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ISS: New Compensatory Thoughts & Practices (Annual Program)

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Executive Compensation Webinar Series
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About Anthony “Tony” Eppert

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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2024 Webinars

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- 2024 webinars:
  - Pressure Points When Negotiating Executive Employment Agreements (2/8/24)
  - International Employees: Is a Global Employment Company a Solution (3/14/24)
  - Partnerships & LLCs: Solutions to Underwater Profits Interests Awards (4/11/24)
  - Comparing and Contrasting Equity Awards: A Life Cycle Approach (5/9/24)
  - Navigating Employee v. Independent Contractor Classifications (6/13/24)
  - ABCs of Private Company ESOP Transactions (7/11/24)
  - Compensatory Thoughts on Navigating Blackout Periods (8/8/24)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/12/24)
  - Governance: Properly Hiring and Terminating an Executive Officer (10/10/24)
  - Introduction Course on Employment Taxes (11/14/24)
  - What Happened in 2024: Year-End Review of Compensatory Items(12/12/24)

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Our Compensation Practice – What Sets Us Apart

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

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

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- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation

Our Compensation Practice – What Sets Us Apart (cont.)

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

- The purpose of this program is to discuss recent pronouncements from ISS and other institutional shareholder advisory services with respect to compensation matters, including:
  - Areas where ISS and other institutional shareholder advisory services are likely to focus their attention this proxy season;
  - The impact of the foregoing on compensation designs; and
  - Practical compensatory thoughts as issuers begin preparing for the 2024 annual shareholders' meetings

2023 Proxy Season Recap

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

2023 Proxy Season Recap (cont.)

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

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

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

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

2023 Proxy Season Recap (cont.)

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

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

ISS Updates on December 11, 2023

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- With respect to the Equity Plan Scorecard (“EPS”), weighting of the Grant Practices pillar decreased, while weighting of the Plan Features pillar increased (change applicable to S&P 500, Russell 3000 & non-Russell 3000)
  - Plan Cost pillar is 43 (45 for non-Russell 3000)
  - Plan Features pillar moved up 17 to 22 as the maximum score (29 for non-Russell 3000)
  - Grant Practices pillar decreased from 38 to 35 as the maximum score (28 to 26 for non-Russell 3000)

- As background, the equity plan scorecard (EPS) was adopted by ISS in 2015 and weighs positive and negative factors around the following 3 pillars (EPS does not apply to non-employee director plans):
  - Plan cost,
  - Plan features, and
  - Grant practices

- “Plan cost” means the total estimated cost of the issuer’s equity plans relative to industry/market cap peers, measured by the issuer’s estimated Shareholder Value Transfer (SVT) in relation to peers. [SVT measures the estimated value of the issuer that will be transferred to employees & directors] Plan cost considers both:
  - SVT on new shares requested, plus outstanding unvested/unexercised grants; and
  - SVT on new shares requested, plus shares remaining for future grants

ISS Updates on December 11, 2023 (cont.)

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- "Plan features" considers:
  - The presence of any single-trigger awards,
  - Discretionary vesting authority,
  - Liberal share recycling,
  - Lack of minimum vesting periods,
  - Dividends payable prior to the award becoming vested, and
  - Quality of disclosure of award upon a change-in-control
- "Grant practices" considers:
  - The issuer's 3-year burn rate relative to its industry/market cap peers;
  - Vesting provisions in the most recent CEO equity grants (with a 3-year look-back);
  - The estimated duration of the plan (based on the sum of shares remaining available and the new shares requested, divided by the average annual shares granted during the prior 3 years);
  - The proportion of the CEO's most recent equity grant/awards subject to performance conditions;
  - The existence of any clawback policy, provided, however, that no points for a clawback policy will be provided if the policy only complies with the minimum requirements of Dodd-Frank because such Dodd-Frank rules generally exempt time-based vesting equity from compensation covered by such policy;
  - The existence of any post-exercise or post-vesting share-holding provisions
- Passing = 59 (S&P 500), 57 (Russell 3000) and 55 (non-Russell 3000)

Glass Lewis Updates

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- Glass Lewis updated their U.S. proxy voting guidelines, applicable to annual meetings held on or after January 1, 2024. The compensatory provisions of such update are as follows:

- With respect to recoupment policies, and in addition to NYSE and NASDAQ listing requirements, Glass Lewis provides that:
  - Recoupment policies should allow issuers to recoup incentive compensation when there is evidence of problematic decisions or actions, the consequences of which have not already been reflected within incentive payments and where recovery is warranted. Glass Lewis will assess the appropriateness of any situation where an issuer decides not to recover under the above, and such will be reflected in its advisory vote recommendation
  - A new section was added to support minimum stock ownership requirements, and disclosure of the same in the proxy statement (including proxy disclosure) highlighting the types of awards counted – though the inclusion of unearned performance-based awards or unexercised stock options to satisfy the policy requirements could be problematic without an adequate rationale

