Benefits & Compensation University

2021 Hot Topics in Executive Compensation

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Hot Topics

- Update on Clawback and Recoupment Policies
- Executive Compensation Issues in SPACs and IPOs
- State and Local Laws Impacting Executive Compensation
- Key Recent Cases Impacting Executive Compensation
- Impact of Tax Proposals on Executive Compensation if Passed
- Expansion of Covered Employee for Section 162(m)
- Regulatory Updates
  - Withholding and Deposit Obligations – NSOs, SARs, and RSUs
  - Final Regulations Section 162(m)
  - IRS Updates Its Nonqualified Deferred Compensation Audit Guide
- ESG and Executive Compensation
- Odds and ends

Clawback and Recoupment Issues

- Section 304 of the Sarbanes-Oxley Act—Generally requires public company chief executive officers (CEOs) and chief financial officers (CFOs) to disgorge bonuses, other incentive- or equity-based compensation, and profits on sales of company stock that they receive within the 12-month period following the public release of financial information if there is a restatement because of material noncompliance, due to misconduct, with financial reporting requirements under the federal securities laws.
  - SEC enforced (not private enforcement)
  - Limited to CEO and CFO
  - Requires misconduct but not clear whose misconduct? SEC has successfully argued that the CEO and CFO do not personally need to have engaged in the misconduct.

Clawback and Recoupment Issues

- Section 954 of Dodd Frank Act
- 2015 Proposed Regulations—Require the national securities exchanges to adopt listing standards that require listed companies to adopt and disclose clawback policies to recover amounts from executive officers during three fiscal years prior to date when company is required to restate financial statements due to a material error
  - Mandatory to pursue gross amount of payment that would not have been made if financials were correct
  - No fault required for executive
- Spring of 2022 New Proposed Regulations Expected. Not effective prior to final regulations being adopted

Clawback and Recoupment Issues

Securities and Exchange Commission

Sunshine Act Meetings

TIME AND DATE: Notice is hereby given, pursuant to the provisions of the Government in the Sunshine Act, Pub. L. 94-409, the Securities and Exchange Commission will hold an Open Meeting on Wednesday, October 13, 2021 at 10:00 a.m.

PLACE: The meeting will be held via remote means and/or at the Commission's headquarters, 100 F Street, NE, Washington, DC 20549.

STATUS: This meeting will begin at 10:00 a.m. (ET) and will be open to the public via webcast only on the Commission's website at www.sec.gov.

MATTERS TO BE CONSIDERED:

The Commission will consider whether to re-open the comment period for Listing Standards for Recovery of Erroneously Awarded Compensation, Release No. 33-9862 (Jul. 1, 2015), 80 FR 41143 (Jul. 14, 2015), and issue additional requests for comment on the proposed implementation of Section 10D of the Securities Exchange Act of 1934, as added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Clawback and Recoupment Issues

- Section 956 of Dodd Frank Act—Requires enhanced disclosure and reporting of compensation arrangements for financial institutions that meet the definition of "Covered Institutions" and prohibits incentive-based compensation arrangements that (1) encourage Covered Institutions to take inappropriate risks through the provision of excessive compensation or benefits or (2) could lead to material financial loss to the Covered Institution
- 2016 Proposed Regulations—Never finalized
- "Covered Institutions" generally include banks, investment advisers, broker-dealers and credit unions with over $1 billion in assets (but requirements of rule differ in amount for different sizes of covered institutions).

Clawback and Recoupment Issues

- Among many other requirements, under the proposed rule, the two largest categories of covered institutions would be required to include clawback provisions in incentive-based compensation arrangements that permit the Covered Institution to recover incentive-based compensation from current and former Senior Executive Officers or Significant Risk-Takers for seven years following the date such compensation vests if the Covered Institution discovers that the individual engaged in (i) misconduct that resulted in significant financial or reputational harm to the Covered Institution, (ii) fraud or (iii) intentional misrepresentation of information used to determine the Senior Executive Officer's or Significant Risk-Taker's compensation award.

Clawback and Recoupment Issues

- ISS:
  - Equity Plan Scorecard—Full points for clawback policy that would authorize recovery of gains from all or most equity awards in the event of certain financial restatements.
  - ISS Governance Scorecard—For the US market, ISS defines clawback as the company's ability to recoup performance-based awards (including any cash-based incentive awards, at a minimum) in the event of fraud, restatement of results, errors/omissions or other related activities.

