Trends in Designing Performance-Based Equity Awards

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Our Compensation Practice – What Sets Us Apart

- 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
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 Multi-Disciplinary Compensation Practice

- Corporate Governance & Risk Assessment
- Securities Compliance & CD&A Disclosure
- Accounting Considerations
- Taxation, ERISA & Benefits
- Shareholder Advisory Services
- Listing Rules
- Global Equity & International Assignments
- Human Capital
- Surveys / Benchmarking
Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

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Upcoming 2018 Webinars

- Planning for an IPO: Compensation Considerations (Part 1 of 2) (9/13/2018)
- Compensation Changes Due to Loss of EGC Status (Part 2 of 2) (10/11/2018)
- Taxation of Equity Awards: The 101 Training Course (11/8/2018)
- How to Negotiate Executive Employment Contracts (12/13/2018)

Upcoming 2019 webinars:
- List will be created around September 2018


Compensation blog
- C-Suite Compensation Center
- Sign up here: https://www.csuitecompensationcenter.com/
Typical Forms of Long-Term Equity Incentives

- The three primary equity vehicles most often used are:
  - Restricted stock units ("RSUs") and/or performance share units ("PSUs"),
  - Restricted stock awards ("RSAs"), and
  - Stock options (both incentive stock options and non-statutory stock options)

- Stock options
  - Due to the tax efficiency and the optionality inherent in the award, stock options continue to be the most prevalent equity incentive used by privately-held corporations
  - Stock options are still used by publicly-traded corporations, however, their usage as the sole equity vehicle continues to decline
    - The decline started with the implementation of FAS 123R (now ASC Topic 718)
    - Such decline continued, in part, due to the theory often shared by institutional shareholder advisory services that time-based stock options are not “performance-based”
  - However, stock options are still a primary equity vehicle for technology-based companies
  - The most standard vesting schedule for stock options is ratably over 3 years (i.e., it vests pro rata over a 3-year period on the 1st, 2nd, and 3rd anniversaries of the Vesting Commencement Date)
    - Though monthly vesting after the 1st vesting tranche is also common (i.e., it vests pro rata over a 3-year period, with 33% vesting on the 1st anniversary of the Vesting Commencement Date, and thereafter, the remainder shall vest pro rata on a monthly basis over the next 2-year period)
RSUs and PSUs are the classic equity vehicles used to contain performance-based metrics (though such could be designed as time-based)

- These awards are contractual promises to pay cash or equity in the future (i.e., the settlement date)
- A design opportunity often utilized with these awards (by both public and private companies) is to defer the recipient’s tax event until the settlement date (i.e., a date that coincides with the last vesting tranche or some later date)
  - Since private companies lack a market for its common stock, these awards are often designed to become settled on a date that coincides with a liquidity event for the company’s shareholders
  - For publicly-held companies, the award is often deferred until the settlement date for administrative ease (though FICA is owed at vesting – which generally will save the employer and the recipient tax dollars if the fair market value of the underlying stock increases throughout the vesting schedule)

In contrast, RSAs are typically time-based awards

- With an RSA, a corporate transfer occurs on the date of grant
- As a result, and due to the lack of liquidity and the inability to implement a deferral mechanism, RSAs are typically not used by private companies unless the value of the shares is low on the date of grant and the recipient makes an 83(b) election
- Due to a public market for the trading of its stock, RSAs are still a common equity vehicle for public companies
- For public companies, the most common vesting schedule is annually over a 3 or 4 year period
Stock options and RSAs are typically time-based awards

For private companies, performance metrics within RSU and PSU awards are generally designed to align with the dream shared by its shareholders, that is, to increase shareholder value and work towards the dream of a high valued liquidity event (e.g., M&A event, financing transaction, monetization of the company’s intellectual property)

- Stock options are typically time-based awards
- RSAs are typically time-based awards
- For RSUs and PSUs containing performance-based metrics, the metrics are typically design towards increasing the return to shareholders at the liquidity event
  - For example, with respect to an executive the performance metrics include change in control sale price, EBITDA, net sale proceeds, etc.
  - And with respect to an award geared towards a leader of a division, the performance metric is sometimes tailored to the performance goals of his/her division (e.g., a sales metric for a sales person)
For publicly-traded companies, performance-based equity awards such as RSUs and PSUs tend to focus on financial performance measures that drives stock price, such as:
- Total shareholder return ("TSRs");
- Operating income, earnings per share, EBITDA and net income;
- ROE, ROA, ROIC; and
- Revenue, sales growth, cash flow

