Skadden

2019 Compensation Committee Handbook

Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates

2019 Compensation Committee Handbook

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Preface

The duties imposed on compensation committees of publicly traded companies have evolved and grown over time. This fifth edition of the *Compensation Committee Handbook* from the lawyers of the Executive Compensation and Benefits group at Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates is intended to help compensation committee members understand and comply with the duties imposed upon them. We have also undertaken to describe in some detail the concepts underlying a variety of areas within the bailiwick of compensation committees (for instance, the types of equity awards that are commonly granted and their respective tax treatment) and to provide our perspective on some of the many decisions that compensation committees must make (for instance, the pros and cons of hiring a compensation consultant and the factors that go into that hiring decision).

In short, we hope that this Handbook will help compensation committee members understand their responsibilities and how best to discharge them.

We deliberately wrote this Handbook in a non-technical manner. We intend it to be something to read, not something to parse — more of a "how to" guide than a reference source for arcane rules. With that said, some of the chapters deal with technical rules, and at some length, where we think it is essential for compensation committee members to appreciate them.

Precisely because so many of the applicable rules are technical and complex and because the circumstances addressed by compensation committees are often nuanced to begin with, it is important to recognize that this Handbook has limitations, in part again due to our non-technical approach to writing it. As such, compensation committee members should not expect this Handbook to be an exhaustive compliance manual.

Indeed, in some places, this Handbook may even raise questions, not answer them. We hope so, because that means we achieved what we set out to do — to help compensation committee members think in a fresh way about what they are charged with doing and why.

This Handbook focuses on considerations for publicly traded companies and specifically those listed on the NYSE or Nasdaq. Many of the principles discussed have broader application, however.

There have been significant developments over this past year to executive and director compensation practices, and those are discussed in this new edition of the Handbook, particularly with respect to the application of 162(m) of the Internal Revenue Code (discussed principally in Chapter 8) and director compensation litigation (discussed principally in Chapter 13).

We expect that this Handbook will evolve further over time to address the seemingly never-ending developments in the legal and commercial landscape applicable to compensation committee responsibilities. In the meantime, we of course welcome any questions you might have.

Chapter 1

Overview of Committee Member Responsibilities

Compensation committee (Committee) members' duties and responsibilities generally are outlined in the Committee's organizational charter (Charter) approved by the Board of Directors (Board) of the applicable company (Company), which should reflect requirements imposed by the securities exchanges, some of which are the result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank), applicable Securities Exchange Commission (SEC) regulations and other legal limitations. All of those obligations are discussed in greater detail later in this Handbook.

The Committee is responsible for establishing and overseeing an executive compensation program for the Company. The Committee should make executive compensation decisions within the context of its members' executive compensation philosophies and the corporate governance standards applicable to directors generally.

This chapter provides an overview of the most important considerations that relate to the proper discharge of the Committee's responsibilities, including the role of advisors to the Committee. The remaining chapters address those considerations in more detail.

Overview of Committee Member Responsibilities

Adopting and Implementing a Compensation Philosophy

The Committee is responsible for establishing or recommending to the Board the various components of compensation for the Company's senior executives, which typically consist of some of the following components, among others: base salary, annual bonuses (which are usually paid in cash), long-term incentives (which may consist of cash or equity-based awards, or a combination), executive benefit plans (for instance nonqualified deferred compensation plans, including supplemental pension and savings plans) and perquisites. The Committee often will need to make compensation decisions on an ad-hoc basis, for example to provide specialized incentives for particular circumstances (such as a corporate transaction or special performance initiatives) that were not contemplated in the ordinary course.

> The most common philosophy surely has been and remains "pay for performance."

The Committee's overarching compensation philosophy should enable it to assess the suitability of various compensation program components in a rigorous way. The most common philosophy in more recent years surely has been and remains "pay for performance" — though that of course begs the question of what type of performance is rewarded and how. For most companies, stock price performance is one natural measure of success; that is not necessarily the case for all companies, however, and the Committee should be sure to consider whether other measures are appropriate (and of course to consider as well whether a pay for performance model is not appropriate for the Company in the first instance).

One consideration in implementing a compensation philosophy is determining how much potential pay should be fixed (typically in the form of salary and benefits) and how much should be "at risk" (typically in the form of cash or equity incentive compensation).

- The implementation of the philosophy may differ depending on the level of the affected executive. For example, it is common for more senior executives to have more pay "at risk" than lower level executives.
- Another important consideration for the at risk component of compensation is whether the incentive should be short-term (typically annual) or longer-term in nature.

In recent years there has been a much-discussed trend toward a greater portion of pay being at risk in the form of long-term compensation based on performance rather than time-based vesting criteria, a trend that seems to have been well received by shareholders.

Corporate Governance Standards — Business Judgment Rule

Most directors are familiar with the so-called business judgment rule that applies in respect of Delaware companies and that has analogs in most other states. The business judgment rule was developed as a complement to a director's two fundamental fiduciary

duties under Delaware corporation law, first, the duty of loyalty, which requires a director to act without self-interest and in a manner that the director honestly believes is in the best interests of the Company and its shareholders and, second, the duty of care, which requires the director to act prudently and with diligence.

The business judgment rule creates a rebuttable presumption that in making a business decision, directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the Company and its shareholders. The protection of the business judgment rule is not absolute. It can be rebutted if a plaintiff can present facts sufficient to support a claimed breach of duty.

In assessing a claim of breach of the duty of care, the courts place emphasis on process and look for objective evidence that directors undertook a careful, educated decision-making process. Accordingly, when making a decision, directors should:

- become familiar with all material information reasonably available in order to make an informed decision;
- secure independent expert advice (for instance from legal counsel or a compensation consultant) where appropriate and fully understand the expert's findings and the bases underlying such findings;
- actively participate in discussions and ask questions of officers, employees and outside experts, rather than passively accept information presented;
- understand and weigh alternative courses of conduct that may be available and the impact of such alternatives on the Company and its shareholders; and
- take appropriate time to make an informed decision.

These considerations apply equally to Committee members when making determinations regarding compensation matters.

Where compensation decisions involve directors paying themselves, Delaware courts are particularly cognizant of the need for careful scrutiny. Self-interested compensation decisions made without independent protections are subject to the same entire fairness review as any other interested transaction. The compensation of directors as such is discussed further in Chapter 13.

Special considerations apply in the case of tender offers and in the mergers and acquisitions (M&A) context generally. These considerations are discussed in Chapter 12.

Communicating the Executive Compensation Program to Shareholders

Compensation Discussion and Analysis

One of the most visible roles of the Committee is to discuss with management the Compensation Discussion and Analysis (CD&A) that is included in the Company's annual SEC filings and to recommend to the Board that the CD&A be included in the filings. As discussed in greater detail in Chapter 4, the members of the Committee must sign a Compensation Committee Report attesting that it has discharged that obligation.

While preparation of the CD&A is the responsibility of management, it is important that the Committee be involved at all stages. Ultimately the CD&A is describing the compensation philosophy and programs that the Committee has approved for the

Company's executive officers, and the Committee is effectively confirming it is in agreement with the contents by recommending inclusion of the CD&A in the Company's SEC filings.

It is not enough that the CD&A be accurate, however, because the CD&A can greatly influence the outcome of the say on pay shareholder vote discussed in greater detail in Chapter 4. It also should be a persuasive advocacy piece for why the compensation philosophy and programs are appropriate for the Company. Moreover, in some cases — typically where the Company received a low favorable say on pay vote in the prior year — the pay practices described in the CD&A may cause proxy advisory firms (such as Institutional Shareholder Services (ISS) and Glass Lewis) to recommend voting against a Committee member's re-election, which of course is unwelcome attention.

While preparation of the CD&A is the responsibility of management, it is important that the Committee be involved at all stages.

Where shareholder support for the say on pay vote is low, it can often make sense to meet with significant shareholders to explain the Committee's decisions and permit them to ask questions and raise concerns. While such meetings are sometimes arranged and attended by management rather than Committee members, in many cases direct involvement by Committee members can be helpful in addressing specific shareholder concerns.

Internal Controls/Risk

Item 402(s) of Regulation S-K (discussed in greater detail in Chapter 4) requires that the Company disclose in its SEC filings its policies and practices for compensating employees, including nonexecutive officers, as they relate to risk management practices and risk-taking incentives to the extent that the risks arising from those policies and practices are reasonably likely to have a material adverse effect on the Company.

- Companies typically conclude that their policies and practices do not create risks that are reasonably likely to have a material adverse effect.
- While the responsibility for making that determination is not expressly imposed on the Committee, the determination typically is made by the Committee based upon a management presentation, a result that is of course not surprising given the Committee's role in establishing those policies and practices.
- In making its determination, the Committee should also consider whether the Company has internal controls in place that are reasonably designed to ensure that the compensation policies and practices are properly administered and that they are not subject to manipulation and further to ensure that the information required to generate proxy disclosure of that compensation is accurately captured.

In short, it is rare, but not impossible, for a Company to conclude that its compensation policies and practices are reasonably likely to have a material adverse effect on the Company. If that is the case, the Committee would likely seek to mitigate those risks. Accordingly, as noted above, most disclosure that implicates Item 402(s) simply recites that the Company has determined that there is no such risk.

Input From Compensation Consultants/Management

The Committee may give considerable weight to the views of management and its advisors in establishing its compensation philosophy and making compensation decisions under it, but ultimately the Company's executive compensation programs are the responsibility of the Committee, not management or the Committee's advisors.

Committees often retain compensation consultants to help guide their view on the appropriate compensation for executive officers and particularly how the Company's programs compare to those at other peer companies. Such reliance can help the Committee substantiate that it has complied with the conditions underlying the protections offered by the business judgment rule as discussed above. However, the Committee must be sure not to substitute the judgment of its consultant for its own, as ultimate responsibility for the compensation philosophy and programs lies with the Committee.

Chapter 3 addresses particular concerns in regard to the retention of advisors by the Committee, including independence assessment requirements imposed under the Dodd-Frank Act and the related stock exchange rules.

Recent Legislative/Regulatory/Political Developments

During the past year, a sweeping tax reform law dramatically changed the landscape of executive compensation, the full effects of which are not yet fully known. These changes — principally relating to Section 162(m) of the Internal Revenue Code (Code) — are described in greater detail in Chapter 8.

Additionally, certain Dodd-Frank rules that were proposed under the Obama administration (for example, the rule related to clawback of executive compensation) have still not been finalized. In 2018, the Trump administration helped engineer some changes to Dodd-Frank unrelated to executive compensation, and some commentators still expect to see additional changes to Dodd-Frank. In any event, it remains unclear whether the proposed clawback rules or the other still-pending executive compensation rules will be finalized anytime in the foreseeable future.

It is not possible to predict what additional changes to executive and director compensation practices may be forthcoming given the dynamic political atmosphere in Washington, but in any event Committees should take care to be sensitive and responsive to any developments.

Chapter 2

Stock Exchange and Committee Charter Requirements

Committees are subject to requirements from a variety of sources, including the stock exchanges (only the NYSE and Nasdaq requirements are discussed in this chapter), the Charter that governs the Committee's operations and various statutory/regulatory requirements.

Stock Exchange and Committee Charter Requirements

Exchange Requirements

NYSE Obligations

NYSE-listed companies are required to have a Committee that is composed entirely of independent directors and subject to a written Charter, which must be posted on the Company's website. The requirement to have an independent compensation committee does not apply to controlled companies, limited partnerships, companies in bankruptcy proceedings, management investment companies registered under the Investment Company Act, passive investment organizations in the form of trusts, listed derivatives and special purpose securities, and foreign private issuers.

NYSE imposes certain responsibilities on the Committee. These responsibilities may be delegated to subcommittees but any subcommittee must be composed entirely of independent directors and have a Charter (which likewise must be posted on the Company's website).

Under the NYSE rules, the Charter must address the Committee's purpose and responsibilities, which must include responsibility to:

- review and approve goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of such goals and objectives, and, either as a committee or together with the other independent directors (as directed by the Board), determine and approve the CEO's compensation based upon this evaluation;
  - » In determining the long-term incentive component of CEO compensation, NYSE commentary recommends, but does not require, that the Committee consider the Company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the Company's CEO in past years.
  - » The Committee is not precluded from discussing CEO compensation with the Board generally.
- recommend non-CEO executive officer compensation to the Board for approval together with any incentive and equity-based compensation plans that are subject to Board approval;
- prepare the Compensation Committee Report required under Regulation S-K; and
- provide for an annual performance evaluation of the Committee.

The rules also recommend (but do not require) that the Charter address:

- Committee member qualification, appointment and removal;
- Committee structure and operations; and
- Committee reporting to the Board (including authority to delegate to subcommittees).

Under NYSE rules adopted in response to a mandate under the Dodd-Frank Act, the Committee may, in its sole discretion, retain or otherwise obtain the advice of compensation consultant, independent legal counsel or other advisor, and is directly responsible for the appointment, compensation and oversight of that advisor's work. These rules are discussed in greater detail in Chapter 3.

Nasdaq Obligations

Nasdaq-listed companies, pursuant to a mandate under the Dodd-Frank Act, are required to have a Committee consisting of at least two independent directors. The requirement to have an independent compensation committee does not apply to controlled companies, limited partnerships, management investment companies registered under the Investment Company Act of 1940, asset-backed issuers and other passive issuers, cooperatives, and foreign private issuers.

Under exceptional and limited circumstances (as determined by the Board), and provided the Committee comprises at least three members, one non-independent director may be appointed to the Committee. A member appointed under this exception may not serve longer than two years and the Company must disclose either on its website or in its proxy statement the nature of the director's relationship with the Company and the reasons why he or she was appointed notwithstanding such relationship.

Under the Nasdaq rules, the Company must adopt a written compensation committee Charter, which must be reviewed at least annually by the Committee and should be posted on the Company's website (or included as a proxy statement appendix once every three years or in any year in which the Charter was materially amended). The Charter must specify:

- the scope of the Committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;
- that the Committee will determine or recommend to the Board the compensation of the CEO and all other executive officers; and
- that the CEO may not be present during voting or deliberations on his or her compensation (no similar limitation exists for other executive officers).

As a result of the same Dodd-Frank Act mandate that gave rise to the NYSE rules (and as discussed further in Chapter 3), Nasdaq rules also provide that the Committee may, in its sole discretion, retain or otherwise obtain the advice of a compensation consultant, independent legal counsel or other advisor.

Charter Obligations

Companies should endeavor to create a compensation committee Charter that best reflects their current circumstances and avoid a "one size fits all" approach. Below are some topics that companies should consider when creating or updating a Charter:

- **Purpose.** The Charter should include a description of the Committee's purpose, including for example overseeing the Company's compensation and employee benefit plans and practices, including its executive compensation plans, and its incentive compensation and equity-based plans.
- **Composition.** The Charter should establish the minimum Committee size and address appointment, removal, resignation and replacement of Committee members.

- **Meetings and Minutes.** The Charter should establish a targeted minimum number of annual meetings and any notice/quorum requirements. The Charter should address procedures for maintaining minutes and records and reporting to the Board.
- **Duties and Responsibilities.** The Charter should address the Committee's duties and responsibilities regarding:
  - » the Company's executive compensation plans;
  - » CEO and non-CEO executive officer compensation;
  - » director compensation (unless addressed by a separate committee or the Board as a whole);
  - » consideration of the most recent advisory say on pay vote;
  - » review and discussion of the CD&A with management, and recommending inclusion of the CD&A in the Company's annual proxy statement or annual report on Form 10-K;
  - » preparation and inclusion of the Compensation Committee Report in the Company's annual proxy statement or annual report on Form 10-K; and
  - » evaluation of whether incentive and other forms of pay encourage unnecessary or excessive risk taking.

  The Charter also should address the Committee's duties and responsibilities in respect of general compensation and employee benefit plans, including incentive-compensation plans and any pension or equity-based plans.

Companies should endeavor to create a compensation committee Charter that best reflects their current circumstances and avoid a "one size fits all" approach.

- **Delegation of Authority.** The Charter should address the Committee's ability to delegate its duties to subcommittees or others. Care should be taken to ensure that, if desired, any delegation complies with the performance-based compensation requirements of Section 162(m) of the Code to the extent they remain applicable and Rule 16b-3 under the Securities Exchange Act of 1934 (Exchange Act), each of which is discussed in greater detail in Chapters 8 and 9, respectively.
- **Evaluation of the Committee.** The Charter should provide that the Committee will conduct an annual self-evaluation of its performance and review of the Charter.
- **Consultants and Advisors.** The Charter should address the Committee's rights and responsibilities under the applicable NYSE and Nasdaq listing rules, as described above under "Exchange Requirements."

Dodd-Frank Clawback Rules

In July 2015, the SEC issued long-awaited proposed rules that would implement the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Act. As proposed, the rules would direct the stock exchanges to adopt listing standards requiring listed companies to develop and implement clawback policies and satisfy

related disclosure obligations. Under the proposal, all listed companies (including foreign private issuers, controlled companies, emerging growth companies (which are discussed further in Chapter 4) and smaller reporting companies, but excluding certain registered investment companies) would be required to adopt a "no-fault" clawback policy generally providing for recovery of incentive-based compensation awarded to any current or former executive officer during the three-year period preceding the year in which the Company is required to prepare an accounting restatement resulting from material noncompliance with financial reporting requirements. Under a "no-fault" policy, noncompliance need not result from misconduct, unlike the clawback provisions enacted as part of the Sarbanes-Oxley Act of 2002 (SOX) discussed below. Under the proposed rules, the Company could be subject to delisting if it does not adopt a clawback policy that complies with the applicable listing standard, disclose the policy in accordance with SEC rules or comply with the policy's recovery provisions.

The Dodd-Frank provisions expand upon, but do not replace, the SOX clawback provisions, which provide that if a company is required to prepare an accounting restatement because of "misconduct," the CEO and CFO (but no other individuals) are required to reimburse the company for any incentive or equity-based compensation and profits from selling company securities received during the year following issuance of the inaccurate financial statements. If a company's CEO or CFO is required to reimburse an issuer pursuant to Section 304 of SOX, any amounts recovered would be credited against any amounts owed under the proposed Dodd-Frank rule. Notably, while the SOX clawback provisions require the existence of misconduct, the 9th Circuit court, in *SEC v. Jensen* (August 31, 2016), held that Section 304 of SOX allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from personal misconduct on the part of those officers.

The proposed rule still has not been finalized, and it is unclear whether the SEC will do so anytime soon, but in any event, companies would not be subject to the requirements of the proposed rules until the stock exchanges propose and adopt their new listing standards, which will occur only after the SEC adopts final rules. Once the new listing standards are in effect, a listed company will be required to comply with the disclosure requirements in its first annual report or proxy or information statement, as well as meet the applicable standards within 60 days of the effectiveness of the listing standards in order for its shares to continue trading on that exchange. A listed company would be required to recover all excess incentive-based compensation that is granted, earned or vested on or after the effective date of the adopted SEC rule that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after that effective date.

Other Statutory/Regulatory Requirements

There are various additional statutory and regulatory requirements that govern the administration of executive compensation programs, most notably those imposed under SEC and IRS regulations. These requirements are discussed in greater detail in the remaining chapters, principally in Chapters 4, 8, 9 and 11.

Chapter 3

The Use of Advisors by the Compensation Committee

As Committees grapple with the heightened complexity of the compensation setting process — including the technical details of various forms of compensation and the increased transparency and potential for close scrutiny through public disclosures — it is common for them to seek assistance from external advisors and consultants. In particular, many Committees engage and seek the advice of compensation consultants, legal counsel or other advisors such as proxy solicitation firms. In fact, the NYSE and Nasdaq listing standards both provide that a Committee's Charter must address the Committee's authority to retain advisors and require the Committee to provide for funding of any such advisors.

The Use of Advisors by the Compensation Committee

The Pros and Cons of Using an Advisor

PROs

- **Access to Peer Company and Other Executive Compensation Data.** As part of setting or reviewing compensation for the Company's executive officers, the Committee often will take into consideration the compensation data disclosed by peer or other companies and may actively use that data to make adjustments to compensation levels or awards for the Company's executive officers. Consultants can assist with the collection, organization and analysis of compensation data, often tailored to provide useful comparisons to the Company's actual executive officers' positions and roles.
- **Expert Advice Regarding Compensation Trends and Design of Compensation Programs.** Consultants may assist with identifying trends in public company executive compensation, including changes within the Company's peer group in terms of design of compensation arrangements, forms of compensation awards and allocations of overall compensation into different types of compensation awards (*e.g.*, the allocation of performance-based compensation vs. compensation that is not at risk).
- **Expert Advice Regarding Potential Investor Perception of and Reaction to Compensation Arrangements.** Consultants may advise on the potential reaction to levels or elements of compensation by investors or shareholder advisory services such as ISS or Glass Lewis. This understanding can be critical to understanding the impact of compensation decisions on say on pay voting or the likelihood of approval of other proxy proposals such as equity compensation plan approvals.
- **Assistance With and Analysis of Technical/Legal Compliance.** Legal advisors can assist with compliance with the myriad legal and regulatory requirements that must be satisfied in connection with any compensation decision. From disclosure obligations and consequences to understanding of tax consequences under Sections 409A, 162(m) or 280G of the Code (discussed in greater detail in Chapter 8), individual compensation decisions may have dramatic and adverse legal consequences.
- **Additional Protection Against Litigation Relating to Director Compensation.** As discussed in Chapter 13, recent years have seen an increase in shareholder claims relating to director compensation, in particular regarding the level of judicial review courts will apply to directors' decisions relating to their own compensation. Reliance on (and disclosure of the advice received from) a compensation consultant and legal advisors can help mitigate the risk of such suits.
- **Third-Party Assessment and Opinions Regarding Compensation Decisions.** While the advisor need not be "independent" under any specific statutory or regulatory guidelines, input and analysis from an advisor retained by the Committee can be a relevant and useful data point for consideration by the Committee.

CONs

- **Expense.** The retention and use of an advisor may add significant expense to the compensation decision-making process.

- **Time.** Inclusion of an advisor in the compensation decision-making process may result in additional time required to adequately assess and process the advisor's contributions. However, this may be managed through efficient use of and instructions to the advisor.
- **Inappropriate Reliance on the Advisor.** While an advisor may be helpful in providing advice to the Committee, the Committee must be mindful of its duties and obligations and take care to not let an advisor's philosophy or recommendations supplant its own. An advisor should be a tool for the Committee to avail itself of as it makes its decisions, not a replacement for the Committee's own analysis and conclusions.

Types of Advisors Commonly Used

External Compensation Consultant. The Committee may retain directly the services of one of the many compensation consulting firms. Typically, the consultant is retained directly by, and reports to, the Committee.

Management-Retained Compensation Consultant. In some circumstances, Company management may retain a compensation consultant to assist management with the review and formulation of compensation proposals for recommendation to the Committee. Under this approach, the consultant is retained by and reports to management, not the Committee.

Company Legal Counsel. Often, the Company has retained and management then works with legal counsel. Under this common approach, legal counsel is retained by Company management to assist with executive compensation legal issues and provides advice to the Company on which the Committee then relies.

External Legal Counsel. The Committee may find it desirable to retain legal counsel with expertise in executive compensation issues to provide advice directly to the Committee.

Proxy Solicitation Firms. With the advent of say on pay votes, influence of shareholder advisory firms such as ISS and Glass Lewis and increased shareholder activism and proxy-related litigation, Committees have found it helpful to enlist the services of firms specializing in proxy-solicitation analysis and advice. Typically, such firms are retained by the Company, but their advice may be provided directly or indirectly to the Committee for its consideration as part of the compensation decision-making process.

Retention of the Advisor — Practical Considerations

It is common for a Committee to retain compensation consultants or other advisors directly. Where the Committee engages an advisor directly, the terms of its engagement should be in writing and specify at a minimum:

- the scope and role of the advisor's engagement;
- the Committee's expectations with respect to the advisor, including deliverables expected of the advisor and responsibilities to attend Committee meetings;
- any limitations on the scope of what is expected of the advisor;

- the time period for the engagement (it is common for such engagements to be made on an annual basis, with the Committee engaging in an annual review of the advisor's performance and making a determination whether to renew the advisor's appointment);
- the person or persons to whom the advisor will report;
- the person or persons in whom the authority to terminate the relationship with the advisor resides;
- the fees, costs and bases on which the advisor will be compensated for its services; and
- the advisor's commitment to provide the Committee with information necessary for the Committee to satisfy its independence analysis of the advisor, as discussed below.

The Committee can utilize the assistance of management in connection with its direct retention of an advisor. Management may assist in proposing advisors for retention, schedule and participate in interviews of proposed advisors as well as provide input as to the proposed scope of the advisor's role and responsibilities. However, care should be taken in connection with management's involvement in the advisor engagement processes to ensure the advisor is made cognizant of its role as advisor to the Committee (and not management), reporting to and subject to the Committee's direction.

In some circumstances, management may engage an advisor of its own, which then provides, directly or indirectly, advice to the Committee. A common example of this is external legal counsel retained by the Company, whose advice is provided to the Committee and who may participate in Committee meetings and deliberations. In many circumstances, involvement by a management-retained advisor will be the most efficient means of providing robust analysis of compensation decisions, especially where advice is sought on a real-time basis in the midst of Committee deliberations, or where legal review is sought of a management proposal in advance of its presentation to the Committee. It is not uncommon for legal counsel retained by the Company to work closely with a compensation consultant who has been retained by the Committee. As a practical matter, an advisor retained by management may work most effectively to implement the Committee's decisions as a result of more regular day-to-day interaction between the advisor and management.

