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Comp Talks

Practical Implementation Tips for Dodd Frank Act Pay Ratio Disclosure, Pay Versus Performance Disclosure and Clawback Policies

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Agenda

- Status of Dodd-Frank Act executive compensation provisions
- Pay ratio disclosure
- Pay versus performance
- Clawback policies

Dodd-Frank Act
Executive Compensation Provisions

- Say on pay & frequency of say on pay (adopted/effective)
- Say on parachutes (adopted/effective)
- Compensation committee independence (adopted/effective)
- Compensation committee consultants/advisors (adopted/effective)
- Pay ratio (adopted/effective for most 2018 proxies covering 2017 compensation)
- Pay versus performance (proposed rules; comment period closed)
- Clawback policy (proposed rules; comment period closed)

Pay Ratio Disclosure

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What Is the Pay Ratio Rule?

- Requires disclosure of:
  - the median of the annual total compensation of all employees of the company, except the CEO (that is, the point at which half the employees earn more and half earn less);
  - the annual total compensation of the CEO; and
  - the ratio of the two amounts above

What Is the Pay Ratio Rule?

- Based on annual total compensation for the last completed fiscal year for the CEO and the median employee
- “Total compensation” is calculated consistent with disclosure requirements for the Summary Compensation Table
- Most companies must disclose pay ratio for 2017 in 2018 proxy statement

What Is the Rule on Identifying the Median Employee?

- Identification of the median employee need only be conducted once every three years
- Companies may use annual total compensation, another consistently applied compensation measure, statistical sampling, or other reasonable estimates to identify the “median employee”

What Is the Rule on Identifying the Median Employee?

- Must consider all employees, including full-time, part-time, seasonal, and temporary employees of company and any of its consolidated subsidiaries
- Companies may exclude non-U.S. employees in jurisdictions where access to information would violate data privacy laws
- Companies may exclude non-US employees representing up to 5% of the total workforce (with employees excluded due to privacy laws counting towards this 5% limit)

How Do We Apply the Rule on Identifying the Median Employee?

- Select the metric that will be used to identify your median employee
  - Define target metric, which must be consistently applied across all employees
  - Calculation may be different for different countries
  - Determine adjustments across geographies/business segments as applicable
- Consider using the full population vs. statistical sampling
- Select a data cutoff date that falls within three months of the fiscal year end

Additional Steps for Global Companies

- Assess appropriateness of implementing either non-US exemption: (1) EU data privacy law; and/or (2) 5% de minimis exclusion
- Consider applying a cost of living adjustment to non-US jurisdictions

How Do We Apply the Rule on Identifying the Median Employee?

- Combine data from all of a company's payroll systems
- Assemble data from a full population analysis or sample
- Select median employee by target compensation metric

We Identified Our Median Employee! Now What?

- Calculate pay ratio
  - Calculate total compensation based on prescribed total compensation formula
  - Calculate ratio of CEO to median employee
- Analyze and Strategize
  - Risk of media attention?
  - Risk of employee shock?
  - What’s the story?
  - Does it make sense to run any supplemental ratios?

What Does the Rule Require Us to Disclose?

- Must briefly describe (and consistently apply) the methodology used to identify the median employee, and any material assumptions, adjustments, or estimates used to identify the median or to determine total annual compensation
- Disclosure required in registration statements, proxy statements, and annual reports on Form 10-K that require executive compensation information

What Else Should We Consider Disclosing?

- Companies may supplement the required disclosure with a narrative discussion or additional ratios if they so choose
- It is likely that companies will include additional disclosure to provide context and to present the ratio in its best possible light

What Are the Risks?

- Doing the calculation and doing it accurately (ratio is to be “filed,” not “furnished”)
- Director or company embarrassment if the media latches onto a high value
- Internal problems when 50% of employees learn they are paid below the median
- Negative impact on say-on-pay votes
- Calculation volatility from year to year

Pay Versus Performance

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Pay Versus Performance Disclosure – Don’t We Already Do This?

- Currently, many companies voluntarily provide information in the annual proxy that is intended to convey the relationship between company performance and executive pay, but there is little consistency in definitions, time period or manner of calculation
- These new pay for performance rules are intended to create uniformity in these disclosures

What Is the Proposed New Format?

- Disclosure of the relationship between “compensation actually paid” and “company financial performance”
- Tabular disclosure of “total compensation” as shown in the company's Summary Compensation Table, as well as a new measure of "compensation actually paid”
- Show these data separately for the CEO and as an average for the other named executive officers (NEOs)
- “Company financial performance” is TSR

Tabular Disclosure Under Proposed Rule

Pay Versus Performance

Year (a)	Summary Compensation Table 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)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)

What Else is Required?

