October 6, 2022

MAYER | BROWN

BENEFITS & COMPENSATION UNIVERSITY

Hot Topics in Executive Compensation

Debra B. Hoffman
Partner
+1 312 701 7219
dhoffman@mayerbrown.com

Ryan Liebl
Partner
+1 312 701 8392
rliebl@mayerbrown.com

Today's Speakers

Debra B. Hoffman
Partner
dhoffman@mayerbrown.com
Chicago
+1 312 701 7219

Debra Hoffman has practiced in the employee benefit and executive compensation area for over 30 years and had significant depth and breadth in all relevant areas, both in the domestic and international context. Her practice focuses exclusively in the areas of employee benefit plans and executive compensation and she advises both public and private clients daily with respect to on-going benefits and executive compensation matters, such as issues relating to employment agreements, equity and equity-based arrangements, deferred compensation arrangements, bonus and incentive arrangements, severance agreements, change in control/golden parachute issues, governmental audits, pension de-risking, health plan issues and compliance issues. Debbie also advises creditors and debtors in connection with various types of financing structures, bankruptcy and reorganizations. In addition, she has extensive expertise with respect to issues that arise in the context of corporate transactions, including divestures, acquisitions, mergers, spin-offs, and initial public offerings.

Ryan J. Liebl
Partner
rliebl@mayerbrown.com
Chicago
+1 312 701 8392

Ryan Liebl focuses his practice on advising public and private companies and individual executives on executive compensation related matters, including designing, drafting and administering nonqualified deferred compensation plans, excess benefit plans, equity compensation plans and agreements, cash-based incentive compensation plans and agreements, severance plans and individual employment and separation agreements. He also has extensive experience advising clients regarding employee benefits and executive compensation issues in corporate transactions. Ryan has recently been recognized by The Best Lawyers in America for Employee Benefits (ERISA) Law (2023).

Hot Topics in Executive Compensation

- Pay versus Performance Disclosure
- Tax on Redemption of Securities
- Update on Clawbacks
- Executive Compensation Related Cases
- Updates on Executive Compensation for Private Companies

Pay versus Performance Disclosure

- On August 25, 2022, the US Securities and Exchange Commission (SEC) finally adopted a "pay versus performance" rule in accordance with a Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandate that requires SEC reporting companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company.
- The new pay versus performance disclosures must be included in proxy and information statements for fiscal years ending on or after December 16, 2022.
- The new rule will generally apply for the upcoming 2023 proxy season.

Pay versus Performance Disclosure

- As adopted, new Item 402(v) of Regulation S-K requires:
  - a new pay versus performance table,
  - a clear description of the relationship between the compensation actually paid to the principal executive officer (PEO) and to the other NEOs (Remaining NEOs) and the company's performance across each of the measures included in the pay versus performance table, which may be presented as a narrative, a graph or a combination of the two, and
  - a tabular list of the most important financial performance measures that the company uses to link NEO compensation to company performance.

Pay versus Performance Disclosure

- **Pay versus Performance Table.** The pay versus performance table must disclose the compensation paid to the PEO and the average compensation paid to the Remaining NEOs as compared to four performance measures. The performance measures required to be included are:
  - company total shareholder return (TSR),
  - peer group TSR,
  - company net income, and
  - a company-selected financial performance measure (Company-Selected Measure).
- The new table must contain data for five years, except that smaller reporting companies (SRCs) are permitted to provide three years of data.

Pay versus Performance Disclosure

Year (a)	Summary Compensation Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO Named Executive Officers (d)	Average Compensation Actually Paid to non-PEO Named Executive Officers (e)	Value of Initial Fixed $100 Investment Based on:		Net Income* (h)	[Company-Selected Measure]* (i)
					Total Shareholder Return (f)	Peer Group Total Shareholder Return* (g)		
Y1								
Y2								
Y3								
Y4*								
Y5*								

Pay versus Performance Disclosure

- **Description of Pay Versus Performance Relationship.** The required tabular disclosure must be accompanied by a clear description of the relationship between:
  - Both executive compensation actually paid to the PEO and the average compensation actually paid to the Remaining NEOs', and each of the following:
    1. company TSR and the peer group TSR,
    2. company net income, and
    3. the company-selected measure.