In any event, the Company must provide appropriate funding, as determined by the Committee, for payment of reasonable compensation to the advisor.

Retention of the Advisor — NYSE and Nasdaq Listing Standards

Independence Factors

Under the NYSE's and Nasdaq's current listing standards, *before* selecting or receiving advice from a compensation consultant or other advisor (whether in respect to executive compensation decisions or otherwise), the Committee must take into consideration the following factors:

- the provision of other services to the Company by the advisor's employer;
- the amount of fees received from the Company by the advisor's employer, as a percentage of the total revenue of the advisor's employer;

- the policies and procedures of the advisor's employer that are designed to prevent conflicts of interest;
- any business or personal relationship of the advisor with a member of the Committee;
- any stock of the Company owned by the advisor; and
- any business or personal relationship of the advisor or the advisor's employer with an executive officer of the Company.

In addition, the NYSE requires consideration of *all* factors relevant to an advisor's independence. Nasdaq does not have a similar catch-all requirement.

Importantly, neither the NYSE nor Nasdaq listing standards preclude the Committee from selecting or receiving advice from an advisor even where one or more of the factors set forth above evidence an actual or perceived conflict of interest. The listing standards simply require that the factors above be considered in advance of any selection or receipt of advice. However, the assessment that a conflict of interest with respect to a compensation consultant exists after consideration of these factors may result in additional disclosure obligations under Item 407(e) of Regulation S-K, as discussed below.

Typically, compensation consultants and other advisors provide upon request information responsive to the independence consideration factors set forth above. The Committee should take steps to reflect its consideration of those factors in meeting minutes or any other record of its proceedings. Further, the Committee should be prepared to reassess these factors on an ongoing basis, including in connection with any reapproval of a consultant's retention. The Committee should instruct its advisors to bring any changes in respect of these factors to its attention on a timely basis, and before the Committee receives additional advice from the advisor.

Consultant for Management: Special Considerations

One issue that has surfaced following the approval of the final NYSE and Nasdaq compensation committee advisor independence rules is how and whether those rules are implicated where an advisor is retained by management on behalf of the Company and not the Committee. In those circumstances, the Committee should determine whether advice from the management-retained advisor ultimately will be provided to and relied upon by the Committee. In many cases, the advice is sought by management from advisors retained by the Company but the ultimate advice delivered to the Committee is provided to the Committee by the Company's internal legal counsel or other management members following their review of the outside legal advisor's advice. In such circumstances, the Committee may not need to engage in any analysis of the independence of the advisor retained by management because the advice actually provided to the Committee is from a management member who is recognized *per se* by the Committee to not be independent.

In other circumstances, the role of an advisor retained by management may be different. For example, the advisor may be relaying his or her advice directly to the Committee or the advice may be expressly presented by management as advice originating from the advisor. In those cases, the Committee may wish to have the management-retained advisor provide it with information sufficient to analyze the independence factors set forth above in advance of receiving such advice. In either

circumstance, it is a best practice for the Committee to have an understanding of the source — and independence — of the advice on which it is relying, whether it is from management, an advisor retained by management, or an advisor retained directly by the Committee.

One issue that has surfaced following the approval of the final NYSE and Nasdaq compensation committee advisor independence rules is how and whether those rules are implicated where an advisor is retained by management on behalf of the Company and not the Committee.

Because it may not always be clear whether advice provided to management is ultimately provided to and relied upon by the Committee, or because an advisor who typically interfaces with management may be called unexpectedly and in short order to provide advice directly to the Committee, it may make sense for advisors to be assessed for independence on a prophylactic basis even where it is not presently expected that they will provide advice directly to the Committee.

Disclosure Obligations

In General

The extent to which an advisor is involved in the compensation-setting process for executive officers must be disclosed by the Company in the following circumstances:

First, the CD&A should include, if material, disclosure regarding the role a compensation consultant plays in the Company's compensation-setting process.

Second, Item 407(e) of Regulation S-K requires additional disclosure regarding the use of compensation consultants in certain circumstances. Specifically, Item 407(e)(3)(iii) requires disclosure of the role of compensation consultants in determining or recommending the amount or form of executive and director compensation during the Company's last fiscal year. The identity of the consultant should be included, together with a statement of whether the consultant was engaged directly by the Committee (or persons performing the equivalent functions) or any other person. The disclosure must describe the nature and scope of the consultant's assignment and the material elements of the instructions or directions given to the consultant with respect to the performance of its duties under the engagement. This disclosure obligation does not apply to any role of a compensation consultant that is limited to consulting on broad-based plans that do not discriminate in scope, terms or operation in favor of executive officers or directors of the Company and that are available generally to all salaried employees, or is limited to providing information that is not customized for the Company or that is customized based on parameters that are not developed by the compensation consultant and about which the compensation consultant does not provide advice.

Additional Fee Disclosure

Additional disclosure must be provided if a consultant provides services other than executive compensation advice to the Committee or management. Specifically, if a consultant was engaged by the Committee to provide advice or recommendations on the amount or form of executive or director compensation and the consultant and its affiliates also provided additional services to the Company with a value in excess of $120,000 during the last fiscal year, then disclosure is required of the aggregate fees for determining the amount or form of executive and director compensation and the aggregate fees for the additional services. In addition, disclosure must be provided as to whether the decision to engage the consultant or its affiliates for the additional services was made, or recommended, by management, and whether the Committee or the Board approved the additional services of the consultant or its affiliates.

Moreover, under Item 407(e)(3)(iii)(B) of Regulation S-K, if the Committee has not engaged a compensation consultant, but management has engaged a consultant to provide advice or recommendations on the amount or form of executive and director compensation for which disclosure is required under Item 407(e)(3)(iii) and the consultant or its affiliates has provided additional services to the Company with a value in excess of $120,000 during the last fiscal year, then disclosure must be provided as to the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the consultant or its affiliates.

Conflicts of Interest

Item 407(e)(3)(iv) of Regulation S-K requires that, with regard to any compensation consultant whose work has raised any conflict of interest, disclosure must be included as to the nature of the conflict and how the conflict is being addressed. Instructions to Item 407(e)(3)(iv) indicate that the following six factors should be considered in determining whether a conflict of interest exists:

- the provision of other services to the Company by the advisor's employer;
- the amount of fees received from the Company by the advisor's employer as a percentage of the total revenue of the advisor's employer;
- the policies and procedures of the advisor's employer that are designed to prevent conflicts of interest;
- any business or personal relationship of the advisor with a member of the Committee;
- any stock of the Company owned by the advisor; and
- any business or personal relationship of the advisor or the advisor's employer with an executive officer of the Company.

These are the same factors set forth above in connection with the independence assessment required of the Committee under the NYSE and Nasdaq listing standards.

As a result of these disclosure obligations, the Committee should expect that any use of an advisor in connection with its decision-making process may trigger public disclosure of the advisor's role. The extent of and need for such disclosure should be reviewed with legal counsel.

Chapter 4

SEC Filings

The Committee assists with and supervises the Company's compliance with its public disclosure requirements. This chapter provides an overview of two disclosure requirements that implicate Committee concerns:

- the executive compensation disclosure required under Item 402 of Regulation S-K (which usually is set forth in a Company's annual proxy statement but can be required in certain other public filings); and
- the requirement to disclose certain personnel and compensation matters on SEC Form 8-K.

SEC Filings

Special Note About Emerging Growth Companies

It is important to note that special rules apply to so-called emerging growth companies (EGCs), a category of company created under the Jumpstart Our Business Startups (JOBS) Act in 2012. For instance, the disclosure discussed below under Item 402 of Regulation S-K is greatly simplified for EGCs, in that fewer individuals are subject to the disclosure, no CD&A is required, and certain portions of the otherwise required tabular disclosure may be omitted. Members of the Committee of an EGC should seek special counsel focused on the Company's status as an EGC.

An EGC is defined as an issuer that had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year (as adjusted for inflation from the original $1.0 billion). An issuer that is an EGC continues to be an EGC until the earliest of:

- the last day of the fiscal year during which it had total annual gross revenues of at least $1.07 billion;
- the last day of the fiscal year following the fifth anniversary of the initial public offering of its equity;
- the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or
- the date on which it is considered to be a "large accelerated filer" under the Exchange Act.

An issuer does not qualify as an EGC if it conducted an equity IPO on or before December 8, 2011.

Regulation S-K Item 402 Disclosure

CD&A (Item 402(b)(1))

In General. The Company must provide in narrative form a general overview of its executive compensation practices as they apply to the Company's named executive officers (NEOs). The CD&A must cover compensation for the preceding fiscal year, but should also discuss post-termination compensation arrangements that were in effect during that year (even if not triggered) and also, if they could affect a fair understanding of compensation for the preceding fiscal year, new compensation arrangements and policies (or arrangements or policies from earlier years).

The NEOs include for any year the Company's CEO and CFO, the three most highly compensated employees other than the CEO and CFO serving as an executive officer at the end of the year and up to two additional individuals for whom disclosure would have been provided (*i.e.*, because they had higher compensation than one of the other additional three executives) except that the individual was not serving as an executive officer of the Company at the end of the fiscal year.

The CD&A is designed in large part to facilitate an understanding of the detailed tabular presentation of compensation that follows it (as discussed further below). At a minimum, the Company must discuss each element of the following:

- the material principles underlying the Company's executive compensation policies and decisions;
- the objectives of the Company's compensation programs;
- what the compensation programs are designed to reward;
- each element of compensation;
- why the Company chooses to pay each element;
- how the Company determines the amount (and, where applicable, the formula) for each element it pays; and
- how each compensation element and the Company's decisions regarding that element fit into the Company's overall compensation objectives and affect decisions regarding other elements.

Other required disclosures will vary based on facts and circumstances, but the SEC has identified the following list of potential material information, which, among others, may need to be discussed if applicable to the Company:

- policies for allocating between long-term and currently paid out compensation;
- policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- for long-term compensation, the basis for allocating compensation to each different form of award;
- how the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
- what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- how specific elements of compensation are structured and implemented to reflect these items of the Company's performance and the executive's individual performance;
- how specific forms of compensation are structured and implemented to reflect each NEO's individual performance and/or individual contribution to these items of the Company's performance, describing the elements of individual performance and/or contribution that are taken into account;
- policies and decisions regarding the adjustment or recovery of awards or payments if performance measures are restated or adjusted in a manner that would reduce the award or payment (*i.e.*, clawback policies);
- the factors considered in decisions to increase or decrease compensation materially;
- how compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (*e.g.*, how gains from prior option or stock awards are considered in setting retirement benefits);
- with respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payments at, following, or in connection with any termination or change in control, the basis for selecting particular events as triggering payment;

- the impact of accounting and tax treatments of a particular form of compensation including the consequences under Section 409A and Section 162(m) of the Code, to the extent applicable, which are discussed in Chapter 8, and the Company's general approach to compliance with any remaining performance-based compensation requirements under Section 162(m);
- the Company's stock ownership requirements or guidelines and any policies regarding hedging the economic risk of such ownership;
- whether the Company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- the role of executive officers in the compensation process.

Confidential Information. Award targets that contain confidential commercial or business information need not be disclosed in the CD&A. While the Company is not required to formally seek confidential treatment for omitted information, the ability to omit information is subject to the same standards as when the Company requests confidential treatment in other public filings. If targets are not disclosed, the Company must describe how difficult it will be for the Company (or executive, as the case may be) to achieve the undisclosed target.

The Company is specifically required to analyze and discuss the methods it uses to select the terms of incentive compensation awards, such as the grant date and the exercise price of options.

Award Timing Considerations. The Company is specifically required to analyze and discuss the methods it uses to select the terms of incentive compensation awards, such as the grant date and the exercise price of options. According to the SEC, the Company should pay careful attention to the following:

- Does the Company have a program, plan or practice to time option grants in coordination with the release of material non-public information?
- How does the timing of option grants to executives fit in the context of option grants to employees generally?
- What is the Committee's role in approving such a program or practice? Did the Board or Committee consider this information in determining when and in what amount to make such grants? Did the Committee delegate authority to administer the program to any other persons?
- What is the role (if any) of the executive officers in the timing of option grants?
- Are option grant dates for new executive officers coordinated with the release of material non-public information?
- Does the Company time the release of non-public information to affect the value of executive compensation?

If an option exercise price is not based on the stock's closing price on the actual grant date, the CD&A should describe how the exercise price is determined.

Discussion of Say on Pay Vote Results. The Company must disclose whether it considered the results of the most recent say on pay vote in determining executive compensation policies and decisions and, if so, how that consideration affected those policies and decisions. Moreover, ISS has stated that if the Company's say on pay proposal does not receive at least 70% support, it will closely scrutinize the Company's responsiveness to shareholder concerns and, based on that review, it will consider whether to recommend against the re-election of Committee members and against the Company's next say on pay proposal. The say on pay vote is discussed in more detail below in this chapter.

Executive Compensation Tables and Narrative Disclosure (Items 402(c) – (j))

In addition to the CD&A, the Company must provide extensive quantitative information about the compensation paid to each NEO — generally in tabular form — including the Summary Compensation Table (which generally includes three years of historical compensation for each NEO) and more detailed information in respect of the most recent year regarding incentive compensation grants, outstanding equity awards, equity awards exercised or vested during the year, pension and deferred compensation benefits, and payments upon employment termination or a change in control of the Company. Any table, or column in any table, can be omitted entirely if there is no information to disclose.

Director Compensation Table (Item 402(k))

Item 402(k) requires a Director Compensation Table covering compensation paid to directors for the preceding fiscal year, together with a narrative description of the compensation programs in effect for that year. The table is similar in many respects to the Summary Compensation Table required for NEOs, though it relates to the preceding fiscal year only, not the three preceding years, and it is not supplemented with the additional tabular disclosure provided for NEOs. Despite the relatively limited disclosure requirements of Item 402(k), for the past several years there has been an increasing trend toward including additional disclosure around director compensation, which may be attributable to the increased scrutiny of director compensation by shareholders in recent years, which is discussed in greater detail in Chapter 13.

In addition to Item 402(k), a Nasdaq rule became effective in July 2016, requiring listed companies to annually disclose information about compensation that the Company's directors and director nominees receive from third parties. The disclosure must include the material terms of all arrangements between any director or nominee and any person or entity, other than the Company, that relates to compensation or other payments in connection with that person's candidacy or service as a director of the Company, other than (i) arrangements only for expense reimbursement, (ii) pre-existing arrangements (except that material compensation increases under such arrangements due to nomination or service must be disclosed) and (iii) arrangements already publicly disclosed (*e.g.*, pursuant to Item 402(k)). The disclosure must be located on the Company's website (or accessible from the website) or included in its proxy or information statement for any shareholders' meeting at which directors are elected (or Form 10-K or Form 20-F, as applicable).

Risk of Compensation Programs (Item 402(s))

As discussed in Chapter 1, the SEC requires companies to disclose the relationship of the Company's compensation policies and practices to risk management, but *only* if those compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the Company. The Company is not required to include an affirmative

statement that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the Company, but many companies include this statement, as well as an explanation of the Company's process for evaluating risks arising from compensation policies and practices, in order to address the concerns of shareholders and proxy advisors.

The SEC rule, in effect, ensures that the Company monitors and reviews the risks associated with its executive and employee compensation programs at least once each year. The risk assessment process will vary from company to company, depending on a variety of factors, including company size, maturity, industry sector and compensation philosophy. Responsibility for the assessment also typically will vary from company to company. Typically, management leads the assessment (perhaps with a consultant) and provides the results to the Board and/or the Committee. In other cases, the Committee (or less likely, the Board), will oversee the assessment, using management to gather the necessary information and conduct the analysis.

CEO Pay Ratio (Item 402(u))

Under Item 402(u), which implements the controversial "CEO pay ratio" disclosure requirements that were first proposed by the SEC in 2013 and mandated by Congress pursuant to the Dodd-Frank Act, the Company must disclose (i) the median of the annual total compensation of all employees of the Company other than the CEO, (ii) the annual total compensation of the CEO and (iii) the ratio of those two amounts. The comparison must be disclosed either as a ratio (*e.g.*, 50:1 or 50 to 1) or narratively in terms of the multiple. (For example, "The CEO's total compensation amount is 50 times that of the median of the annual total compensation of all employees.")

Certain non-U.S. employees may be excluded from the median employee calculation pursuant to a foreign data privacy law exemption and/or a 5% *de minimis* exemption; however, reliance on either exemption requires additional disclosure. In addition to disclosing the pay ratio, the Company is required to briefly describe the methodology used to identify the median employee, as well as any material assumptions, adjustments (including cost-of-living adjustments) or estimates used to determine the median employee or annual total compensation. To identify the median employee, companies may use a "consistently applied compensation measure," rather than calculating each employee's "annual total compensation" under Item 402(c).

In September 2017, the SEC issued an interpretive release on the disclosure requirements, and the staff of the SEC's Division of Corporation Finance issued separate guidance regarding the use of statistical sampling in conducting the pay ratio analysis. This new guidance was a welcome development and affirmed that the SEC and its staff intend to provide companies with a wide range of flexibility in complying with the pay ratio rules.

The interpretive release generally provides significant flexibility to companies in identifying their median employee and calculating the median employee's total annual compensation and also expressly provides that as long as the Company uses reasonable estimates, assumptions and methodologies, the pay ratio calculation and related disclosure will not provide the basis for an SEC enforcement action, unless the company lacked a reasonable basis for the disclosure or it was not made in good faith. Moreover, a Company may use existing internal records that reasonably reflect employees' annual compensation to identify its median employee, even if those records do not include every element of compensation, such as equity awards widely distributed to employees.

The separate guidance issued by the SEC staff sets forth hypothetical examples to assist companies in determining how to use statistical sampling methodologies and other reasonable methods that may be appropriate for their specific circumstances. For instance, the staff identified various sampling techniques (*e.g.*, simple random sampling, stratified sampling, cluster sampling and systematic sampling) as well as potential situations under the pay ratio rules in which companies may use reasonable estimates, which may be appropriate depending on the Company's particular circumstances.

EGCs, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirements. There are also transition periods for private companies that go public and companies engaging in business combinations or acquisitions.

The 2019 proxy season will be the second year in which companies are required to include CEO pay ratio disclosure. Although, as described above, the SEC rules and guidance, permit a fair degree of flexibility, in the first year of disclosure, most companies appeared to keep the actual calculation as simple as possible. Notably, resulting ratios tended to correlate with specific industries, with certain industries generally having higher ratios than others. ISS and Glass Lewis, the two largest proxy advisory firms, have indicated that they are continuing to assess CEO pay ratio but as of the time this fifth edition of the Handbook went to press, neither firm had indicated whether CEO pay ratio will have a policy implication or become a factor in its voting recommendations for the 2019 proxy season.

Compensation Committee Report

As noted in Chapter 1, the Committee must discuss the CD&A with management and recommend to the Board that the CD&A be included in the Company's annual proxy or annual report on Form 10-K, and each member of the Committee must sign a Compensation Committee Report attesting that the Committee has discharged that obligation.

The Compensation Committee Report will not be deemed soliciting material under the proxy rules or "filed" with the SEC, and as such it will be subject to limited liability under the federal securities laws. Regardless, in order to help ensure the accuracy of the Compensation Committee Report, the Committee should review the CD&A carefully in advance of furnishing the CD&A.

Say on Pay Votes

Say on pay actually includes three separate non-binding shareholder votes that must be held in varying circumstances:

- a vote on executive compensation (say on pay vote);
- a vote on whether future say on pay votes should take place every one, two or three years (say on frequency vote); and
- a vote on certain M&A-related compensation arrangements (say on golden parachute vote).

An EGC is exempted from the requirement to hold say on pay votes.

Say on Pay

The say on pay resolution must indicate that the shareholders are voting to approve the compensation of the Company's NEOs as disclosed "pursuant to Item 402 of Regulation S-K" or a plain English equivalent of those words. The proposal should also indicate that the vote is advisory and will not be binding on the Company.

It has become common for companies to include, as part of the proposal, information that is designed to support a positive vote, for instance favorable information about the Company's operational results and how payments under the Company's compensation programs promote or are conditioned upon those results.

Say on Frequency

In addition to a say on pay vote, the Company must allow shareholders to vote, at least once every six years, on how frequently to hold the say on pay vote, which is also a non-binding advisory vote. Shareholders must be given the choice of one of the following times for holding the say on pay vote:

- every year;
- once every other year;
- once every three years; or
- abstaining from the vote.

The Board is not required to make a recommendation as to how shareholders should vote. In that case, however, the proxy must make it clear that shareholders are not voting in favor of or against the Company's recommendation.

Because many companies first provided shareholders the opportunity to cast a say on frequency vote in 2011, many included the non-binding advisory vote in 2017 proxy statements. At the overwhelming majority of companies, shareholders voted in favor of an annual say on pay vote, and that frequency remains by far the most common.

Say on Golden Parachute

In connection with most M&A and tender offer transactions, the say on golden parachute rules require the Company to provide disclosure of the compensation and benefits that may be provided to target and acquiring company NEOs in connection with the transaction and generally afford shareholders a non-binding advisory vote as to whether those benefits should be provided.

The following information must be disclosed (and must be separately identified as either "single trigger" or "double trigger"):

- cash severance;
- value of accelerated equity awards;
- pension and deferred compensation benefit enhancements;
- perquisites and health and welfare benefits;
- tax gross-ups; and
- any other elements of compensation.

Additional narrative disclosure must describe any material conditions or obligations regarding the payment, such as non-compete or non-solicitation obligations, specific circumstances triggering payments, the duration of payments and other material provisions of the agreement or arrangement providing for the M&A-related compensation.

The say on golden parachute vote is separate from the vote to approve the transaction and will not factor into whether the transaction has obtained the requisite shareholder approval. Although agreements or understandings between the acquiring company and the target company NEOs must be disclosed, they are not subject to the vote requirement. In that (not particularly unusual) case, the target company must provide a second disclosure table containing information for only those arrangements that are subject to the say on golden parachute vote.

Form 8-K

Overview

Form 8-K is a report filed by the Company with the SEC to disclose a variety of circumstances on a current basis (typically within four business days of the event). A fairly wide variety of circumstances can trigger an 8-K filing. Those most relevant to the Committee are:

- the departure of a director or certain officers;
- the appointment of certain officers;
- the election of a director;
- the adoption or material amendment of a material compensation arrangement with an NEO;
- the occurrence of a blackout period under a Company benefit plan; and
- the results of certain shareholder votes.

The 8-K *disclosure* obligation is separate from the *filing* obligation that may also apply (*i.e.*, where a document must be filed as an exhibit to the Company's next 10-Q or 10-K).

Departure of a Director as a Result of a Disagreement or Removal

Disclosure is required if a director resigns or refuses to stand for re-election because of a disagreement with the Company regarding its operations, policies or practices or is removed for cause. In such a case, the Company must describe:

- the date of resignation, refusal to stand for re-election or removal;
- any committee memberships of the director; and
- the disagreement that caused the director's resignation, refusal to seek re-election or removal.

If the director delivers any notice or letter to the Company regarding his or her resignation, refusal or removal, the Company must file the notice or letter.

Departure of Director for Other Reasons/Departure of Certain Officers

Disclosure is also required if a director departs for a reason other than a disagreement with the Company or for cause (as described immediately above) or if any of the following officers retire, resign or are terminated:

- CEO;
- CFO;
- President;
- Accounting Officer;
- COO; or
- any other person listed as an NEO in the Company's most recent proxy statement.

In this case, the Company must disclose the departure and the date it occurred.

Appointment of Certain Officers

Disclosure is required if the Company appoints a new:

- CEO;
- CFO;
- President;
- Accounting Officer; or
- COO.

In this case, the Company must describe:

- the name, age and position of the officer;
- the date of appointment;
- the officer's employment history for the previous five years;
- the material terms of any material arrangement with the new officer or any material amendment or any award or grant (or modification thereto) to the new officer under such arrangement;
- any related party transactions under Item 404(a) of Regulation S-K between the new officer and the Company (which generally includes any transaction in which the Company was or is to be a participant where the amount involved exceeds $120,000 and in which the new officer had or will have a direct or indirect material interest); and
- any relationships between the new officer and other officers and directors.

If the Company plans to issue a press release or make some other public announcement regarding the new appointment, the Company may delay filing the Form 8-K until the date it issues the announcement. Note, however, that if the Company is appointing the new officer to replace an officer whose departure must be disclosed, disclosure of the departure may not be delayed, which limits the utility of delaying disclosure of the appointment.

Election of a New Director

Disclosure is required if the Company adds a new director other than by shareholder vote at a meeting. In this case, the Company must describe:

- the name of the director;
- the date of appointment;
- any committees on which the director will serve;
- any arrangement under which the director was appointed;
- any related party transactions between the new director and the Company;
- any relationships between the new director and other officers and directors; and
- any material compensation arrangements.

Compensatory Arrangements of Certain Officers

Disclosure is required if:

- the Company adopts a new material compensation plan, agreement or arrangement — or materially amends an existing plan, agreement or arrangement — in which an NEO participates or to which he or she is a party; or
- a material grant or award under any such plan, agreement or arrangement to an NEO is made or materially modified.

Disclosure is not required of:

- a plan that does not favor executive officers and is generally available to all salaried employees, such as a typical broad-based severance plan; or
- an award or agreement that is subject to shareholder approval (though no other contingency defeats the current obligation to disclose, and disclosure is required once shareholder approval is obtained).