- Following the table, the new rules would also require a description, in narrative or graphic form or both, of the relationship of compensation actually paid to executives as shown in the table compared to the company's financial performance as reflected in its TSR, as well as a description of the relationship of the company’s TSR to the TSR of the peer group

What Time Period Is Covered?

- Disclosure is required for each of the five most recently completed fiscal years (three years for smaller reporting companies)
- Reporting would be phased in starting with three years of disclosure, increasing annually to five years and, for smaller reporting companies, starting with two years, increasing to three

What Is “Compensation Actually Paid”?

- “Compensation actually paid” is based on the “total compensation” column in the Summary Compensation Table, but with adjustments to the amounts included for:
  - pension benefits
  - equity awards

What Are the Compensation Adjustments?

- For purposes of the calculation of pension benefits, only the actuarial present value of benefits attributable to services rendered during the applicable fiscal year is included
- For equity awards, accounting value of amounts <u>vesting</u> in the applicable year are included, rather than amounts <u>granted</u> in the applicable year

How Do We Value Options at Vesting?

- The Summary Compensation Table discloses the aggregate fair value of options at the *date of grant* calculated in accordance with the fair value guidance in FASB ASC Topic 718
- "Compensation actually paid" assumes equity awards are actually paid on the date of vesting and would be valued at fair value at the *date of vesting* regardless of when such options were granted
- What is the fair value of an option at vesting?
  - FASB ASC Topic 718 generally permits companies to select the valuation model that best fits the substantive characteristics of the instrument being valued
  - Black-Scholes-Merton model (Black-Scholes or BSM) often used for grant date option valuations; lattice models often considered for later option valuations
  - Lattice models are often used in option modification cases and do not create a precedent to require their ongoing use for grant date values of options

Black-Scholes vs. Lattice Models

Black-Scholes

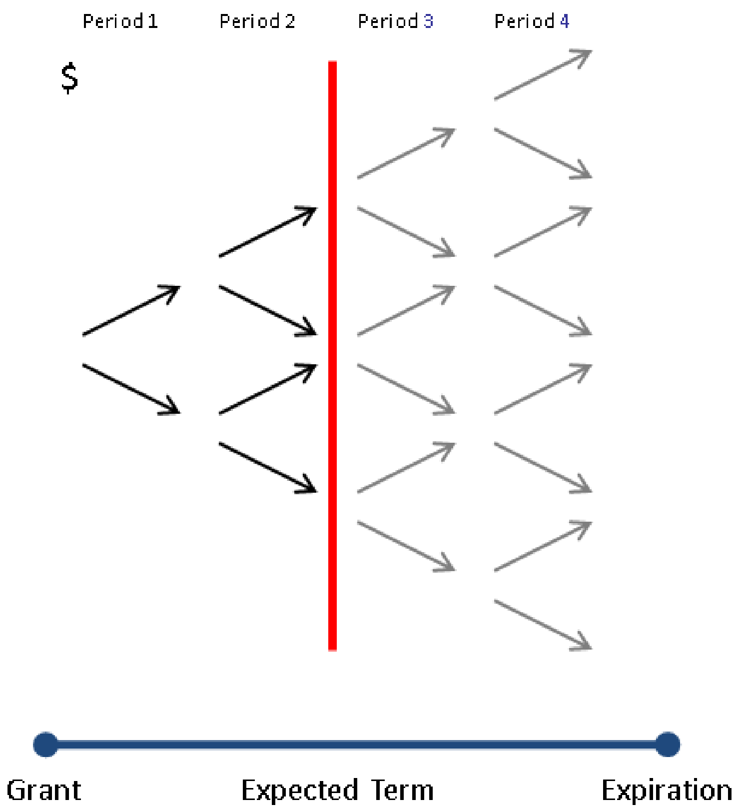
- Forecasts future exercise behavior based on expected employee *patience* (the "expected term" estimate)
- Relatively easy to use (used by ~80% of public companies)
- Generally used for grant date fair value when all options share essentially the same circumstances (e.g., at-the-money, ten years to expiration, three year vest) as historical grants and so historical data can be leveraged to develop an expected term
- Typically not used to value options at vesting when no longer at-the-money because of difficulty forming a reliable expected term estimate