In addition, common performance metrics chosen by energy companies that we surveyed tend to include:
- Return on average capital employed,
- Reserve replacement ratio,
- Production per debt adjusted share, and
- Reserve adds per debt adjusted share
TSR is most common performance metric used by publicly-traded companies

- This is mostly the result of pay-for-performance methodologies adopted by institutional shareholder advisory services such as ISS
- However, this may change going forward given the addition of performance metrics by ISS (discussed in a below slide)
- And too, companies are beginning to realize that TSR should not be the sole performance metric
  - TSRs do not have direct line of sight to the business goal for the executive
  - Depending upon the TSR design and the selection of the peer group, an unintended consequence is that TSRs can payout even though the stock price didn’t perform (and not payout even though the stock price did perform)
  - Perhaps TSRs will be used in the future as a modifier to another performance-based award

TSRs are discussed in greater detail below
As part of its quantitative evaluation (i.e., the Relative Pay and Financial Performance Assessment), ISS added the following financial metrics (in addition to the TSR metric) to help it determine whether a pay-for-performance misalignment exists:

- Return on equity,
- Return on assets,
- Return on invested capital,
- Revenue growth,
- EBITDA growth, and
- Growth in cash flow from operations

Financial performance will be measured by a weighted average of the 7 financial metrics, and weightings will vary depending on the company’s GICS code.

This means that a company’s CEO will be compared to the 3-year financial performance of the weighted average of the above 7 financial metrics.
Payout Levels and the Performance Period

- Payout levels typically include:
  - A minimum level of performance (i.e., a floor or threshold) that must be achieved before any of the award is earned
    - For example, 25% of target (though a typical range for a floor is 25%-50% of target)
  - A target level of performance (typically 100%, though sometimes TSRs have a lower target percentile)
  - A maximum level of performance (i.e., a stretch goal)
    - For example, achieving performance at 150% of target (though a typical range is 150%-200% of target)

- The most common performance period with respect to RSUs and PSUs at publicly-traded companies is 3 years
  - Though some programs will allow an opportunity for the participant to “kick the can down the road” for an additional year (i.e., an additional year for the participant to satisfy the performance metric before the award is otherwise forfeited)
Generally, TSR is defined as stock price appreciation/depreciation, plus reinvestment of dividends, over a measurement period. Another way to look at it, is that TSR measures the return an investor would receive if he or she bought one share of common stock at the beginning of the measurement period, accumulated dividends during the measurement period, and then sold the common stock at the end of the measurement period.

There are two main formulas with respect to TSR programs:
- Absolute,
- Relative, and
- A combination of both.

An absolute TSR formula is calculated as follows:

\[
TSR = \frac{\text{Ending Price} - \text{Beginning Price} + \text{Dividends}}{\text{Beginning Price}}
\]

The payout is then determined as a function of the company’s TSR compared to predetermined goals (i.e., it is not compared to the TSR of the peer group).
A relative TSR program has the same math formula as an absolute TSR program; however, with a relative TSR program the payout is determined as a function of the company’s TSR ranking/ratio compared to the TSR ranking/ratio of its peer group.
  
  For example, if the company’s TSR percentile rank/ratio equals or exceeds x%, then the percentage of the target award that earned equals x%.
  
The following represents a hypothetical (though typical) relative TSR program:

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<th>Relative TSR Rank</th>
<th>Payout %</th>
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<tr>
<td>Maximum: 75^{th} percentile</td>
<td>200%</td>
</tr>
<tr>
<td>Target: 50^{th} percentile</td>
<td>100%</td>
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<tr>
<td>Threshold: 25^{th} percentile</td>
<td>50%</td>
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<tr>
<td>Below: Less than 25^{th} percentile</td>
<td>0%</td>
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In the above example, if the company’s TSR rank relative to its peer group is at the 80^{th} percentile, then the payout would be 200% of the target shares.
What happens when there is no alignment between absolute TSR and relative TSR? For example:

- Should management be rewarded when absolute TSR is high, but relative TSR is low (i.e., a reward to reflect the gains realized by shareholders)?
- Should management be rewarded when absolute TSR is low, but relative TSR is high (i.e., a reward to reflect outperformance of the peer group)?

