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Executive Compensation Updates and Trends: What You Need to Know

December 16, 2022

Agenda

- **New SEC Rules**
  - *Regulation S-K, Item 402(v)*: Pay versus Performance ("PvP")
  - *Exchange Act Rule 10D-1*: Listing Standards for Recovery of Erroneously Awarded Compensation (the "Clawback Rules")

- **Restrictive Covenants** – Developments in State Law

- **Environmental, Social and Governance Metrics** – Incentive Compensation

PvP – New Proxy Table

- The SEC recently adopted final rules, originally proposed in 2015, regarding pay versus performance disclosures, which will apply for calendar year end filer's 2023 proxy statements
  - Disclosure rules do not apply to Emerging Growth Companies, Foreign Private Issuers and Registered Investment Companies
  - Scaled rules apply to Smaller Reporting Companies ("SRCs") and new issuers
- The key component of the required disclosures is the following table, which will initially cover fiscal years 2020, 2021 and 2022, but will eventually cover information for a five-year period (2021 and 2022 for SRCs, eventually covering a three-year period, with no Peer Group TSR and no Company-Selected Measure):

PAY VERSUS PERFORMANCE

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO NEOs	Average Compensation Actually Paid to Non-PEO NEOs	Value of Initial Fixed $100 Investment Based On:		Net Income	[Company-Selected Measure]
					Total Shareholder Return	Peer Group Total Shareholder Return		
2022								
2021								
2020								

PvP – Overview of Rule Requirements

- Must include narrative and/or graphical disclosure accompanying the table that uses the information presented in the table to provide a clear description of the relationship between:
  - Executive compensation actually paid to the PEO & the other NEOs and the company's cumulative TSR across the last [five] fiscal years
  - Executive compensation actually paid to the PEO & the other NEOs and the company's net income across the last [five] fiscal years
  - Executive compensation actually paid to the PEO & the other NEOs and the Company-Selected Measure across the last [five] fiscal years
  - The company's TSR and the peer group TSR
  - **Note:** During first year of disclosure, issuers are required to report only three fiscal years (or two fiscal years for SRCs)
- Performance Measures
  - "Company-Selected Measure" included in the table to represent the "most important financial performance measure" used to link compensation actually paid to company performance in the most recently completed fiscal year. **Note:** Not required for SRCs.
  - Also must disclose a list of 3 to 7 financial performance measures (including the Company-Selected Measure) used to link compensation to performance. **Note:** Not required for SRCs.
    - As long as at least 3 *financial* measures are chosen, non-financial performance measures may also be included in this list
    - Note, for the 3 to 7 measures included in the list (other than the Company-Selected Measure), disclosure of the results of those measures is not required

PvP – Compensation "Actually Paid" is a Misnomer

- Calculation begins with "Total Compensation" from the Summary Compensation Table and makes two key adjustments with respect to (i) change in pension value and (ii) stock awards and option awards. Note: Pension adjustments not required for SRCs.
- Replaces "Change in Pension Value" component with (i) actuarial present value under all plans attributable to services rendered *during* the covered fiscal year (Service Cost) plus (ii) entire cost of benefits granted (or credit for benefits reduced) under plan amendment or plan initiation during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the amendment (Prior Service Cost)
- Replaces "Stock Award" and "Option Award" values with amount intended to measure the change in fair value of outstanding unvested awards at FYE, and awards that vest during the covered fiscal year, on a year-over-year basis, calculated as:
  - The fair value of all awards granted during the FY that are outstanding and unvested as of FYE, plus
  - The change in fair value (+/-) from prior FYE of awards granted in prior FY that are outstanding and unvested as of FYE, plus
  - The fair value as of the vesting date for any awards granted during the FY that vest in the same FY, plus
  - The change in fair value (+/-) from prior FYE as of the vesting date of awards granted in prior FY that vest during the FY, minus
  - The fair value as of the prior FYE for any awards granted in a prior fiscal year that are forfeited during the covered FY
- Planning Point: Many issuers are running new Black-Scholes/Monte Carlo simulations as of each FYE for options and performance-based awards and as of vesting dates for options. Pension plan actuaries should be engaged for NEO service cost cautions for issuers with defined benefit pension plans.