An important exception to disclosure applies where a new award is consistent with the terms of a previously disclosed plan or agreement, such as a typical annual or long-term incentive award. Such an award is not subject to 8-K disclosure and instead merely must be disclosed as part of the regular executive compensation disclosure (typically in the annual proxy) as and when required.

Note that new awards or compensation programs for directors are not subject to 8-K disclosure (though, as noted above, material compensation arrangements for newly appointed directors must be summarized when their appointment is disclosed).

Delayed Compensation Information for NEOs

If the salary or bonus for any of the NEOs cannot be determined by the time the Company must file compensation information in its Form 10-K or annual proxy statement, the Company must file an 8-K to disclose the information once it is finally determined. Similarly, if the CEO's salary or bonus information cannot be determined by the time the Company must file its Form 10-K or annual proxy statement and, as a result, the CEO Pay Ratio disclosure is not determinable at such time, the Company must file an 8-K to disclose the CEO Pay Ratio information once it is finally determined.

Temporary Suspension of Trading Under the Company's Employee Benefit Plans

The Company must file an 8-K if a "blackout period" arises under one of its employee benefit plans. A blackout period generally occurs when trading in the Company's securities under the plan is prohibited (for instance, under a 401(k) plan that includes a Company stock account), though the rule is subject to many and varied exceptions. Typically, blackout periods occur when the plan is changing its record-keeper or investment options or in a plan merger or spinoff scenario (including in the M&A context).

During any such blackout period, a director is generally prohibited by the SEC's Regulation Blackout Trading Restriction (so-called Regulation BTR) from purchasing, selling or otherwise acquiring or transferring any equity security of the Company if the security was acquired in connection with his or her service as a director.

Submission of Matters to a Vote of Security Holders

After the Company holds a shareholders meeting, it must file an 8-K to report the results of the votes presented to shareholders at that meeting. If the shareholders voted to elect directors, this information must be broken out by each director nominee.

Other Events

The Company may voluntarily file an 8-K to report any other information whose disclosure is not otherwise required if it believes shareholders would find the information important, for example if the Company reaches a settlement of outstanding material litigation.

Failure to File a Form 8-K

The failure to file a Form 8-K is a violation of the Company's obligations under the Exchange Act and subjects the Company to potential liability, which can include a loss of the Company's right to use a Form S-3 for both primary and secondary offerings.

Chapter 5

Proxy Advisory Firms

Institutional shareholders typically maintain holdings in hundreds or even thousands of companies. During proxy season, these companies present various proposals, some of which are compensation-related, to their shareholders for voting purposes. Many shareholders, including the largest institutional shareholders, do not have the resources available to read, analyze and make independent determinations in connection with the proposals in such a short span of time. As a result, many institutional shareholders rely on guidance and voting recommendations from proxy advisory firms.

ISS is the largest proxy advisory firm by a considerable margin, with the next largest being Glass Lewis. Some ISS and Glass Lewis clients follow the voting recommendations without further review, while others do additional research and analysis to supplement the information from the firms.

Proxy Advisory Firms

The Significance of Proxy Advisory Firms

Until the 2011 proxy season, the influence of proxy advisory firms within the compensation world was largely limited to instances in which a company sought shareholder approval of a new equity compensation plan (or an increase in authorized shares under an existing plan). However, this changed dramatically when the SEC issued rules implementing the Dodd-Frank Act's say on pay vote requirement.

As discussed in more detail in Chapter 4, say on pay is an advisory vote to approve the compensation of the Company's NEOs as disclosed pursuant to Item 402 of Regulation S-K (which includes the CD&A, the compensation tables and the other narrative executive compensation disclosure). A say on pay vote was first required at the 2011 annual meeting of shareholders and is held every one, two or three years thereafter, depending on the frequency chosen by the Company's shareholders in the separate say on frequency vote. The most common frequency is annual.

The advisory firms review the Company's annual proxy after it is filed and then make a recommendation either "for" or "against" the Company's proposals, including the say on pay proposal. Proposals receiving an "against" recommendation typically receive significantly lower support from shareholders (often about 20-30% lower), and almost all companies with say on pay or equity plan related proposals that ultimately fail have received an "against" recommendation from either or both of ISS and/or Glass Lewis.

Although the say on pay vote is non-binding, a company that receives fewer than 70% of the shareholder votes and that does not proactively respond with shareholder outreach — and (potentially) program changes — runs the risk of having that perceived lack of responsiveness constitute additional, independent grounds for an "against" recommendation the following year. If the Company receives fewer than 70% of the shareholder votes, ISS may also recommend "against" or "withhold" from re-election of Committee members, on a case by case basis, in a subsequent year. ISS views a company receiving fewer than 50% of the shareholder votes in respect of its say on pay proposal as warranting the highest degree of responsiveness.

Additionally, ISS may recommend "against" or "withhold" for all members of the Committee and potentially the full Board in the absence of a say on pay proposal (*e.g.*, in a year where no say on pay proposal is required) or in egregious situations. Some of the situations identified by ISS that may result in a vote against or withhold for the entire Committee include:

- significant misalignment between CEO pay and Company performance;
- maintenance of significant problematic pay practices; and
- poor communication and responsiveness to shareholders.

If ISS identifies a significant pay for performance misalignment that results in an adverse recommendation on the say on pay proposal or the election of Committee members, ISS also may recommend a vote against an equity plan proposal on the same ballot.

Additionally, ISS adopted a policy, first effective for shareholder meetings occurring on or after February 1, 2018, providing for adverse vote recommendations for Board or Committee members who are responsible for approving or setting nonemployee director

compensation where there is a recurring pattern (two or more consecutive years) of excessive nonemployee director pay without a compelling rationale or other mitigating factors. As further explained in Chapter 13, ISS has delayed implementation of this policy, such that it will first impact ISS vote recommendations in 2020.

In September 2018, the SEC withdrew two of its previously issued interpretive letters, pursuant to which the SEC staff had determined that a proxy advisor's receipt of compensation from a company to which it provides advice on corporate governance issues would not affect the proxy advisor's independence from an investment advisor as long as the investment advisor made an assessment of the proxy advisor's ability to analyze proxy issues and make impartial recommendations in its clients' best interests. The effect of the withdrawal of these interpretive letters is not yet clear, but the SEC's withdrawal of the letters, coupled with its holding in November 2018 of a roundtable on the proxy process, may signal that the SEC is taking a closer look at the role of proxy advisory firms.

Say on Pay — Actions for the Committee to Take at Each Stage of the Process

Committee members must be mindful of the climate created by the say on pay requirement and the strong influence of proxy advisory firms not only during proxy season, but at each stage of the compensation process.

Committee members must be mindful of the climate created by the say on pay requirement and the strong influence of proxy advisory firms not only during proxy season, but at each stage of the compensation process.

Analyze Shareholders and Prior Reports. The Committee should carefully analyze the Company's institutional shareholder base and determine the degree of influence that each of ISS and Glass Lewis will have on the manner in which its shareholders will vote. In addition, the Committee should carefully analyze the reports issued by ISS and Glass Lewis in respect of prior years in order to focus on any specific concerns that may have been raised.

Conduct Outreach. The advisory firms express a high level of concern when they feel that a company has not conducted adequate shareholder outreach efforts, particularly when they feel that the Committee has been disconnected from outreach efforts. The Company should document and describe any shareholder outreach efforts in detail in the proxy, and it should emphasize the involvement of the Committee in those efforts, whether via direct interface with shareholders or though determination of the content and direction of those communications. The Committee should consider implementing year-round communication and proactive outreach to facilitate investors' understanding of the Company's compensation arrangements instead of communicating only after there has been a negative recommendation. Effective outreach should solicit reactions to the Company's existing executive compensation program, as well as views regarding any concerns raised by ISS and others, and could include making presentations via teleconference, providing written materials regarding the Company's current program and proposed changes, as well as holding in-person meetings. For purposes of shareholder outreach communications, the Company should consider implementing policies and procedures intended to avoid Regulation Fair Disclosure (Reg FD) violations, such as pre-clearing discussion topics or having Company counsel participate in meetings.

Run a "Pay for Performance" Analysis. The Committee should review, on an annual basis, the degree to which there is a "pay for performance disconnect" between the compensation paid to the CEO and the Company's performance, based on the advisory firms' models. This disconnect is the most common reason for a negative or "against" recommendation. It should be noted that this performance is measured on both an absolute and relative basis, with the latter measurement being performed based on a "peer group" comparison. Peer groups chosen by the advisory firms for purposes of the performance measurement may differ from company to company and from the peer group chosen by the Committee for purposes of setting executive compensation. In addition to a "pay for performance" disconnect being an independent basis on which the Company may receive an "against" recommendation, if the analysis identifies any items of "medium" or "high" concern, ISS will perform a deeper analysis of the Company's arrangements than would be the case if there was a "low" level of concern. A company finding itself in this position for the first time may thus find that compensation arrangements that were not flagged by the advisory firms as being problematic in past years are now, when viewed under a stronger microscope, a source of concern and potentially a negative recommendation.

Be Aware and Mindful of Typical Advisory Firm Concerns. The Committee should be aware in setting compensation of the factors that traditionally cause advisory firms to issue an "against" recommendation, which, in addition to a pay for performance disconnect, include:

- "golden parachute" excise tax gross-up provisions (inclusion of a gross-up can trigger an "against" recommendation even in the absence of any other concerns);
- equity award grants that are time-based rather than performance-based, particularly if such grants represent a substantial portion of the Company's equity grant program (this can also trigger an "against" recommendation on its own, if the time-based awards represent a sufficiently large portion of the Company's grants);
- retention or "mega" equity grants or bonuses, particularly without a rigorous justification in the proxy;
- performance goals that are deemed by the advisory firms to be insufficiently challenging;
- duplicative performance measures used across plans, which ISS has characterized as creating double awards for the same performance;
- benchmarking above the 50th percentile, and/or use of a benchmarking peer group that the firms view as inappropriate or designed to ratchet up compensation at the Company;
- severance payments that could (based on ISS calculations) result in compensation greater than three times an executive's annual compensation;
- compensation viewed by the firms as being egregiously high, even where the Company's performance is excellent;
- outsized CEO pay in relation to the rest of the executive group;
- discretionary or other non-formulaic bonus programs (particularly if the Company has not clearly explained the strategic reasoning behind this plan structure in the proxy);
- insufficient disclosure of executive compensation at "externally managed issuers," companies (for instance, many REITs) where management functions are performed by a management company in exchange for a management fee;

- termination and severance payments to an outgoing CEO, particularly in the case of a "friendly" termination (such as a termination characterized as a retirement or where the individual remains on the Board); and
- sign-on or "mega" grants to newly hired CEOs.

Although ultimately the process of setting compensation is influenced by many factors, the Company may want to consider these advisory firm concerns when designing its plans and programs. In addition, the Committee should consider adopting policies that the advisory firms view as exemplifying good corporate governance, including stock ownership requirements, a clawback policy and an anti-hedging policy. When reviewing these issues in the context of potential compensation decisions, the Committee should be aware that ISS Corporate Solutions, a subsidiary of ISS, will (for a fee) provide advice, but cannot guarantee a positive recommendation from ISS.

Proxy Drafting. The Company should begin the proxy drafting process months in advance by identifying those individuals who will need to provide input for the proxy, including individuals from the legal, human resources, finance, stock administration and other departments, as well as external legal counsel, compensation consultants and accounting firms. Each piece of the puzzle will need to be integrated into a document that ultimately "tells the story" of the Company's executive compensation programs in a coherent and compelling manner. The Company should consider using charts, graphs and an otherwise reader-friendly presentation in order to achieve maximum clarity for the Company's message. This disclosure may extend well beyond what is required by SEC rules and include executive summaries and charts showing the amount of pay actually realized by executives (which may be less than the compensation included in the Summary Compensation Table). In addition to describing the Company's programs and shareholder outreach efforts, the proxy should also address any specific concerns raised by the advisory firms and perhaps shareholders as well. Even if the Company decides not to make changes in response to those concerns, it should note in the proxy that those concerns were reviewed and considered. If the Company does make changes, it will be viewed favorably by ISS and other services if the changes are described in some detail and explicitly linked to the concerns that were raised.

Review the Advisory Report Thoroughly. It is important to read the advisory firm reports carefully upon receipt, even if the recommendation is positive, in order to ensure that all of the Company's plans and arrangements have been described accurately, and to reach out to the firms with corrections as soon as possible. In recent proxy seasons, a number of companies have alleged that the shareholder advisory firms made mistakes of fact regarding the terms and parameters of compensation arrangements, particularly in the case of incentive compensation plans. While each situation has its own unique characteristics and context, the fact that this issue was raised by multiple companies is a reminder that when drafting proxy disclosure with respect to complex arrangements, it is critical to be exceptionally clear and to have the disclosure carefully reviewed by multiple parties to check for overall comprehensibility.

Be Prepared to Respond Quickly. Advisory firm reports are typically issued a few weeks prior to the scheduled shareholder meeting, which provides very little time for follow up actions such as supplemental filings and the correction of factual errors. Presently, ISS provides companies in the S&P 500 with the ability to elect to receive an advance draft report. The election must be made at least 30 days prior to the scheduled shareholder meeting. ISS typically provides a very limited period of time for review of and comment upon draft reports, usually 24-48 hours, and corrections are generally limited to factual errors.

Consider Issuing a Supplemental Filing. Companies receiving a negative recommendation from ISS and/or Glass Lewis may consider issuing supplemental proxy materials to make their case directly to shareholders, although it is not clear that such supplemental filings have a substantial impact on vote results. Over the past several years, these filings have covered issues such as the following:

- One of the most frequently articulated concerns is the degree to which the peer groups chosen by ISS and Glass Lewis are different from the peer groups chosen by companies. While this concern has begun to decrease as the advisory firms have refined the methodology by which they choose peer groups, many companies still express concerns in their supplemental filings such as:
  - » being compared with peer groups based solely on revenue, at times resulting in peer groups in which not a single peer is in the same market capitalization range;
  - » excluding peers in the Company's geographical area when that is the area within which the Company competes for talent (and/or not taking into account that the geographical area in question has an unusually high cost of living); and
  - » inclusion of many companies not in the Company's industry.
- Some companies express frustration that ISS has not acknowledged the unique circumstances of CEO transitions, during which an outgoing CEO might be paid a retention amount at a time when it is unclear how long a search for his or her successor will take, and a new CEO could be awarded sign-on and make-whole awards as part of the recruiting process.
- Some supplementary filings focus on the perception by companies that ISS has materially overstated CEO pay by focusing on the grant date value of awards. Companies have noted that the ISS methodology allocates to one year (the year of grant) a lump sum amount based on the award's grant value for accounting purposes, an amount that is both potentially vastly overstated relative to actual value delivery and allocated in a lump sum to a single year prior to the year (if any) that any value is or can be realized.
- ISS still considers total shareholder return to be the most important measure of a company's performance in determining whether there is a "pay for performance disconnect." A number of companies have argued strongly in supplemental filings against using a single measure in this manner. If the Company believes that measures other than total shareholder return are more relevant to its shareholders — such as quality of assets held (in the case of financial institutions), safety (in the case of industrial companies) or low volatility and consistent dividends (in the case of utilities) — it should also discuss this point in the CD&A to provide shareholders with that context. Notably, and likely in recognition of a trend away from Company reliance on total shareholder return as an exclusive performance measure, ISS has begun using other measures of companies' performance to supplement relative total shareholder return, at least on a qualitative basis, including relative return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth and growth of cash flow from operations. Additionally, in 2018, ISS also began taking into consideration the rankings of CEO total pay and Company financial performance relative to a peer group.
- Companies frequently express disagreement in supplemental filings with the ISS policy that stock options are not "performance-based compensation" (absent a performance-based vesting schedule), despite the fact that no value can be received with respect to a stock option unless the stock price increases.

Consider Post-Recommendation Changes. The Committee should consider whether changes should be made to the Company's programs following an "against" recommen-

dation and prior to the annual meeting. Such changes have been known on rare occasions to cause ISS to alter its vote recommendation. An ISS recommendation change typically occurs when ISS identifies a particular problematic issue — for example, the Company entering into a new agreement containing a "golden parachute" excise tax gross-up or granting a significant time-based equity award. In circumstances such as these, the Company can (with the executive's consent) eliminate the gross-up or layer performance vesting conditions onto the award, and this has on occasion been sufficient to tip the balance and cause the advisory firms to change their recommendation. However, most post-recommendation changes do not have this effect (although they could potentially sway some shareholders, if coupled with an effective communication strategy).

Special Golden Parachute Gross-Up Consideration. As noted above, provision of a golden parachute excise tax gross-up is viewed quite negatively by proxy advisory firms, and in recent years there has been a pronounced trend away from providing them. Interestingly, however, over the last few years there have been numerous instances of gross-up protection being implemented at target companies in connection with M&A transactions, typically where an executive might otherwise lose a substantial benefit if the benefit were limited to his or her 280G limit or be subject to a significant excise tax (for instance, because the executive is a recent hire with resulting low historical compensation). While the advisory firms do not appear to view such circumstances any more sympathetically than otherwise, at least some companies are willing to risk a negative advisory firm recommendation at the time of the company sale.

Equity Plan Approvals

As described in Chapter 6, when a public company proposes to adopt a new equity plan, or materially modify an existing equity plan (including reserving additional shares under an existing plan), the NYSE and Nasdaq require shareholder approval prior to the issuance of equity securities. In order for shareholders to make an informed decision regarding the proposal, shareholders must have an understanding of how the existence of the plan and the reservation of shares for employee grants will affect their own interests as shareholders. The role that advisory firms play in this process is to evaluate the plan based on their own particular models to determine whether to recommend that shareholders vote to approve the plan.

ISS Approach. In its 2015 policy update, ISS significantly restructured its approach to equity compensation plan proposals and continued to refine its approach in its subsequent annual updates. The following does not include any updates that may be applicable to the 2019 proxy season not yet announced as of the time this fifth edition goes to press.

Under the prior ISS regime (applicable to annual meetings held prior to February 1, 2015), an "against" recommendation was triggered by failing any one of the following pass/fail tests: whether the cost of the Company's equity plans, taking into account the new plan, was reasonable, based on a proprietary ISS measurement of shareholder value transfer (SVT); whether the Company's three-year burn rate exceeded an ISS-determined cap; whether equity awards to executives contributed to a pay-for-performance disconnect; and whether the plan contained certain problematic features (*e.g.*, permitted repricing).

The updated policy (which ISS has named the Equity Plan Scorecard or EPSC) represents a shift to a more holistic analysis based on the following factors, which generally are weighted as follows for companies in the S&P 500 and Russell 3000:

- **Plan Cost (45%)** – measures SVT relative to peers (determined based on industry and market capitalization), calculated in two ways: first, based on the sum of new shares requested and shares remaining for future grants; and second, based on the sum of new shares requested, shares remaining for future grants, and outstanding unvested/unexercised grants.
- **Plan Features (19%)** – evaluates the following plan features: treatment of vesting on a change in control; discretionary vesting authority; liberal share recycling (*e.g.*, returning to the plan shares withheld on vesting to cover taxes); and minimum vesting periods for grants made under the plan.
- **Grant Practices (36%)** – focuses on three-year average burn rate relative to peers; vesting requirements in the most recent CEO equity grants (based on a three-year lookback); estimated duration of the plan (based on the Company's three-year average burn rate); proportion of the CEO's most recent equity grants subject to performance conditions (again, based on a three-year lookback); whether the Company has a claw-back policy; and whether the Company has established post-exercise/vesting holding periods for the shares received.

Special scoring rules apply to S&P 500/Russell 3000 companies that fall into a "Special Cases" category (companies with less than three years of disclosed equity grant data, such as IPO companies and companies emerging from bankruptcy).

Unlike the prior series of pass/fail tests, under the EPSC approach a low score in one area can be offset by a high score in another. As such, a plan with a cost that is somewhat higher than that of peers could potentially still receive a "for" recommendation if plan feature and grant practice considerations are extremely positive. Conversely, a lower plan cost may not be sufficient to receive a "for" recommendation if the plan includes enough problematic provisions or if past grant practices raise concerns. Some "overriding" provisions (such as the ability to reprice options without shareholder approval) are viewed by ISS as egregious and will result in an automatic negative recommendation. In addition, if ISS identifies a significant pay for performance misalignment that results in an adverse recommendation on the say on pay proposal or the election of Committee members, it also may recommend a vote against an equity plan proposal on the same ballot based on certain considerations, including, but not limited to, the severity of the pay for performance misalignment, whether problematic equity grant practices are driving the misalignment and whether equity plan awards have been heavily concentrated to the CEO and/or other NEOs (as opposed to the plan being considered broad-based).

ISS sells a service through its consulting arm under which it provides assistance in determining whether a proposed plan is acceptable under its EPSC system.

Glass Lewis has its own analytical tools for determining whether to recommend that shareholders approve a new equity plan or an increase in the number of shares reserved for issuance under an existing plan. While Glass Lewis does not disclose the details of its models, the goal of the analysis is to determine whether the proposed plan is more than one standard deviation away from the average peer group plan with respect to various measures, and whether the proposed plan exceeds any absolute limits in the model.

Given the analytical complexity and the specificity of the advisory firm models, the Committee should engage early in the process with internal finance and equity specialists, as well as external legal counsel and compensation consultants, in order to confirm that the plan documentation and number of shares are appropriate and that the proposal is likely to receive a "for" recommendation from the advisory firms.

Chapter 6

Equity Compensation

Equity-based compensation is one of the most versatile and powerful executive compensation tools. As explained in greater detail in Chapters 8 and 9, equity compensation grants to executive officers are typically made by the Committee because of considerations applicable under Rule 16b-3 under the Exchange Act and, historically, Section 162(m) of the Code.

This chapter provides an overview of:

- the types of equity awards most commonly issued by employers;
- the tax consequences of equity awards for the grantee and the Company;
- key considerations for the development of an equity granting policy;
- the shareholder approval requirements of the NYSE and Nasdaq applicable to equity compensation plans; and
- the securities law requirements that are applicable to equity grants (namely the requirement that they either be registered under the Securities Act of 1933, as amended (Securities Act), or be exempt from such registration).

Equity Compensation

Common Types of Equity Awards

Although the overarching objective of all executive compensation awards is essentially the same — incentivizing individual performance to maximize the Company's short- and long-term value — no single compensation formula fits all companies. This is particularly true in the area of equity compensation awards, where many different types of awards are used.

The table below identifies the most common types of equity-based compensation awards.

Type of Award	Description
Stock Options	• A stock option is a right to purchase a fixed number of shares within a fixed period of time at a fixed price, typically following the satisfaction of service-based and/or performance-based vesting conditions. • Because of requirements that apply under Section 409A of the Code (as discussed in greater detail in Chapter 8), stock options generally must be granted with an exercise price that is not less than the fair market value of the underlying shares on the date of grant. Section 409A also effectively requires the grant to be made in respect of common stock only. • Options come in two basic varieties: (i) incentive stock options (so-called ISOs), which offer certain favorable tax treatment for the grantee as described below and (ii) nonqualified stock options, which comprise any option that does not qualify as an ISO. Most companies that grant options grant nonqualified options though ISOs are typical in some industries. • To qualify as an ISO, among other requirements, the option must: » be granted pursuant to a plan approved by shareholders that specifies the number of shares that may be made subject to the ISO and may be issued only to employees (not consultants or non-employee Board members); and » not exceed certain limits on the number of shares that may vest in any year (shares with a value, determined as of the grant date, not in excess of $100,000). • While options are often written to require the payment of an exercise price in exchange for delivery of the full number of shares subject to the option, cashless exercise (either broker-assisted or net settlement in shares or cash by the Company) has become increasingly prevalent in recent years, particularly since financial accounting rule changes eliminated the unfavorable treatment that had previously applied to options with a net settlement feature. Note that, under the cashless exercise approach, the Company is deprived of the cash that otherwise would be paid upon exercise; depending on the magnitude of the grants and stock price, the lost cash flow can be substantial.
Stock Appreciation Rights (SARs)	• SARs entitle the grantee to receive the appreciation in the underlying stock over the SAR's exercise price; they are essentially stock options with a mandatory net settlement feature. Like stock options, SARs generally must be granted with an exercise price of no less than fair market value of the underlying shares on the date of grant • SARs can provide that they will be settled in either cash or stock (though the accounting treatment varies between the two).

Type of Award	Description
Restricted Stock	• A restricted stock award is an award of actual shares of stock that is subject to forfeiture if vesting conditions, typically service-based and/or performance-based, are not satisfied over the vesting period or restricted period specified by the terms of the grant. • Because the award consists of actual outstanding shares, restricted stock is entitled to any voting and dividend rights appurtenant to the particular class of stock subject to the award. • The voting and dividend rights can be limited pursuant to particular award conditions. For example, sometimes dividends are accrued and paid only upon ultimate vesting of the underlying shares. • Restricted stock is often used in lieu of restricted stock units (discussed immediately below) where the Company wants to provide executives with voting and current dividend rights.
Restricted Stock Units (RSUs)	• An RSU represents the right to receive a share of stock (or the cash value thereof) in the future, based upon satisfaction of any applicable vesting conditions, typically service-based and/or performance-based conditions. • Until the unit is vested and the stock (if stock settled) is delivered to the grantee, the grantee does not have any voting or dividend rights (because, in contrast to restricted stock, an RSU is a promise to deliver stock in the future after satisfaction of vesting conditions as opposed to an award of actual stock that is subject to forfeiture if the vesting conditions are not satisfied). • It is typical for dividends to be subject to the vesting conditions that apply to the award of RSUs — *i.e.*, to accumulate during the vesting period and for the accumulated dividends to be paid upon settlement of the unit (in cash or in kind, as the case may be). • An additional critical distinction between restricted stock and RSUs is that settlement of the unit may be delayed until some specified time after vesting (subject to the requirements of Section 409A of the Code). Delayed settlement may result in beneficial tax consequences to the grantee because a unit is subject to income tax only upon actual or constructive receipt of the underlying cash or stock. Accordingly, while settlement is often made at the time of vesting, that is not always the case. For instance, the units may vest over a period of years but the underlying shares might be delivered only upon a subsequent termination of employment. No such delay is possible with restricted stock since, as discussed below, income and employment taxes are imposed immediately upon vesting.
Bonus Shares	• As noted above, the entitlement to an award is typically made subject to the satisfaction a either a pre-established service- or performance-based vesting condition, though there is no legal requirement that any vesting conditions apply. For example, an immediately exercisable option or fully vested and nonforfeitable shares might be awarded to an executive as additional compensation for exceptional prior service. • For example, an immediately exercisable option or fully vested and nonforfeitable shares might be awarded to an executive as additional compensation for exceptional prior service.

