Know

Designing and Implementing an Effective Executive Compensation Plan: Your Guide for 2017 & Beyond

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From complex cross-border transactions to exclusively local deals, clients rely on Shearman & Sterling's vast international network to help accomplish their business goals. The firm has approximately 850 lawyers in 20 offices around the world, and its lawyers come from some 80 countries, speak more than 60 languages and practice US, English, EU, French, German, Italian, Hong Kong, OHADA and Saudi law. They also practice Dubai International Financial Centre law and Abu Dhabi Global Market law.

VLP LAW GROUP LLP

VLP offers a broad variety of business and transactional services to companies, financial institutions, investors and universities throughout the nation. Our attorneys provide counsel and strategic representation in a diverse range of practice areas. VLP's clients include businesses of all sizes, from entrepreneurs and early-stage startups to Fortune 100 companies operating in a wide cross section of industries.

Designing and Implementing an Effective Executive Compensation Plan: Your Guide for 2017 & Beyond

Brief Speaker Bios:

Shearman & Sterling
Doreen E. Lilienfeld
Partner

Doreen E. Lilienfeld Doreen Lilienfeld is the Practice Group Leader of the Compensation, Governance & ERISA Group of Shearman & Sterling LLP. She has been involved in a wide variety of compensation-related matters, including the design and implementation of retention and compensation plans, disclosure and regulatory compliance, and employment negotiations with senior executives. She has significant experience in compensation and benefits issues relating to private equity and other mergers and acquisitions transactions. Ms. Lilienfeld has advised both U.S. and non-U.S. issuers on corporate governance and regulatory requirements relating to compensation and benefits matters. Legal directories, such as Chambers and Legal 500 US, have named Ms. Lilienfeld as a leader in her field.

Shearman & Sterling
Gillian Emmett Moldowan
Counsel

Gillian Emmett Moldowan is counsel in the Compensation, Governance & ERISA group of Shearman & Sterling LLP. She advises on compensation and benefit arrangements, including equity-based incentives, deferred compensation and employment, retention and severance arrangements, with emphasis on disclosure and issues arising in mergers and acquisitions transactions and securities offerings. Ms. Moldowan also advises executives and employers on the applicability of federal securities law, tax law and general employment-related matters. She regularly counsels clients on proxy disclosure, Section 16 and corporate governance matters and the negotiation of executive employment arrangements.

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Designing and Implementing an Effective Executive Compensation Plan: Your Guide for 2017 & Beyond

Brief Speaker Bio:

VLP Law Group LLP
Mark D. Bradford
Partner

Mark D. Bradford is a partner at VLP. He specializes in executive compensation, equity compensation, and employee benefits for clients ranging from start-ups to emerging growth public companies. He also represents individual executives in negotiating employment agreements, terminations and severance, and entire management teams in significant M&A transactions.

Mark has over 16 years of experience as an executive compensation and employee benefits attorney. In over 200 cross-border and domestic M&A deals, he has represented buyers and sellers, with transactions ranging in size from a $1 million acquihire to a $7 billion sale of a major client. In connection with these transactions, Mark has negotiated and drafted deal-related agreements, including employment, incentive, retention, severance and non-competition, and worked on post-closing integration matters. He has also worked with more than 35 companies on compensation matters arising out of their initial public offerings.

Designing and Implementing an Effective Executive Compensation Plan: Your Guide for 2017 & Beyond

As businesses, regulators and stakeholders continue to explore ways in maximizing business value and securing better alignment of interests, crafting an effective and well-tailored executive compensation plan has become a worthwhile endeavor for most companies. However, considering the intricacies and challenges involved in plan designs and management coupled with the constantly changing executive compensation landscape, these corporate objectives may not be achieved.

In this LIVE Webcast, a panel of distinguished professionals and thought leaders organized by The Knowledge Group will provide the audience with an overview of the latest trends and salient issues with respect to executive compensation plans. Speakers will help them understand all the important aspects of this significant topic and will also offer best practices and practical tips in designing and implementing an effective and efficient executive compensation plan while ensuring compliance with applicable laws.