PvP – Footnote Disclosure for Adjustments

- The PvP rules require footnote disclosure of (1) each of the amounts deducted and added (provided as averages for the other NEOs), and (2) the name of each NEO included as PEO or in the average other NEO groups and the fiscal years in which such persons are included.
- The following is sample footnote tabular disclosure. One table would be used for the PEO and a second table would disclose averages for the other named executive officers.

Year	Summary Compensation Total (SCT Total)	Deductions from SCT Total(a)	Additions to SCT Total(b)	Compensation Actually Paid
2022				
2021				
2020				

(a) Represents the grant date fair value of equity-based awards granted each year and the change in pension value for each year previously reported in the Summary Compensation Table.
(b) Reflects the value of equity-based awards, as well as the service cost and prior service cost for our defined benefit pension plans, calculated in accordance with Item 402(v)(2)(iii).

- Additional detail on any assumptions in valuations that differ materially from those disclosed as of the grant date should also be provided.

PvP – Footnote Disclosure for Adjustments

- The following is an alternative sample footnote with narrative disclosure for equity award adjustments.

1. Calculated as follows for [year]: $[●], which is the Summary Compensation Table Total for the PEO, minus (ii) $[●], which is the aggregate grant date fair value of stock and option awards granted to the PEO during the year, plus (iii) $[●], which is the fair value as of the end of the covered fiscal year of all awards granted to the PEO during the covered fiscal year that were outstanding and unvested as of the end of the covered fiscal year, plus (iv) $[●], which is an amount equal to the change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted in any prior fiscal year that are outstanding and unvested as of the end of the covered fiscal year, plus (v) $[●], which is an amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted to the PEO in any prior fiscal year for which all applicable vesting conditions were satisfied at the end of or during the covered fiscal year, minus (vi) $[●], which is an amount equal to the fair value at the end of the prior fiscal year for any awards granted in any prior fiscal year that failed to meet the applicable vesting conditions during the covered fiscal year, plus (vii) $[●], which is the dollar value of any dividends or other earnings paid on PEO stock awards in the covered fiscal year prior to the vesting date that are not otherwise included in the total compensation for the covered fiscal year.

2. Calculated as follows for [year]: $[●], which is the average Summary Compensation Table Total for the other NEOs, minus (ii) $[●], which is the average aggregate grant date fair value of stock and option awards granted to the other NEOs during the fiscal year, plus (iii) $[●], which is the average fair value as of the end of the covered fiscal year of all awards granted to the other NEOs during the covered fiscal year that were outstanding and unvested as of the end of the covered fiscal year, plus (iv) $[●], which is the average change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted to the other NEOs in any prior fiscal year that are outstanding and unvested as of the end of the covered fiscal year, plus (v) $[●], which is an amount equal to the average change as of the vesting date (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted to the other NEOs in any prior fiscal year for which all applicable vesting conditions were satisfied at the end of or during the covered fiscal year, minus (vi) $[●], which is the average fair value at the end of the prior fiscal year for any awards granted in any prior fiscal year that failed to meet the applicable vesting conditions during the covered fiscal year, plus (vii) $[●], which is the average dollar value of any dividends or other earnings paid on other NEO stock awards in the covered fiscal year prior to the vesting date that are not otherwise included in the total compensation for the covered fiscal year.