Pay versus Performance Disclosure

- **Tabular List.** Additionally, companies (other than SRCs) must provide an unranked list of the three to seven most important financial performance measures used to link executive compensation actually paid to NEOs during the last fiscal year with the company's performance.
- Companies are permitted to include non-financial measures in the list if they consider such measures to be among their three to seven most important measures. If a company uses less than three measures to link NEOs compensation to company performance, only measures actually used must be included.

Pay versus Performance Disclosure

- **Companies Covered.** The pay versus performance rule applies to all SEC reporting companies, *except*:
  - foreign private issuers,
  - registered investment companies and
  - emerging growth companies.
- Business development companies (a category of closed-end investment company that are not registered under the Investment Company Act) and SRCs are subject to the rule, although the disclosure requirements for SRCs are scaled down.

Pay versus Performance Disclosure

- **Filings Covered.** As previously noted, pay versus performance disclosure is required in proxy and information statements that are required to contain executive compensation disclosure pursuant to Item 402 of Regulation S-K. The pay versus performance information will not be deemed to be incorporated by reference into any filing under the US Securities Act of 1933, as amended, or the US Securities Exchange Act of 1934, as amended, unless the company specifically incorporates it.

Pay versus Performance Disclosure

- **Executives Covered.** The pay versus performance table must separately provide compensation information for the PEO, on an annual basis, for each of the past five fiscal years (three in the case of SRCs). If more than one person has served as PEO in any year, data for each PEO must be reported in separate columns.
- In addition, the table must provide average (*i.e.*, mean) compensation, on an annual basis, for the Remaining NEOs for such years. The Remaining NEOs whose compensation amounts are included in the averages reported for a given year must be individually identified by a footnote. The footnote will allow investors to consider the average compensation reported with changes in composition of the Remaining NEOs.

Pay versus Performance Disclosure

- **Pay Covered.** The elements of compensation actually paid category reflects that information contained in the Summary Compensation Table is distinct from the compensation paid to an NEO in a given year. Under Item 402(v)(2), compensation actually paid for each individual is comprised of total compensation disclosed in the Summary Compensation Table modified to adjust the amounts included for pension benefits, equity awards and above-market or preferential earnings on deferred compensation that is not tax qualified, each as described below.

Pay versus Performance Disclosure

- **Pension Benefits.** For each year included in the pay versus performance table, companies will be required to deduct from the Summary Compensation Table total the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans, and add back the aggregate of:
  - (i) actuarially determined service cost for services rendered by the NEO during the applicable year (service cost); and
  - (ii) the entire cost of benefits granted in a plan amendment (or initiation) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the plan amendment or initiation (prior service cost), in each case, calculated in accordance with US generally accepted accounting principles.
- The scaled disclosure requirements do not require SRCs to make this pension adjustment.

Pay versus Performance Disclosure

- **Equity Awards.** To calculate compensation actually paid for equity awards for each year included in the pay versus performance table, companies need to deduct the equity award amounts shown in the Summary Compensation Table from total compensation and then add or subtract the following amounts, as applicable:
  - the year-end fair value of any equity awards granted in the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year;
  - the amount of change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value of any awards granted in prior years that are outstanding and unvested as of the end of the covered fiscal year;
  - for awards that are granted and vest in the same covered fiscal year, the fair value as of the vesting date;

Pay versus Performance Disclosure

Equity Awards continued:

- for awards granted in prior years that vest in the covered fiscal year, the amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value;
- for awards granted in prior years that are determined to fail to meet the applicable vesting conditions during the covered fiscal year, a deduction for the amount equal to the fair value at the end of the prior fiscal year; and
- the dollar value of any dividends or other earnings paid on stock or option awards in the covered fiscal year prior to the vesting date that are not otherwise reflected in the fair value of such award or included in any other component of total compensation for the covered fiscal year.

• Vesting date valuation assumptions have to be disclosed by footnote if they are materially different from those disclosed as of the grant date.

Pay versus Performance Disclosure

- **Definition of Vesting.** The vesting date of equity awards is not defined in the final rules, and the limited guidance on this topic leaves questions regarding the correct timing for when an award would be considered "vested" for purposes of this disclosure.
- The determination of when an equity award is considered vested is significant under Item 404(v) as the year in which such award becomes vested is the last year in which any amount needs to be included with respect to such award in the pay versus performance table.
- For federal tax purposes, vesting is generally analyzed as occurring at the point in time when the equity award is no longer subject to a substantial risk of forfeiture (although the concept is defined differently in different sections of the Internal Revenue Code).