Key issues that will be covered in this course are:

- Executive Compensation Programs
- Critical Issues and Challenges
- Tips for Plan Design and Implementation
- Executive Compensation Tools and Legal Compliance
- Practical Analysis of Key Regulatory Issues
- Latest Trends and Best Practices

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Structuring a pay-for-performance compensation program

- Start with a strong compensation philosophy
- Choosing your compensation vehicle
  - Performance units
  - Options
  - Cash-based notional equity programs

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Choosing your performance measures

- Balance short- and long-term incentives
- Balance stretch goals with achievability
- Use both stock price and operational performance measures
- Consider customer and employee satisfaction as business goals
- Align with business plan
  - Alignment of business goals with performance incentives makes for more compelling pay-for-performance narrative in CD&A


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Moving beyond Total Shareholder Return (TSR)

- Criticisms
  - Commonly used in response to pressure from institutional stockholders
  - Studies suggest leading and lagging indicator of performance, even with 3-year performance period
  - Not truly pay-for-performance match, as share prices can increase or decrease due to outside factors beyond company's control
- Consider balancing TSR awards with operational performance measures
- Equilar suggests using economic profits (operating profit less cost of capital) as better way to tie day-to-day operations to long-term value creation

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Mitigating risk factors

- Avoid
  - incentives that are not balanced among business goals
  - paying for fixing mistakes instead of stopping them
  - over-reliance on one objective (e.g., sales) to the exclusion of other objectives to drive business goals
- Monitor
  - high-risk incentives
  - poor compliance
  - whistleblower allegations/ethics hotline complaints as guide to examine troublesome areas

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Mitigating risk factors (cont.)

- Clawbacks—what do they look like today
    - Interaction with existing contracts
- Holding requirements
    - Minimum number of shares
    - Specified period after vesting
- Prohibitions on hedging or pledging

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Know your shareholders

- Examine shareholder base
- Proactively engage key shareholders to explain compensation decisions and philosophy
  - Talk to shareholders outside of the proxy season
  - Ask for feedback
  - Give feedback thoughtful consideration
  - Prepare disclosure that shows (not just tells about) shareholder engagement—the impact of feedback
  - Make directors available (but ensure they are properly trained)
  - Address performance problems head-on and proactively

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Know your Shareholders (cont.)

- Activist preparation
  - Undertake a regular review of compensation programs from an activist perspective
    - Use outside advisors to identify weaknesses
  - Develop an activist response plan
  - An informed compensation committee
    - Company compensation programs
    - Compensation performance measures in use and at what level performance is achieved (or is expected to be achieved)
    - Understand any underperformance and how it is impacting compensation
    - Media reports
    - Calls into the company from shareholders or others regarding compensation
    - Third party governance ratings of the company
  - Monitor peer group for activist activity
  - Review voting guidelines of institutional shareholders and proxy advisors

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Know your Shareholders (cont.)

- Hot-button compensation issues for activists
  - Performance and pay misalignment
  - Unaddressed negative say on pay results
  - Board diversity
  - Low director election support
  - Use of the same performance measures through compensation plans
  - Use of non-objective “soft” performance criteria
  - Insufficient performance-based long-term awards
  - Evergreen executive contracts
  - Executive only benefit plans and programs

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Know your Shareholders (cont.)

- Evolving role of historically passive institutional investors
  - Expect to see increased "activism" from passive institutions
  - Vanguard 2017 Investment Stewardship Report: Advocating for effective corporate governance
    - Independent and diverse Boards (diversity of gender, experience, race, background, age, and tenure)
    - Annual Board elections by majority vote
    - Right of shareholders to call special meetings and proxy access
    - Performance-linked compensation
    - Effective risk oversight and disclosure of risks impacting long-term shareholder value
  - State Street Corp and Blackrock – diversity on Boards


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Director compensation structure

  - Shareholder approval of reasonable limits
  - Use of performance awards
  - Holding periods
- Self-evaluations by Committees and the full Board
  - Required by NYSE, but not Nasdaq
- Rotating committee chairs

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Effective Compensation Committee/Board of Directors Process (cont.)