PvP – Other Items

- Key Decision Points
  - Company-Selected Measure and Tabular List
  - Peer Group for TSR
- Proxy Placement
- Intersection with CD&A Disclosures

Clawback Rules – Overview

- Background: SEC adopted Dodd-Frank rules requiring stock exchanges to require listed companies to have "no fault" clawback policies providing for the mandatory recovery of incentive compensation
- Effective Date:
  - The Clawback Rule was published November 28, 2022.
  - Stock exchanges must propose listing rules consistent with the Clawback Rule by February 26, 2023.
  - Effective date of the stock exchange listing standards must be no later than November 28, 2023.
  - Issuers must adopt recovery policies consistent with the stock exchange listing standards no later than 60 days following the date such listing standards become effective.
  - Latest possible date for adopting a recovery policy is January 27, 2024 but could be earlier.
- New Disclosure Requirements:
  - File policy as 10-K/20-F/40-F exhibit
  - Indicate by check mark on cover page if financial statements reflect the correction of an error in previously issued financial statements, and if so, whether any such correction required a recovery analysis

Clawback Rules – Key Features – Covered Individuals and Trigger

- Covers current and former "executive officers"
  - "Executive Officer" generally tied to the Section 16 "officer" definition and includes the Principal Accounting Officer
- Triggered by an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, including
  - Any required accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements ("Big R" restatements), or
  - Any required accounting restatement that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period ("Little R" restatements)
- An individual's misconduct or responsibility for the restatement is not relevant

Clawback Rules – Key Features – Covered Compensation

- Only apply to incentive-based compensation that is received during the three-year period preceding the date on which the issuer is required to prepare the accounting restatement
  - "Incentive-Based Compensation" includes performance-based cash and equity that is granted, earned, or vested based wholly or in part upon the attainment of a "financial reporting measure"
    - Measure determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, and any measure derived wholly or in part from such measures, including stock price and total shareholder return
  - Incentive-based compensation deemed "received" in the issuer's fiscal period during which the financial reporting measure specified in the incentive-based compensation award is *attained*, even if the payment or grant of the incentive-based compensation occurs after the end of that period
- Annual base salaries, discretionary bonuses and equity awards that are granted without regard to any financial reporting measure and vest solely based on continued service would not be covered

Clawback Rules – Key Features – Recoupment

- Amount Recouped: Amount of "incentive-based compensation" received by the executive officer in excess of what would have been received if the "incentive-based compensation" was determined based on the restated financial statements.
- Discretion: The Clawback Rule does not permit the exercise of discretion by the issuer. Amounts must be recouped unless certain narrow exceptions are met.
- Exceptions: No recoupment required if compensation committee, or in the absence of such a committee, a majority of the independent directors, determines that recovery would be impracticable and one of the following conditions is met:
  - Direct expense paid to a third party to enforce recoupment policy would exceed amount recovered and a reasonable attempt to recover such compensation was made and documented;
  - Recoupment would violate home country law; or
  - Recoupment would likely cause an otherwise tax-qualified, broad-based retirement plan to fail to meet applicable requirements.

Restrictive Covenants – Developments in State Law

- In recent years, states have become increasingly active in regulating the use of restrictive covenants (particularly non-compete covenants).
- Issuers often include a broad array of restrictive covenants in award agreements used in connection with annual equity award cycles.
- The following states have adopted statutes in recent years with restrictions and limitations that could impact the use of restrictive covenants in award agreements:

  - Colorado
  - Illinois
  - Maine
  - Maryland
  - Massachusetts
  - Nevada
  - New Hampshire
  - Oregon
  - Rhode Island
  - Utah
  - Virginia
  - Washington

Restrictive Covenants – Notice Periods

- Colorado:
  - Notice must be provided in separate document from other covenants and worker must sign the notice
  - New workers: Must provide prior to offer acceptance; Current workers: Must provide 14 days prior to earlier of covenant effectiveness or provision of consideration
- Illinois: Must provide at least 14 calendar days to review a copy of any non-compete or non-solicit covenant
- Maine: Must provide at least 3 business days to review a copy of any non-compete covenant
- Massachusetts: New workers: Must provide prior to earlier of formal offer of employment or 10 days prior to start date; Current workers: Must provide 10 days prior to covenant effectiveness
- New Hampshire: Must disclose to new workers prior to acceptance of employment offer
- Oregon: Notice in a written employment offer at least 2 weeks before start date must indicate a non-compete is required as a condition of employment. Note: Non-compete after employment commences must be in connection with a "subsequent bona fide advancement" of the employee
- Washington: New workers: Must disclose in writing before offer is accepted; Current workers: May enter into if independent consideration provided