Clawback and Recoupment Issues

- Current Trends:
  - Most public companies have a clawback policy for material financial restatements with fault. Many companies have voluntarily adopted such policies even while Dodd-Frank rules are not yet applicable for good governance and shareholder support
  - Many public company boards and compensation committees considering or implementing clawback policies for bad behavior and no-fault restatements
    - Consideration of “Me too” cases, Wells Fargo and CBS news stories, etc.
  - Not clear what SEC will propose with new Dodd-Frank rules

Clawback and Recoupment Issues

- Key Decisions
  - Mandatory or discretionary clawback?
  - Gross or net amount? Executive may not be able to get taxes back
  - Look-back period for compensation subject to clawback
  - Legal fees—Should company pay fees and advance fees in dispute?
    - Even if not addressed expressly in clawback policy be careful of other agreements or bi-laws that may provide legal fees to executive for dispute
  - Investigation period:
    - Be careful of tax issues if company has authority to hold payments during investigation

Clawback and Recoupment Issues

- Forfeiture of any unpaid amounts
- Triggers:
  - Restatement as a result of the fault of the executive
  - No fault restatement
  - Misconduct without regard to financial statements
  - Acts or omissions that cause reputational harm with no financial impact
  - Failure to supervise or identify risk that results in financial harm
  - Breach of restrictive covenants

Clawback and Recoupment Issues

- Key Decisions
  - Consider Cause definition as part of this process.
    - Many dated Cause definitions do not contain provisions that line up with reputational harm and failure to supervise type concepts.
    - Many Cause definitions do no clearly address conduct that occurred prior to employment or legal conduct that occurs outside of the scope of employment.
    - Also consider whether incentive award agreements permit discretionary forfeiture trigger on determination that Cause exists even without regard to termination.

Clawback and Recoupment Issues

– Private Company Considerations?

– Clawbacks are not common for private companies.

  - Occasionally, you will see an agreement that allows a company to demand repayment if the Board determines later that Cause existed during employment.
  - Private Equity and other investors will often include provisions that require forfeiture if Employee or former Employee engage in bad acts or breach restrictive covenants at any time prior to a liquidity event.
  - Boards do not typically have independent directors so Executives are much more reluctant to have contractual provisions that could require repayment.

Clawback and Recoupment Issues

- Enforceability of Clawback Policies?
- TUNE IN NEXT WEEK!!!

Please join us for Mayer Brown's Benefits & Compensation University. During this webinar series, we are exploring ERISA, benefits and compensation issues in depth and hearing from leading Mayer Brown lawyers about the changing regulatory landscape, including trends in US Department of Labor audits and investigations. The Mayer Brown team will provide practical, business-focused guidance on dealing with these challenges. The third session will cover such areas as:

- New requirements regarding the use of non-compete and non-solicitation agreements
- Enforcement issues in clawbacks and forfeiture of equity compensation
- Other recent legislative and regulatory developments

CLE credit is pending.

Have a scheduling conflict? Register for the webinar, and we will send you a link to the webinar recording and related slide deck shortly after the broadcast date. Please note that to receive CLE credit, you must attend the live program; you will not be eligible for CLE credit based on listening to the recording.

Wednesday, October 20, 2021

United States
12:00 p.m. – 1:30 p.m. EDT
11:00 a.m. – 12:30 p.m. CDT
10:00 a.m. – 11:30 a.m. MDT
9:00 a.m. – 10:30 a.m. PDT

Europe
5:00 p.m. – 6:30 p.m. BST
6:00 p.m. – 7:30 p.m. CEST

Speakers

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State and Local Laws Impacting Executive Compensation

- **California's Board Diversity Law**. On September 30, 2020, California enacted a new law requiring publicly-traded companies based in California to increase board diversity by 2023.
  - Applies to all domestic or foreign companies with its principal office in California
  - Public companies are required to increase board diversity for underrepresented groups, including Blacks, African Americans, Hispanics, Latinos, Asians, Native Americans and members of the LGBTQ community
  - By the end of 2021, all boards must have one underrepresented member
  - By the end of 2022, boards with nine or more members must have three underrepresented members; boards with five to eight members must have two underrepresented members
  - Companies that fail to meet these requirements will be subject to penalties of $100,000 to $300,000
- This follows California's adoption in 2018 of a law requiring that any publicly-held company with a principal office in California include women on their boards, with one woman on each board by the end of 2019, and almost parity, for the end of 2021.

