Morgan Lewis

# GLOBAL PUBLIC COMPANY ACADEMY

## Executive Compensation in a Volatile Stock Market

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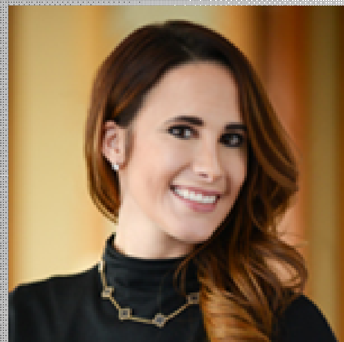

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# Areas of Concern in a Volatile Market

- Managing Equity Plan Share Reserve
- Inducement Grants
- Retention Grants
- Strategies for Underwater Options

# Managing Equity Plan Share Reserve

# Managing Equity Plan Share Reserve

- Significant drop in stock price can lead to dwindling share reserve
  - Increases the number of shares required to deliver target value
- Volatile stock market can lead to discrepancies in number of shares covered by awards that are meant to deliver similar value
  - Options granted several months apart can have very different exercise prices
  - Number of RSUs needed to produce same target value can differ widely
- Shareholder approval is required to increase share reserve
  - If company performance has not been strong compared to peers, ISS may limit the number of shares that can be requested

# Managing Equity Plan Share Reserve

- Strategies to manage equity plan share reserve:
  - Use RSUs instead of stock options
    - Stock options require more shares than full-value awards like RSUs
    - However, plans that have fungible share counting will use a multiple to count the shares subject to RSUs
  - Set the number of shares subject to equity grants based on a trailing average stock price that includes a prior trading period when prices were higher
  - Make annual equity awards subject to shareholder approval
    - Requires "mark-to-market" financial accounting unless shareholder approval is a foregone conclusion

# Managing Equity Plan Share Reserve

- Strategies to manage equity plan share reserve:
  - Increase the amount of cash compensation to offset the reduced availability of equity
  - Use equity awards payable in cash
    - Requires “mark-to-market” financial accounting
    - Possible to grant RSUs payable in cash or shares so that shares can be used if available at a later date

# Managing Equity Plan Share Reserve

- Strategies to manage equity plan share reserve:
  - Reduce upside on performance awards so fewer shares have to be reserved for maximum performance
  - Grant options with 5- to 7-year terms to reduce future overhang
  - Grant equity awards outside the shareholder-approved equity compensation plan as “inducement grants” for newly hired employees

# Inducement Grants

# Inducement Grants

- NYSE/NASDAQ listing rules generally require shareholder approval of equity plans
- As an exception, NYSE/NASDAQ rules permit equity awards to be made to newly hired employees as an inducement to employment without shareholder approval if certain requirements are met
- Inducement grants help reduce depletion of equity plan share reserves
- However, they are not "free" shares and will be taken into account by ISS and Glass Lewis as outstanding equity grants when an equity plan is next submitted to shareholders for approval
- For more information: Inducement Grants Enable Companies to Avoid Depletion of Equity Plan Share Reserves – Publications | Morgan Lewis

# Inducement Grants

- An inducement grant must be:
  - A “material inducement” to the individual being hired (or rehired)
  - Granted to a prospective employee (nonemployee directors and consultants are not eligible)
  - Approved by the independent compensation committee or a majority of independent directors
  - Disclosed in a press release that includes the recipient of the award and the number of shares involved
    - Note: filing a Form 8-K does not satisfy the press release requirement

# Inducement Grants

- Exceptions to the immediate, individualized press release rules:
  - Routine inducement grants to new hires under a program in which equity grants are made to new hires without individual negotiation can be aggregated in a press release no less frequently than every two weeks
  - Aggregated disclosure is permitted when inducement grants are made to employees of a target company in connection with a merger or acquisition, other than grants made to executive officers of the post-merger company
- An immediate press release is required for individually negotiated inducement grants or inducement grants made to executive officers

# Inducement Grants

- Inducement grants are made outside of the shareholder-approved equity plan
  - Do not count against the share reserve
  - Are not subject to shareholder approval
- Can be in the form of any type of equity compensation other than incentive stock options (ISOs)
  - ISOs are ineligible for inducement grants because ISOs may only be granted through a shareholder-approved equity plan
- Inducement grants can be structured as:
  - A special share pool under an existing equity plan
  - A separate equity plan for inducement grants only
  - Awards of inducement grants outside of any equity plan

# Inducement Grants

- Shares for inducement grants must be listed on NYSE/NASDAQ
- Shares for inducement grants must be registered on Form S-8
- Inducement grants require 10-K and/or proxy statement disclosure for NEOs
  - If granted to a named executive officer (NEO), need to be included in the CD&A, Summary Compensation Table, and Grants of Equity Awards table
- Amendments to inducement grants may require shareholder approval
- Shareholders, ISS, and Glass Lewis will take inducement grants into account as outstanding awards when determining the number of shares to be available for future equity plan proposals