Lattice

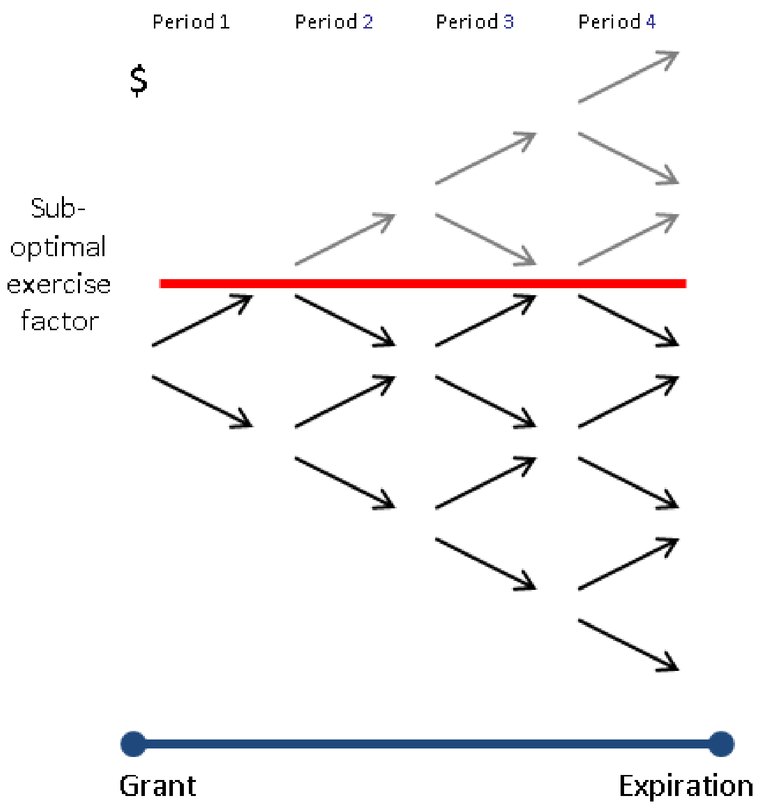
- Forecast future exercise behavior based on expected employee *greed* (i.e., the worth the options must attain before the employee is induced to exercise and capture that worth)
- More flexible – can accommodate a broader array of inputs with respect to employee exercise behavior, volatility, dividend and interest rate assumptions
- Do not require an "expected term" to be estimated, but rather "chooses" an expected term based on the circumstance
- Typically a better fair value estimate when option is in-the-money or out-of-the-money

Black-Scholes vs. Lattice Models

Black-Scholes



Lattice



How Do the Values Differ for an Option That Is Not At-the-Money and Is Mid-Way Through Its Life?

- Sample assumptions:

Stock Price	Volatility	Risk-free Rate	Dividend Yield	Remaining Term	Remaining Vesting Life
$60	50%	1%	3%	5 Years	0 Years

- Sample results:

Strike Price	Moneyness- Level When Exercise is Triggered	BSM Value	Lattice Value	Difference	Percentage
$40.00	1.20	$26.52	$20.00	$6.52	11%
$40.00	1.40	$26.52	$20.00	$6.52	11%
$40.00	1.60	$26.52	$21.99	$4.53	8%
$80.00	1.20	$16.33	$8.48	$7.85	13%
$80.00	1.40	$16.33	$12.13	$4.20	7%
$80.00	1.60	$16.33	$14.49	$1.85	3%

Will a Lattice Model Always Result in a Lower Value than the Black-Scholes Model?

- No!
- Sample assumptions:

Stock Price	Strike Price	Volatility	Risk-free Rate	Dividend Yield	Remaining Term	Remaining Vest Life
$60	$35	35%	1%	3%	3 Years	0 Years

- Using these assumptions (where remaining term is expected life), the Black-Scholes calculator says the value is $23.99
- The intrinsic value is $25 – can the fair value really be less?
- A lattice model using the same assumptions would value the option at $25.92

What Is “Company Financial Performance”?

- Companies would be required to use TSR to reflect their financial performance
- Companies, other than smaller reporting companies, would also be required to disclose peer group TSR, weighted according to market capitalization

Which Peer Group?

- The peer group for this purpose is the same index or peer group used for purposes of the “performance graph” under Regulation S-K, Item 201(e), or, if applicable, the companies disclosed in the CD&A for purposes of disclosing the company's compensation "benchmarking" practices
- If the peer group is not a published index, the composition of the peer group would need to be disclosed or incorporated by reference from prior filings
- TSR is calculated in the same way as for the performance graph

What Else Should We Consider Disclosing?

- May supplement the required disclosure by providing measures of “realized pay,” “realizable pay” or other appropriate measures of compensation paid, as well as supplemental measures of financial performance
- However, any additional disclosure must be clearly identified, not misleading and not presented with greater prominence than the required disclosure

What Else Should We Consider Disclosing?

- Consider additional explanatory disclosures to address potential distortions triggered by the rules, for example:
  - equity awards are included in year of vesting, even though they may have been granted years in the past
  - TSR may not truly represent performance for companies in some sectors
  - if two or more people served as CEO in any year, their compensation would be aggregated for that year, potentially resulting in misleadingly high CEO compensation values

What Should We Do Now?