State and Local Laws Impacting Executive Compensation

- **Portland's and San Francisco's CEO Pay Ratio Taxes**
- *San Francisco's Overpaid Executive Tax* (also referred to as the Overpaid Executive Gross Receipts Tax) was approved by San Francisco voters on November 3, 2020 and becomes effective on January 1, 2022. It imposes an additional gross receipts tax of 0.1% to 0.6% on taxable gross receipts from businesses in which the highest-paid managerial employee earns more than 100 times the median compensation of employees based in San Francisco. Businesses that pay the Administrative Office Tax will pay an additional 0.4% to 2.4% on their payroll expense in San Francisco in lieu of the additional gross receipts tax.
  - Not limited to public companies (exemptions for small businesses and certain charitable organizations
- *Portland, Oregon's Tax,* enacted in 2018, imposes a 10 percent surcharge on the city's business tax for public companies whose CEO pay exceeds a 100 to 1 CEO to median employee pay ratio. The surcharge increases to 25 percent if the CEO to median employee pay ratio exceeds 250 to 1.

Employee State Tax Taxation of Deferred Compensation

- Generally, nonqualified deferred compensation is subject to taxation in state where employee earned the compensation and not the state where the employee resides when the compensation is paid.
- However, Section 114(a) provides that: "No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State)."
- Section 114(b)(1)(I)(i) provides that retirement income includes payments from a nonqualified deferred compensation plan if the payments are equal periodic payments (at least annually) made over the life of the participate or a period of ten years or more.

Employee State Tax Taxation of Deferred Compensation

- Section 114(b)(1)(I)(ii) provides that retirement income includes payments from an excess benefit plan (a plan "maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply").
- Section 114 is particularly valuable for retirees who move from state with high state taxes (CA or NY for example) upon retirement to a state with no state taxes (FL or TX for example).
- Company has to take a position on this issue for state withholding taxes. Employee can take his or her own position on the filing of their various state tax returns if needed.

Recent Cases

- Retirement Benefits Claims
  - *Sullivan v. Nissan Supplemental Exec. Ret. Plan II*, 2021 BL 252526 (M.D. Tenn., No. 3:20-cv-00752, 7/6/21
  - *Malloy v. Walgreen Co.*, 2021 BL 272945, N.D. Ill., No. 1:20-cv-05686, 7/20/21
- Recoupment of Executives' Compensation
  - *McDonald's Corp. v. Easterbrook*, Del. Ch., No 202-0658, 2/2/21
  - *Hertz Corp. v. Frissora, D.N.J., No. 2.19-cv-08927*, unpublished 6/3/21

Recent Cases

- Allegations that Investors Were Misled
  - *Flynn v. Exelon Corp*., 2021 BL 146244, N.D. Ill., No. 1:19-cv-08209, motion to dismiss denied 4/21/21
- Excessive Compensation
  - *Gatto v. BioXcel Therapeutics Inc*., Del. Ch., No. 2021-0521, complaint filed 6/15/21
  - *Alpha Venture Capital Partners LP v. Pourhassan*, Del. Ch. No. 2020-307, settlement notice filed 1/28/21
  - *Garfield v. Allen*, Del. Ch. No. 2021-0420, complaint filed 5/1321
- You can be incompetent as long as you are honestly incompetent
  - "GE's Board Won't Seek Clawbacks After $200 Billion Meltdown," *Bloomberg Law News* 1/5/2021

Executive Compensation Issues in SPACs and IPOs

- SPAC and IPOs-Two ways to take a private company public.
- "An IPO is basically a company looking for money, while a SPAC is money looking for a company."
- SPACs are also called "blank check" companies. Transaction with SPAC that takes a private company public is called a de-SPAC transaction.
- For both transactions, companies need to consider the following high level issues:
  - Public company compensation structure
    - Annual bonus and equity grants
    - Pay for performance
    - Public disclosure of compensation program and rationale
    - Shareholder approval of equity plans
  - Peer Group
  - ISS/Shareholder Issues