Pay versus Performance Disclosure

- To illustrate how complicated a vesting date determination can be, consider a company that grants restricted stock units that become fully vested on the earlier of the three-year anniversary of the date of grant or the executive's retirement, and the grant is made to an executive who meets the criteria for retirement. Additionally, the restricted stock unit grant provides that shares will be distributed to the executive one year following the year in which the restricted stock units become vested, and the shares distributed are subject to a clawback for two years following the date of distribution.
- If the executive remains employed through the entire three-year vesting period and receives such shares in year four (one year after the date of vesting), it is unclear when such restricted stock units should be considered vested for purposes of pay versus performance table.

Pay versus Performance Disclosure

- In this example, the restricted stock units would be considered vested on the date of grant for federal tax purposes because the shares would no longer be considered to be subject to a substantial risk of forfeiture, and the executive would be taxed on the fair market value of the shares in year four when distributed.
- Under Item 404(v), it is not clear when this restricted stock unit award would be considered to have satisfied all applicable vesting conditions.
- The restricted stock units could be considered vested on the date of grant if the fact that the executive met the conditions of the retirement definition on the date of grant was analyzed as the point in time where the applicable vesting conditions were satisfied (similar to the federal tax analysis leading to the conclusion that this equity award was substantially vested on the date of grant).

Pay versus Performance Disclosure

- Alternatively, the restricted stock units could be considered vested on the completion of the three-year vesting period or when the executive receives the fully vested shares in year four and is able to realize the economic gain of the shares by selling them.
- Finally, the restricted stock units could be considered vested only after the end of the clawback period, because until such period is complete there is a possibility that the executive will forfeit the shares.

Pay versus Performance Disclosure

- **Above-Market Earnings.** Additionally, compensation actually paid must include above-market or preferential earnings on deferred compensation that is not tax qualified.
- Such amounts may be viewed to approximate the value that would be set aside currently by the company to satisfy its obligations in the future.
- Such amounts of deferred compensation that are not tax qualified must be included whether or not such amounts are vested and whether or not such amounts are actually paid during such year. Exclusion of these amounts until they are actually paid would not be reflective of the compensatory amounts actually paid, but rather contingent upon an executive's decision to withdraw or take a distribution from their account.

Pay versus Performance Disclosure

- The pay versus performance table also must disclose, in an accompanying footnote, the amounts of compensation deducted from, and added to, Summary Compensation Table total compensation in determining compensation actually paid to the PEO and Remaining NEOs.
- Finally, any one-time payment, such as a signing or severance bonus, must be included in compensation actually paid. While such amounts may not be reflective of what an executive typically receives in a year, they are amounts that were actually paid in that year.

Pay versus Performance Disclosure

- **Measures of Performance.** Company TSR and peer group TSR must be included as performance measures in the pay versus performance table, calculated, in accordance with Item 201(e) of Regulation S-K, by “dividing the (i) sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the company’s share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period.”
- Both company and peer group TSR are calculated based on a fixed $100 investment.
- The peer group TSR presented in the table must be weighted according to the respective issuers’ market capitalization at the beginning of the relevant period.

Pay versus Performance Disclosure

- The peer group must be identified by footnote or such identification may be incorporated by reference from prior SEC filings, unless the peer group is a published industry or line of business index. Additional disclosures are required any time the company modifies the peer group used for TSR. SRCs do not need to provide peer group TSR.
- In addition, the final rule requires companies to include net income for each year included in the pay versus performance table.

Pay versus Performance Disclosure

- The last column included in the pay versus performance table sets out the Company-Selected Measure, which must be a numerically quantifiable financial performance metric. The Company-Selected Measure must be what the company believes is the most important financial performance measure used to determine NEO compensation not already included in the pay versus performance table. The Company-Selected Measure can change from year to year.