US Tax Treatment of Equity Awards

The table below provides a general summary of the United States federal tax rules applicable to each type of equity compensation award described above.

Type of Award	Tax Consequences to the Grantee	Tax Consequences to the Company
Nonqualified Stock Options	• No recognition of income at the time of grant or vesting. • Upon exercise, employee recognizes ordinary wage income equal to the excess of the fair market value of the shares received over the exercise price. • Upon exercise, income tax must be withheld and employment (*i.e.*, FICA/FUTA) tax is due.	• The Company generally will be entitled to a tax deduction at the time and in the same amount as the employee recognizes income.
Incentive Stock Options (ISOs)	• No recognition of income at the time of grant, vesting or exercise. • No income tax must be withheld, and no employment tax is due, upon exercise of an ISO. • If the shares acquired upon exercise are held for at least two years from the date of grant and at least one year from the date of exercise, the employee recognizes capital gain or loss upon a subsequent sale of the shares equal to the difference between the sale price and the exercise price. » A disqualifying disposition thus essentially causes the ISO to be treated as a nonqualified stock option for income tax purposes (though the option still escapes the income tax withholding and employment tax payment requirements). • Generally the "spread" on the exercise date will be an item of adjustment for purposes of the alternative minimum tax.	• If the required holding periods are satisfied, no deduction is allowable to the Company (as the income to the employee is capital gain rather than ordinary wage income). • Upon a "disqualifying disposition," the Company is generally entitled to a deduction in the same amount as the employee recognizes income.
Stock Appreciation Rights	• Same as for nonqualified stock options.	• Same as for nonqualified stock options.

Type of Award	Tax Consequences to the Grantee	Tax Consequences to the Company
Restricted Stock (No 83(b) Election Is Made)	• No recognition of income at the time of grant. • The employee recognizes ordinary wage income when the shares vest (*i.e.*, when they are transferable or no longer subject to a "substantial risk of forfeiture," whichever occurs first). • Upon vesting, income tax must be withheld and employment tax is due.	• The Company generally will be entitled to a tax deduction at the time and in the same amount as the employee recognizes income.
Restricted Stock (83(b) Election Is Made)	• Pursuant to a so-called 83(b) election (which references Section 83(b) of the Code), an employee may elect to recognize the value of the stock at the time of grant as ordinary wage income, notwithstanding that the stock has not yet vested. » In that case, upon a subsequent disposition of the stock (*i.e.*, after it has vested), the difference between the sale price and the amount of income recognized will be treated as a short-term or long-term capital gain or loss, as the case may be. • The 83(b) election must be made — by the employee — within 30 days of the date following the date of grant. • Upon the making of the election, income tax must be withheld and employment tax is due. • If the shares are later forfeited, no tax deduction is allowable to the employee for the loss in respect of forfeited shares (though a capital loss is allowed to the extent any payment was made for the shares when granted).	• The Company generally will be entitled to a tax deduction at the time and in the same amount as the employee recognizes income. • If the shares are later forfeited, the Company will be deemed to recognize ordinary income equal to the amount of the deduction allowed to the Company at the time of the 83(b) election.

Type of Award	Tax Consequences to the Grantee	Tax Consequences to the Company
Restricted Stock Units	• No recognition of income at the time of grant or by reason of vesting. Ordinary wage income is recognized upon settlement of the award (which might or might not occur coincident with vesting depending on the award design) equal to the value of the shares or cash delivered; income tax must be withheld at the time of settlement. • Employment tax is due upon vesting, regardless of whether shares or cash are delivered at that time (subject to several administrative exceptions).	
Bonus Shares	• The employee recognizes ordinary wage income equal to the value of the shares delivered.	• The Company generally will be entitled to a tax deduction at the time and in the same amount as the employee recognizes income.

Equity Grant Policies

As discussed in Chapter 4, it may be appropriate to disclose in the CD&A how the determination is made as to when equity-based awards are granted. When it originally published the CD&A requirements, the SEC expressed a particular interest in practices regarding the timing and pricing of stock options grants, including practices of selecting option grant dates for executive officers in coordination with the release of material non-public information, the timing of option grants to executive officers vis-á-vis option grants to employees generally, the role of the Committee and the executive officers in determining the timing of option grants and the formula used to set the exercise price of an option grant. To a considerable extent, this requirement of the CD&A — and the focus on option grants — arises out of option grant practices that gave rise to shareholder assertions of option backdating (deeming the grant date to be before the corporate action giving rise to the grant), "spring loading" (deliberately making grants before favorable news about a company becomes public) and "bullet dodging" (delaying a grant until unfavorable news becomes public).

The establishment of a written policy addressing the timing and process for granting equity awards can help the Company with shareholder claims and also promote the smooth and appropriate operation of the Company's equity grant program. In addition to ensuring that the Company's equity grants comply with the Charter and state and federal laws, a written policy can accomplish the following objectives:

- articulate the role that equity grants play in the Company's executive compensation philosophy;
- authorize the delegation of grant-making authority to appropriate committees or individuals (typically with prescribed limits on the individuals to whom they may make grants and with individual and aggregate limits on grant sizes) together with a description of the process to be used in exercising such delegated authority;
  - » Note that authority to grant awards to Section 16 officers should generally be retained by the Committee to ensure that the grants are exempt under Exchange Act Rule 16b-3.
  - » In a similar vein, grant authority should be retained by the Committee to the extent compliance with the performance-based compensation exception to Section 162(m) of the Code is intended, which the December 2017 Tax Cuts and Jobs Act limited to qualifying compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and not materially modified after that date. See Chapter 8 for additional discussion about these changes made to Section 162(m).
- describe the procedure and timing for making annual equity grants, off-cycle equity grants and grants to new hires;
- formalize the process of recording the date and price of equity awards and communicating such awards to employees;
- develop standard grant terms and standard grant documentation;
- establish special rules that apply to director grants (such as meaningful limits on the value of grants or perhaps providing for regular, automatic grants rather than discretionary, ad-hoc grants); and
- establish an error correction process.

A written equity grant policy likely will help ensure that grants are made in accordance with the applicable equity plan's terms, including for example, compliance with limits on the number of shares that may be granted pursuant to awards under the equity plan.

Consideration should be given to designating one or more specific Company employees (including human resources, legal and accounting representatives) to be responsible for ensuring compliance with the Company's equity grant policies. Moreover, the Company's compliance with the policies should be subject to regular internal audit.

Special considerations relating to grants made proximate to M&A activity are discussed in Chapter 12.

Stock Exchange Shareholder Approval Requirements

In General

The NYSE and Nasdaq have each established rules regarding shareholder approval of equity compensation plans. Those rules, which are substantially similar for the NYSE and Nasdaq:

- require shareholder approval of all equity compensation plans and material revisions to such plans;
- provide limited exemptions from the shareholder approval requirement for inducement awards to new employees, tax-qualified plans and parallel non-qualified plans, as well as in connection with M&A activity;
- require companies to disclose publicly the material terms of any inducement award and (in the case of NYSE-listed companies) to notify the NYSE when the Company utilizes any of the exemptions from the shareholder approval requirement; and
- prohibit NYSE-member organizations (*i.e.*, broker/dealer firms) from voting on equity compensation plans (regardless of whether the company proposing the plan is listed on the NYSE) in the absence of voting instructions from the beneficial owners of shares.

Plans That Are Not Equity Compensation Plans

The NYSE rules define an equity compensation plan as a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services, whereas the Nasdaq rules refer to a stock option or purchase plan or other equity compensation arrangement pursuant to which options or stock may be acquired by officers, directors, employees or consultants. The following are *not* considered equity compensation plans under the listing rules:

- plans that are made available to shareholders generally, such as a dividend reinvestment plan;
- plans that allow employees, directors or other service providers to buy shares on the open market or from the issuer for fair market value; and
- under the Nasdaq rules only, issuances of warrants or rights generally to all of a company's security holders.

Material Revisions and Option Repricings

A "material revision" (the NYSE term) or a "material amendment" (the Nasdaq term) includes, but is not limited to, the following types of revisions:

- a material increase in the number of shares available under the plan, other than an increase solely to reflect reorganizations, stock splits, mergers, spinoffs or similar transactions;
- an expansion of the types of awards available under the plan;
- a material expansion of the class of employees, directors or other service providers eligible to participate in the plan;

- a material extension of the term of the plan;
- a material change to the method for determining the strike price of options under the plan; and
- a repricing of an option absent a plan provision that permits it or a limitation or deletion of any plan provision prohibiting the repricing of options.

The NYSE commentary to its rule notes that an amendment to an equity compensation plan will not be considered a "material revision" if it curtails rather than expands the scope of the plan in question. In 2016, the NYSE clarified that an amendment to an equity compensation plan to allow for maximum tax withholding is not a "material revision," which was timely because it allowed companies to amend plans without shareholder approval to reflect a recent change to accounting rules giving companies the flexibility to withhold at a rate above the minimum for equity compensation. (Because of the substantial overlap in the provisions of the two rules, commentary on and interpretation of one exchange's rule is often helpful as to the scope of the other.)

Exemptions From the Shareholder Approval Requirement

The listing rules exempt the following plans from the requirement to obtain shareholder approval:

- inducement awards to new employees (the material terms of which must be publicly disclosed);
- tax-qualified plans intended to meet the requirements of Section 401(a) of the Code (*e.g.*, a broad-based pension plan or a 401(k) plan) or Section 423 of the Code (*i.e.*, employee stock purchase plans);
- parallel excess plans (the NYSE term) or parallel non-qualified plans (the Nasdaq term), in each case generally meaning a nonqualified pension or savings plan that is designed to make up for limits under the Code on benefits that can be provided pursuant to the underlying tax-qualified plan;
- rollover of options or other equity compensation awards in connection with a merger or acquisition; and
- post-transaction grants by the acquirer under the target company's pre-existing shareholder-approved plan to individuals who were employed by the target immediately prior to the time the merger or acquisition was consummated.

Securities Law Considerations

The Securities Act requires the registration of each offering of securities unless an exemption is available. Accordingly, when the Company makes equity award grants to employees, executives or directors, it must ensure that the offer and sale of securities is registered or that an exemption is available in respect of such offer and sale. State securities laws (so-called blue sky laws) may impose additional requirements. Because of their wide variation and because they generally have less relevance for public companies (in that the federal securities laws preempt state registration requirements for exchange-listed securities), blue sky laws are not discussed here.

Registration

Public companies typically register the offer and sale of equity compensation awards on a Form S-8. Form S-8 is an attractive registration vehicle because, unlike a Form S-1 (and, to a lesser extent, Form S-3), it requires the direct inclusion of very little information about an issuer and relies instead upon the issuer's existing SEC filings to ensure that adequate public information is available regarding the issuer. For this reason, Form S-8 is available only to companies that are subject to the reporting provisions of the Exchange Act before filing the registration statement and that have filed all Exchange Act reports (Form 10-Ks, Form 10-Qs, Form 8-Ks, etc.) during the preceding 12 months or for any shorter period for which the Company was required to file such reports.

Form S-8 registration statements enjoy two important additional benefits. First, Form S-8 registration statements are not subject to the SEC staff review and comment process, which often can impose lengthy delays and additional costs. Second, Form S-8 registration statements become effective immediately upon filing. These two benefits, taken together, remove many of the delays, costs and burdens companies otherwise face for certain other public offerings (*e.g.*, IPO registration statements).

A company registering the offer and sale of securities on Form S-8 must provide a prospectus to each individual who receives an award under the plan. The prospectus provides material information regarding the plan, the Company and its securities. The prospectus, however, is not contained in the registration statement that is filed with the SEC.

Exemptions

Public companies rarely rely on exemptions from registration because of the ease with which a Form S-8 may be filed. Private placement exemptions nonetheless are available.

The most commonly used exemptions are found under the SEC's Regulation D or Section 4(a)(2) of the Securities Act. To meet the requirements of these exemptions, however, the issuer often must make extensive disclosures regarding the nature and character of and risk factors relating to the offering. Moreover, while a properly executed private placement is exempt from the registration provisions of the Securities Act, the transaction (and the disclosures made or a lack thereof) remains subject to the anti-fraud and civil liability provisions of the Exchange Act.

Because of these significant limitations on the private placement exemptions and because of the ease with which a Form S-8 may be filed, care generally should be taken to ensure that the offer and sale of shares under the Company's equity compensation plan is registered.

Chapter 7

Employment Agreements and Executive Compensation/ Benefit Plans

In addition to the equity compensation described in Chapter 6, the Committee may determine that it is appropriate, as part of the overall compensation philosophy established by the Committee, to adopt additional compensatory plans and arrangements for the Company's executives. This chapter outlines some of the more common types of arrangements and certain factors the Committee should keep in mind when considering their implementation.

Employment Agreements and Executive Compensation/Benefit Plans

This Chapter 7 discusses some of the most common executive compensation arrangements and also briefly summarizes certain tax consequences of such arrangements. For taxable years beginning after 2017, the changes to 162(m) of the Code (discussed in Chapter 8) can have a significant effect on the availability of the federal income tax deduction for payments under these arrangements.

Employment and Severance Agreements

Companies sometimes memorialize the terms of employment of senior executives in a formal employment contract in order to have explicit agreement as to the terms of the employment arrangement, as well as for recruiting and retention purposes, since many executives may be accustomed to having a written contract.

Terms

Items typically covered by the contract provisions include:

- **Title, Duties, Responsibilities and Reporting Relationship.** Duties and responsibilities are sometimes set forth in detail, particularly where the executive's role might otherwise be ambiguous or overlap with other employees. Where a position is more traditionally understood and defined (such as the CEO, CFO or General Counsel), some companies simply state that the duties and responsibilities will be those "typically associated" with the position. While the CEO typically reports to the Board (and may be stipulated in the contract to be nominated to become a member of the Board), other executives typically report either to the CEO or to one of his or her direct reports, depending on the particular executive's level. To the extent that the definition of "good reason" (as described below in the "Severance Payments and Benefits" bullet) is triggered by a material adverse change in duties, responsibilities and/or reporting relationship, the specific description of the duties, responsibilities and reporting relationship contained in the employment agreement can be critical in connection with a contested termination of employment.

- **Term of Employment.** Executive employment agreements may provide for an indefinite term, a fixed term (often three to five years) of employment (it being understood that the contract will be renegotiated as the end of the term nears) or an initial term with an "evergreen" renewal process. An evergreen agreement provides that the agreement will automatically be extended for an additional year (or other period greater or less than a year) unless either party indicates (typically by a date that is three months to a year prior to the end of the then-current term) that it does not wish to extend the contract. In some industries, it is common for contracts to provide for an indefinite term; however, the Committee should consider carefully the limitations on its flexibility that such indefinite term contracts may impose.

- **Base Salary.** Employment agreements typically provide for an initial level of base salary and then indicate that the base salary may be increased based on periodic performance reviews. It is frequently stipulated that, once increased, the base salary may not be decreased (or materially decreased) without triggering the right of the executive to terminate employment and receive severance. Alternatively, the employment agreement may provide that base salary may be decreased only in connection with across-the-board base salary reductions or may be reduced only by not more than a particular percentage.

- **Terms of Annual and Long-Term Cash Incentives.** As discussed in more detail below, companies typically provide annual bonus programs and may provide for long-term cash-based incentives as well. Sometimes companies further stipulate in the employment agreement that the target bonus will be no less than a particular percentage of salary (often 50-100%), or that the executive will participate in incentive plans on a basis no less favorable than other senior executives.
- **Terms of Equity Awards.** In the case of an employment agreement being entered into with a newly hired executive, or a renegotiated agreement being entered into with an existing executive, the employment agreement may contain specific terms of one-time equity award grants. Additional provisions may be negotiated as part of the employment agreement, including guarantees of future grants. More typically, the employment agreement will provide that the executive will be eligible for participation in the Company's equity plans and will receive grants based on the Board's regular grant process for senior executives.
- **Benefits, Vacation and Perquisites.** Employment agreements at the senior executive level may provide that the individual executive will be eligible to participate in the Company's benefit plans on the same basis as such plans are made available to other senior executives. A number of weeks of vacation (typically three to five weeks, most often four weeks) is generally stipulated; however, the employment agreement may instead make reference to the Company's applicable policy. Participation in perquisite programs is sometimes addressed in the same general manner as benefit plan participation, but may be described more specifically if the executive will receive perquisites that either differ from or are more generous than those provided to other executives.
- **Severance Payments and Benefits.** This provision enumerates the payments and benefits to be received by the executive upon certain terminations of employment. Typically, amounts in excess of accrued obligations are paid only upon a termination by the Company without "cause" or by the executive for "good reason," and the terms of these definitions are among the more carefully negotiated portions of the agreement. The payments may include a multiple of salary (and potentially bonus, based on target or historical bonus rate), welfare benefit continuation and equity vesting (to the extent that vesting is not addressed in the equity agreement itself). Receipt of such payments and benefits is often subject to the execution and non-revocation of a release of claims against the Company.
- **Restrictive Covenants.** These provisions often include restrictions on competition with company competitors and solicitation of employees and customers as well as non-disparagement, confidentiality and similar provisions. The nature, duration and extent of these provisions must be carefully reviewed under applicable state and federal law. For example, Companies should closely review confidentiality and similar provisions to ensure that these provisions don't run afoul of the whistleblower protections mandated under the Dodd-Frank Act and that these provisions satisfy conditions established by the Defend Trade Secrets Act (which was enacted in 2016) to preserve certain remedies for the Company in actions brought by employees.

While some companies prefer the certainty of entering into an employment agreement (and employment agreements are customary or expected in some industries), other companies enter into more limited agreements with respect to severance and restrictive covenants, without a full employment agreement, while still others prefer not to have any individual agreements at all and rather rely primarily on equity or other compensation arrangements, which may include broad-based or executive severance or change in control severance plans, to attract and retain their executive team. This is ultimately a strategic decision, and one made in consultation with internal specialists and external strategic advisors, including compensation consultants.

Disclosure and Say on Pay Issues

As described in Chapter 4, employment agreements with new NEOs may be subject to disclosure on a Form 8-K. In addition, existing employment and severance arrangements are described in the CD&A, while amounts paid pursuant to any such agreement appear in the proxy compensation tables (particularly the Summary Compensation Table) and amounts to be paid on termination of employment are described and quantified in the "Potential Payments on Termination or Change in Control" section. In addition to monitoring amounts actually paid to the CEO under any such contract, proxy advisory firms are also watchful of any provisions that they may view as a problematic pay practice, whether or not such provisions are actually triggered.

Change in Control Agreements and Plans

Some companies prefer to offer severance protection only for terminations of employment that occur following or in contemplation of a change in control, while others may decide to enhance existing severance benefits for these types of terminations. While many of the considerations associated with these types of arrangements are the same as those discussed earlier in this chapter, some additional considerations apply when entering into or implementing a change in control agreement or plan.

Some companies prefer to offer severance protection only for terminations of employment that occur following or in contemplation of a change in control, while others may decide to enhance existing severance benefits for these types of terminations.

Covered Terminations

The definition of "cause" may be narrowed and/or the definition of "good reason" broadened following a change in control, as the acquiring entity will likely be making the determination as to the nature of the termination. In addition, certain pre-change in control terminations may be covered where the termination was in contemplation of the change in control.

Benefits

Benefits may be enhanced (for example, by increasing the severance multiplier or providing equity vesting) or may be paid in a lump sum following a change in control rather than in installments, which are more common for severance paid outside of a change in control period. Changes to the form of payment must be drafted with care and reviewed by specialist advisors so as not to inadvertently create a violation of Section 409A of the Code.

Plan or Agreement

While senior executives have most commonly been provided with change in control severance protection through individual agreements, there is an increasing trend towards the use of a change in control plan format. This is primarily due to simplicity of administration given that many provisions will apply uniformly to all participants, as well as the ease of amending the plan (although a plan will typically provide that it cannot be amended

following a change in control). Companies with currently effective agreements may provide a plan for executives without change in control agreements and then, as agreements expire, individuals who had been subject to change in control agreements may instead be moved into the plan.

Golden Parachute Tax Treatment

Severance payments and equity vesting, along with other payments and benefits provided in connection with a change in control-related transaction, may trigger the imposition of "golden parachute" excise taxes, as described in more detail in Chapter 8. In the past, excise tax gross-up provisions — that is, a provision providing the executive an amount sufficient to leave him or her in the same after-tax position as if the "golden parachute" excise tax had never applied — were more common. However, such provisions, unless in old agreements and thus "grandfathered," will typically cause proxy advisory firms to recommend "against" a say on pay proposal and, in certain situations (such as continued violations in consecutive years), can cause the advisory firm to recommend "against" re-election of Committee members. The significance of advisory firms in connection with the setting of compensation strategy is discussed in Chapter 5. It is more typical for change in control arrangements in the current climate to provide that payments will be either cut back or paid in full (with the executive paying the excise tax), depending on which treatment puts the executive in a better after-tax position. The most economical but least executive-friendly alternative is to provide for a cutback in all circumstances. These parachute tax considerations are discussed in greater detail in Chapter 8.

Non-Equity-Based Annual and Long-Term Incentive Plans

General

While equity awards (as discussed in more detail in Chapter 6) provide one form of incentive compensation, companies also typically provide cash-based incentives based on annual performance goals, and sometimes also provide longer-term cash-based incentives.

Plan Design

Performance criteria and performance periods are two important components of non-equity-based annual and long-term incentive plans, each of which vary significantly from company to company.

Performance Criteria

Some of the more common financial measures include the following:

- earnings before interest, taxes, depreciation and amortization (EBITDA);
- gross or net sales;
- gross or net income;
- cash flow;
- return on assets, capital or equity; and
- total shareholder return (absolute or relative to peers) although in recent years there has been a trend away from using total shareholder return as an exclusive measure.

In addition, companies often use industry-specific measures.

Historically, these goals (among many others) are typically set forth in a Company's omnibus incentive compensation plan, although the impact of the December 2017 federal tax legislation, commonly referred to as the Tax Cuts and Jobs Act, may make that practice less common, as discussed in greater detail in Chapter 8). The choice of which measures to use and targets to set is a business matter typically determined based on consultation by the Committee with the executive team, internal finance specialists, and external compensation consultants.

Performance Periods

For the typical annual bonus plan, goals are set at the beginning of the performance year (usually within the first calendar quarter for a company with a calendar-based fiscal year), performance is measured as soon as year-end results are available, and bonuses are paid in the first couple of months of the year following the performance year. Long-term cash-based performance plans are more variable in their design. For example, a long-term cash-based performance plan could be structured to have two-year performance periods that do not overlap, or rolling three-year performance periods with a new performance cycle beginning each year. As with identifying appropriate performance criteria and target setting, the selection of a performance cycle should be made based on consultation with internal and external specialists with an eye towards the Company's overall business strategy.

Disclosure and Say on Pay Issues

As described in Chapter 4, grants and payouts under cash-based incentive plans will be disclosed in the compensation section of the Company's annual proxy. The following items should be kept in mind with respect to the views of proxy advisory firms with respect to cash incentive plans:

- **Challenging Goals.** Proxy advisory firms comment negatively on incentive plans containing goals that are deemed (in the view of the advisory firms) to be insufficiently challenging. The Company should review the rigor of the plan and its goals when it is being established. In particular, plans with measures which are so qualitative as to potentially be viewed as discretionary have been subject to particularly negative advisory firm commentary.
- **Duplicative Measures.** Advisory firms may view using the same measures in the Company's annual and long-term plans negatively and potentially characterize the plans as providing duplicate rewards for the same performance. The Committee should review the performance measures used to reward executives under not only the annual and long-term cash incentive plans but also the Company's equity plans in order to confirm that a sufficient variety of measures have been used.
- **Clear Disclosure.** Some companies have issued supplemental proxy filings stating that proxy advisory firms have misunderstood and inaccurately described the operation of certain of their compensation plans. Because an advisory firm's erroneous understanding of the Company's incentive plans can lead to a negative say on pay vote recommendation, the Committee should ensure that the proxy disclosure with respect to these plans is clear and comprehensible.

Deferred Compensation Plans

General

Most companies maintain tax-qualified 401(k) plans for their U.S. employees, including executives, in order to provide plan participants with the ability to accumulate retirement savings on a tax-deferred basis. However, the Internal Revenue Code limits the amount that can be deferred each year under tax-qualified retirement plans to an amount that is typically far less than executives would prefer, given the size of their income and tax and financial planning goals. In order to provide executives with an additional opportunity to defer taxation on employment income, some companies adopt a nonqualified deferred compensation plan permitting deferral of additional income.