Executive Compensation Issues in SPACs and IPOs

- De-SPAC Transaction Issues:
  - Change in Control
    - 409A
    - 280G
    - Equity and Compensation Contract Issues
      - What if vesting only specified on IPO?
      - What if lock up period does not clearly include de-SPAC transaction?
      - What if change in control provision is triggered?
  - Earn Out Concepts
  - Form S-8 Filing Delay—Can't file for 60 days until after transaction

ESG and Executive Compensation

- ESG is growing in popularity as metric or factor in incentive compensation payouts. Statistics in next two slides from studies by Semler Brossy and WTW.
- Despite growth in popularity, not many requests to draft language into grant agreements for legally defined metric. Statistics show why this is the case.
- ESG has taken on a life of its own in discussions as a single concept, but really is an umbrella of several unrelated topics that require completely separate metrics.
- Environmental, Social and Governance or Environmental, Sustainability and Governance. Ironically, no longer defined as an acronym very often.

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ESG and Executive Compensation

- 5% of S&P 500 use ESG metrics in performance shares but 57% use ESG metrics in annual plans.
  - While ESG tend to be long-term focus points for companies, it is hard for companies to craft long-term goals. It is also important for companies to show immediate change.
- It is still most common for ESG factors to be part of a modifier for other financial metrics or part of a subjective individual evaluation portion of annual plans.
- Most common are D&I, Safety and Customer Satisfaction. Emissions are also used as a factor.

ESG and Executive Compensation

- WTW Survey of 338 global boards of directors:
  - 32% plan to tie ESG metrics with executive compensation in next 12 months and
  - Additional 37% plan to do so within next three years
- WTW survey indicates 51% tie ESG metrics into short-term plans but only 3% tie EST metrics in long-term plans.

ESG and Executive Compensation

- Recommendations:
  - Discuss ESG metrics and their use with compensation consultants and compensation committee. Ask for feedback on what peer group is doing.
  - Consider what ESG factors line up with company culture and would be a good fit for a compensation metric.
  - Discuss how any such metrics would be measured (quantitative or qualitative metrics) and how it would be publicly described in the proxy.

Tax Proposals

- Where are we?
  - On May 28, 2021, U.S. Treasury Department released the "Green Book" containing the Biden Administration's explanation of its tax proposals.
  - On September 15, 2021, the House Ways & Means Committee approved the Build Back Better Act ("BBBA") which if approved, will amount to a significant overhaul of the Internal Revenue Code. It must eventually be reconciled with a tax package that will emerge from the Senate.

Tax Proposals

- Increase in highest marginal income tax rate to 39.6%
  - Would increases the top marginal rate on income in excess of $400,000 from 37% to 39.6% for income over (i) $450,000 for married individuals filing a joint return, (ii) $400,000 for unmarried individuals, (iii) $425,000 for head of household filers, and (iv) $225,000 for married individuals filing separately.
    - Indexed for inflation after the 2022 tax year.
    - Would apply to tax years beginning after December 31, 2021.

Tax Proposals

- Increase in capital gains rate
  - Current law provides for a maximum capital gains rate and a maximum qualified dividends tax rate of 20%.
  - The BBBA would increase the top rate for both to 25% in 2021 after September 13, 2021 through December 31, 2021 for taxpayers currently subject to the 20% rate.
  - For 2022 and later years, the 25% rate will apply to taxpayers subject to the 39.6% marginal income tax rate.
  - Gains recognized in a tax year that includes September 13, 2021 that arise from transactions entered into on or prior to September 13, 2021 pursuant to a binding written contract will be treated as occurring prior to September 13, 2021.
- The BBBA tax rates represent a more modest increase in capital gains rates compared to the Biden Administration's Green Book proposal, which would have taxed capital gains and qualified dividends at a 39.6% rate for taxpayers with income over $1 million.

Tax Proposals

- Expansion of the Net Investment Tax to Trade or Business Income for High Income Individuals
  - The 3.8% net investment income tax currently applies to net investment income of taxpayers with adjusted gross income exceeding $200,000 ($250,000 for joint filers and surviving spouses).
  - The BBBA would expand the 3.8% net investment income tax to cover net investment income derived in the ordinary course of a trade or business for taxpayers with greater than $400,000 in taxable income (single filers) or $500,000 (joint filers) and for trusts and estates. As a result, individuals with interests in pass-through entities will be subject to the net investment income tax or the 3.8% self-employment Medicare tax on all income (whether wages, passive income, or active business income) derived from such entities.

