Items of Interest for Fall 2023

- Some of the more highlighted points are contained on the following slides

- Compensation Committee concerns will be very similar to its concerns in prior years, such including:
  - Implementing Dodd-Frank recoupment policies (if haven't already been effectuated);
  - Volatility of stock price and its impact on compensation arrangements such as conversion ratios, stock ownership policies, relative total shareholder return and similar performance metrics;
  - Addressing underwater stock options;
  - Addressing long-term performance metrics that are not likely to pay out;
  - Addressing change-in-control retention issues in the context where the employer is or might be the target;
  - Addressing retention issues for executives who otherwise could receive a "fresh grant" of equity if he or she took employment with another entity; and
  - Disclosure

Annual Grant Policy

- This topic is not new. Having a documented annual grant policy could provide an affirmative defense to an allegation that the equity grant was intended to time the market
  - It is common practice that grants of equity awards are first denominated in dollars (*e.g.*, 100% of base salary), and then converted into a number of shares
  - An issue with the foregoing is whether shareholders might allege that the executives took advantage of a downward slide in stock price by timing dollar denominated equity award grants to coincide with low stock price, thus resulting in a higher share award than if the stock retained a higher stock price

- And too, the SEC's guidance on spring-loaded equity awards is yet another reason why issuers should consider adding an annual grant policy. Under such guidance:
  - Spring-loading occurs when an equity award is granted just prior to a public announcement that the issuer expects will increase its stock price
  - There are two issues with spring-loaded grants. First, the compensation expense will be lower than it would have been had the award been granted immediately following such public announcement. Second, for issuers with dollar-denominated grants, the executive will have received more shares than he or she would have received if the grant occurred after the public announcement
  - The SEC guidance differentiates between routine and non-routine grants, and implies that routine grants might not be subject to the guidance. Thus, a routine grant pursuant to an annual grant policy may avoid the issue of spring-loaded equity awards

Shrinking Labor Market – Succession Strategy Thought

HUNTON ANDREWS KURTH

- The cost of retaining key employees may increase as the baby boomers continue to exit the workforce

- It is anticipated that a thinning labor market will become the norm even in the face of, or during, an economic downturn

- Consider performing an assessment to determine whether retention gaps exist within the issuer's compensation structure. For example:
  - Consider adding a "retirement" provision within equity award agreements and key employee employment agreements that allow for accelerated vesting (all or some) if the key employee terminates his or her employment due to retirement
  - BUT . . . Require advance notice (e.g., 6 months, 12 months) advance written notice before the key employee can effectuate such retirement
  - Such advance notice could help an issuer with its succession strategies by providing the issuer with time to find and train a successor key employee

Stock Price Volatility: Underwater Stock Options

- This slide sets up the factual problem:

- Outstanding stock options run the risk of becoming underwater and a drag on the share reserve of the equity incentive plan

- If the Compensation Committee desires to reprice underwater stock options, the issuer would have to file a Schedule TO with the SEC unless:
  - The repricing is conducted on an individually negotiated basis with a small number of key executives (*see* March 21, 2001 SEC Exemptive Order); or
  - A repricing is permitted unilaterally (*i.e.*, without optionee consent), thus negating the Schedule TO rules because there is no "offer" and the optionee would not have to make an investment decision
    - However, a significant drawback to a unilateral repricing is that incremental compensation expense could be significant since a "value-for-value" exchange cannot be effectuated (such requires optionee consent because a lesser number of shares generally results under the amended award)

  - And too, other issues must be considered when repricing stock options, such as:
    - Whether the cancelled shares return to the share reserve under the equity plan;
    - Whether shareholder approval is required under the terms of the equity plan and under applicable NYSE/NASDAQ listing rules (answer is most likely yes that such approval is required); and
    - Whether adverse tax and accounting consequences could be avoided

Stock Price Volatility: Underwater Stock Options (cont.)

HUNTON ANDREWS KURTH

- A possible idea to fix the prior problem could be to insert a stock-price forfeiture

- The stock option award agreement would provide that if the stock option ever becomes underwater by $x.00 (or the stock price ever falls by $y.00), then both the vested and unvested portions of the stock option are automatically and immediately forfeited for no consideration
  - Depending on the equity plan's terms, the forfeited shares would return to, and act to replenish, the share reserve of the equity plan

- The goal is avoid the time, expense and shareholder relationship issues associated with repricings and compliance with the SEC's tender offer rules

- Risk to be vetted
  - Under NYSE and NASDAQ listing rules, a cancellation followed by a **<u>required</u>** regrant is deemed to be a repricing, which generally would require shareholder approval
  - This "cancellation" issue will need to be vetted by legal counsel
  - A possible solution to consider is whether a cancellation followed by a **<u>voluntary</u>** grant (the latter of which would be pursuant to a written or operational annual grant policy) would sufficiently negate the nexus between a cancellation and regrant, thus negating the repricing characterization

Insufficient Shares: Inducement Grants

HUNTON ANDREWS KURTH

- 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 of equity 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

Insufficient Shares: Inducement Grants (cont.)

- 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

Insufficient Shares: Inducement Grants (cont.)

HUNTON ANDREWS KURTH

- 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 shareholder-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 key employees of the target entity
  - 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
    - If inducement grants will be frequent, then draft an inducement plan
    - But if inducement grants will be infrequent, then approve stand-alone inducement grants on an ad hoc basis
  - Have an inducement grant (or plan) be covered by a Form S-8

New Clawback Requirements (cont.)

- Issuers have until December 1, 2023, to adopt Dodd-Frank compliant clawback policies to be effective on October 2, 2023
  - Board approval is required (unless such was previously delegated to a committee of the Board)

- As a quick review, the current requirements of the Dodd-Frank Act clawback include:
  - Compensation clawback policy must apply at least to current and former executive officers
    - In contrast, Section 304 of SOX applies only to the CEO and CFO
  - The clawback policy must be triggered any time the issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws
    - In contrast, Section 304 of SOX applies only when a restatement of financial statements is "required" and is the result of "misconduct". Thus, Section 304 of SOX contains a fault requirement and Dodd-Frank does not
    - Dodd-Frank clawback applies to "Little r" restatements (*i.e.*, financial restatements that are not deemed material errors and do not require a full restatement of previously issued financial statements)
    - Dodd-Frank clawback applies to "Big R" restatements (*i.e.*, financial restatements that are deemed material errors and do require a full restatement of previously issued financial statements)

New Clawback Requirements (cont.)

HUNTON ANDREWS KURTH

- [Continued List from Prior Slide]:
  - Once the clawback is triggered, it would apply to all "incentive-based" compensation that is "received" based on financial information required to be reported under the securities laws
    - In contrast, the look back period under Section 304 of SOX is 12 months
    - For this purpose, compensation is "received" in the fiscal year during which the relevant goal in question is satisfied (even if payment or grant occurs after the end of such period)
  - 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 of SOX 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 restatement
    - To the extent the financial metrics involve stock price and TSR, reasonable estimates may be used to determine the impact of the restatement
    - Such amount to be recovered must be calculated without respect to taxes paid by the executive officer
  - No discretion not to pursue recovery except in 3 situations:
    - If enforcement costs of recovery would exceed the amount to be recovered,
    - If recovery would violate the home country laws, or
    - If recovery would violate rules governing tax-qualified retirement plans

Don’t Forget Next Month’s Webinar

- Title:
  - PubCo Governance & Internal Controls: A Compensatory Perspective
- When:
  - 10:00 am to 11:00 am Central
  - October 12, 2023