Reason to address negative returns – Why should management be entitled to a payout for outperforming peers when shareholders lost money?

Reason to ignore negative returns – Management should be paid for outperforming peers because shareholder loss could have been greater at a peer company

- An additional negative is that the existence of a possible elimination of payout, a cap or a formula modifier would decrease the “fair value” of the award, thus possibly increasing the number of shares subject to the award.
Possible ways to address negative returns:

1\textsuperscript{st} – Eliminate any payouts when absolute TSR is negative over the performance period
   – Consider too whether this should work in the reverse, to provide a payout when absolute TSR is high but relative TSR is low (\textit{i.e.}, a reward to reflect the gains realized by shareholders)

2\textsuperscript{nd} – cap the payout opportunity when absolute TSR is negative over the performance period
   – Such caps typically limit the payout to the target level
   – If applicable, the cap would apply irrespective of whether the relative TSR formula would have otherwise required a higher payout opportunity
   – Consider whether the cap should work in the reverse, to protect management in instances where absolute TSR is high but relative TSR is low (\textit{i.e}, a reward to reflect the gains realized by shareholders)

3\textsuperscript{rd} – have a formula modifier that downward adjusts the payout when the company has a negative return (\textit{i.e.}, similar in formula to an upward adjustment that would apply if the company had positive TSR)
Equity-based performance awards that have maximum payout modifiers (e.g., 200% of target) will draw from the share reserve of the equity incentive plan at the maximum amount on the date of grant.

The above poses design issues for companies who struggle with an insufficient share reserve caused by failure of their stockholders to increase the share reserve. And this problem is exacerbated when the maximum payout is really in unrealistic stretch goal. And the problem is even further exacerbated when the unrealistic stretch goal covers a performance period of more than one year (e.g., a 3-year TSR performance period).

For the above reasons, some companies have partially moved to a cash-settled performance award program. For example, a company could settle the award in equity up to the target level, and then settle any payout above the target level in cash (thus hoping to eliminate the share reserve issue with respect to unrealistic stretch goals over multiple performance years).
Equity incentive plans with liberal share counting are counted/depleted on a net basis
  - For example, if 100 shares are subject to the award and only 60% of the award becomes vested, then 40 shares would return to, and replenish, the share reserve of the equity incentive plan

In contrast, shares registered pursuant to a Form S-8 are counted/depleted on a gross basis
  - Using the above example, all 100 shares would count towards and deplete the remaining share reserve subject to the Form S-8

This means!
  - Do not rely upon your equity incentive plan capitalization table to determine how many shares remain available under the Form S-8
  - When determining how many shares to register under a Form S-8, always register more than are then available under the equity incentive plan
Accelerated Vesting Due to Retirement

- There are two types of vesting schedules that contain “retirement” provisions that act to accelerate vesting:
  - Those with performance-based vesting provisions, and
  - Those with time-based vesting provisions

- For agreements with performance-based vesting provisions that provide for accelerated vesting upon retirement:
  - The continued application of the performance-based metrics within the award agreement should act as a substantial risk of forfeiture under Section 83 of the Code. Such is the answer even though the employee has a “contractual” right to benefits (to the extent the performance condition is satisfied) due to his or her attaining retirement age
  - For the above reasons, there is no taxation to the employee due to his or her attaining retirement age. This means no withholding obligation and no FICA/FUTA is triggered at retirement age or upon a termination of employment on or after attaining retirement age
  - Instead, taxation (both withholding and FICA/FUTA) would be triggered when the performance condition becomes satisfied
For agreements with only time-based vesting provisions that provide for accelerated vesting upon retirement BUT payout only upon a separation from service:

- The substantial risk of forfeiture under Section 83 is eliminated when the employee attains retirement age.
- Absent the agreement being designed to comply with Section 409A, the employee would have taxable income (subject to employment taxes, income tax withholding, etc.) when he or she attains retirement age WITHOUT regard to whether he or she terminates employment at such time.

If the agreement is designed to comply with Section 409A, e.g., having the award payout upon his or her separation from service even though he or she previously attained retirement age, then:

- FICA/FUTA is still triggered upon the employee attaining retirement age, and
- Income tax withholding would be deferred until the employee incurred a separation from service.