Tax Proposals

- Limitation on Qualified Business Income
  - Under current law, non-corporate taxpayers are effectively allowed a 20% deduction for certain pass-through income. This deduction equals the lesser of:
    - (i) the taxpayer's "combined qualified business income amount" (i.e., income from qualified trades or businesses carried on by the taxpayer, plus 20% of qualified REIT dividends and qualified publicly traded partnership income); and
    - (ii) 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital gain.
  - The BBBA would cap the overall amount of the deduction at (i) $500,000 for joint return filers or a surviving spouse, (ii) $400,000 for single filers, (iii) $250,000 for a married individual filing a separate return, and (iv) for an estate or trust.
  - Would apply for taxable years beginning after December 31, 2021.

Tax Proposals

- Surcharge on High-Income Individuals, Trusts and Estates
  - The BBBA would impose a tax equal to 3% of a taxpayer's modified adjusted gross income in excess of $5 million ($2.5 million for a married individual filing a separate return)
    - "Modified adjusted gross income" would be adjusted gross income reduced by any deduction allowed for investment interest.

Tax Proposals

- Acceleration of Expansion of Section 162(m) Deduction Limitation.
  - Section 162(m) currently limits, to $1 million, a public company's deduction for compensation paid to its principal executive officer, its principal financial officer, and its three executive officers whose compensation is required to be reported in the public company's proxy statement ("covered employees"). As a result of the American Rescue Plan Act of 2021 ("ARPA"), any executive who was a covered employee for any preceding year beginning after December 31, 2016 remains a covered employee. ARPA also provided for a further expansion of "covered employees" for taxable years beginning after December 31, 2026 to include *the next* five "highest compensated employees."

Tax Proposals

- Acceleration of Expansion of Section 162(m) Deduction Limitation
  - The BBBA would:
    - Accelerate the expansion of the $1 million cap to cover the next five highest compensated employees from 2026 to 2022.
    - Apply the controlled group rules of Section 414 (b), (c), (m) and (o) and expressly reference performance-based compensation, commissions, post-termination compensation, and beneficiary payments in the definition of compensation limited by Section 162(m) ("applicable employee remuneration") to subject remuneration paid by affiliated pass-through entities to the $1 million cap.

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Tax Proposals

- Carried Interest (Partnership Interests Held In Connection with the Performance of Services)
  - The BBBA would replace the current three-year holding period for capital gains treatment of certain types of carried interest (“applicable partnership interests” or “API”) issued as compensation for executives in the investment management industry.
    - Would adopt a five-year holding period for any net long-term capital gain on API and for any other amounts included as gross income from one or more APIs treated as capital gain or taxed at a capital gain rate.
      - The broad language in the BBBA may expand the scope of an investment manager’s income to include amounts currently excluded under the carried interest regulations, such as property used in a trade or business.

Tax Proposals

- Retirement
  - The BBBA would prohibit new contributions to a Roth or traditional IRA if the total value of an individual's IRA and defined contribution accounts exceeds $10 million.
  - The BBBA would also impose new minimum distribution requirements on individuals whose retirement accounts exceed $10 million and income exceeds $400,000.

Regulatory Updates: Withholding and Deposit Obligations – NSOs, SARs, and RSUs

- In 2020, the IRS released two informal updates to guidance on income-inclusion timing, and withholding and deposit rules, for nonqualified stock options ("NSOs"), stock-settled stock appreciation rights ("SARs"), and restricted stock units ("RSUs," which for purposes of this presentation, include performance stock units ("PSUs"))
  - IRS issued Generic Legal Advice Memorandum 2020-004 (the "GLAM") on May 22, 2020, which outlines the views of the IRS Office of Chief Counsel with respect to the timing of income inclusion and the application of Federal Insurance Contribution Act ("FICA") and Federal income tax ("FIT") withholding and deposit obligations for these three types of stock-settled equity awards.
  - Second, the IRS updated Section 20.1.4.26.2 of the Internal Review Manual ("IRM Update") on May 26, 2020, to expand the categories of equity awards eligible for certain administrative relief from the penalties of the Next-Day Deposit Rule, while slightly tightening the conditions for such relief.
- See Mayer Brown's Blog Post at: https://www.usbenefits.law/2020/08/irs-updates-guidance-on-timing-of-wage-and-fica-withholding-for-stock-options-and-rsus/.
- Why does this matter?
  - Employers that accumulate $100,000 or more in income taxes and FICA taxes during a monthly or semi-monthly deposit period must deposit the taxes within one business day after the income recognition event occurs (the "One-Day Rule").