ISS Refresh - 5 Global Compensation Principles of ISS

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- With respect to compensation matters, and by way of introduction, ISS has a framework that is built around the following 5 global principals:
  - Maintain appropriate pay-for-performance alignment, with an emphasis on long-term shareholder value;
  - Avoid pay-for-failure arrangements;
  - Maintain an independent Compensation Committee;
  - Provide clear and comprehensive compensation disclosures; and
  - Avoid inappropriate pay for non-executive directors (*i.e.*, do not allow pay to compromise independence)

ISS Refresh - Voting Guide: Generally

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- Vote against say-on-pay proposals if:
  - There is a misalignment between CEO pay and performance of the issuer (*i.e.*, pay-for-performance),
  - The issuer maintains significant problematic pay practices, or
  - The Board exhibits poor communication and responsiveness to its shareholders

- Vote against or withhold from members of the Compensation Committee (and possibly the full board) and against the say-on-pay proposal if:
  - There is no say-on-pay vote on the ballot and an against vote would otherwise have been warranted due to any of the above,
  - The prior say-on-pay proposal received less than 70% support of the votes cast and the Board failed to adequately respond with disclosure of engagement efforts with major institutional investors, disclosure of concerns voiced by lead dissenting shareholders, and disclosure of meaningful responsive action by the Company, or
  - The issuer has recently practiced or approved a problematic pay practice

ISS Refresh – Voting Guide: Equity & Incentive Plans

- For equity-based compensation plan proposals, generally vote in accordance with the outcome of the equity plan scorecard
- Additionally, vote against the proposal if certain conditions exist, including:
  - There is a liberal change-in-control definition,
  - The plan would permit repricing without shareholder approval,
  - The plan is a vehicle for problematic pay practices,
  - The plan creates a significant pay-for-performance disconnect, or
  - The plan is excessively dilutive to shareholders
- Vote in favor of proposals to amend equity and incentive plans if the amendment addresses administrative features only
- All other votes are on a case-by-case basis
  - Requests for additional shares will be based upon the Equity Plan Scorecard evaluation and the overall impact of the amendments
  - If there is no request for additional shares, and no request to extend a term, then the request is based upon the overall impact of the amendment and the Equity Plan Scorecard evaluation will be shown for informational purposes only

ISS Refresh - Voting Guide: Equity & Incentive Plans (cont.)

- Vote in favor of a proposal to implement an ESOP (or an increase to the shares of an existing ESOP) unless the ESOP would own more than 5% of the outstanding shares

- Vote in favor of a proposal to implement an ESPP if:
  - The discount is no greater than 15,
  - The offering period is 27 months or less, and
  - The number of shares allocated to the ESPP is 10% or less of the outstanding shares

- Vote against an ESPP proposal if:
  - The discount is greater than 15%,
  - The offering period is more than 27 months, or
  - The number of shares allocated to the ESPP is more than 10% of the outstanding shares

ISS Refresh - Voting Guide: Non-Employee Directors

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- ISS has a policy with respect to evaluating proposals seeking shareholder ratification of non-employee director cash or equity compensation
- Qualitative factors that will be considered include:
  - Director compensation compared to issuers with a similar corporate profile,
  - Any problematic pay practices with respect to non-employee director compensation,
  - The presence of any stock ownership guidelines (i.e., at least 4x the annual cash retainer) or hold requirements applicable to non-employee directors,
  - Vesting schedules with respect to equity awards,
  - The mix between cash and equity compensation,
  - The presence of any meaningful limits on director compensation (i.e., likely resulting from *Seinfeld* and *Calma*),
  - The presence of retirement benefits or perquisites, and
  - The quality of the disclosure addressing non-employee director compensation
- The above last bullet is yet another reason why robust disclosure should be included within the narrative that directly precedes the Director Compensation Table of the proxy statement

ISS Refresh - Voting Guide: Non-Employee Directors (cont.)