Plan Design

By explicitly limiting participation in a nonqualified deferred compensation plan to a select group of management or highly compensated employees, the Company can usually, subject to filing a statement with the U.S. Department of Labor upon plan establishment, avoid having the plan be subject to requirements related to minimum vesting, funding, and participation or the rigorous fiduciary obligations under the Employee Retirement Income Security Act of 1974, as amended (ERISA). Given ERISA's limited applicability, nonqualified plans can be structured in a number of different ways:

- **Linked Plan.** The plan may be specifically linked to the Company's 401(k) plan, providing the ability to defer only those amounts which cannot be deferred under the 401(k) plan due to Internal Revenue Code limitations.
- **Matching Contributions.** Provision may be made for Company matching contributions, either in a manner linked to the 401(k) plan or on a completely separate basis; these contributions may vest over time.
- **Earnings.** The participant's account may earn interest at a stipulated rate, or the participant may be able to choose among hypothetical investment options, with the individual's account balance being increased (or decreased) based on the actual performance of such investments.
- **Funding.** While these plans are unfunded (or funded via a "rabbi trust" that remains subject to the claims of the Company's general creditors), the plans may contain a funding trigger on a change in control, given that executives may be less confident in the ability or willingness of an acquirer to pay amounts under the plan in the future.

Tax Consequences

The following tax-related issues should be kept in mind and assessed in connection with the adoption of any nonqualified deferred compensation program:

- **Section 409A.** Most importantly, as described in Chapter 8, Section 409A of the Code was enacted to deal specifically with deferred compensation, and while its intricate rules apply to many different types of compensation arrangements, it perhaps has the greatest impact on the design of deferred compensation plans like those being described here. Rules under Section 409A range from the timing of elections, to the types of events that are permitted to trigger payment, to the manner in which changes to payment elections can be made. If the Company is considering the adoption of a deferred compensation plan, it should consult extensively with outside legal specialists and allow sufficient time to make determinations on the various decision points. Some

companies eventually determine that it is simplest to adopt a prepackaged plan with an associated adoption agreement from a third-party provider, not unlike the types of documents that are commonly used in connection with standardized 401(k) plans.

- **Corporate Tax Deduction.** While a tax-qualified retirement plan permits the Company to deduct compensation deferred under a 401(k) plan at the time the compensation would otherwise have been paid absent deferral, no corporate tax deduction is available under a nonqualified deferred compensation plan until the date on which the amounts are actually paid to the individual, which may be many years in the future.
- **Employment Taxes.** While *income* taxation on amounts contributed to a deferred compensation plan is generally deferred until such amounts are actually paid to the individual, *employment* (*i.e.*, FICA/FUTA) taxes are due upon contribution of amounts to the plan (or, if later, when the deferred amounts vest).

Disclosure and Say on Pay Issues

The Company's annual proxy must include disclosure of amounts accrued or deferred under a nonqualified deferred compensation plan. So long as the plan design is within market parameters (particularly with respect to Company contributions), it is unlikely that the plan itself will attract the ire of proxy advisory firms. However, it should be noted that any earnings will be counted by the proxy advisory firms monitoring the CEO's compensation as part of CEO compensation for the year in question.

Supplemental Retirement Plans

General

Just as Internal Revenue Code regulations limit the benefits available to executives under 401(k) plans, they also limit the amounts that can be provided to executives under traditional "defined benefit" pension plans. Defined benefit pension plans are designed to provide participants with a fixed retirement benefit based on a formula set forth in the plan — for example, a percentage of the individual's compensation in the final five years of employment. Historically, to provide executives with additional retirement income, some companies adopted a nonqualified supplemental executive retirement plan (SERP) in order to provide executives with retirement income in excess of the amounts available under the company's applicable tax-qualified defined benefit plan, while other companies adopted a SERP even in the absence of an existing broad-based retirement plan as part of their strategy to attract and retain executive talent. These types of plans are often disfavored by institutional investors and proxy advisory firms and have become far less prevalent in recent years. While the term SERP can also be used to refer to a deferred compensation plan with matching contributions (as described in the previous section), for purposes of this section, the term SERP will be used to refer to a nonqualified defined benefit plan.

Plan Design

Similar to nonqualified deferred compensation plans, by limiting participation to a select group of management or highly compensated employees, the Company can avoid subjecting the plan to most provisions of ERISA. As with a nonqualified deferred compensation plan, the Company should file a statement with the U.S. Department of Labor upon establishment of the plan. Given this flexibility, plans can be structured in a number of different ways:

- **Linked Plan.** The plan may be specifically linked to the Company's qualified defined benefit pension plan (if any) and provide the ability to receive amounts which would have been received under the qualified plan but for Internal Revenue Code limitations.
- **Benefit Formula.** Rather than link the SERP benefit formula to a qualified plan, the SERP may contain its own formula. For example, the plan may provide for an annual benefit equal to a percentage of the final average compensation over a specific number of years of the participant's employment, and may define compensation to include or exclude various types of payments.
- **Forms of Payment.** As with qualified defined benefit plans, SERPs may provide for lump sum or installment payments, and more complex versions may include options such as joint and survivor annuities.
- **Benefit Variations.** Benefits may be provided at different levels based on the type and timing of the termination of employment (*e.g.*, early retirement, regular retirement, death, disability) and may provide for vesting and payment acceleration upon a change in control.
- **Funding.** While these plans are unfunded, they may contain a rabbi trust funding trigger on a change in control, given that executives may be less confident in the ability or willingness of an acquirer to pay amounts under the plan in the future, or may be subject to rabbi trust funding even absent a change in control.

Tax Consequences

The following items should be kept in mind from a tax perspective:

- **Section 409A.** As with the deferred compensation plans discussed above, Section 409A of the Code should be carefully considered in the drafting and operation of a SERP, since by its nature a SERP is designed to pay benefits that constitute deferred compensation. Great care should be taken in ensuring compliance, which in many cases will require compliance with myriad technical rules.
- **Corporate Tax Deduction.** No corporate tax deduction is available under a SERP until the date on which the amounts are actually paid to the individual, which may be many years in the future.

Disclosure and Say on Pay Issues

The Company's annual proxy must provide disclosure of pension plans (including SERPs), including the number of years of service and the present value of the benefit and any withdrawals or distributions made in the prior fiscal year, in each case for each NEO. SERPs are an area of focus for proxy advisory firms, particularly when the benefit formula is viewed as especially generous or where additional service credit is granted under certain circumstances (such as upon a change in control). The Committee should consider the terms of any plans carefully in consultation with its advisors.

Perquisites

General

In order to attract and retain executives, companies may provide perquisites — that is, special programs and benefits that are made available only to senior executives. Whether a particular perquisite is appropriate for a specific company will depend on many factors, including industry standards. Some common types of perquisites are:

- company car (or allowance);
- tax and financial planning;
- executive health programs;
- country or eating club membership;
- use of company aircraft;
- home security;
- relocation programs, potentially including home purchase programs and tax gross-ups;
- spousal travel; and
- charitable gift matching.

Prevalence

While the percentage of companies offering perquisites to their executives has decreased in recent years, and the extent and number of perquisites at companies that do offer such programs has narrowed, many companies offer at least one of the perquisites listed above. The perquisites that have become less common are those that can be perceived externally in a negative light, such as country club memberships or use of company aircraft, while tax and financial planning is among the perquisites most frequently retained. The decision as to whether to offer perquisites to executives is based on a number of factors, including the practices of competitors and whether proxy advisory firms have raised related concerns in past say on pay vote recommendations. Where a company provides no perquisites, it typically highlights that fact in its annual proxy.

Tax Issues

In general, the types of perquisites described above are subject to taxation as ordinary income, based on the fair market value of the perquisite in question (which is generally determined based on the amount that the individual would have to pay a third party, in an arm's length transaction, for the item or service). With respect to the personal use of corporate aircraft, there are several valuation methodologies; the most commonly used methodology is the Standard Industry Fare Level (or SIFL) method, which is based on factors including the length of the trip, type of aircraft, number of people accompanying the employee and whether the employee is a "control" or "non-control" individual. "Control" individuals are generally directors and senior executives of the Company. These calculations can be complex and should be prepared with the assistance of experienced internal or external specialists.

Disclosure and Say on Pay Issues

Perquisites provided to the Company's named executive officers may need to be specifically disclosed depending on their value. Certain of these amounts, and in particular the value of Company aircraft usage, are subject to complex calculation rules (and typically are reported at values that differ from their imputed value for taxation purposes). Some perquisites, such as financial and tax planning assistance, rarely receive comment from the proxy advisory firms. By contrast, other perquisites (especially personal use of the Company aircraft and tax gross-ups) may draw a negative comment or negative recommendation, especially if there are several such practices and if they are coupled with other pay practices that are, in the view of the firms, problematic.

Chapter 8

Compensation-Related Tax Provisions

This chapter provides an overview of Sections 162(m), 280G and 409A of the Code — the Code sections most frequently implicated by compensation arrangements — and issues facing compensation committees in regard to those provisions. Effective for taxable years beginning after 2017, the Tax Cuts and Jobs Act significantly expanded the scope of Section 162(m), which denies a corporate tax deduction for executive compensation in certain circumstances. The TCJA both expanded Section 162(m)'s coverage and prospectively eliminated its most significant exception, one for performance-based compensation. This chapter summarizes the new rules under Section 162(m), though the application of some of them remains uncertain pending additional future guidance from the IRS.

Compensation-Related Tax Provisions

Section 162(m)

Section 162(m) — Snapshot

- Section 162(m) imposes a limit of $1 million on the amount of compensation that a public company may deduct in any calendar year with respect to compensation paid to each "covered employee."
- A "covered employee" is any individual who, at any time during the year, serves as the CEO or CFO of the Company or is acting in either such capacity and the three other most highly compensated officers as well as any other person who is a covered employee for any taxable year after December 31, 2016.
- Prior to the enactment of the Tax Cuts and Jobs Act (TCJA), qualified "performance-based compensation" was not subject to the Section 162(m) limit. The TCJA eliminated the performance-based compensation exemption such that all compensation paid to a covered employee in excess of $1 million is nondeductible, including post-termination and post-death payments, severance, deferred compensation and payments from nonqualified plans.
- Compensation payable pursuant to a written binding contract, including compensation payable to the CFO (not previously considered a "covered employee" prior to the TCJA) under such a contract, that was in effect on November 2, 2017, and not materially modified after that date, remains exempt under a transition rule.
- The TCJA's changes to Section 162(m) of the Code are expected to dramatically impact the way many companies design and administer executive compensation programs.

Tax Cuts and Jobs Act

The TCJA dramatically altered the application of Section 162(m) of the Code with respect to taxable years beginning after December 31, 2017. The description of Section 162(m) below addresses the application of Section 162(m), as amended, as well as an important transition rule that grandfathers certain existing compensation arrangements for treatment under Section 162(m) prior to the enactment of the TCJA.

Overview

The deduction that a publicly held corporation can claim in any tax year for compensation paid to a covered employee is limited to $1,000,000 (*i.e.*, compensation in excess of this limitation, unless otherwise excludable, is non-deductible to the Company). Compensation subject to the $1,000,000 limit does not include employer contributions to tax-qualified retirement plans or amounts excludable from gross income.

Prior to the implementation of the TCJA, payments of qualified performance-based compensation made to covered employees were exempt from the $1 million annual limitation. The TCJA substantially modified Section 162(m) by eliminating the exemption for qualified performance-based compensation and expanding the scope of individuals who may qualify as covered employees subject to the $1 million annual limitation. The TCJA does, however, include an important transition rule under which the changes made to Section 162(m) will not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and is not materially modified after that date, including any contract with the CFO, who, prior to enactment of the TCJA, was not included as a "covered employee."

The Tax Cuts and Jobs Act substantially modified Section 162(m) by eliminating the exemption for qualified performance-based compensation and expanding the scope of individuals who may qualify as covered employees subject to the $1 million annual limitation.

Section 162(m) had previously applied only to corporations with publicly traded equity. As modified by the TCJA, Section 162(m) now applies to corporations that have publicly traded debt, as well as foreign private issuers that meet the new definition of a publicly held corporation (even if not subject to the executive compensation disclosure rules of the Securities Exchange Act).

Covered Employees

Under the TCJA, a "covered employee" includes any individual who served as the CEO or CFO at any time during the taxable year and the three other most highly compensated officers for the taxable year, regardless of whether the individual is an executive officer at the end of the year and regardless of whether the individual's compensation is required to be disclosed for the last completed fiscal year under SEC rules. Additionally, the TCJA expanded the scope of covered employees under Section 162(m) by providing that any individual who is or was a covered employee for any taxable year beginning after December 31, 2016, will remain a covered employee for all future taxable years.

Qualified Performance-Based Compensation

Compensation that constituted qualified performance-based compensation under Section 162(m) prior to its amendment by the TCJA is still excluded from the $1,000,000 deduction limitation. Performance-based compensation must meet the following requirements to be qualified:

- the compensation is payable pursuant to a written binding contract that was in effect on November 2, 2017, and not materially modified after that date;
- the compensation is paid solely on account of the attainment of one or more pre-established, objective, performance goals;
- the performance goals are established by a committee (or sub-committee) comprised solely of two or more "outside directors" of the Company;
- the performance goals are established in writing not later than 90 days after the commencement of the applicable performance period;
- the material terms of the performance goal under which the compensation is to be paid have been disclosed to shareholders and approved by a majority of shareholders in a separate shareholder vote before the compensation is paid;
- the Committee certifies in writing prior to payment of the compensation that the performance goals were satisfied; and
- there is no discretion to amend the performance goals once established or to increase the compensation payable upon attainment of the goal(s).

Written Binding Contract in Effect on November 2, 2017 and Not Materially Modified

As noted above, the TCJA includes an important transition rule, under which the changes made to Section 162(m) will not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and that is not subsequently materially modified after that date, including any contract with the CFO, who, prior to enactment of the TCJA was not a position included as a "covered employee."

A "written binding contract" exists only to the extent that the Company is obligated under applicable law (including state contract law) to pay the specified remuneration if the employee performs services or satisfies the applicable vesting conditions. Unless a contract is materially modified on an earlier date, grandfathered status under the transition rule generally may last until the date on which the contract may be terminated by the employer. There are specific operational rules that apply in determining both whether a written binding contract was in effect on November 2, 2017 and whether such a contract has been materially modified after such date. The operational rules and guidance from the IRS are complex and many unresolved issues remain. For this reason, it is advisable for Companies to conduct a thorough review of their existing compensation plans, agreements and arrangements with their legal advisors, including an analysis of the extent to which the transition rule may apply to the Company's arrangements as well as steps necessary to avoid inadvertent material modifications that could jeopardize the deductibility of compensation paid to covered employees for current and future taxable years.

Pre-Established, Objective Performance Goals

For compensation payable pursuant to arrangements eligible for grandfathered treatment under the transition rule of the TCJA, in order to be "pre-established," the performance goals must be established:

- no later than 90 days after commencement of the period during which the employee performs the relevant services;
- prior to the time that 25% of such period has elapsed; and
- prior to the time that attainment of the goals is substantially certain.

In order for the performance goals to qualify as "objective," the goals must indicate the method for computing the amount of compensation to be paid if the goals are attained (*i.e.*, a third party must be capable of making such determination) as well as the individual employees or class of employees to which the formula applies. Generally, a formula must preclude the Committee from exercising any discretion to increase the amounts payable. If a change is made to accelerate the payment of compensation, the change would be treated as an increase (*i.e.*, as an impermissible exercise of discretion) unless the payment is appropriately discounted to reflect the time value of money. Similarly, a change which defers the payment of compensation will be treated as an increase unless any additional amounts reflect the crediting of not more than a reasonable rate of interest. The Committee can always exercise "negative discretion" (*i.e.*, it may reduce or eliminate compensation that would otherwise be payable).

Setting Performance Goals After the TCJA

Even though the Section 162(m) exception for qualified performance-based compensation generally will no longer be available, most companies will still want to maintain performance-based compensation programs in order to appropriately incentivize execu-

tives and respond to the demands of pay-for-performance by proxy advisory firms and shareholders. Proxy advisory firms have become increasingly interested in the rigor of performance goals in recent years, and there is good reason to expect that this trend will continue even as companies will have more flexibility to establish performance goals without being limited to shareholder-approved goals under the prior rules for qualified performance-based compensation under Section 162(m). Companies should continue to consider the views of shareholders and proxy advisory firms and shareholders when designing performance goals in future years. While proxy advisory firms continue to analyze the impact of the changes under Section 162(m), ISS indicated in early 2018 that it did not expect to change its framework for analyzing pay for performance as a result of those changes.

Special Rules for Options

With respect to compensation payable under arrangements grandfathered pursuant to the TCJA, in order for compensation attributable to stock options (or stock appreciation rights) to qualify as performance-based compensation, the grant must be made by a qualifying Committee and the plan must set forth a "per employee" limit, *i.e.*, the plan must state the maximum number of shares with respect to which options may be granted to any covered employee during a specified period. For this purpose, options that are cancelled in connection with a grant of a new option will count against the maximum number of shares that may be granted to the employee. Repricing of an option will be treated as a cancellation/re-grant and will count against the maximum number of shares that may be granted to the employee. Options that are granted "below market" (*i.e.*, with an exercise price less than the fair market value on the grant date) will not qualify as performance-based compensation unless the exercise of the option is contingent upon attainment of a performance goal that otherwise satisfies the requirements of the regulations. Additionally, options with an exercise price less than the fair market value on the grant date will be subject to the requirements of Section 409A of the Code.

Outside Directors

The regulations provide that a director is an "outside director" for purposes of Section 162(m) if the following requirements are met:

- the director is not a current employee of the Company;
- the director is not a former employee of the Company who receives compensation for prior services (other than under a qualified retirement plan) during the taxable year;
- the director has not been an officer of the Company; and
- the director does not receive remuneration from the Company, either directly or indirectly, in any capacity other than as a director.

Because many companies have designed their compensation programs to qualify for the Section 162(m) performance-based compensation exception, Committee members typically have been "outside directors" for Section 162(m) purposes. While companies will no longer be required to monitor the status of outside directors for purposes of the qualified performance-based exception under Section 162(m), other than for purposes of grandfathered arrangements eligible under the transition rule, companies will still need to comply with the independence requirements for compensation committees under the NYSE and NASDAQ listing standards, as applicable, and the rules under 16(b) of the

Securities Exchange Act. Additionally, proxy advisory firms and shareholders have views and expectations concerning director independence. The requirements to qualify as a Section 162(m) outside director are discussed more fully in Chapter 11.

Disclosure and Shareholder Approval

For compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, to qualify as "performance-based compensation" for purposes of Section 162(m), the material terms of the performance goals must have been disclosed to and approved by shareholders. The material terms of the performance goals include:

- the individuals or class of individuals eligible to receive compensation;
- a description of the business criteria on which the goals are based; and
- either the maximum amount of compensation to be paid upon attainment of the goals or the formula used to calculate the compensation to be paid.

Note that the specific targets need not have been disclosed, nor was the Company required to disclose confidential information so long as the disclosure indicated the Committee's belief that disclosure of such information would adversely affect the Company.

Transition Rule for Initial Public Offerings

Prior to the enactment of the TCJA, in the case of an IPO, the deduction limitation of Section 162(m) did not apply to a plan in effect prior to the effectiveness of the offering during the transition period described below, provided that the prospectus accompanying the IPO disclosed information about those plans or agreements that satisfied all applicable securities disclosure laws then in effect. The TCJA and subsequent guidance have not clarified the extent to which this transition rule for IPOs remains applicable. Practitioners generally expect that further guidance from the IRS will offer clarification on this issue.

Generally, under the transition rule for companies undergoing an IPO, a Company may rely on the transition rule until the earliest to occur of: (a) the expiration date of the plan or agreement, (b) a material modification of the plan to increase compensation payable under the plan, (c) exhaustion of all shares reserved under the plan, or (d) the first meeting of the Company's shareholders at which directors are to be elected that occurs after the close of the third calendar year following the year of the IPO. This Section 162(m) IPO transition rule applies to compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement that existed prior to the IPO, provided that the grant (or, in the case, of RSUs, payment) occurs on or before the earliest of the events described above.

The impact of this IPO transition rule is that the deductions upon ultimate exercise or vesting of stock options, stock appreciation rights and restricted stock that were granted prior to the expiration of the transition period will not be subject to the deduction limitation of Section 162(m), even if the grants vest after the expiration of the transition period. RSUs granted on or after April 1, 2015, and prior to expiration of the transition period are not exempt from the deduction limit of Section 162(m) unless the units are also paid out prior to such expiration.

Section 280G

Section 280G — Snapshot

- Section 280G denies a corporation a deduction for "excess parachute payments" made to "disqualified individuals."
- Section 4999 imposes a 20% excise tax on the recipient of any excess parachute payment and requires the corporation to withhold the excise tax from the individual's compensation.

Overview

In general, Section 280G of the Code provides that no deduction is allowed to the Company for "excess parachute payments," and Section 4999 imposes an excise tax on the recipient of any excess parachute payment equal to 20% of such amount.

Parachute Payment

A "parachute payment" is any payment made to a "disqualified individual" that is contingent on a change in control of the Company including, for example, severance benefits, additional retirement benefits and non-cash compensation such as the continuation of health insurance and the accelerated vesting of stock option and other equity-based awards.

A payment is considered contingent on a change in control if it would not have been made had the change in control not occurred or if the timing of such payment is accelerated by the change in control. In addition, any payment made pursuant to an agreement (or an amendment to an agreement) entered into within one year before a change in control is presumed to be contingent on that change in control.

Disqualified Individual

A disqualified individual is any individual who is an employee or other service provider who is also an officer, a highly compensated individual or a shareholder owning a significant amount of the Company's outstanding shares of stock (*i.e.*, stock with a fair market value exceeding 1% of the fair market value of the outstanding shares of all classes of the Company's stock).

Excess Parachute Payments and the 299% Safe Harbor

Excess parachute payments consist of the excess of parachute payments over a disqualified individual's "base amount." "Base amount" means the average taxable compensation received by him or her from the Company during the five taxable years (or his or her entire period of employment if less) preceding the year in which the change in control occurs. The Code provides a "safe harbor" of 300% of the executive's base amount (*i.e.*, the parachute rules do not apply if aggregate parachute payments are less than that amount).

If the parachute payments equal or exceed the safe harbor amount, the entire excess over the base amount (*i.e.*, the five-year average taxable compensation) will be subject to the excise tax and disallowance of deduction. For example, if an executive has a base amount of $100,000, parachute payments of up to $299,999 will not be subject to the excise tax or the disallowance of deduction, but a parachute payment of $300,000 (only

$1 more) will be subject to those rules to the extent of $200,000.

Note that, because of this treatment, an individual entitled to parachute payments only slightly in excess of his or her safe harbor amount may be in a better after-tax position if his or her payments are automatically reduced to the safe harbor amount. Such an individual is sometimes said to be "in the valley." In the above example, the individual avoids an excise tax of $40,000 (20% of the $200,000 excess parachute payment) merely by having his or her payments reduced by $1.

Although theoretically straight-forward, calculating parachute amounts is complex. The regulations under Section 280G contain complicated formulas for determining the parachute value of particular types of compensation as well as numerous technical exceptions. Parachute calculations are typically prepared by an accounting firm or outside counsel using Company-provided information.

Strategies for Addressing the Excise Tax

There are several methods of addressing the problem of the excise tax in the design of change in control severance agreements. For purposes of completeness, this section contains a summary of the various approaches for mitigating the excise tax impact; however, it should be noted that tax gross-ups are viewed unfavorably by proxy advisory firms and are currently characterized as a problematic pay practice that generally will yield an automatic "no" recommendation in respect of the say on pay vote.

Cap on Payments. In order to ensure the deductibility of the payments, it may be desirable to limit the amount of potential parachute payments to no more than the executive's safe harbor amount. This approach is frequently referred to as the "cap" approach.

Example 1: Executives 1 and 2 each have base amounts of $100,000 and have parachute payments of $300,000 and $450,000, respectively. The parachute payments to each of Executives 1 and 2 would be reduced to $299,999.

Valley Approach. As an alternative to the cap approach, parachute payments may be cut back to the safe harbor amount only if the cutback results in a higher after-tax payment to the executive after taking into account both the excise tax that the executive would otherwise pay on the excess parachute amount and the larger income tax the executive would otherwise pay if the payment were not reduced — *i.e.*, the Company agrees to bear the additional cost of nondeductibility but only if that additional cost results in an increased benefit for the executive. This approach is frequently referred to as the "valley" approach (and it is sometimes also referred to as a "soft cap," "best net" or "gross down").

Example 2: Same facts as Example 1. The parachute payments for Executive 2 will not be reduced because he would retain $200,000 on an after-tax basis ($450,000, less $70,000 excise tax (20% of $350,000) and less $180,000 income tax (assuming a 40% tax rate)) which exceeds the after-tax amount of $179,999 that he would retain if he were "capped" at $299,999 ($299,999 less $120,000 income tax (assuming a 40% tax rate)). Executive 1's parachute payment would again be reduced to $299,999 because the $1 reduction in the payment results in a savings to Executive 1 of $40,000 of excise tax (20% of $200,000).