Regulatory Updates: Withholding and Deposit Obligations – NSOs, SARs, and RSUs

- GLAM Guidance:
  - NSO/SARs: the fair market value (minus the exercise price in the case of an NSO) of stock transferred to an employee pursuant to the exercise of an NSO or SAR are includible in income on the exercise date. The employer's FICA and FIT wage withholding obligations also arise on that date, even though in the case of a public company, to meet the SEC's T+3 settlement requirement, the proceeds of shares sold upon exercise of an NSO to fund required tax withholdings may not be deposited in the employee's brokerage account until two days later.
  - RSUs: income recognition occurs when the employer initiates payment (i.e., directs a broker to commence the settlement of the RSUs by transferring shares to the employee), even though, in the case of a public company, to meet the SEC's T+3 settlement requirement the proceeds of shares sold upon settlement of the RSU to fund required tax withholdings may not be deposited in the employee's brokerage account until two days later. The fair market value of the shares on such date also constitutes wages subject to FICA and FIT withholding.
- The GLAM guidance and the SEC's T+3 settlement requirement would seem to put public companies in an impossible situation because to satisfy the SEC T+3 requirement, they would not meet the next-day deposit requirement and face the imposition of failure to deposit ("FTD") penalties.

Regulatory Updates: Withholding and Deposit Obligations – NSOs, SARs, and RSUs

- For public companies, what the GLAM imposes, the updated IRM ameliorates:
  - In the case of NSOs and SARs, the T+2 settlement date rather than the exercise date of the award will be treated as the liability incurred date for purposes of calculating FTD penalties under the One-Day Rule, provided that the settlement date is within two days of the exercise date.
  - Similarly, in the case of RSUs, the T+2 settlement date rather than the transfer-initiation date will be treated as the liability-incurred date for the One-Day Rule's FTC penalty purposes.
- Ways to lessen the administrative burden:
  - For RSUs, adopt a uniform payment date for RSUs that are settled upon vesting for new grants (e.g., the same date or dates each year in the year of vesting rather than a date based on the grant date).
  - For RSUs for which payment is triggered by a termination of employment, adopt a uniform date such as the 15th day of the month following the month in which employment terminates (taking into consideration the six-month delay for specified employees) for RSUs that are subject to Section 409A.
  - For NSOs and SARS of private companies, adopt exercise windows.

Regulatory Updates: Withholding and Deposit Obligations – NSOs, SARs, and RSUs

- Gap in the GLAM guidance:
  - Guidance on the withholding and deposit requirements with respect to restricted stock for which an employee or director has made a Section 83(b) election.
    - No clear answer.
    - Best to coordinate if possible.

Regulatory Updates: IRS Updates Its Nonqualified Deferred Compensation Audit Guide

- In June 2021, the IRS released its updated *Nonqualified Deferred Compensation Audit Guide* (Publication 5528) ("2021 Audit Guide"). It replaces the audit guide last updated in 2015. The 2021 Audit Guide:
  - Includes an expanded discussion of the constructive receipt and economic benefit doctrines and cash equivalency.
  - Includes citations to the relevant Internal Revenue Code and Treasury Regulations provisions and citations to relevant revenue rulings.
  - Includes an expanded discussion of Section 409A.
  - Discusses arrangements that may result in a plan being considered a funded plan for purposes of Code Section 409(b) which would also result in a 20% additional tax and premium interest being imposed.
  - Also contains guidance on the timing of employer deductions, FICA, FUTA, and withholding obligations.
- Section B of the 2021 Audit Guide is devoted to examination techniques. It provides a preview of what to expect if an IRS examiner chooses to focus on an employer's nonqualified deferred compensation plans.