# Retention Grants

# Retention Grants

- Retention grants have become popular as one-time enhanced or supplemental grants to support retention
- Companies may want to use retention grants to indirectly replace unearned performance-based compensation
- Companies often want to use time-based vesting for retention grants
  - Performance-based retention awards are viewed more favorably by shareholders/ISS/Glass Lewis
- Retention grants raise significant shareholder/ISS/Glass Lewis scrutiny
  - Off-cycle retention arrangements are generally viewed negatively

# Retention Grants

- ISS position on granting retention awards where performance awards were earned below target (December 2021 FAQ: Compensation Policies):
  - Investors do not expect boards to reward executives when performance goals are not achieved, whether by lowering or waiving goals (a problematic pay practice) or granting other awards to compensate for the absent incentive payouts.
  - Investors recognize, however, that retention of key talent may be critical to performance improvements and future shareholder value. To the extent one-time awards are granted in the year (or following year) in which incentives are forfeited, companies should explain the specific issues driving the decision to grant the awards and how the awards further investors' interests.

# Retention Grants

- ISS position on granting retention awards where performance awards were earned below target (December 2021 FAQ: Compensation Policies):
  - Granting one-time awards to replace forfeited incentives and/or to insulate executives from lower pay outcomes will be viewed as a problematic action.
  - Awards should be reasonable in magnitude and be an isolated/nonroutine occurrence. The awards should also be strongly performance-based and have limitations on termination-related vesting.

# Retention Grants

- Clear, thorough explanation of rationale of retention awards needs to be in the CD&A of the next proxy
  - Describing rationale merely as "retention" is not sufficient
- Consider whether Form 8-K should be issued at time of retention grant
- Retention grants without sufficient explanation have been the cause of many ISS and Glass Lewis negative recommendations on say on pay
- Prepare for shareholder scrutiny by advance shareholder outreach

# Other Considerations

# Other Considerations

- Performance metrics: plan ahead
  - What metrics are appropriate in a volatile market? E.g., Relative TSR vs Absolute TSR
  - Do the grant documents give the compensation committee discretion to make adjustments?
- Check Good Reason definition in equity grants and severance arrangements
  - Would a reduction in LTI target opportunity trigger Good Reason?

# Strategies for Underwater Options

# Strategies for Underwater Options

- Option Repricing Program:
  - The terms of the outstanding underwater option are unilaterally amended by the company to provide for a lower exercise price
- Option Exchange Program:
  - Option-for-Option Exchange – outstanding underwater options are cancelled and replacement options with a lower exercise price are issued
  - Option-for-Other Security Exchange – outstanding underwater options are cancelled and exchanged for another form of award (i.e., restricted stock, RSUs, phantom stock, etc.)
- Option Buyout Program:
  - The outstanding underwater option is repurchased by the issuer for cash

# Reasons To Do A Repricing/Exchange/Buyout

- Attract and retain talent
  - Key employees may view their underwater option holdings as worthless
  - Repricing/exchanges may provide for renewed or extended vesting
- May reduce dilution and stock-based compensation account expenses related to underwater options
- Potentially increase available share pool by adding cancelled options back into the pool of available shares
- May help manage equity burn rate and cash reserves by not issuing additional equity awards and/or increasing cash compensation to supplement the underwater options

# Reasons NOT To Do A Repricing/Exchange/Buyout

- Immaterial number of underwater options
  - Consider the extent to which the options are underwater, who is holding the options, and when the underwater options were granted
- Negative optics
  - Programs may be viewed as an overreaction to short-term decline
  - Investors are not afforded same opportunity
  - Institutional investors and proxy advisor firms strongly disfavor programs
- Programs are time consuming, involve multiple parties (including stock administration, accounting, tax, legal, and outside counsels), and are costly
- Usually require shareholder approval

# Shareholder Approval Issues

- NYSE/Nasdaq rules require shareholder approval of option repricing/exchange programs unless the equity plan specifically permits option repricings without shareholder approval
- For purposes of these rules, option repricing includes:
  - Lowering the exercise price of an outstanding underwater option
  - Exchanging an underwater option for another option or other equity security
  - Any other action treated as a repricing for accounting purposes
- NYSE/Nasdaq rules do not require shareholder approval of cash buyouts of underwater options
- If a company's need for shareholder approval does not coincide with the timing of its annual meeting, a special shareholder meeting will be necessary to obtain the necessary approval