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- With respect to an equity plan proposal for non-employee directors, ISS recommends voting on a case-by-case basis, based upon:
  - The estimated cost of the equity plan relative to the industry and market cap peers, measured by the Company's estimated SVT (described in later slides);
  - The Company's 3-year burn rate relative to its industry/market cap peers; and
  - The presence of any egregious plan features

ISS Refresh: Responsiveness/Communications

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- In evaluating an item on a ballot, ISS will consider the Board's responsiveness to investor input and engagement on compensation issues

- Bad facts include:
  - Failure to respond to a majority-supported shareholder proposal on executive pay,
  - Failure to "adequately" respond to a prior say-on-pay proposal that received less than 70% of the votes cast

- Addressing this latter point, ISS will evaluate:
  - The issuer's response, including:
    - Whether the issuer adequately addressed and disclosed engagement efforts with major institutional shareholders on issues giving rise to the low support
    - Whether specific actions were taken to address the issue, and
    - Whether any other actions were taken by the Board
  - Whether the issues raised are recurring or isolated;
  - The issuer's ownership structure; and
  - Whether support was less than 50% (which would require the highest degree of responsiveness)

ISS Refresh on Problematic Pay Practices

- There are numerous problematic pay practices that ISS will evaluate on a case-by-case basis to determine whether such are contrary to a performance-based pay philosophy, including:
  - Multi-year guarantees of pay,
  - Excessive new-hire packages,
  - Incentives that motivate excessive risk-taking (discussed on next slide),
  - Abnormally large bonus payouts without performance linkage or proper disclosure,
  - Egregious pension/supplemental executive retirement plan payouts,
  - Excessive or extraordinary perquisites,
  - Excessive severance and/or change-in-control provisions (*e.g.*, single triggers, new or materially amended agreements containing excise tax gross-ups, etc.),
  - Excessive reimbursement of income taxes,
  - Dividends or dividend equivalents paid on unvested performance shares or units,
  - Internal pay disparity (*i.e.*, excessive differential between CEO total pay and that of the next highest paid NEO), and
  - Repricings without prior shareholder approval

ISS Refresh Problematic Pay Practices (cont)

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- Additionally, there are certain problematic pay practices that are deemed "significant," the presence of which will likely result in an adverse recommendation from ISS, such being:
  - Repricing without shareholder approval,
  - Excessive perquisites or tax gross-ups,
  - New or extended executive agreements that provide for:
    - Change-in-control payments exceeding 3x base + average/target/most recent bonus,
    - Single trigger or modified single trigger change-in-control severance payments without a substantial diminution of duties,
    - Excise tax gross-ups for change-in-control payments,
    - "Good Reason" termination definitions that are not conducive to an adverse constructive discharge theory and present windfall risk. [Note: Definitions that are triggered by the failure of an acquiring entity to assume the agreement in question no longer trigger the problematic pay practices policy.]
    - Multi-year guaranteed awards or increases that are not at risk due to rigorous performance conditions, and
    - Liberal change-in-control definition combined with any single trigger change-in-control benefits
  - Insufficient executive compensation disclosure by externally-managed issuers, such that a reasonable assessment of the pay programs and practices for such externally-managed issuers is not possible
  - Severance payments made when termination is not clearly disclosed as involuntary,
  - Any other provision or practice deemed to be egregious and presents a significant risk to investors

ISS Refresh: Problematic Pay Practices (cont.)

- The following are examples of incentives that could motivate excessive risk-taking:
  - A single or common performance metric used for both short-term and long-term plans,
  - Multi-year guaranteed bonuses,
  - Mega annual grants providing unlimited upside and no downside risk, and
  - High pay opportunities relative to industry peers
- ISS acknowledges that risky incentives can be mitigated with rigorous clawback provisions and robust stock ownership/holding guidelines

ISS Refresh: Problematic Pay Practices (cont.)

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- Excessive non-employee director compensation
  - ISS will issue an adverse vote recommendation for board members responsible for approving non-employee director pay when the issuer exhibited a recurring pattern of excessive pay without a compelling rationale over two or more consecutive years
  - The following circumstances would typically mitigate concern:
    - Onboarding grants for new directors that are clearly identified to be one-time in nature, and
    - Payments related to corporate transactions or special circumstances
  - To determine whether compensation is excessive, ISS will compare individual non-employee compensation to pay outliers, representing individual non-employee directors who are paid above the top 2% of all comparable directors within the same index and sector
- Front-loaded awards
  - ISS is unlikely to support front-loaded awards that are intended to replace grants covering more than 4 future years (*i.e.*, the grant year plus three future years)
  - With respect to front-loaded awards of 4 years or less, ISS requires the issuer to make a firm commitment to not grant additional awards over the covered period

Don’t Forget Next Month’s Webinar

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- Title:
  - Pressure Points When Negotiating Executive Employment Agreements

- When:
  - 10:00 am to 11:00 am Central
  - February 8, 2024

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