Gross-Up. Under certain circumstances, it may be appropriate to provide for a special "gross-up" payment to ensure that the executive receives the after-tax benefit he or she

would have received had the payments not been subject to the excise tax. Assuming a marginal tax rate (combined federal, state, local and FICA) of 40%, approximately $2.50 of gross-up payments will be needed to make the executive whole for $1 of excise tax liability ($0.50 for each $1 of excess parachute payment). Such a "gross-up" payment would be nondeductible for federal income tax purposes.

Example 3: Same facts as Example 1. The parachute payment of neither executive will be reduced. Executive 1 would receive an additional payment of approximately $100,000 and Executive 2 would receive an additional payment of approximately $175,000.

Section 409A

Section 409A — Snapshot

- Section 409A governs the timing of elections to defer compensation, the timing of distributions of deferred compensation and the reporting and taxation of deferred compensation.
- Section 409A can not only cover standard deferred compensation arrangements but also often apply to severance arrangements, employment agreements, change in control arrangements and equity awards.
- A violation of Section 409A will result in immediate inclusion in the individual service provider's income of the vested deferred amounts, a 20% penalty tax (in addition to ordinary income tax) and interest penalties. Service providers include employees, directors and many independent contractors.
- There is no penalty imposed on the Company for failure to comply with Section 409A other than potential penalties related to the failure to report or withhold on amounts that become taxable due to a Section 409A failure.

Overview — What is Section 409A?

Section 409A is concerned with the time and form of payment of deferred compensation. Prior to the enactment of Section 409A, no single Code section governed taxation of nonqualified deferred compensation. Broadly speaking, Section 409A represents a significant restriction of the contracting parties' ability to control the timing of receipt and inclusion of nonqualified deferred compensation in income. The restriction of control is reflected in the Section 409A rules regarding initial deferral elections, permissible payment events, the ability to accelerate payment of nonqualified deferred compensation (including the prohibition of so-called haircut provisions pursuant to which deferred compensation is distributed on an accelerated basis with a penalty or haircut) and the rules related to the re-deferral of previously deferred compensation.

Although any detailed explanation of Section 409A is beyond the scope of this Handbook, it is important to remember that Section 409A significantly affects the way nonqualified deferred compensation may be structured.

General Application — When Does Section 409A Apply?

Amounts are generally considered deferred if an individual obtains a legally binding right in one tax year to receive compensation in a later tax year. Thus Section 409A can cover not only standard deferred compensation plans but also supplemental executive retirement plans, severance plans, employment agreements, change in control agreements, equity

awards and many other arrangements that are not generally thought of as providing deferred compensation.

To Whom Does Section 409A Apply?

Section 409A applies to deferred compensation earned by "service providers." The regulations under Section 409A specify that the term "service provider" includes an individual, a corporation (private and public), a Subchapter S corporation, a partnership, a personal service corporation as defined under Section 269A(b)(1) of the Code (or an entity that would be a qualified personal service corporation if it were a corporation), and a qualified personal service corporation as defined under Section 448(d)(2) of the Code (or an entity that would be a qualified service corporation if it were a corporation). Importantly, Section 409A covers employees, directors, and many consultants. Section 409A does not apply to service providers using the accrual method of accounting. The term "service provider" also includes a person who has separated from service (*i.e.*, a former service provider who is no longer providing services).

Exceptions to Section 409A Coverage

There are at least three important exceptions to the coverage of Section 409A. As more fully described below, Section 409A does not apply to short-term deferrals, grandfathered benefits and certain severance plans.

Short-Term Deferrals. The short-term deferral rule is a significant exception that covers most annual bonus payments and many lump sum severance arrangements. The short-term deferral exception generally provides that amounts which are only payable no later than 2½ months following the end of the taxable year in which the employee's right to the compensation is no longer subject to a "substantial risk of forfeiture" are not subject to Section 409A.

Grandfathered Benefits. Section 409A does not apply to benefits that were earned and vested as of December 31, 2004, and credited earnings on such amounts.

Certain Severance Benefits. Section 409A does not apply to severance payable only in connection with an involuntary termination of employment that does not exceed two times the lesser of the employee's compensation for the year prior to termination or the applicable IRS limit on compensation under a qualified pension plan for the year of termination of employment ($275,000 for 2018 and $280,000 for 2019). The severance amount must be paid by December 31 of the second year after the year in which the termination occurs.

Complying With Section 409A

Deferred compensation that is subject to Section 409A must comply with rules aimed at restricting the contracting parties' ability to control the timing of receipt and inclusion of the compensation in income. To comply with Section 409A, deferrals must be made pursuant to a written plan that complies with documentary and operational requirements under Section 409A. Generally, Section 409A:

- strictly limits when compensation may be deferred (*i.e.*, when the initial election to defer compensation may be made);
- offers limited permissible payment events — namely a specified date (or schedule),

death, disability, unforeseeable emergency, separation from service or change in control event; and

- strictly limits the ability to change when deferred compensation may be paid (*e.g.*, the ability to either accelerate or delay the payment of deferred compensation).

Many of the rules under Section 409A are complex and many unresolved issues remain.

Special Section 409A Rule Applicable to Public Companies — Six-Month Delay

Section 409A applies to both private and public companies. However, one aspect of Section 409A applies only to public companies — if payment of deferred compensation to a "specified employee" is triggered by a "separation from service," that payment must be delayed for at least six months after the separation from service. It is important to note that the six-month delay does not apply if the amount payable is not deferred compensation within the meaning of Section 409A (for instance is exempt as a short-term deferral).

The "specified employees" are generally the top 50 highest paid officers of the Company (including each of its subsidiaries). Any employee who owned more than 5% of the Company's stock at any time during the year and any employee who owned more than 1% of the Company's stock and received annual compensation greater than $150,000 is also considered a "specified employee."

Equity Incentive Compensation

Many equity compensation arrangements are either excluded from the definition of nonqualified deferred compensation (*i.e.*, not subject to Section 409A) or can be designed to comply with Section 409A. Tax-qualified equity arrangements (*e.g.*, incentive stock options and employee stock purchase plans within the meaning of Section 423 of the Code) are exempt from Section 409A.

Options/SARs. Stock options and stock appreciation rights to acquire "service recipient stock" are exempt from Section 409A if the exercise price is not less than the fair market value of the stock on the date of grant and the grant does not include any additional deferral features. The Section 409A regulations define service recipient stock as stock that, as of the grant date, (a) is common stock for purposes of the Code, (b) does not have a distribution preference, (c) is not subject to a mandatory repurchase obligation and (d) is issued by an "eligible issuer." Generally, an eligible issuer means the company for which the individual provides services and certain affiliates (not including subsidiaries).

Restricted Stock. Restricted stock is generally not subject to Section 409A even in

situations where the value of the transferred property may not be immediately includable in income (*e.g.*, where the restricted stock is subject to vesting).

Restricted Stock Units. Unlike restricted stock, a grant of restricted stock units may be subject to the requirements of Section 409A if the grant is not structured as a short-term deferral (*e.g.*, by including provisions which require payment promptly following vesting of the award). Many restricted stock unit awards are subject to Section 409A because of features such as vesting upon retirement or continued vesting following certain employment terminations.

Section 409A Violation Consequences

Deferred compensation that is subject to, and does not comply with, Section 409A must be included in the gross income of the service provider upon vesting. In addition to regular federal income tax, the service provider is subject to a 20% penalty tax on any deferred compensation that is taxable under Section 409A. Under certain circumstances a substantial interest penalty may be applied in addition to the 20% penalty tax. Certain states also impose additional taxes on noncompliant deferred compensation. For example, California imposes an additional state tax penalty of 5%, bringing the total penalty tax to 25% (exclusive of any interest). Although the Section 409A violation penalties apply only to the service provider, the service recipient/employer may also be liable for penalties and interest related to the failure to withhold, report and deposit federal income taxes.

Cautionary Note

Because Sections 162(m), 280G and 409A of the Code are very technical in nature, the Company should engage with sophisticated advisors, including external legal counsel, at all phases of the compensation process from design to documentation and implementation in order to avoid the numerous opportunities for foot-faults potentially resulting in significant negative tax consequences to the Company and its employees.

Chapter 9

Section 16 of the Securities Exchange Act of 1934

This chapter provides an overview of Section 16 of the Exchange Act and the related rules adopted by the SEC, including rules regarding equity awards made by the Committee. Section 16 applies only in respect of companies that have registered a class of equity securities under Section 12 of the Exchange Act, excluding foreign private issuers.

Section 16 of the Securities Exchange Act of 1934

Section 16

Section 16 — Snapshot

- Section 16 requires public disclosure of officers', directors' and 10% owners' transactions in Company equity securities, including derivative securities, and prohibits them from profiting from short-term trading, regardless of whether they possess any material non-public information.

Overview

Section 16 was adopted with the intent of deterring public company insiders from profiting from short-term trading transactions in Company stock and related securities. To that end, Section 16 requires each Section 16 Insider — each officer or director of a Company that has registered a class of its equity securities under Section 12 of the Exchange Act, as well as each beneficial owner of more than 10% of any class of Company voting equity security registered under that section — to report transactions in and holdings of Company equity securities, to disgorge to the Company any profit realized from trading in Company equity securities that occurs within a period of less than six months, and to refrain from "shorting" Company equity securities. Under case law, persons or entities with a close relationship to a director may also be subject to Section 16 under the so-called director by deputization theory, depending on facts and circumstances.

Section 16 applies to not only stock exchange transactions, but also (in whole or in part) to most other transactions that change a Section 16 Insider's pecuniary interest in Company stock or derivative securities, including private purchase or sale transactions, equity-based awards, option exercises, certain transactions in Company benefit plans, gifts, and estate-planning transactions. Further, Section 16 applies to not only the direct interests of Section 16 Insiders (such as their individual transactions), but also to certain of their indirect interests, such as the interests of their immediate family members sharing the same household; interests via certain trusts for the benefit of themselves or immediate family members; and interests via contractual rights, holding companies, partnerships, or other relationships in which the Section 16 Insider has the "opportunity, directly or indirectly, to profit or share in any profit derived from a transaction" in Company equity securities.

The rules under Section 16 specifically define which "officers" are subject to the provisions of Section 16, although they are generally the same persons as the executive officers required to be named in the Company's proxy statement or annual report plus the Company's principal accounting officer, together with persons who have taken on any of the relevant positions since such statement or report. The applicable definition captures both holders of specified titles and person who hold policy-making power or oversee principal Company units, divisions or functions, without regard to title. Interim occupants of offices may become Section 16 Insiders during the term of their interim service, as may persons who exercise the de facto authority of an office (such as after the departure of an office holder, or an employee of a corporate parent or subsidiary), even absent a title. It may be good practice for the Board to annually identify the Company's

"executive officers" and Section 16 "officers," and to consider whether newly promoted or hired officers, including interim officeholders, should be designated as Section 16 Insiders. These determinations are generally granted considerable deference.

Section 16 applies not only to Section 16 Insiders' transactions in common stock and other classes of Company stock, but also to derivative securities.

Section 16 applies not only to Section 16 Insiders' transactions in common stock and other classes of Company stock, but also to derivative securities, *i.e.*, securities with a conversion or exchange right at a price related to a Company equity security, or which have a value derived from the value of a Company equity security. This includes customary employee equity-based awards such as stock options, restricted stock units and stock appreciation rights. So-called performance awards (that is, equity-denominated grants that remain subject to the satisfaction of performance criteria), however, are not derivative securities unless their value (or the criteria by which they are deemed earned) is dependent solely on the passage of time or the value of a Company equity security (*e.g.*, performance units earned solely on the basis of the Company's stock price reaching some target). Performance awards conditioned on total shareholder return should be considered in light of whether any factor other than share price is significant in satisfying the performance criteria (*e.g.*, if a Company does not pay a dividend, shareholder return may be just another way to describe a stock price target).

The Three Operative Provisions of Section 16

Section 16(a) of the Exchange Act requires that Section 16 Insiders file reports with the SEC identifying themselves and disclosing their holdings of Company equity securities when they initially become Section 16 Insiders, and that they continue thereafter to disclose their transactions and holdings in Company equity securities for so long as they remain Section 16 Insiders and, in certain circumstances, for up to six months thereafter.

Section 16(b) of the Exchange Act provides for the recovery by the Company of any profit realized by Section 16 Insiders on the matched purchase and sale, or sale and purchase, of the Company's equity securities within any period of less than six months ("short-swing profits"), unless an exemption applies to one or both of the purchase or sale transactions. Under Section 16(b), a transaction in a particular Company derivative security (*e.g.*, buying an exchange-listed call option on Company stock) may be "matched" against a transaction in the underlying equity security (*e.g.*, a sale of Company stock) or a different Company derivative security (*e.g.*, buying an exchange listed put option on Company stock). Although the scope of Section 16 extends beyond Committee matters, the Committee often has an important role in providing an exemption from the short-swing profit rule for certain transactions between the Company's officers or directors, on the one hand, and the Company, on the other hand, as discussed in further detail below.

Finally, Section 16(c) of the Exchange Act requires that Section 16 Insiders refrain from making "short" sales of Company equity securities. Neither the Company nor the Committee ordinarily plays a significant role with respect to this aspect of Section 16.

Reporting by Section 16 Insiders Under Section 16(a)

Section 16(a) Reporting — Snapshot

- Most transactions by Section 16 Insiders are subject to public reporting.
- The reporting deadline is generally the second business day after the transaction.
- There are limited exemptions for events considered not to present the opportunity for abuse.
- Company personnel customarily assist officers and directors with their reporting obligations, but those obligations are the officer's or director's alone.

Section 16 Insiders are required to file with the SEC an initial statement of beneficial ownership (Form 3) identifying themselves as persons subject to Section 16 with respect to the Company and disclosing their beneficial ownership of Company equity securities. In the case of the Company's initial registration of a class of equity securities under Section 12 of the Exchange Act (*e.g.*, in connection with a company going public in the U.S.), such Form 3 filings are due on the same day such registration becomes effective. For persons becoming Section 16 Insiders of an already-public company, the Form 3 filing is due within ten days of becoming a Section 16 Insider. Section 16 Insiders are not required to file an additional Form 3 upon taking on a new role, or changing roles, with the Company (*e.g.*, an officer who later becomes a director), although a person who ceases to be a Section 16 Insider and then later again becomes one should file another Form 3 in connection with the resumption of Section 16 Insider status.

Section 16 Insiders are further required to file with the SEC a statement of changes of beneficial ownership (Form 4) for most changes in beneficial ownership of any Company equity securities, including derivative securities, within two business days of when they occur. Certain transactions, such as gifts, are eligible for deferred reporting, but must be reported (together with any other unreported transactions subject to reporting) on an annual statement of changes in beneficial ownership (Form 5) within 45 days after the end of the Company's fiscal year, if not voluntarily reported earlier on a Form 4.

No filing is required to report that a person has ceased to be a Section 16 Insider, although certain related transactions may themselves require a filing (*e.g.*, transactions deemed to occur immediately prior to the effectiveness of the resignation, termination or other event causing such person to cease to be a Section 16 Insider). Also, in some circumstances the obligations of Section 16, including these reporting requirements, may continue to apply to former officers and directors for up to six months after leaving office.

Ordinarily all of these reports are required to be filed on the SEC's EDGAR system and are publicly available; they are also required to be posted on the Company's website. Customarily, companies assist their officers and directors in filing such reports, both for Section 16 Insiders' open-market trading and for Company equity-based grants. The Company must disclose any Section 16 Insider's failure to timely make any required report, specifying in either the Company's annual proxy statement or annual report the name of any Section 16 Insiders who failed to timely file a report, the number of transactions reported late and the number of instances of late and missing reports.

Although typically the time at which a person becomes a Section 16 Insider, or when a transaction occurs, will be fairly obvious, particular facts and circumstances may require closer consideration. Generally a transaction occurs when a Section 16 Insider's

rights and obligations regarding Company equity securities become fixed. For instance, although the Committee may give its approval of an equity award on a given date, if that approval is subject to future facts, such as an option strike price determined on a later date, that later date may be the transaction date. Because a determination of the relevant transaction date may be complicated, new award structures should be discussed with Company counsel in advance, if possible.

Other complicated issues arise from performance awards, which may not be subject to Section 16 when first awarded but which may become subject to reporting under Section 16 upon the satisfaction of the applicable performance criteria or conditions.

Other complicated issues arise from performance awards, which may not be subject to Section 16 when first awarded (if the value of such awards, or whether they will ultimately be earned, is dependent on criteria or conditions not based solely on the price of the Company's stock or the passage of time), but which may become subject to reporting under Section 16 upon the satisfaction of the applicable performance criteria or conditions.

Certain categories of transactions (largely either transactions of a personal nature or transactions available to broader categories of persons, such as Company employees or shareholders generally) are eligible for exemptions from the short-swing profit rule of Section 16(ab) — and, in most cases, from the reporting obligations of Section 16(a) as well — making some transactions entirely exempt from reporting and permitting others to be deferred to an annual statement of changes in beneficial ownership (Form 5). Most commonly, Section 16 Insiders may defer to Form 5 the reporting of bona fide gifts (whether as giver or recipient) and inheritances (both of which are also exempt from the short-swing profit rule), as well as small acquisitions of no more than $10,000 in the aggregate. Transactions occurring pursuant to a qualified domestic relations order (such as in connection with a state court divorce proceeding) are entirely exempt from Section 16, as are most payroll-based transactions in Company employee stock purchase plans, 401(k) plans and other benefit plans satisfying Internal Revenue Code coverage and participation requirements.

Certain transactions available to or affecting all shareholders on an equal basis, such as normal dividend reinvestments made pursuant to a broad-based dividend reinvestment plan (or pursuant to an employee benefit plan offering the same terms as a broad-based DRIP), and pro rata stock splits and similar transactions applying equally to all shareholders, are also exempt from Section 16. Transactions that involve only a change in the form of a Section 16 Insider's beneficial ownership, but not a change in pecuniary interest (*e.g.*, a Section 16 Insider's deposit of Company stock into a trust of which the Section 16 Insider is both trustee and sole beneficiary), are also exempt from Section 16.

The Short-Swing Profit Rule

Short-Swing Profit Rule — Snapshot

- Section 16 Insiders are required to disgorge any profit that could be ascribed to transactions in Company equity securities made within a period of less than six months.
- Calculation of profit is extremely disadvantageous to Section 16 Insiders and a profit can be found even when the economic result of a series of transactions is a loss.
- Plaintiffs' attorneys are active in bringing claims for recovery.
- The Committee may exempt certain transactions from this rule.

As described above, to deter Section 16 Insiders from seeking to profit on short-term trading on the basis of undisclosed information, Section 16(b) requires every Insider to disgorge any "statutory profit" realized from any purchase and sale (or any number of these transactions) of equity securities of the Company which take place within any period of less than six months. Although adopted to combat misuse by insiders of non-public information, this short-swing profit rule is a strict liability requirement that applies without regard to any showing of actual knowledge, and it may neither be waived nor indemnified by the Company. Section 16(b) also permits any shareholder of the Company to bring a suit for recovery on the Company's behalf if the Company fails to do so.

The statutory profit is calculated on the basis of comparing every sale of Company equity securities to every purchase (or *vice versa*) within a period of less than six months. The short-swing profit rule applies to any purchase of applicable securities (at a lower price) and sale of applicable securities (at a higher price), regardless of whether the same shares are involved in both transactions, and even applies to a transaction in a derivative security, on the one hand, and the underlying common stock, on the other hand. Although purchases and sales of derivative securities are subject to the short-swing profit rule, the exercise or conversion of an in-the-money option or other derivative security is not subject to the rule, regardless of which side of the transaction the Insider is on (although such transactions must be reported). Further, where an Insider holds the right to exercise such a security, its expiration or cancellation for no value will not be subject to the rule.

Calculations of statutory profit arising from transactions in different classes of securities (such as transactions in options and in the underlying stock) are complicated and often unfavorable to Section 16 Insiders. Further, the statutory profit that results from a series of multiple purchases and sales within a period of less than six months may exceed the actual net profit of all the transactions. In this way, a series of transactions that are subject to the short-swing profit rule may both produce an actual economic loss and a further obligation to disgorge to the Company a hypothetical "profit" that exists only under the unique statutory measurement. Because of these complexities, it is important to consult counsel to identify the potential short-swing profit that may arise from proposed transactions.

Exemptions From the Short-Swing Profit Rule

Absent some special treatment, ordinary transactions between the Company and its officers and directors — *e.g.*, the grant of Company options or restricted stock, or withholding of shares from an officer's award at vesting — would be subject to the

short-swing profit rule. However, as discussed in greater detail below, most transactions between Company officers and directors (but not Section 16 Insiders who are only 10% beneficial owners), on the one hand, and the Company (or a Company subsidiary or employee benefit plan) on the other hand — including to the grant of equity-based awards — are or may be exempt from the short-swing profit rule.

Pre-Approval Exemption

Pre-Approval Exemption — Snapshot

- Often called the "16b-3" exemption, this permits the Board or Committee to exempt transactions between the Company and an officer or director from the short-swing profit rule by giving advance approval.
- The Committee must comprise at least two directors and may include only "non-employee directors."
- "Independent" directors are not necessarily "non-employee directors."

By giving its advance approval, the Board or the Committee (if it qualifies) may exempt from the short-swing profit rule most transactions between the Company and a Company officer or director, including the grant of equity-based awards or participation in deferred compensation plans.

For purposes of Section 16, an "independent" director under SEC and stock exchange rules is not necessarily a "non-employee director." The requirements to qualify as a "non-employee director" for this purpose are discussed in Chapter 11. If the Committee does not consist solely of non-employee directors, the Committee should consider forming a qualifying subcommittee to make approvals for purposes of this exemption.

Accordingly, the Committee (or the Board) should approve in advance transactions between the Company and its officers and directors that are intended to be exempt from the short-swing profit rule. Although advance approval is most commonly used to exempt equity-based awards, this exemption from the short-swing profit rule is available for any transaction between the Company and an officer or director (other than a Discretionary Transaction as described below), and so may also be used to exempt officer or director participation in private placements of Company stock, Company repurchases of Company stock from officers or directors in issuer self-tender offers, net settlement of equity awards to satisfy tax withholding and exercise price obligations, participation in Company-sponsored deferred compensation plans investing in Company securities, officer and director participation in mergers involving Company equity securities, and other transactions involving the Company. The Committee's (or the Board's) approval of any such transaction should be sufficiently specific to the transaction in order to maintain the availability of the exemption.

The major exception to the Board's or Committee's power to grant this exemption is for certain volitional, participant-directed transactions under employee benefit plans, such as an officer's or director's decision to exchange into or out of a Company stock fund in a 401(k) plan, from or into another investment under that plan, or to fund a cash withdrawal from such a plan by disposing of Company equity securities in the plan. These transactions are defined as "Discretionary Transactions" and are subject to different rules, as discussed further below.

Benefit Plan Exemptions. Except for Discretionary Transactions (which are discussed below), an officer's or director's transactions in Company equity securities pursuant to a qualified stock purchase plan, an employee benefit plan, or an excess benefit plan operated in conjunction with a qualified employee benefit plan are entirely exempt from the short-swing profit rule of Section 16(b) and the reporting obligations of Section 16(a). Most commonly, these exemptions apply to ordinary transactions in plans satisfying applicable Internal Revenue Code coverage and participation requirements, such as a payroll-based investment in the Company stock funds in a Company 401(k) plan or purchases through a Company ESOP, as well as in plans that provide greater benefit or contribution limits than those permitted by the Internal Revenue Code, but which are operated in conjunction with an employee benefit plan (*e.g.*, supplemental plans that offer benefits on the basis of the same formula that applies under a broadly available employee plan, but which apply with respect to compensation beyond the limit required in respect of the broadly available plan).

Other Exemptions. In addition to advance approval by the Board or Committee, shareholder approval or ratification of a transaction made by an officer or director (other than a Discretionary Transaction) may also exempt the transaction from the short-swing profit rule. Such approval or ratification will be effective for purposes of the exemption only if it is given at a meeting by holders of a majority of the shares present or represented at the meeting and entitled to vote, or by written consent of a majority of the shares entitled to vote. In either case, the shareholders must be sufficiently informed that their approval would exempt the transaction from the short-swing profit rule, the approval must otherwise be made in compliance with the federal proxy rules and other requirements under Section 14 of the Exchange Act, and any ratification must be received no later than the date of the next annual meeting of shareholders of the Company.

A Company officer or director may also secure an exemption from the short-swing profit rule for an acquisition of Company equity securities from the Company by holding the acquired securities (or the underlying securities, in the case of derivative securities) for at least six months. No similar exemption is available for officer or director dispositions.

Discretionary Transaction Exemption. A Discretionary Transaction is a transaction pursuant to an employee benefit plan that: occurs at the volition of the plan participant; is not made in connection with the participant's death, disability, retirement or termination; is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and results in either an intra-plan transfer involving a Company equity securities fund or a cash distribution funded by a volitional disposition of a Company equity security. In short, these are voluntary, in-service "fund switching" transactions within benefit plans, such as deferred compensation plans, or "cash out" transactions funded by the disposition of Company equity securities. Discretionary Transactions do not include investments in employee benefit plans made by the contribution of money from outside the plan (*e.g.*, payroll contributions or employer "matching" contributions). Transactions that are not Discretionary Transactions because they fail to meet one or more of the criteria enumerated above may be eligible for the other exemptions discussed further above (*e.g.*, the advance-approval exemption). Although the date of the election governs whether the Discretionary Transaction is exempt from the short-swing profit rule, the other aspects of the transactions relevant to Section 16 (*e.g.*, the date on which the reporting obligation arises) are determined by when the transactions actually occurs.