If retirement provisions are going to be used within equity awards, then consider only using RSU and PSU awards because it is easier to facilitate deferral opportunities within these types of awards.
The primary objective of an 83(b) election is to maximize capital gains treatment for the participant.

If no 83(b) election is timely filed, then:
- The participant would generally recognize ordinary taxable income equal to the fair market value ("FMV") of the award (less any amount paid) on the date the award becomes vested.
- Any dividends received by the participant prior to vesting would be treated as compensation (not dividends).
- Any sale of the vested stock would be treated as capital gain or loss equal to the difference between the sale price and the participant’s tax basis.

Tax treatment to participant assuming an 83(b) election was timely filed:
- The participant could attempt to capture as much of the projected appreciation of the underlying stock at capital gains rates if the participant makes an “83(b) election” within 30 days from the date of grant.
  - The purpose of an 83(b) election is to limit the ordinary income tax element to the value of the stock on the date of grant (which can be much lower than the amount of ordinary taxable income the participant would otherwise recognize at the time of vesting).
  - This means the participant would be taxed at the time of the initial transfer (at a time when the FMV of the stock may be low).
  - Thereafter, any increase in the FMV of the stock would be taxed at capital gains rates when the participant sells the underlying stock.
Tax treatment to the company:
- If the participant is an employee, the company’s withholding obligation and depositing of employment taxes would be triggered
- Also, the company would have a corresponding compensation deduction

The following slides are intended to show the tax impact of making (or failing to make) a timely 83(b) election AND assumes the award in question is a restricted stock grant

Assume the following hypothetical facts:
- An employee received 10,000 shares of restricted stock on February 1, 2017, when the FMV per share was $10
- The award vests 100% on the two year anniversary of the date of grant (no interim vesting)
- When 10,000 shares vest on January 31, 2019, the FMV per share is $30
- The employee then sells the shares for $400,000 in May 2019, when the FMV per share is $40

[The calculation on the following slide only addresses federal income tax]
If an 83(b) election IS timely filed upon receipt of the award:

- Ordinary income upon grant 2/1/17: $100,000
- Ordinary income tax 2/1/17 (40% x 100,000): 40,000
- Ordinary income upon vesting 1/31/19: 
- Capital gain at sale 5/19 ($400,000 - $100,000): 300,000
- Capital gains tax 5/19 (23.85% x $300,000): 71,400

Aggregate Tax on Award: $111,400

If an 83(b) election IS NOT filed:

- Ordinary income upon grant 2/1/17: $------
- Ordinary income upon vesting 1/31/19: 300,000
- Ordinary income tax 1/31/17 (40% x $300,000): 120,000
- Capital gain at sale 5/19 ($400,000 - $300,000): 100,000
- Capital gains tax 5/19 (23.8% x $100,000): 23,800

Aggregate Tax on Award: $143,800

In this example, the tax cost to the employee for failing to make an 83(b) election is $32,400 ($143,800 less $111,400)
The greater the increase in the value of the shares during the vesting schedule, the greater the tax cost to the employee for failing to make an 83(b) election.

When determining whether or not to make an 83(b) election, the employee generally must carefully consider the risk that the employee may terminate employment prior to full vesting of the award.

- Under the foregoing Example, if the employee files an 83(b) election but terminates employment prior to any vesting, the employee will forfeit all the shares and will have paid $32,400 in tax for which he/she generally cannot claim a refund.
- Whereas if the employee did NOT file an 83(b) election and terminated employment prior to any vesting, he/she would have forfeited all of the shares but would not have paid any tax.

Worth noting is that some companies negate the above economic risk by providing the employee with a gross-up at the time an 83(b) election is made. Such a formula could be:

\[
\text{Total Gross Up} = \left[\frac{\text{(date of grant FMV)}}{1 - \text{tax rate}}\right] - \text{date of grant FMV}
\]
The Tax Cuts and Jobs Act of 2017 (the “Act”) eliminated the performance-based exception to the $1mm deduction limit (the “Exception”) and expanded the definition of “who” is subject to the $1mm deduction limit.