Section 162(m)
Final Regulations

- 2017 Tax Cut and Jobs Act ("TCJA") made three significant changes to Section 162(m):
  - Broadened definition of publicly traded company to include companies that are required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (public debt)
  - Changed definition of "Covered Employees"
  - Performance-based Compensation exception eliminated!
- Changes to Section 162(m) do not apply to remuneration that is provided pursuant to a written binding contract that was in effect on November 2, 2017, and that was not modified in any material respect on or after that date ("Grandfather Rule").
- Final Regulations for the amendments to Section 162(m) made by the TCJA issued December 18, 2020. The final regulations made only minor changes to the proposed regulations and do not address the changes to Section 162(m) made by the American Rescue Plan Act of 2021.

Section 162(m)
2021 Expansion for 2027

- The American Rescue Plan Act of 2021 (ARPA) contains provisions further affecting Section 162(m) beginning with tax years beginning on or after January 1, 2027. As noted above in the Tax Proposals discussion, the proposed BBBA would make this effective for 2022 (plus other changes described in the discussion of Tax Proposals) but has not passed yet.
- In particular, ARPA expanded the number of covered employees from five to ten to include the five most highly compensated employees (the "next top five group") in addition to PEO, PFO and the next three most highly compensation officers. It does not appear that the next top five group must be comprised of officers.
- The "once a covered employee always a covered employee" rule, however, does not extend to the individuals included in the next top five group. Rather, individuals are included in the next top five group only so long as they are in that group.

Section 162(m)

2021 Expansion for 2025

- No guidance issued on this update. It is not clear if there will be any grandfathering protections for existing agreements.
- Proposal in current House bill would accelerate this change into an earlier tax year but not clear if this will pass or not.

Section 162(m)

What to Do Now? Proactive Considerations

- Take steps to track any employees who could be considered a Covered Employee in future years (try to avoid an accidental "one-year" NEO, who then becomes a permanent Covered Employee):
  - Consider who is an "officer".
  - Track officers who have compensation close to the top three.
  - Add update for expansion of covered employees.
- Consider requiring deferrals of compensation above a certain amount each year and requiring such amounts to be paid in installments in future years.

Section 162(m)
What to Do Now? Proactive Considerations

- Make use of equity inducement grants
  - Consider making equity grants to any newly hired executive officers as inducement grants instead of grants from a shareholder-approved plan.
  - Previously of limited value (performance-based compensation exception required a grant from a shareholder-approved plan).
- Reconsider more subjective performance goals
  - Consider whether cash and equity grants that have performance goals should have some subjective adjustment component added (previously an issue for performance-based compensation).
  - Be careful of too much discretion, causing disclosure to shift from non-equity incentive compensation to bonus in the summary compensation table.

Odds and Ends

- **SEC settles charges against National Beverage Corp. for failure to disclose executive perquisites provided to its CEO** (*Exch. Act. Rel. No. 92560* (August 4, 2021)).
  - National Beverage failed to disclose the cost of 33 trips taken by its CEO between 2016 and 2020 that were paid by the company but not on company business ("integrally and directly related to the CEO's job duties").
    - Effect was to understate the CEO's compensation by $1.5 million during those years.
    - National Beverage settled the charges for a civil penalty of $481,000.
  - Key takeaway: the SEC continues to focus on underreporting of perquisites.

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Odds and Ends

- **Can you avoid California's broad prohibition of non-competition and non-solicitation agreements with a choice-of-law provision that provides for the application of another state's law?**
  - California Business and Professions Code Section 16600 broadly prohibits non-competition agreements, with limited exceptions for non-completion agreements entered into in connection with the sale of a business and non-compete agreements with retiring partners.
    - Section 166000 has been interpreted to prohibit non-solicitation agreements.
  - Under California Labor Code Section 925, an employee who primarily resides and works in California can void provisions in (i) contracts requiring the employee to litigate claims arising in California in another state or country or (ii) which provide for the governing law to be that of another state or country.
    - California Labor Code Section 925 *does not* apply to a contract with an employee who is individually represented by legal counsel in negotiating the terms of the contract designating the venue or forum or the contact's governing law.