A Discretionary Transaction is exempt from the short-swing profit rule of Section 16(b), but not from the reporting requirements of Section 16(a), if the transaction is effected

"pursuant to an election made at least six months following the date of the most recent election, with respect to any plan of the [Company], that effected an [opposite-way transaction]." Accordingly, where Section 16 Insiders are permitted by the terms of benefit plans to make Discretionary Transactions, it is important that Company policies and procedures either preclude a Section 16 Insider from making opposite-way Discretionary Transactions within any six-month period or that the Company at least advise the insider of the implications of making a later Discretionary Transaction within six months after an earlier one.

Effect of Mergers on Officer and Director Equity

In a merger of two companies, equity securities of the target company are surrendered and equity securities of the acquiring company may be acquired. Absent an exemption from Section 16(b), these dispositions of target company equity securities by that company's officers and director may be treated as "sales," and acquisitions of the acquiring company's equity securities by that company's officers and directors (including persons who take such offices in connection with the merger) may be treated as "purchases." Although such dispositions of target company equity securities may not literally be transactions "between" the issuer and its officers and directors, the staff of the SEC agreed with an interpretive request made by Skadden in 1999 pursuant to which the advance approval of the applicable company's board of directors or a qualifying committee will exempt the disposition of the target company's equity securities or the acquisition of the acquiring company's equity securities. Note that in two-step mergers (that is, a tender offer by the acquirer followed by a back-end merger), a target company officer's or director's participation in the tender offer is not seen as a transaction with the company that issued the shares and accordingly is not likely to qualify for the advance approval exemption.

Litigation Challenging Pre-Approval Exemption

Plaintiffs have recently challenged the availability of the exemption from the short-swing profit rule of Section 16(b) for officers and directors' dispositions of shares to the Company that are deemed to arise in net share settlements made to satisfy tax or exercise-price withholding obligations.

These plaintiffs have alleged variously that the Committee did not approve the disposition arising under the net settlement with sufficient specificity, that the Committee's grant of discretion to the officer or director was insufficient to establish the exemption, that the net share settlement as ultimately effected was outside the scope of the terms approved in advance, or even that the SEC lacks authority to provide for an exemption in certain circumstances. These arguments seek to portray net share settlements as sales subject to Section 16(b) and to match those alleged sales against purchases made within a period of less than six months. Although these plaintiffs have suffered a number of losses on both procedural and substantive grounds, they have been persistent in pursuit of their theories.

While pre-approval by the Committee of each instance of net share settlement should be sufficient to protect the Company from these claims, neither the SEC nor the courts require such a high degree of specificity. Companies should review their award agreements and resolutions relating to net share settlement or other share withholding provisions to ensure compliance with the Section 16 rules and minimize the threat posed by these claims.

Chapter 10

Executive Compensation Litigation/Enforcement

Recent years have seen a significant increase in executive compensation litigation. The cases fall loosely into "types," or "waves," pursuant to which plaintiffs seize on a particular type of perceived compensation deficiency and target companies with demand letters or complaints that follow similar lines. As a result, the specific nature of the deficiencies alleged have tended to evolve over time as companies modify their practices to avoid being caught up in the most current wave.

Moreover, this past year the SEC indicated renewed interest in enforcement of the Regulation S-K 402 compensation disclosure requirements, particularly involving disclosure of perquisites. Such disclosure requirements are described in greater detail in Chapter 4.

It is important that Committee members be familiar with these litigation/enforcement trends so that steps can be taken to reduce the risk that the Company will become a target and, in any event, so that the Company is in a position to respond promptly and confidently if it does become a target.

Executive Compensation Litigation/ Enforcement

This chapter focuses on "waves" of litigation rather than the perpetual series of one-off challenges to executive compensation determinations. The latter cases — often involving claims of breach of fiduciary duty and corporate waste — are of course no less significant to any individual Company but are less susceptible to helpful synthesis in a forum like this Handbook because of their typically fact-intensive nature. Accordingly, this chapter focuses on historical challenges to failed say on pay votes, ongoing proxy disclosure and Section 162(m) claims and recent developments in SEC enforcement proceedings.

Failed Say on Pay Votes

The Dodd-Frank Act expressly provides that the results of a say on pay vote may not be construed to create or imply any change in directors' fiduciary duties or impose any additional director duties. Nonetheless, after the first season of say on pay votes in 2011, plaintiffs began filing derivative actions against companies with failed say on pay votes. These suits typically alleged that directors breached their fiduciary duties by approving executive compensation arrangements that were not in the best interests of shareholders as evidenced by poor Company performance and low shareholder approval rates.

While several of the early suits settled, most were dismissed on procedural grounds applicable to derivative actions. In a derivative action, the plaintiff must first demand that the Board itself take action to initiate the suit (which would largely eliminate the incentive to bring this type of suit) or demonstrate that such a demand would be futile, either because the directors had an interest in the transaction and thus were not independent or because the transaction at issue was not the result of a valid exercise of the Board's business judgment.

The courts generally found that a failed say on pay vote did not excuse demand because it was not enough to call the directors' business judgment and independence into question, particularly given that the vote is advisory and the Dodd-Frank Act makes clear that it does not impose additional duties.

As a result, these types of suits are generally no longer seen today, though their history sheds helpful light on the nature of the next wave of suits that followed.

Alleged Proxy Disclosure Deficiencies

This wave of proxy litigation began in 2012 and was initiated primarily by a single plaintiffs' law firm. The strategy borrows from an approach common to the M&A context, where a shareholder alleges that merger proxy disclosure is inadequate because it misstates or omits material information. The shareholder seeks to delay the vote to approve the transaction until supplemental disclosure is provided, and such suits often settle (generally with attorney's fees paid) once the supplemental disclosure is provided.

The litigation alleging proxy disclosure deficiencies borrows from an approach common to the M&A context.

In the executive compensation context, the case is typically filed (or, in many instances, no case is filed but a letter threatening a lawsuit is sent to the Company) shortly after the Company files its definitive proxy statement. The plaintiff's threatened or actual claims allege breaches of fiduciary duties in connection with compensation-related proposals, generally the say on pay proposal or, more commonly now, a proposal to adopt or increase the amount of shares reserved under an equity compensation plan.

These cases are generally brought as class actions in the state court in which the Company's principal place of business is located. The demands for additional disclosure often are not based on allegations of deficient disclosure under SEC rules but rather on the theory that a director may breach his or her state-law fiduciary duties by failing to disclose material information in connection with a request for shareholder action (*e.g.*, the say on pay or equity plan approval vote). Plaintiffs claim that a variety of additional information is necessary for shareholders to make an informed vote.

A preliminary injunction was granted in one of the earliest cases, the April 2012 California state court case of *Knee v. Brocade Communication Systems, Inc.* In that case, plaintiffs alleged insufficient disclosure regarding a proposal for a relatively significant increase in shares reserved for issuance under an equity plan where the increase was based on undisclosed equity grant projections. Despite the plaintiffs' initial victory in that case, companies that have been willing to resist these lawsuits have largely been successful. In a string of 2013 decisions, courts held that the information requested by plaintiffs, while potentially helpful, was not material and thus not a required subject of disclosure.

Some companies concerned about potential disruption to their annual meetings have been willing to settle these claims, however. There have been at least six reported settlements, all involving proposals to increase the number of shares authorized under equity plans. These settlements have generally involved supplemental disclosure and payment of up to $625,000 of plaintiffs' attorneys fees. Other companies have settled prior to the filing of a formal lawsuit, generally for significantly smaller amounts.

While "investigations" have continued to be announced by law firms specializing in this type of litigation, it appears there has been a slowdown in reported litigation activity arising from those investigative efforts. The Company should nevertheless be aware of the threat of litigation.

Although there is no single approach to avoiding these lawsuits and shareholder demands, the Company should determine whether additional proxy disclosure is warranted, particularly with respect to equity compensation plan proposals.

Not surprisingly, it is now common to see equity compensation plan proposal disclosure that is much more fulsome than in years past and that includes the type of information that has typically been provided in supplemental disclosure as part of claim settlements, including as applicable:

- a summary of the relevant information presented to the Committee by its independent compensation consultant;
- how the Board determined the number of additional shares to be authorized;
- the contemplated size and timing of new award issuances and the potential equity value and/or costs of the issuance of the additional shares;
- the dilutive impact that issuing additional shares may have on existing shareholders and the amount of planned additional stock repurchases;
- the Company's gross burn rate, net burn rate and overhang compared to the compensation peer group or the survey data used to formulate the overall size of the plan; and
- a detailed breakdown of the different groups of individuals who may receive grants under the plan (*e.g.*, employees, directors, consultants), the size of each such group and the extent to which foreign subsidiary employees receive grants.

Providing such disclosure in the proxy as initially filed may make the Company a less likely target of this type of litigation.

Section 162(m) of the Internal Revenue Code

What is often thought of as the third wave of proxy litigation relates to Section 162(m) of the Code. Claims under Section 162(m) are not new, but the pace of claims accelerated markedly approximately five years ago. The recent changes to Section 162(m), which are discussed in Chapter 8, likely mean that the existing types of claims relating to Section 162(m) that are discussed here gradually will dry up.

The claims usually allege some mix of corporate waste, unjust enrichment and breach of fiduciary duties by directors and have been brought even where the Internal Revenue Service has not asserted noncompliance with Section 162(m).

- the directors failed to structure the executive compensation program in compliance with the (now repealed) exceptions to the tax deduction limits under Section 162(m) and thus forewent an available deduction; or
- the Company failed to comply with those exceptions under Section 162(m) where the proxy statement stated that it would do so.

For example, a typical claim, and one of the more problematic, is that executives were awarded equity grants in excess of the per-person limit set forth in the plan and approved by shareholders.

At least one company that had exceeded the per-person limit in its equity plan voided the grant in question and then sought shareholder approval for an increase in the annual per-person limit under the plan, which required the company to postpone its annual meeting to provide additional time for the proposed increase to be considered (and ultimately approved) by shareholders. Similar rescissions of grants by other companies have occurred in apparent response to threats of litigation.

As with the earlier proxy disclosure deficiency wave of litigation, most Section 162(m)-based claims have been dismissed on procedural grounds (namely a failure to demonstrate

demand futility). Some cases have gone forward, however, at least where the plan at issue also provided for grants to directors (such that the independence of their judgment was open to more question and their determinations potentially subject to a more stringent standard of review).

One recent case involving Netflix has drawn considerable attention (*City of Birmingham Relief and Retirement System v. Hastings)*. In April 2018, a shareholder filed a derivative claim against certain Netflix directors and executive officers alleging breaches of fiduciary duty and corporate waste. At bottom, the complaint alleges in relevant part that the company's proxy disclosure was misleading because it indicated that the company's Performance Bonus Plan complied with the Section 162(m) performance-based exception and that the goals thereunder, when set, were substantially uncertain to be achieved whereas, according to the complaint, defendants knew attainment of the goals was substantially certain and, indeed, Netflix's top officers had hit their target in seven out of eight quarters. As a result, Netflix paid approximately $18.73 million out of a target pool of $18.75 million in the applicable period — a result the plaintiffs allege shows the program was "rigged."

In light of the repeal of the performance-based compensation exception to Section 162(m), there are limited steps that a Company can now take to avoid a derivative suit alleging fiduciary failures associated with Section 162(m) claims based on compensation payments and other activities in respect of years before 2018. With respect to payments that are grandfathered under Section 162(m), the Company should ensure that any incentive compensation payments comply with the terms of the applicable plan and that the applicable compensation program is accurately described in the proxy — including its grandfathered status under Section 162(m). It may be further advisable for the Company to avoid stating in its proxy that any payment is in fact grandfathered given the uncertainty as to the application of the applicable rules in some circumstances, and consideration should be given to clarifying in the proxy as appropriate that compensation programs are no longer being designed with a view toward compliance with the repealed Section 162(m) provisions.

Recent Developments

Notable recent developments in litigation/enforcement waves involve the Exchange Act Rule 16b-3 litigation discussed in Chapter 9 and enhanced SEC scrutiny of perquisite disclosures after a relatively long period of not bringing such actions.

For example, in January 2017, the SEC issued an order instituting cease-and-desist proceedings against MDC Partners for its failure to disclose more than $11 million in perquisites paid from 2009 to 2014 to its then-CEO. MDC took a number of remedial actions and paid a $1.5 million penalty to settle those charges, among others. In May 2017, the SEC issued a separate order against the CEO alleging that he knew, or was reckless in not knowing, that the proxy statements contained materially false and misleading executive compensation disclosures and that they omitted numerous personal expenses for which he sought reimbursement as business expenses. The CEO agreed to repay the perquisites and personal expense reimbursements, pay $5.5 million in disgorgement and penalties to the SEC, and be banned from serving as an officer or director of a public company for five years.

Even more recently, in early July 2018, the SEC issued an order finding that The Dow Chemical Company failed to properly disclose approximately $3 million in perquisites. The SEC imposed a $1.75 million penalty, required Dow to retain an independent consultant to evaluate and recommend changes to the company's policies and procedures relating to perquisites disclosure and generally to implement the consultant's recommendations.

Later that same month, the SEC filed a complaint against the CEO of Energy XXI alleging various disclosure violations, including the company's failure to report at least $1 million in compensation over a five-year period — including expenses that the SEC claimed were unreasonable, personal and/or not appropriately documented. The CEO agreed to a $180,000 penalty and a five-year ban on serving as an officer or director of a public company.

In light of the foregoing, companies should ensure that their policies and procedures for compliance with perquisite disclosure rules — a relatively tricky area of disclosure — are appropriate and consistently followed. In practice, it can be difficult to determine whether a benefit is a perquisite. Although the SEC has provided general principles and interpretive guidance, companies must analyze the applicable facts and circumstances in order to determine whether a benefit is a perquisite, and significant grey areas remain. Once the determination has been made, the disclosure rules themselves also are rather complicated, and care must be taken to ensure compliance.

Chapter 11

Eligibility to Serve

Under the Exchange Act, as amended by the Dodd-Frank Act, each member of the Committee must be an independent member of the Board. In addition, in order to take advantage of certain exemptions under the short-swing profit recovery rules under the Exchange Act and certain (now grandfathered) exemptions from the deduction limitation on employee compensation under Section 162(m) of the Code, each member of the Committee also must qualify as a "non-employee director" for purposes of Section 16 of the Exchange Act and as an "outside director" for purposes of Section 162(m).

Eligibility to Serve

Independence for Exchange Purposes

Even prior to the enactment of the Dodd-Frank Act, the NYSE and Nasdaq required Committee members to be independent under their general standards on director independence. Under these general standards, the NYSE and Nasdaq apply their own tests (objective and subjective, respectively) to determine whether or not a director is independent. With the enactment of the Dodd-Frank Act, the NYSE and Nasdaq were required to develop additional independence requirements specific to members of the Committee.

The NYSE and Nasdaq standards for Committee member independence are generally consistent with each other. Each member must qualify as independent pursuant to the general standards on independence and, in addition, the Board must make an affirmative determination that each Committee member is independent after considering the following factors:

- whether the Committee member receives compensation from any person or entity (including any consulting, advisory or other compensatory fees paid by the Company to the Committee member) that would impair the Committee member's ability to make independent judgments about the Company's executive compensation; and
- whether an affiliate relationship places the Committee member under the direct or indirect control of the Company or its senior management or whether it creates a direct relationship between the director and senior management, in each case of a nature that would impair the Committee member's ability to make independent judgments about the Company's executive compensation.

Both the NYSE and Nasdaq generally allow a listed issuer to cure a failure to comply with the independence standards applicable to Committee members. If a Committee member ceases to be independent for reasons outside of the Committee member's control, the member may continue to serve on the Committee without disqualifying the Company until the earlier of its next annual shareholders' meeting or the one-year anniversary of the event that caused the Committee member to no longer be independent. The Committee member independence requirements are also subject to transition relief periods for IPOs, spinoffs, carve-outs, companies emerging from bankruptcy and certain other circumstances.

Section 162(m) Requirements

As discussed in Chapter 8, Section 162(m) of the Code imposes a limit of $1 million on the amount of compensation that a public company may deduct in any taxable year with respect to compensation paid to certain covered employees. However, certain "performance-based compensation" that qualifies for the transition rule under the TCJA will not be not subject to the Section 162(m) deduction limitation. In order to qualify as grandfathered "performance-based compensation," under the TCJA, among other requirements, a committee consisting solely of two or more "outside directors" must certify in writing prior to payment of the compensation that the applicable performance goals were satisfied.

The regulations under Section 162(m) provide that a director is an "outside director" of the Company if the following requirements are met:

- the director is not a current employee of the Company;
- the director is not a former employee of the Company who receives compensation for prior services (other than under a tax-qualified retirement plan) during the taxable year;
- the director has not been an officer of the Company; and
- the director does not receive remuneration from the Company, either directly or indirectly, in any capacity other than as a director. A director will be viewed as having received remuneration in a capacity other than as a director if payment for non-director services is made:
  - » to an entity in which the director has a beneficial ownership interest of greater than 50% (in which case the amount is considered paid when actually paid (and throughout the remainder of the Company's taxable year) and, if earlier, throughout the period any obligation to pay the remuneration was in force);
  - » during the Company's preceding taxable year to an entity (a "minority-owned entity") in which the director has a beneficial ownership interest of at least 5% but not more than 50% (other than de minimis amounts); or
  - » during the Company's preceding taxable year to an entity (an "employing entity") by which the director is employed or self-employed other than as a director (other than de minimis amounts).

Grandfathered "performance-based compensation" remains subject to a performance certification requirement.

For the foregoing purposes, amounts paid to a minority-owned or employing entity generally are de minimis if they did not exceed 5% of the entity's gross revenues for its taxable year ending with or within the Company's preceding tax year, though amounts in excess of $60,000 are not de minimis if paid to a minority-owned entity or if paid for personal services (*e.g.*, legal, accounting, banking or consulting services) to an employing entity.

Rule 16b-3 Requirements

As discussed in Chapter 9, Section 16(b) of the Exchange Act provides that certain Company insiders are generally liable to the Company for any profits resulting from the sale of Company equity securities within six months following an acquisition. Rule 16b-3 under the Exchange Act provides an important exception for awards granted to an officer or director where the grant is approved by a committee composed solely of two or more "non-employee directors."

Rule 16b-3 provides that a director is a "non-employee director" if the following requirements are met:

- the director is not an officer or employee of the Company or a Company parent or subsidiary;

- the director does not receive compensation from the Company or a Company parent or subsidiary for services rendered in any capacity other than as a director of the Company, except in an amount that since the beginning of the fiscal year does not exceed the amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K ($120,000); and
- the director does not have an interest in any "related party" transaction for which disclosure would be required in the Company's proxy statement pursuant to Item 404(a) of Regulation S-K.

Disclosure under Item 404(a) is generally required for any transaction since the beginning of the Company's last fiscal year, or for any currently proposed transaction, in which the Company was or is to be a participant for which the amount involved exceeds $120,000 and in which any "related person" had or will have a direct or indirect material interest. The term "related person" generally means any director or executive officer of the Company or his or her immediate family members, any nominee for director or his or her immediate family members, or a beneficial owner of more than 5% of the Company's voting securities or his or her immediate family members.

Chapter 12

Special Considerations in the M&A Context

Executive compensation receives special attention in the M&A context because of the significant payment amounts that are often involved. Committee members should be familiar with the compensation incentives of Company management in the M&A context; those incentives may differ depending on whether the Company is the target or the acquirer. Moreover, when the Company is the acquirer, Committee members may be asked their views regarding the compensation potentially payable to management of the target.

Special Considerations in the M&A Context

Compensation Programs

Where the Company is the target in a pending or anticipated transaction, the principal goal of the Board is to ensure that the Company's shareholders receive the best value for their shares. Executive compensation programs can further this goal by encouraging the continued attention and dedication of management to their assigned duties (including facilitating execution and closing of a sale agreement) and discouraging premature management departures or distraction that would be to the detriment of the Company and its shareholders. The most typical tools in this regard include:

- employment agreements with severance provisions;
- change in control severance agreements (a severance agreement that pays only in the change in control context); and
- retention agreements (whether on a stand-alone basis or as a complement to existing severance protections).

Who should have such agreements and what their specific provisions ought to be is a question unique to each company. It is important to analyze that question in the overall context of the Company's compensation program, for example with regard to how any transaction-specific arrangements complement existing long-term incentive awards.

Even where the Company is the acquirer, it is important to understand the consequences of existing Company executive compensation arrangements to identify any unintended consequences. For example, there may be circumstances under which a change in control definition may be triggered, particularly if the definition is of older vintage and the transaction approximates a merger of equals. While this could be appropriate in some limited circumstances, shareholders may view it skeptically (particularly if single-trigger equity vesting is the result). The acquisition also may require performance metrics under the Company's existing incentive compensation programs to be adjusted.

It is important for Committee members to periodically review existing arrangements and consider the need for new, amended or different arrangements so that the arrangements continue to serve their intended purpose. As discussed below, revising programs may become difficult once an actual transaction is contemplated and so it is generally preferable to implement any changes on a "clear day."

Due Diligence Considerations

Where the Company is the acquirer, it is of critical importance to understand the consequences of the contemplated transaction for the target company's executive compensation arrangements, including not only the cost but also the executive retention implications. From an operational perspective, the existence of a different compensation program at the target may be an indication of potential roadblocks to a successful integration of the two companies for cultural or other reasons.

Regardless of whether the Company is the target or acquirer, special attention should be paid to golden parachute (280G) tax treatment, which is discussed in Chapter 8. Any loss of tax deduction for golden parachute payments will add to the cost of severance payments, particularly if the payments are grossed up for the excise tax imposed on the executive. As noted in Chapter 8, golden parachute gross-ups have become less common in recent years.

Scrutiny of New Compensation Programs

Adoption of new (or amendments to existing) compensation programs when a takeover or other M&A activity is pending or anticipated can be subject to enhanced scrutiny if the action is deemed to have been taken as a defensive measure. In such a case (under the so-called Unocal standard), directors must be able to demonstrate that:

- they had a reasonable basis for concluding that there was a danger to corporate policy and effectiveness; and
- the adoption of new or amendments to existing compensation programs was reasonable in relation to the threat posed.

If this standard is satisfied the directors will be entitled to the protections of the business judgment rule (as discussed in Chapter 1). Because of the risk that the standard may not be satisfied (and because of the risk that in any event the action may cause the directors' activities to be more closely scrutinized), it is advisable to adopt new (or amendments to) existing compensation programs when there is no pending or anticipated M&A activity involving the Company.

Special Considerations in the Case of a Tender Offer — Best Price Rule

Pending tender offers present special concerns in regard to compensation arrangements because of the "best price rule," which requires that all tendering security holders be paid the same consideration in a tender offer.

- Historically there had been concerns that compensatory and other arrangements with a Company's security holders, who may be employees or have other relationships with the Company, could be deemed additional consideration for their tendered shares above and beyond the price offered and paid to other security holders in the tender offer, in violation of the best price rule.
- Several years ago the SEC amended the best price rule to clarify that it applies only to consideration paid in exchange for securities tendered and not to consideration that relates to an aspect of the acquisition transaction other than payment for the tendered securities simply because it is paid to persons who happen to be security holders (*e.g.*, employees).

Due to the particular focus on compensatory arrangements, the SEC adopted a specific exemption from the best price rule for employee compensation, severance and benefit arrangements. Accordingly, the best price rule *does not apply* to the "negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such an arrangement, with respect to any security holder" where the amount payable under the arrangement:

- is being paid or granted as compensation for past services performed or future services to be performed or refrained from (*i.e.*, non-competition agreements), and matters incidental to those services; and
- is not calculated based on the number of securities tendered or to be tendered by the security holder.

A non-exclusive safe harbor provides that an arrangement entered into in connection with a tender offer (whether conducted by a third party or an issuer) will be deemed to be within the exemption if it was approved as being an employment compensation, severance or other employee benefit arrangement.

- In a third-party tender offer, this approval generally must be granted by the compensation committee of either the bidder (if the bidder is a party to the arrangement) or the subject company (regardless of whether the subject company is a party to the arrangement).
- In an issuer self-tender, the approval generally must be granted by the compensation committee of the issuer (regardless of whether the issuer is a party to the arrangement) or, if an affiliate of the issuer is a party to the arrangement, that affiliate.

Although the safe harbor is available to eliminate any doubt that approved compensatory arrangements fall within the exemption from the best price rule, compliance with the terms of the exemption itself, without reference to the safe harbor, is sufficient to remove the arrangement from the scope of the best price rule.

Chapter 13

Director Compensation

Director compensation considerations differ from those applicable to executive compensation in some significant respects, and compensation awarded to directors has recently come under particular scrutiny from shareholders. This chapter provides an overview of some typical director compensation arrangements and discusses the special considerations that apply.

Director Compensation

Overview

Often the Board as a whole sets the compensation of directors, though, in some cases, that responsibility may fall within the duties assigned by the Board to the Committee or another committee of the Board, or the Committee (or such other committee) may make recommendations to the Board about the director compensation program.

Most of the considerations discussed in the context of an executive compensation program apply to the establishment of director compensation as well, although, as described below, director compensation programs typically have fewer components than executive compensation programs.