Pay versus Performance

- Final Thoughts:
  - Start calculating relevant equity values for last two years (consider whether help will be needed from outside valuation specialists).
  - Discuss with compensation committee and key executives now to get input and decisions on key points like peer group selection.
  - Discuss vesting timing for purposes of these rules and apply uniformly.
  - Tension between goals of this table and growth of use of ESG goals in compensation.
    - Fred Cook survey notes that 64% of large companies now disclose ESG metrics in incentive plans (vast majority still include in the annual incentive plan and majority uses qualitative rather than quantitative).

Tax on Redemption of Shares ("Buyback Tax")

- The Inflation Reduction Act of 2022 that was enacted on August 16, 2022 adds a new 1% excise tax on certain stock buybacks by domestic public corporations.
  - This is sometimes referred to casually as the "Buyback Tax".
  - The tax is effective for buybacks taking place after December 31, 2022; no grandfathering provisions are included (such as for pre-approved buybacks in effect prior to the effective date).
- Although not technically an executive compensation tax, actions taken with respect to certain equity compensation can have an impact on the Buyback Tax.
- The tax is imposed on the value of the stock of a covered corporation that is repurchased by the corporation during a calendar year; for purposes of the tax, the value of stock repurchased is reduced by the value of new issuances during the same year.

Tax on Redemption of Shares

  - A covered corporation is a publicly traded US corporation (and certain non-US corporations treated as US corporations for tax purposes).
  - The tax does not apply to certain repurchases, including repurchased stock (or value thereof) contributed to retirement plans or employee stock purchase plans and the amount of repurchases in a year that do not exceed $1M.
- In general, a “repurchase” for purposes of the excise tax is defined broadly and would include repurchases from a corporation’s employees.
- In the executive compensation area, a repurchase could occur in a variety of ways; one common way would be through the net exercise of an option and/or payment of the taxes of an award through the withholding of stock.
  - This type of repurchase is not covered by the exceptions contained in the statute.

Tax on Redemption of Shares

- Although these repurchases may be taken into account for the tax, we would expect that, in most cases, the value of the shares withheld would be offset by the value of the shares issued in connection with the award, thus having little to no impact on the overall value of repurchases during a year.
- It will be important to keep track of these repurchases (and offsets) for purposes of calculating the overall tax for the corporation for each year.
- The IRS is expected to issue regulations under this provision.

Update on Clawbacks

- As a refresher, the Dodd-Frank Act required the SEC to issue rules directing national securities exchanges to establish listing standards that require companies to adopt, disclose and comply with a compensation clawback policy as a condition of listing on the exchange.
  - The initial proposed compensation clawback rule (originally proposed in 2015) required recovery in the event the issuer was required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws.
  - Recovery would be made from any of the issuer's current or former executive officers who were awarded incentive-based compensation during the three-year period preceding the date the issuer is required to prepare the restatement; misconduct of the officer (or matters under officer's responsibility) was not required.

Update on Clawbacks

- On June 8, 2022, the SEC announced (for the third time) the reopening of the comment period for the proposed clawback rule; the current reopened comment period expired on July 14, 2022.
  - No changes were made to the proposed rule in connection with the reopening of the comment period.
- In the last comment period (which ended on November 22, 2021), the SEC suggested that it was considering broadening the proposed rule to pick up a broader class of restatements (i.e., those required to correct errors that were not material to a prior financial statement but that would result in material misstatements if left uncorrected or recognized in the current period—sometimes referred to as "little r" restatements).

Update on Clawbacks

- The new comment period was reopened after reviewing comments received in the last round and was accompanied by a staff memo (from the Division of Economic and Risk Analysis (DERA)) which summarizes the results of research on a couple of points:
  - The DERA memo concludes that since the original publication of the proposed rule, the number and percentage of issuers disclosing a clawback policy has roughly doubled; DERA's conclusion based on this was that the proposed rule (as well as the increased compliance costs) will be reduced.
  - The DERA memo also concludes that the broadening of the types of restatements to include little r restatements would account for approximately three times as many restatements requiring analysis as are currently covered by the proposed rule; also concluded that broadening the types of restatements to be analyzed may not result in actual compensation recovery after the analysis is completed.

Update on Clawbacks

- As executive compensation people, why do we care about this?
  - ISS also takes into account in its equity plan scorecard analysis whether a company has a clawback policy and whether it is disclosed; has also changed how it assesses whether a company maintains a clawback policy to require it to authorize recovery on a financial restatement and to cover all or most equity-based compensation for named executive officers; no points given if policy merely indicates it will comply with the Dodd-Frank Act.
  - Boards and Compensation Committees should be kept up to date on these developments, particularly since it seems as though the SEC is getting closer to adopting definitive guidance.
  - Plans and existing policies may need to be changed.
  - Consider recruitment issues (vs. non-public companies).