Restrictive Covenants – Workforce Limitations

- Colorado: Employee must earn annualized cash compensation no less than state's threshold (currently $101,250 per year)
- Illinois: Employee's actual or expected annualized earnings must exceed $75,000 (for non-compete) or $45,000 (for non-solicit). Amounts subject to scheduled increases starting in 2027
- Maine: Employee must earn wages in excess of 400% of the federal poverty level
- Maryland: Employee must earn more than $15/hr or $31,200/year
- Massachusetts: Not enforceable against (i) non-exempt employees under FLSA; (ii) undergraduate/graduate students; (iii) employee terminated without cause or laid off; or (iv) employees age 18 or younger
- Nevada: Non-compete not enforceable against an hourly employee
- New Hampshire: Employee must earn hourly rate in excess of 200% of the federal minimum wage
- Oregon: Annual gross salary and commissions must exceed $100,533 at time of termination (adjusted annually)
- Rhode Island: Not enforceable against (i) non-exempt employees under FLSA; (ii) undergraduate/graduate students; (iii) employees age 18 or younger or (iv) if average annual earnings are not more than 250% of the federal poverty level
- Virginia: Average weekly earnings must equal or exceed average weekly wage in Virginia ($1,290 for 2022), but exempts employee paid in whole or predominate part from commissions, incentives or bonuses
- Washington: Annualized earnings must exceed $100,000 per year (adjusted annually)

Restrictive Covenants – Statutory Time Limitations

- Maine: Non-compete generally cannot take effect until later of: (1) following one year of employment or (2) six months after agreement is signed
- Massachusetts: Post-termination restricted period limited to 12 months following cessation of employment, subject to limited exceptions
- Oregon: Post-termination restricted period limited to 12 months following cessation of employment, subject to limited exceptions
- Utah: Post-termination restricted period limited to one year from the date of termination (different timing rules for broadcast employees)
- Washington: Rebuttable presumption that post-termination restricted period exceeding 18 months after termination unreasonable and unenforceable

Environmental, Social and Governance Metrics – Incentive Compensation

- Largely driven by shareholder advocacy and interest, companies are increasingly incorporating environmental, social and governance ("ESG") metrics into their incentive-based compensation arrangements.
- A 2022 study of companies on the S&P 500 found the following *("2022 Use of Environmental, Social, and Governance Measures in Incentive Plans" by FW Cook):*
  - 74% of the largest companies disclose ESG measures in incentive plans with the vast majority incorporating such metrics in the annual incentive plan
  - Most common approach is to incorporate ESG metrics into a broader assessment of individual performance
  - ESG incentive measured on a qualitative basis, with less than a quarter of companies that use ESG incentive measures disclosing quantitative performance achievement.
- The following are broad categories of ESG metrics:
  - Diversity & Inclusion
  - Customer Satisfaction
  - Employee Safety
  - Product Quality
  - Environmental Goals (e.g., carbon footprint, emissions, energy efficiency, water usage)

Environmental, Social and Governance Metrics – Incentive Compensation

- Key considerations for incorporating ESG metrics into an incentive compensation arrangement:
  - ESG Metric: Identify ESG metrics that are best suited to the company's business and overall strategy
  - Measurement: Consider whether to adopt ESG metrics that are quantitative (e.g., number of accidents) versus qualitative (e.g., satisfaction with company culture)
  - Covered Employees: Consider whether ESG metrics should apply to incentive compensation paid to top executives or larger segments of the workforce
  - Covered Compensation: Consider whether the ESG metrics should be incorporated into an annual cash plan and/or long-term incentive compensation.
    - Certain goals may take longer to measure meaning a long-term incentive plan is more appropriate
    - Qualitative goals requiring subjective judgment better suited to annual cash plans (such goals could complicate accounting for long-term, equity-based awards)
  - Impact: Consider the extent to which achievement of financial metrics can be impacted or even overridden by ESG metric achievement