- Director education, including shareholder engagement
- Compensation program and goal setting
    - Working with compensation consultants and legal advisors
    - Let directors ask the difficult questions
    - Use executive sessions
    - Focus directors on the disclosure implications of decisions

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Planning for Board succession

- Review Board needs compared with skills and experience of existing Board members
- Examine seniority
- Balance fresh perspectives without causing disruption or lack of historic perspective
- Develop talent for leadership roles
- Consider mandatory term limits or retirement policy

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Planning for CEO succession

- Orderly transition planning
- Emergency planning
- Work with other appropriate committee (i.e., nominating and governance)
- Go beyond the CEO and ensure robust succession planning for the whole C-suite


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Oversight of Culture as Corporate Asset – Report by Blue Ribbon Commission of National Association of Corporate Directors

- Boards should be engaged, proactive and regularly measure and monitor company-specific values and behaviors
- Need to understand cultural tone at top and behaviors and values of rank-and-file employees
- Highly engaged employees is indicator of healthy culture and better organizational performance
- General Counsel should advise Board on cultural oversight
- Culture Red Flags
  - Focus on performance with little regard to how results are achieved
  - High performers allowed to operate outside established policies, and rewards for conduct inconsistent with stated values or code of conduct
  - Excessive focus on consensus or collegiality to “go along to get along”
  - Discourage sharing of bad news
  - Promotions or recognition tied to relationships rather than skills and performance


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Oversight of Culture as Corporate Asset – Report by Blue Ribbon Commission of National Association of Corporate Directors (cont.)

- Culture Red Flags
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Tips for Effective Disclosures

- Review proxy disclosures annually
  - Consider whether they remain fresh and describe the current program
  - Avoid "cut and paste" approach
  - Remove stale information
- Address performance problems or missteps head-on


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Tips for Effective Disclosures (cont.)

- Focus on the "Why"
- Tell your story—get beyond mere compliance
  - Use proxy and CD&A executive summaries
  - Effective narrative can add color and clarity to pay-for-performance practices to preemptively address claims of pay-for-performance disconnect


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Tips for Effective Disclosures (cont.)

- Provide disclosure that enables readers to meaningful assess pay practices, rigor of performance goals, comparability with peers and alignment of pay and performance
  - Rationale for selecting performance targets
  - Describing changes from targets in prior years
  - Connect changing performance goals to changing business strategies
- Simple and graphic presentation
- Reduce duplication

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Pay Ratio

- Not applicable to all public companies (emerging growth companies, smaller reporting companies, foreign private issuers)
- Required disclosures
  - Total annual compensation of identified median employee
  - Total annual compensation of CEO
  - Ratio
  - Details about how median employee selected
- Data collection

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Pay Ratio (cont.)

- d.Flexibility
  - No mandated method of identifying median employee
  - De minimis exclusion for non-U.S. employees
  - Privacy exclusion

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Pay Ratio (cont.)

- Flexibility (cont.)
  - SEC September 2017 Guidance
    - Each registrant has flexibility to determine method that best suits its own facts and circumstances
    - Reasonable estimates, assumptions and methodologies allowed, so long as reasonable basis made in good faith
    - Statistical sampling techniques over entire population available
    - Can use existing internal records to determine annual compensation to identify median employee
      - Even if records exclude equity awards (but cash compensation alone may be inadequate if equity widely distributed to employees)
    - Can use recognized tests (under tax or employment law) to determine who is employee


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Pay Ratio (cont.)

- Preparing for stockholder disclosures
  - Proxy advisors, ISS and Glass Lewis, have announced they won’t incorporate pay ratio into next year’s voting recommendations
  - 2017-2018 ISS Global Policy Survey – Summary of Results (September 25, 2017)
    - Nearly three-quarters of institutional investors indicated they would use pay ratio to compare among companies/industry sectors and year to year
    - Investors intend to use as data point in determining compensation-related resolutions, and as background for engagement with issuer

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Pay Ratio (cont.)

- e.Preparing for Stockholder Disclosures (cont.)
    - Putting Pay Ratio into context in comparison to peer groups
        - Work with investor relations to address anticipated questions
        - Size of company
        - Types of businesses (retail vs. financial services)
        - Location of employees (domestic vs. worldwide)
        - Composition of workforce (employees vs. independent contractors)
        - Types of employees (full-time, part-time, seasonal, temporary)
        - Number of collectively-bargained employees
        - Impact of mergers and acquisitions
        - Impact of CEO turnover, including one-time payments


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Pay Ratio (cont.)