Case Law Update

- *Garfield v. Allen*-Shareholder brought lawsuit against public corporation when board made equity grants in excess of plan limitations. Lawsuit survived motion to dismiss. Court held in part that plan was contract with shareholders.
- *Weinberg v. Waystar, Inc.*-Contract claim where dispute turned on meaning of the word "and" in a call right.
  - *The Converted Units shall be subject to the right of repurchase (the "Call Right") exercisable by Parent, a member of the Sponsor Group, or one of their respective Affiliates, as determined by Parent in its sole discretion, during the six (6) month period following (x) the (i) the Termination of such Participant's employment with the Service Recipient for any reason (or, if later, the six (6) month anniversary of the date of the exercise of the [Substitute20] Options in respect of which the Option Stock was issued,* ***and*** *(y) a Restrictive Covenant Breach. (emphasis added)*
- Weinberg had been terminated but had not breached a covenant.

Executive Compensation in Private Companies

- Public Company and Private Company Executive Compensation
  - Both types of companies are trying to "pay for performance" and align executives' interests with shareholder interests.
  - Shareholder interests are very different:
    - Public company shareholders are generally diverse and have a range of interests (although largest investors are typically institutional investors) and a range of ownership timelines (no horizon on investment).
      - Annual equity grants with philosophy that can change year to year; easier to replace executives.
      - Equity plan must be reloaded every few years; institutional shareholders track burn rate.
    - Private companies with PE ownership have specific investment return timetable.
      - One-time grants at time of investment of PE firm; harder to reward executives who leave midstream or who join company midstream.
    - Other private companies tend to make grants at time of rounds of investment.

Executive Compensation in Private Companies

- In an ideal world, executives would prefer an equity award that:
  - provides tax deferral of any gain received until such time as the equity is sold (i.e., when actual value is realized);
  - results in capital gain treatment on such amounts (rather than ordinary income rates); and
  - does not require the executive to put any personal money at risk.
- Profits interests are the only equity award that gets close to these three goals.
- Note that the company loses the deduction though for amounts that are taxed as capital gain.
- In the corporate structure, executive has to put money at risk to get capital gain tax treatment.
- Incentive Stock Options get close to these three goals but have a value limitation that limits usefulness for senior executives.

Executive Compensation in Private Companies

- Private Company (Early Stage) Typical Executive Compensation Package
  - Base Salary-very low
  - Annual Bonus-very low
  - Restricted Stock for founders and stock options for founders and other employees (often incentive stock options)
- Private Company (VC Investors) Typical Executive Compensation Package
  - Base Salary
  - Annual Bonus
  - Stock Options (both incentive stock options and nonqualified stock options)
    - Early exercise for restricted shares with Section 83 election frequently permitted
  - Late stage highly valuable private companies are starting to grant "Facebook RSUs" more frequently; Section 409A analysis is not clear and is complex.
  - Late stage highly valuable private companies also face liquidity issues for founders for early equity awards. Tension with stock option grants and Section 409A. Consider FF stock solution.

Executive Compensation in Private Companies

- Private Company (PE Owned) Typical Executive Compensation Package
  - Base Salary
  - Annual Bonus
  - One-Time Profits Interest Equity Grant (or stock options if operating subsidiary is a c-corp)
  - One-Time Capital Interest but usually only if co-investment (this may also include a rollover investment requirement at time PE firm buys company for certain executives)
- Public Company Typical Executive Compensation
  - Base Salary
  - Annual Bonus (formulaic for disclosure purposes and not discretionary)
  - Annual Equity Grants
    - Options-not as common anymore
    - Restricted Stock Units
    - PSUs

Disclaimer

- These materials are provided by Mayer Brown and reflect information as of the date of presentation.
- The contents are intended to provide a general guide to the subject matter only and should not be treated as a substitute for specific advice concerning individual situations.
- You may not copy or modify the materials or use them for any purpose without our express prior written permission.

Americas | Asia | Europe | Middle East

mayerbrown.com