Odds and Ends

- **Can your avoid California's broad prohibition of non-competition and non-solicitation agreements with a choice of law provision that provides for the application of another state's law? (continued)**
  - To date, it is unclear whether Section 925's exception for contracts in which an employee (i) was individually represented by counsel, (ii) includes a covenant not to compete, and (iii) provides for the application of another state's laws would be enforced by the California courts if the employee attempted to void the choice of law provision in the contract.
  - The Delaware courts will enforce a contract between an employer and a California resident that provides for Delaware law as the contract's governing law if Section 925 has been complied with.

Odds and Ends

- **Nasdaq Board Diversity and Disclosure Rules***
  - On August 6, 2021, the US Securities and Exchange Commission (SEC) approved Nasdaq's board diversity and disclosure rules.
  - **Nasdaq Board Diversity Standards.** The new rules require Nasdaq-listed companies to have, or to explain why they do not have, at least two diverse directors, including (1) at least one director who self-identifies as female (regardless of gender designation at birth) and (2) at least one director who self-identifies as either an "Underrepresented Minority," as defined in the Nasdaq rule, or as LGBTQ+. Foreign issuers (including foreign private issuers) and smaller reporting companies may satisfy the board-composition requirement by having two directors who self-identify as female. Companies with five or fewer directors may satisfy the diversity objective by having one diverse director. Nasdaq's board diversity representation provisions are set forth in new clause (f) of Rule 5605 of Nasdaq's corporate governance requirements.

* This summary of the Nasdaq Diversity and Disclosure Rules is taken from a larger discussion of the rules by our colleagues Laura Richman, Jennifer Carlson, Robert Gray, Phyllis Korff, and Christina Thomas. See their August 10, 2021 Legal Update available at: https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2021/08/sec-approves-nasdaq-board-diversity-rule.pdf.

Odds and Ends

- **Nasdaq Board Diversity and Disclosure Rules**
  - **Nasdaq Board Diversity Disclosure Requirements.** The new rules also require Nasdaq-listed companies to annually disclose directors' self-identified gender, race and ethnicity (i.e., African American or Black, Alaskan Native or Native American, Asian, Hispanic or Latinx, Native Hawaiian or Pacific Islander, White, or Two or More Races or Ethnicities) and LGBTQ+ status in a standardized board diversity matrix. A foreign issuer may elect to use an alternative board diversity matrix format which, among other things, requires disclosing the number of directors who self-identify as underrepresented individuals in the foreign issuer's home country jurisdiction, as well as indicating whether diversity disclosure is prohibited under its home country law. Nasdaq's board diversity disclosure provisions are set forth in new Rule 5606 of Nasdaq's corporate governance requirements.

Odds and Ends

- **Nasdaq Board Diversity and Disclosure Rules**
  - **Transition and Phase-In Periods.** The time frame for compliance with Nasdaq's board diversity rule depends on the company's listing tier and board size:
    - Nasdaq Global Select Market and Nasdaq Global Market companies must have, or explain why they do not have, one diverse director by August 7, 2023, and two diverse directors by August 6, 2025.
    - Nasdaq Capital Market companies must have, or explain why they do not have, one diverse director by August 7, 2023, and two diverse directors by August 6, 2026. Companies with boards of five or less directors, regardless of listing tier, must have, or explain why they do not have, one diverse director by August 7, 2023.

Odds and Ends

- **Nasdaq Board Diversity and Disclosure Rules**
  - **Other Diversity Initiatives Are Likely to Follow.** Even companies that are not listed on Nasdaq should pay attention to Nasdaq's new board diversity policy because additional board diversity initiatives may be forthcoming. While the Nasdaq rule is the most recent board diversity development, there are already other drivers of board diversity, such as California's statutory mandates for companies with principal executive offices in the state, voting policies established by proxy advisory firms, voting policies and engagement priorities of large institutional investors and public perception. At least one major underwriter has established minimum board diversity requirements for the clients it assists with initial public offerings. The SEC's spring 2021 regulatory agenda targets the fall of 2021 for proposed rule amendments to enhance company disclosures about the diversity of board members and nominees. A number of states are considering board diversity legislation. Taken together, all of these actions may prompt additional board diversity requirements for a growing number of companies, with the Nasdaq rule being the latest catalyst.

Benefits & Compensation University: Upcoming Events

- October 20, 2021: Recent Legislative and Regulatory Developments Regarding the Use of Non-Compete and Non-Solicitation Agreements
- October 27, 2021: Latest ERISA Developments and Trends

CLE credit is available for the programs (pending approval).

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