- Communicating with your employees about Pay Ratio
  - Work with HR and investor relations to address anticipated questions
  - Consider including disclosure about position/tenure of median employee
  - Explain differences between disclosed pay and “take home” pay

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New Section 409A Guidance on Design of Executive Compensation Plans

- Background: Section 409A sets specific rules regarding when employees and independent contractors can be paid non-qualified deferred compensation (amounts earned in one year and paid in a subsequent year)
  - Generally prevents the acceleration or delay of nonqualified deferred compensation payments
  - Violations subject to 20% additional tax plus interest.
- Exempt stock options and SARS may be granted to prospective employees up to 12 months before employment commences
  - BUT consider equity plan and registration statement limitations
- Can repurchase stock rights at below fair market value for bad behavior
  - Forfeiture conditions need not be established at time of grant

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New Section 409A Guidance on Design of Executive Compensation Plans (cont.)

- Exempt stock options can be settled in change of control transactions on same terms applicable to stockholders generally, without affecting exemption
- Short-term deferral can apply if payment is made outside the short-term deferral period if service recipient reasonably anticipates making the payment would violate law and the payment is made as soon as reasonably practicable following the date the payment would not cause violation


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New Section 409A Guidance on Design of Executive Compensation Plans (cont.)

- Employees hired in current year can qualify for “2 x 2” exception to pay severance
- Added flexibility regarding timing of payments following death (and, in certain instances, disability or unforeseeable emergency)
- Right to payment/reimbursement of attorneys’ fees and expenses incurred to pursue a bona fide legal claim against the service recipient with respect to the service relationship does not provide for a deferral of compensation
- Final income inclusion regulations expected by June 30, 2018

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New Section 457 Guidance on Design of Executive Compensation Plans

- Background: Section 457(f) generally governs the deferral of compensation payable by tax-exempt entities to their employees
- Amounts deferred under a severance plan subject to Section 457 are generally taxable to the employee on the later of (i) the first date on which there is a legally binding right to the compensation or (ii) the first date on which the substantial risk of forfeiture lapses if the compensation is subject to a substantial risk of forfeiture
- Amounts are subject to a “substantial risk of forfeiture” only if entitlement is conditioned on the “future performance of substantial services” – Mismatch between tax event and receipt of income if substantial risk of forfeiture lapses before employee actually receives deferred income
- New guidance offers greater flexibility to offer compliant bona fide severance plans

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FASB guidance permitting share withholding in excess of minimum statutory rate

- FASB allows share withholding up to maximum statutory rate in applicable jurisdiction without causing adverse accounting consequences for award
- Effective for public companies for annual reporting periods beginning after 2/15/2016, and for private companies for annual reporting periods beginning after 12/15/2017

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FASB guidance permitting share withholding in excess of minimum statutory rate (cont.)

- Issues raised by implementation
  - Review equity plan and award agreements
    - Shareholder approval generally not required under NYSE and Nasdaq listing requirements
    - ISS Share recycling issue: A plan permitting withheld shares to be added back to share reserve should consider whether to limit number of shares that can be added to plan in light of ISS guidance
  - Section 16 issues
    - Specific approval of share withholding before shares withheld for Section 16 officers
    - Risks of company retaining discretion to withhold
    - Withholding should not exceed estimated tax obligations for Section 16 officer attributed to equity award
  - Coordination required between payroll and stock plan administrators

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T+2 stock settlement

- Broker-dealers need to comply beginning 9/5/2017
- Recognition of improved technology and growing trading volumes
- Need to coordinate payroll and stock plan administration


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New FASB revenue recognition standard ASU 2014-09

- Disclosures required to allow investors to “understand nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.”
- Transition Method
  - Full Retrospective Method: Disclose effect for each reporting period that has been retrospectively adjusted
  - Modified Retrospective Method: Disclose effect in current reporting period

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New FASB revenue recognition standard ASU 2014-09 (cont.)

- Match contract payments with performance obligations
- Revenue recognized when performance obligation is complete
- GAAP revenue becomes more volatile


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New FASB revenue recognition standard ASU 2014-09 (cont.)

- Revenue metrics in incentive arrangements
  - Keep two sets of numbers – one for new standard, one for compensation awards
  - Change arrangement
- Addressing multi-year metrics
- Managing communications and disclosures
  - Lowered targets may appear to be amendments to make goals more readily achievable
  - Clear disclosure required to explain reasons underlying decisions

Designing and Implementing an Effective Executive Compensation Plan: Your Guide for 2017 & Beyond

Q&A:

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