- This means that, starting January 1, 2018, all compensation paid to a covered employee that exceeds $1mm will not be deductible unless the compensation is covered by the grandfathered rules.
- With the exception of grandfathered awards, equity incentive and annual bonus plans should be reviewed to reduce restrictions related to the Exception (e.g., setting performance goals within a certain period of time, certifying the achievement of goals, etc.).
- With respect to the foregoing, issuers should review and update equity plan prospectuses to the extent Section 162(m) tax disclosure is contained therein.
- Annual grant sub-limits within a plan could be removed (though retaining sub-limits could be a form of good compensation governance) and any removal will likely require shareholder approval under NYSE and NASDAQ listing rules (i.e., removal of a sub-limit enlarges a possible benefit to a participant).
- Severance provisions within executive contracts could be amended because, with the elimination of the Exception, performance conditions no longer have to be satisfied in order to receive severance pay (i.e., compliance with Rev. Rul. 2008-13 is no longer necessary).
- The prevalence of soft goals is likely to increase (e.g., leadership).
[Continued from prior slide]

There is a potential erosion of performance-based compensation (e.g., Netflix folding its performance-based bonus into its salary structure), but a large deviation is not likely given that institutional shareholders demand performance-based compensation.

Existing written binding contracts in effect on 11/2/2017 and not materially modified or renewed on or after such date could have grandfathered treatment, however:

- The contract cannot be modified on or after 11/2/2017
- Review IRS Notice 2018-68
- Presence of negative discretion destroys grandfather treatment (i.e., no written “binding” contract)
- A written “binding” contract is not likely to exist if the Compensation Committee has the discretion to terminate or materially modify such contract without the participant’s consent.
[Continued from prior slide]

- “Who” is a covered employee subject to the $1mm deduction limit was expanded to include the CFO, and too, once a covered employee ALWAYS a covered employee
  - Covered employee includes the CEO, CFO and the next 3 most highly compensated executive officers for the tax year whose compensation is required to be disclosed in the Summary Compensation Table
  - Any individual who is a covered employee on or after January 1, 2017, will always remain a covered employee (e.g., even years after termination of employment). However, because the Act does not become effective until January 1, 2018, any covered employee who terminates employment in 2017 would not be included within this “once a covered employee always a covered employee” rule (i.e., he or she would no longer be a covered employee the day after termination of employment within 2017)

- Form 8-K disclosure could be required in instances where a 2018 compensatory decision or award varies from the terms of the plan or prior proxy disclosure
- Review the Compensation Committee charter to determine whether any revisions are required (note: if the issuer has grandfathered plans, then changes are likely nominal)
- Review and revise proxy disclosure for both substantive and procedural changes
- Shareholder re-approval of equity plans will no longer be required every 5 years or, to the extent applicable, upon expiration of any transition periods
[Continued from prior slide]

- Be sure to maintain “outside director” status
  - The Compensation Committee will still need to certify whether performance objectives have been attained with respect to grandfathered plans
  - And too, it is important to keep in mind that Compensation Committee members must maintain independence under Rule 16b-3 and NYSE/NASDAQ listing rules
With respect to future bonuses that are not grandfathered:

- Flexibility exists because it is no longer required that performance targets be determined within the first quarter of the performance period.
- However, if targets are established when they are substantially certain to occur, then the bonus will be reported as a discretionary bonus in the SCT and not within the non-equity incentive column of the SCT.
- Any use of positive discretion will convert a performance-based award that is otherwise reported in the non-equity incentive column of the SCT, to an award that is reported as a discretionary bonus in the SCT.
- Any exercise of positive discretion will need to be disclosed in the CD&A.

Will the loss of the deduction impact grant practices? Not likely.

- The priority is to attract and retain talent.
- The loss of the deduction due to elimination of the Exception may be offset by the effect of the corporate tax rate moving from 35% to 21%.
- ISS has indicated that it will continue to focus on pay-for-performance.
Notwithstanding the prior slide, design considerations that could preserve deductions include:

- Replace the traditional 3-year vesting schedule with longer vesting schedules
- Pay severance in installments instead of a lump sum payment
- Create time windows within which stock option exercises must occur (if at all), and create an annual ceiling on the dollar value of any spread (i.e., the difference between the exercise price and the then fair market value of the underlying stock) that may exist at exercise per calendar year
- Will we see a resurgence of the secular trust?
IRS Notice 2018-68

- See handouts