The focus of director compensation is also different from the focus of executive compensation. The focus of director compensation is on encouraging director oversight of management, protecting the long-term interests of shareholders and avoiding the kind of entrenchment that jeopardizes director effectiveness. By contrast, the focus of executive compensation is on, among other things, rewarding successful strategic decisions during the course of the day-to-day management of the Company and the tenure of high-achievers. Given these differing points of emphasis, director compensation programs focus less on retaining top talent and more on encouraging ongoing engagement and fresh perspectives.

Components of Director Compensation

Directors are typically compensated through a mix of cash and equity with a modest emphasis on equity, particularly for larger companies. More specifically, directors generally have historically received some or all of the following forms of compensation:

Cash Compensation	Equity Compensation
Annual Cash Retainer	Stock Options
Per-meeting Fees	Restricted and Unrestricted Stock Awards
Deferred Cash	Stock-based Awards (*e.g.*, RSUs)

In addition to reimbursement for travel and other business expenses, directors sometimes receive additional benefits, such as life, travel and accident insurance; perquisites (if provided, typically including products, services or health insurance at reduced costs and/or participation in matching charitable contribution programs); and perquisites for spouses and other family members (such as travel to board meeting locations and entertainment while there).

Director compensation programs vary widely based on a company's size, industry and other factors. However, several generalizations can be made.

First, companies generally have moved away from per-meeting fees toward annual cash retainers. This trend is the result of a number of factors, including the expectation of ongoing communications among directors outside of the company's formal meetings.

Most directors at public companies are already strongly incentivized to attend board and committee meetings without the added incentive of per-meeting fees. The proxy advisory firms described in Chapter 5 track the attendance of these meetings, and if a director fails to attend at least 75% of a company's meetings, the proxy advisory firms generally will recommend voting against the director's re-election.

Second, the general trend in equity compensation (for both directors and employees) has moved away from stock options in favor of full-value awards in the form of restricted stock or restricted stock units. (Additional information about these types of awards and equity-based compensation more generally is provided in Chapter 6.) Full-value awards are granted in either fixed-dollar or fixed-share amounts, but the trend has favored fixed-dollar equity awards, which afford a board additional precision in determining the absolute dollar value of equity compensation.

Third, at many companies, directors who take on additional responsibilities receive additional compensation. For example, a non-executive chairperson may receive a larger annual retainer than other board members due to the additional duties that come with the position. Members of the audit, compensation or other committees also may receive larger annual retainers or larger per-meeting fees, and the chairs of the various board committees may receive additional compensation for serving as such.

Finally, for the reasons described below under "Recent Developments in Director Compensation," it has become increasingly common for companies to impose specific limitations on director compensation awarded pursuant to shareholder-approved compensation plans, though the utility of doing so is uncertain and limited.

Stock Ownership Guidelines

Stock ownership guidelines for directors are the norm among public companies. These guidelines serve as an important link between the interests of directors and shareholders and achieve the desired linkage by requiring each director to acquire and hold a meaningful number of the company's shares while serving as director. The number of shares varies from company to company, but, typically, the value of shares that a director must hold is equal to a specified multiple of the director's annual cash compensation. Multiples typically range from three to five times a director's annual cash compensation. Directors are generally given a period of time following their initial appointment — typically between three and five years — to accumulate the shares required to meet the stock ownership requirement.

Recent Developments in Director Compensation

Where compensation decisions involve directors paying themselves, Delaware case law provides that the protections of the business judgment rule typically will not be available.

As discussed in Chapter 2, under Delaware law, a claim involving director conduct generally is subject to review under the "business judgment rule," under which the court will presume the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the decision at issue was in the corporation's best interest. This deferential standard does not apply if a majority of directors are interested in the decision or would derive a personal financial benefit from the decision. Consequently, claims relating to director compensation typically are reviewed under a more onerous level of scrutiny — the "entire fairness" test — which requires that directors bear the burden of proving that their compensation decision was entirely fair to the corporation.

However, if the board can show that the challenged decision was ratified by a vote of fully informed stockholders, then the entire fairness review will not apply, and director action will be reviewed under the more deferential business judgment rule. In recent years, a number of Delaware lower court cases had examined the extent to which shareholder approval of an equity-compensation plan is sufficient to cause grants to directors under such plans to be analyzed under the business judgment rule — a line of cases beginning with *Calma v. Templeton*. Those cases held that stockholder approval of a discretionary equity plan could constitute "ratification" if the equity plan contained a "meaningful limit" on director compensation.

On December 13, 2017, the Delaware Supreme Court issued a decision in *In re Investors Bancorp, Inc. Stockholder Litigation*, which held that, except under limited circumstances, the deferential business judgment rule will not be applied in reviewing challenges to director compensation awards granted by Delaware companies pursuant to stockholder-approved equity plans. Instead, such awards will be subject to the entire fairness standard of review.

In that case, the board of directors submitted an equity plan for stockholder approval pursuant to which the maximum number of shares that could be issued to all non-employee directors totaled 30 percent of all option or restricted stock shares available for awards. The plan did not impose any other limits on grants to directors. After the plan was approved by the company's stockholders, the directors awarded themselves equity awards, the aggregate grant date fair value of which for all 12 board members was approximately $51.5 million. The plaintiff alleged that the directors' compensation exceeded the compensation paid to directors of peer companies. Although the Court of Chancery noted that the director awards in this case appeared to be quite large, it dismissed the case because the plan contained "meaningful, specific limits on awards to all director beneficiaries," and the actual awards granted fell within those limits. As a result, the Court of Chancery found that the stockholder approval of the plan was sufficient to allow defendants to invoke a stockholder ratification defense.

However, the Delaware Supreme Court reversed the Court of Chancery's decision, holding that the discretion granted to directors in the equity plan to approve specific awards precluded the stockholder ratification defense. Consequently, the Delaware Supreme Court found that the grants were "self-interested decisions" and subject to the entire fairness standard of review.

According to the Delaware Supreme Court, ratification is a permissible defense in two scenarios: (1) when stockholders approve specific director awards and (2) when the equity plan is a self-executing formula plan, such that the directors have no discretion in granting the awards to themselves. If directors retain discretion to make awards under the general parameters of a plan — even when the parameters are specific to directors — then the shareholder ratification defense cannot be used to foreclose a breach of fiduciary duty claim.

In light of the ruling, the utility of director specific limits on compensation is unclear. While director limits that still permit discretion when making the awards clearly no longer are sufficient to secure business judgment rule review (even if shareholder approved), they may serve as evidence that there was — or at least serve as a catalyst for establishing — a process for determining that actual director compensation was in fact reasonable. Moreover, as a result, prospective plaintiffs may prefer to target Companies without such limits. For Companies that already had established such limits, eliminating them may prove difficult to explain to shareholders absent compelling circumstances.

ISS Voting Policy Relating to Director Compensation

ISS has adopted a policy, which was first effective with respect to shareholder meetings occurring on or after February 1, 2018, that provides for adverse vote recommendations for Board or Committee members who are responsible for approving or setting nonemployee director compensation where there is a recurring pattern (two or more consecutive years) of excessive nonemployee director pay without a compelling rationale or other mitigating factors. As a result of the two-year pattern requirement, this new policy was not to have impacted votes until 2019, but ISS subsequently announced in November 2018 that the first possible adverse vote recommendations will be delayed until 2020 to give it additional time to refine the policy in light of feedback it has received.

With *Investors Bancorp* and this new ISS policy in mind, the Board should consider taking the following actions to the extent it has not yet already done so:

- Carefully review any limits that currently apply under its cash and non-cash director compensation programs.
- If the Board determines that the current director compensation programs do not include meaningful limits, the Board should consider amending the applicable plan to include meaningful limits and seeking shareholder approval of the amended plan. As explained above, however, the utility of such shareholder approval is at best uncertain. Accordingly, Companies also may wish to consider whether to provide for grants of director compensation awards pursuant to a stockholder-approved formula plan or via grants of awards specifically approved by stockholders.
- If a shareholder ratification defense is not available or otherwise not likely to prevail, the Board should be mindful of considering and developing the relevant factors that would provide a basis for withstanding "entire fairness" scrutiny. Among other steps in that regard, Companies should work with their compensation consultants to regularly conduct a peer review of their director compensation programs in order to determine whether their director compensation, including equity grants, are reasonable. Companies should carefully document this process and disclose it in their annual proxy statements.
- Ensure that the disclosure regarding director compensation in the Company's annual proxy statement is clear and expand it beyond historical norms if necessary to provide a thorough description of its amount and how that amount was determined. While it is clear that nothing along the lines of a CD&A is required, it may be appropriate in particular — as has become increasingly common — to include additional detail regarding the process used by directors to evaluate and set their compensation and any role played by compensation consultants in that regard.

Concluding Note

As is obvious from the heft of this Handbook — even notwithstanding its summary and non-technical approach — the task faced by Committee members is formidable. The world of executive compensation is a dynamic one where new ideas and issues regularly arise, and Committee members need to stay abreast of them while viewing new developments in their proper historical context. It is our hope that this Handbook will help Committee members better understand their responsibilities, arm them with the information they need to discharge those responsibilities and enable them to make the best use of their advisors.

Appendix

- Sample Compensation Committee Calendar of Meetings and Responsibilities
- Glossary of Commonly Used Terms

The chart below sets forth a sample allocation of Compensation Committee responsibilities for a corporation listed on the New York Stock Exchange with a fiscal year coinciding with the calendar year.

Committee Responsibility	Ongoing/ As Necessary	Feb	Mar	Aug	Nov
Oversight of Executive Compensation and Employee Benefit Programs					
Review the Company's executive compensation programs and determine whether they remain effective to attract, motivate and retain executive officers and other key personnel.	•				
Meet with senior risk officers to discuss the Company's compensation policies and practices for employees as they relate to risk management and risk-taking incentives.		•			
Annually review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and either as a committee or together with the other independent directors (as directed by the Board) determine and approve the CEO's overall compensation levels based on this evaluation and in accordance with any applicable employment agreement then in effect.		•			•
Review and approve, annually and at the time of any new executive officer hire, the following with respect to the executive officers of the Company: (a) the annual base salary amount, (b) special bonus arrangements, if any, (c) any longterm incentive compensation (including cash-based and equity-based awards and opportunities), (d) any employment agreements, severance arrangements, and change in control and similar agreements or provisions, and any amendments, supplements or waivers thereto, and (e) any perquisites or other special or supplemental benefits, including retirement benefits and perquisites provided to such persons during and after employment with the Company.	•	•			•
Consider, recommend, administer and implement the Company's incentive compensation and equity-based plans in which the CEO, executive officers and other employees of the Company and its subsidiaries participate, including: (a) approving option grants and restricted stock or other awards, (b) interpreting the plans, (c) determining rules and regulations relating to the plans, (d) modifying or canceling existing grants or awards, and (e) imposing limitations, restrictions and conditions upon any grant or award as the Committee deems necessary or advisable.	•	•			
Annually review and adopt, or recommend to the Board, as appropriate, the adoption of new, or the amendment of existing, compensation plans by the Company and any increase in shares reserved for issuance under existing equity-based plans.	•	•			

Committee Responsibility	Ongoing/ As Necessary	Feb	Mar	Aug	Nov
Monitor the Company's compliance with applicable laws and regulations affecting compensation and benefits matters, including: (a) overseeing policies on structuring programs to preserve tax deductibility, (b) overseeing compliance with the requirements of the Sarbanes-Oxley Act of 2002 relating to 401(k) plans and loans to directors and officers, (c) overseeing compliance with NYSE rules regarding shareholder approval of equity-based compensation plans, and (d) as required, certifying that performance goals under grandfathered awards have been obtained for purposes of Section 162(m) of the Code.	•	•			
Review and approve retention of compensation consultants and other outside advisors as applicable and appropriate.	•				
Review and approve policies regarding the independence of compensation consultants.				•	
Compensation Disclosures in Proxy Statement					
Review and discuss the CD&A with the Company's management (including consideration of the results of the most recent say on pay vote) and determine whether to recommend to the Board that the CD&A be included in the Company's proxy statement.		•			
Prepare an annual Compensation Committee Report, as required by the SEC, for inclusion in the Company's annual proxy statement.		•			
Review all equity-compensation plans to be submitted for shareholder approval under exchange listing standards.	•	•			
Evaluations and Other Responsibilities					
Annually review the Committee's own performance.		•			
Review and reassess the adequacy of the Committee's Charter annually and recommend any proposed changes to the Board for approval.		•			
Report regularly to the Board on the Committee's activities.		•	•	•	•

Glossary of Commonly Used Terms

162(m)
Section 162(m) of the Internal Revenue Code, which imposes a limit of $1 million on the amount of compensation that a public company may deduct in any calendar year with respect to compensation paid to each "covered employee." The TCJA made sweeping changes to the application of Section 162(m) to tax years beginning after 2017, subject to grandfathering treatment for certain amounts payable pursuant to a binding written contract in effect on November 2, 2017, that was not materially modified after that date. Among those changes was the repeal of an exception for performance-based compensation, again subject to the grandfathering rule. See Chapter 8.

280G
Section 280G of the Internal Revenue Code, which generally provides that "excess parachute payments" made to certain individuals are nondeductible by the payor company (and, pursuant to Section 4999 of the Internal Revenue Code, subject to a 20% excise tax imposed on such individuals, in addition to any regular income taxes due with respect to such payments). See Chapter 8.

409A
Section 409A of the Internal Revenue Code, which generally imposes strict limitations on the timing of elections to defer compensation, the timing of distributions of deferred compensation, and the reporting and taxation of deferred compensation. See Chapter 8.

457A
Section 457A of the Internal Revenue Code, which is applicable where deferred compensation, including many types of equity compensation, is earned by U.S. taxpayers who perform services for certain non-U.S. corporations and partnerships located in a jurisdiction that is tax indifferent (or more colloquially, a tax haven).

457(f)
Section 457(f) of the Internal Revenue Code, which is applicable to nonqualified deferred compensation arrangements maintained by a tax-exempt employer to supplement the retirement income of its select management group or highly compensated employees.

Base Amount or 280G Base Amount
An individual's base amount for purposes of Section 280G of the Internal Revenue Code is the average of his or her compensation from the employer that was includible in his or her gross income for the most recent five calendar years ended prior to the year in which the change in control occurs (or, if fewer than five years, the entire period of employment).

Best Net Provision
Provision pursuant to which payments are cut back to a level that would not trigger the excise tax under Section 4999 of the Internal Revenue Code unless the individual would be in a better economic position (generally on an after-tax basis) in receiving all amounts and simply paying such excise tax.

Blue Sky or Blue Sky Laws
A state law and regulation concerning the registration and issuance of securities.

Burn Rate
The gross number of equity awards granted or issued in a given year divided by the weighted average common shares outstanding for the same fiscal year. Shares cancelled or forfeited generally are not excluded from the calculation. See Chapters 5 and 10.

Cashless Exercise
A method of exercising a stock option that allows the holder to acquire the underlying stock without an initial cash payment to cover the exercise price.

CD&A
The Compensation Discussion and Analysis section required in a public company annual proxy statement or Form 10-K pursuant to Item 402(b) of Regulation S-K.

Cutback or 280G Cutback Provision
Provision pursuant to which payments must be reduced to a level that would not trigger the excise tax under Section 4999 of the Internal Revenue Code. Also referred to as a "cap" or "280G cap."

Dodd-Frank
The U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act. The 2010 federal law has the stated aim to "promote the financial stability of the U.S. by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

Double Trigger
Rights, payments or benefits that result from, or are triggered by, the occurrence of a change in control of the Company followed by or coincident with a second event (generally, certain limited types of employment terminations, *e.g.*, termination without cause or termination for good reason).

EGC
An Emerging Growth Company, which is generally defined under the JOBS Act as a company with gross annual revenue of less than $1.07 billion during its most recently completed fiscal year and whose first public offering of common equity securities occurred on or after December 9, 2011.

ERISA
The U.S. Employee Retirement Income Security Act of 1974, as amended.

Excess Benefit Plan
A nonqualified defined contribution plan maintained by an employer to provide benefits for certain employees in excess of the limitations imposed on tax-qualified plans under Section 415 of the Internal Revenue Code.

Excess Parachute Payment
Internal Revenue Code Sections 280G and 4999 are triggered if all parachute payments equal or exceed three times the individual's base amount. The amount of the payment that is not deductible under Section 280G and subject to the excise tax under Section 4999 (the excess parachute payment) is any payment in excess of *one* times the individual's base amount.

Exchange Act
The U.S. Securities Exchange Act of 1934, as amended.

Externally Managed Issuer
A company (for instance, many REITs) whose management functions are performed by a management company and the individuals the management company employs rather than by individuals treated as employees of the externally managed issuer itself.

Form 3; Form 4; Form 5
Every director, officer or owner of more than 10% of a class of equity securities registered under Section 12 of the Exchange Act must file with the SEC a statement of ownership regarding such security. The forms contain information on the reporting person's relationship to the Company and on purchases and sales of such equity securities; the initial filing is on Form 3; changes in beneficial ownership are reported on Form 4; and an annual statement of beneficial ownership of securities is made on Form 5. See Chapter 9.

Full Value Awards
Stock-based awards in which the recipient receives the entire value of each share that vests, as with restricted stock or restricted stock units. In contrast, stock options and stock appreciation rights provide a value equal to the increase in share price over the exercise price and thus are not full-value awards. See Chapter 6.

Fungible Share Counting
A fungible or flexible share-counting provision in a stock plan used to determine how many shares have been used and how many remain available for issuance under the plan. Stock awards with a higher accounting value are weighted more heavily against the plan's share reserve than lower value awards. For example, while stock options may reduce the plan reserve by one share for each option granted, restricted stock or restricted stock units ("full-value awards") reduce the pool by a greater number (*e.g.*, two shares for each restricted stock unit granted) because they have a higher accounting value under ASC Topic 718. The ratio selected also will generally reflect the higher value/cost that proxy advisory firms place on full-value awards when evaluating a company's stock plan.

Glass Lewis
A proxy advisory firm. See Chapters 1, 3 and 5.

Golden Parachute
See "Parachute or Parachute Payment" below.

Gross-Up
An additional payment to an individual to make the individual whole for any excise tax triggered by a certain payment (for instance, excess parachute payments).

In the Money
A stock option, the exercise price of which is less than the fair market value of the shares underlying such option as of any given date.

Insiders
See "Section 16" below.

ISO
An "incentive stock option" within the meaning of Section 421 of the Internal Revenue Code. See Chapter 6.

ISS
ISS (Institutional Shareholder Services), the largest proxy advisory firm operating today. See Chapters 1, 3 and 5.

JOBS Act
U.S. Jumpstart Our Business Startups Act. The 2012 federal law is intended to facilitate the funding of small business in the U.S. by easing certain securities regulations.

LTIP
Long-term incentive plan; may refer to cash- or equity-based awards.

Modified Gross-Up
A gross-up paid if the change in control payments exceed a specified amount over the individual's safe harbor (also known as parachute threshold). For example, an agreement may provide that the gross-up will be payable only if the aggregate amount of the change in control payments exceed the safe harbor amount by 10% or more. Generally, if the change in control payments are below this percentage they will be reduced to the safe harbor amount. See "Cutback or 280G Cutback Provision" above.

NEO
Named Executive Officer, referring to the executive officers of a publicly traded company as defined by Item 402(a) of Regulation S-K (or Item 402(m)(2) of Regulation S-K, in the case of an EGC). See Chapter 4.

Net Exercise
A method of exercising a stock option that entails the withholding of a number of underlying shares upon stock upon exercise with a value equal to the aggregate exercise price (and related employment and withholding taxes, where applicable) with respect to the number of stock options being exercised.

Nonqualified Deferred Compensation Plan
Generally, an unfunded, unsecured promise by an employer to pay compensation at a specified time or upon a specified event in the future or a plan providing for the same. Section 409A of the Internal Revenue Code contains a specific definition of "nonqualified deferred compensation" for purposes of the statute and regulations thereunder. See Chapter 8.

NQSO or Nonqualified Option
A stock option that is not an "incentive stock option" within the meaning of Section 421 of the Internal Revenue Code.

Option or Stock Option
An equity award representing the right to purchase a specified number of shares of common stock at a stated exercise price for a specified period of time subject to the terms, conditions and limitations described in an award agreement or in the equity compensation plan pursuant to which the award is granted. See Chapter 6.

Out of the Money
A stock option, the exercise price of which is greater than the fair market value of the shares underlying such stock option. Also known as "underwater."

Parachute or Parachute Payment
A compensatory payment made to a "disqualified individual" that is contingent on a change in control of the Company, including non-cash compensation such as the continuation of health insurance or the acceleration of otherwise unexercisable or restricted equity. See Chapter 8.

Pay for Performance
Compensation linked to the achievement of specified performance goals or measures (as opposed to compensation for continued services over time). Can include payment of compensation that meets the requirements of Section 162(m) of the Code for "qualified performance-based compensation" and that is grandfathered under the transition rule provided pursuant to the TCJA.
See Chapter 5 and Chapter 8.

PEO
Professional Employer Organization, a firm that provides a service under which an employer can outsource employee management tasks by hiring a client company's employees, thus becoming their employer of record for tax purposes.

Proxy Advisory Firms
Firms retained by institutional shareholders to analyze and provide guidance on corporate governance matters and recommend for or against approval of Company proposals submitted for approval by shareholders, including compensation-related proposals. See Chapter 5.

Qualified Plan
Generally, an employee benefit pension plan that meets the requirements of Section 401(a) of the Internal Revenue Code.

Regulation BTR
Regulation Blackout Trading Restriction under Section 306 of the Sarbanes-Oxley Act of 2002 relating to restrictions on insider trades during retirement plan blackout periods.

Regulation S-K
A regulation under the Securities Act of 1933 that sets forth reporting requirements for various SEC filings used by public companies.

REIT
A real estate investment trust, a company that owns and often operates real estate-related assets. To qualify for certain tax advantages available to REITS, a REIT must meet certain investment and income requirements and must distribute a significant portion of its taxable income each year in the form of dividends to its shareholders.

Restricted Stock or Restricted Shares
An award of common stock that is subject to the terms, conditions, restrictions and limitations described in an award agreement or in the equity compensation plan pursuant to which the award is granted. See Chapter 6.

Restricted Stock Units
An equity-based award representing a promise to deliver a share of stock or the equivalent cash value in the future, subject to the terms, conditions, restrictions and limitations described in an award agreement or in the equity compensation plan pursuant to which the award is granted. The term can be used interchangeably with the term "phantom stock," with restricted stock units commonly payable solely in shares and phantom stock commonly payable in an equivalent cash value. See Chapter 6.

S-8
A registration statement filing with the SEC that is used by a publicly traded company to register securities that will be offered to its employees and other service providers who are natural persons under benefit or incentive plans. See Chapter 6.

Safe Harbor or 280G Safe Harbor
Under Section 280G of the Internal Revenue Code, the safe harbor is three times the executive's base amount, less one dollar. The safe harbor may also be referred to as an individual's "parachute threshold." See Chapter 8.

Say on Pay
The requirement that the Company submit the remuneration of executives to a vote of the Company shareholders. In the U.S., say on pay was added by Dodd-Frank and requires public companies to submit to its shareholders a resolution to approve, on a nonbinding, advisory basis, the compensation of the Company's NEOs as disclosed "pursuant to Item 402 of Regulation S-K" (generally as set forth in the Company's annual proxy statement). See Chapter 4.

Section 16
A section of the Exchange Act that is used to describe the various regulatory filing responsibilities that must be met by directors, officers and principal shareholders (owner of more than 10% of a class of equity securities registered under Section 12 of the Exchange Act). See Chapter 9.

Section 83(b) Election
An election made by the recipient of certain restricted property, such as restricted stock, to include the value of the property in income on a current basis although the property remains subject to a substantial risk of forfeiture. See Chapter 6.

SERP
A supplemental executive retirement plan that is not qualified under Section 401(a) of the Internal Revenue Code, most commonly (but not necessarily) a defined benefit pension plan subject to Section 409A of the Internal Revenue Code. See Chapter 8.

Single Trigger
Rights, payments or benefits that solely result from, or are solely triggered by, the occurrence of a change in control of the Company. A "modified single trigger" incorporates the requirement of a termination of employment for any reason, including the right to "walk away" following a change in control and receive the specified payments or benefits.

Six-Month Delay or 409A Six-Month Delay
A rule under Section 409A of the Internal Revenue Code providing that deferred compensation payable upon a Specified Employee's separation from service cannot be paid until six months after a Specified Employee's separation from service (or, if earlier, the employee's death). The six-month delay rule is one of the 409A rules that require documentary compliance as well as operational compliance, meaning that the plan document must expressly provide for the six-month delay. See Chapter 8.

Specified Employee
For purposes of the six-month delay rule under Section 409A of the Internal Revenue Code, a key employee of a public company, as determined under Section 409A regulations.

Stock Appreciation Rights or SARs
An equity award representing the right upon exercise to the cash equivalent of the increase in the value from the grant date of a specified number of shares over a specified period of time, subject to the terms, conditions, restrictions and limitations described in an award agreement or in the equity compensation plan pursuant to which the award is granted. See Chapter 5.

TCJA
The "Tax Cuts and Jobs Act," the name typically given to the sweeping federal tax reform legislation enacted in December 2017.

Top-Hat Plan
A nonqualified deferred compensation plan (*e.g.*, a SERP) established to provide unfunded deferred compensation benefits only to a select group of management or highly compensated employees. A top-hat plan is exempt from most of the strict ERISA requirements that govern qualified pension benefit plans and funded nonqualified deferred compensation plans.

TSR
Total Shareholder Return, a measure of the performance of the Company's stock over time.

Underwater
See "Out of the Money" above.

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