- Run hypothetical calculations
- Review differences versus Summary Compensation Table and any alternative presentations previously provided (e.g., realized/realizable compensation) and consider how the relationship between these tables and the new pay versus performance table should be described
- Review current peer group and determine whether any revisions are advisable
- Consider whether current vesting schedules/timing make sense

Clawback Policies

What Does the Proposed Rule Require?

- Requires exchange-listed companies to recover from **current and former executive officers** the amount of erroneously awarded "**incentive-based compensation**" received during the three years preceding the date of an accounting restatement that results from the company's material noncompliance with any financial reporting requirement under the securities laws

Don’t We Already Have a Clawback Policy?

- During the nearly five-year wait for the SEC's proposal, some companies—approximately 23% as estimated by the SEC—have adopted interim clawback policies
- Other companies have waited for official SEC guidance, limiting their clawback enforcement to the much narrower mandate of the Sarbanes-Oxley Act of 2002 (SOX)
- The proposal is both broader and more stringent than most interim policies currently in place

Comparison with Sarbanes-Oxley Clawback Rules

	Sarbanes-Oxley	Dodd-Frank
Individuals Covered	CEO and CFO	Current and former executive officers
Arrangements Covered	Compensation/ profits from sale of company securities during the 12-month period following first noncompliant filing	Incentive compensation during three-year period preceding restatement in **excess** of what would have been paid without restatement
Triggering Event	Misconduct resulting in required restatement of any financial reporting required under securities laws	Accounting restatement due to material noncompliance with any financial reporting requirement under securities laws
Covered Period	The 12-month period following the first public issuance or filing of financial document with the SEC	Three-year period preceding date on which company is required to prepare accounting restatement
Who Enforces?	SEC	Company; potential shareholder derivative action

Who Are the Covered Individuals?

- Applies to any person who was an “executive officer” at any time during the performance period for the incentive-based compensation subject to recovery
- The definition of executive officer is the same as the definition of “officer” for Section 16 purposes
  - includes the company's president, principal financial officer, principal accounting officer (or controller, if there is no principal accounting officer), any vice-president in charge of a principal business unit, division or function (such as sales or finance) and any other officer or other person who performs a significant policy-making function for the company

Who Are the Covered Companies?

- Generally applies to all exchange-listed companies, including foreign private issuers, emerging growth companies and smaller reporting companies
- Certain companies had enjoyed exemptions from certain disclosure and say-on-pay requirements but are not excluded from the clawback rules

What Is the Covered Compensation?

- Applies to "incentive-based compensation," defined as any compensation that is granted, earned or vested based in whole or in part on the attainment of a **financial reporting measure**.
  - Cash examples include bonuses earned by achieving, in whole or in part, a target based on a financial reporting measure
  - Equity examples include stock options, restricted stock, restricted stock units and stock appreciation rights (including the proceeds of sale of the shares underlying any of these awards), provided that the awards are earned, granted or vested by attainment, in whole or in part, of goals based on financial reporting measures

What Are "Financial Reporting Measures"?

- Those measures based on accounting principles used in preparing the company's financial statements, any measures derived in whole or in part from that information (including reportable segments of the company's business and non-GAAP financial measures, such as EBITDA or same-store sales), stock price and total shareholder return (TSR)

What About Stock Price and TSR as Financial Reporting Measures?

- The inclusion of stock price and TSR-based metrics as financial reporting measures has been controversial
- When these metrics are used, the amount of erroneously awarded compensation cannot be recalculated directly from the information in an accounting restatement
- As a result, it could be extremely challenging to estimate how much any change in the stock price or TSR is attributable to a restatement

What Should We Do Now?

- Determine which compensation plans and programs, if any, would be deemed to involve "incentive-based compensation" and the effect the clawback of that compensation would have under any other plans
- If incentive-based compensation is treated as compensation for purposes of determining accrued benefits under other company plans, the clawback of the compensation could require an adjustment to the accrued benefit under the other plans

Should We Reconsider Our Performance Metrics?

- The focus on incentive-based compensation tied to financial performance metrics may have the unintended consequence of driving companies to return to the use of more discretionary compensation
- However, there is strong competing pressure from proxy advisory firms and institutional stockholders to base a greater percentage of executive compensation on objective performance criteria, and moving in the other direction may negatively affect votes for say-on-pay proposals

Should We Reconsider Our Performance Metrics?

- In addition, moving to discretionary performance metrics could cause companies to lose the ability to deduct a portion of that compensation under Section 162(m) of the Internal Revenue Code
- Some companies may instead turn to operational or strategic metrics, which may still be objective, performance-based metrics, but, under the proposed rule, would not be subject to clawback

What Is Everyone Else Doing?

- Most companies with interim clawback policies are awaiting final rules before further updating those policies
- Companies without clawback policies may consider adopting an interim clawback policy if it is determined to be appropriate based on corporate governance principles and any concerns raised by shareholders and proxy advisory firms

Questions????

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