# ISS on Option Exchange Programs/Repricing Options

- General Recommendation: Vote case-by-case on management proposals seeking approval to exchange/reprice options taking into consideration:
  - Historic trading patterns - the stock price should not be so volatile that the options are likely to be back "in-the-money" over the near term
  - Rationale for the re-pricing - was the stock price decline beyond management's control?
  - Is this a value-for-value exchange?
  - Are surrendered stock options added back to the plan reserve?
  - Timing - repricing should occur at least one year out from any precipitous drop in company's stock price
  - Option vesting - does the new option vest immediately or is there a black-out period?
  - Term of the option - the term should remain the same as that of the replaced option
  - Exercise price - should be set at fair market or a premium to market
  - Participants - executive officers and directors must be excluded

# Glass Lewis on Option Exchanges and Repricing

- Glass Lewis is generally opposed to the repricing of employee and director options regardless of how it is accomplished
- As shareholders have substantial risk in owning stock, GL believes that the equity compensation of employees and directors should be similarly situated to align their interests with those of shareholders
- There is one circumstance in which a repricing or option exchange program may be acceptable: if macroeconomic or industry trends, rather than specific company issues, cause a stock's value to decline dramatically and the repricing is necessary to motivate and retain employees
  - In such a scenario, GL may opt to support a repricing or option exchange program only if sufficient conditions are met

# Glass Lewis on Option Exchanges and Repricing

- Largely concerned with the inclusion of the following features:
  - Officers and board members cannot participate in the program
  - The exchange is value-neutral or value-creative to shareholders using very conservative assumptions
  - In GL's evaluation of the appropriateness of the program design, it will also consider the inclusion of the following features:
    - The vesting requirements on exchanged or repriced options are extended beyond one year
    - Shares reserved for options that are reacquired in an option exchange will permanently retire (i.e., will not be available for future grants) so as to prevent additional shareholder dilution in the future
    - Management and the board make a cogent case for needing to motivate and retain existing employees, such as being in a competitive employment market

# Design/Structural Considerations – Holder Eligibility

- Holder Eligibility: Who can participate?
  - General Recommendation: Exclude executive officers and directors.
  - Rationale/Explanation:
    - Proxy advisors and institutional investors generally favor programs that do not include option holders who are deemed accountable for the company's performance. Alternatively, companies may consider providing less favorable terms for directors and executive officers than the terms provided for rank-and-file employees, such as higher exchange rates, lower cash payments, and longer vesting requirements.

# Design/Structural Considerations – Option Eligibility

- Option Eligibility: What options can be repriced/exchanged?
  - General Recommendation: Exclude awards that are only slightly underwater. The exercise price of eligible stock options should be greater than the 52-week high for the stock price. Additionally, awards that were recently granted, such as stock options that were granted in the prior two years, should be excluded.
  - Rationale/Explanation:
    - Options only slightly underwater should not be included, as these options may still have meaningful incentive and retention effects. Additionally, including recently-granted options and/or options that are only slightly underwater may send the message that the company does not expect its stock price to improve.

# Design/Structural Considerations – Exchange Ratio

- Exchange Ratio: What is the exchange ratio?
  - General Recommendation: It should result in a value-for-value exchange.
  - Rationale/Explanation:
    - Value-for-value exchanges are more acceptable to shareholders compared to one-for-one exchanges, because they result in less dilution to public shareholders.

# Design/Structural Considerations – Other Considerations

- Vesting Schedule:
  - General Recommendation: The vesting schedule should be reset or a longer vesting schedule should be implemented.
- Surrendered Options:
  - General Recommendation: Shares recaptured through the program should be retired and not made available for new awards under the plan.
- Future Awards:
  - In consideration for support of a repricing or exchange program, institutional investors and proxy advisory firms may compel companies to place limitations on future awards to be granted.

# Tender Offer Implications

- Unless the program is limited to a small number of executive officers or other similarly sophisticated optionees, if option holders have a choice with respect to participating in the exchange/repricing, the program must comply with the tender offer requirements of Rule 13e-4 under the Exchange Act
  - Therefore, upon commencement of a program, a company is required to file a Schedule TO with the SEC and leave the offer open for at least 20 business days
- SEC has provided limited relief from the “All Holders” and “Best Price” requirements of Rule 13e-4:
  - Does not require inclusion of all optionees
  - Permits different amounts of replacement securities to various categories of optionees (i.e., different exchange ratios)

# Disclosure Considerations

- If shareholder approval is required, a company must disclose the material terms of the program in the proxy statement in which approval is sought
  - Note: an option repricing/exchange program proposal would require the filing of a preliminary proxy
- Disclosure also will be required in the CD&A and compensation tables of the company's next proxy statement, but only to the extent any named executive officers participated in the program
  - Summary Compensation Table: Incremental fair value of replacement/modified award
  - Grants of Plan-Based Awards Table: Include any new equity awards
- If any directors participated in the program, the company would disclose any new equity awards granted in the Director Compensation table
- Option exchanges and repricings trigger Form 4 filings for any participating Section 16 insiders (both with respect to cancelled stock options and new equity grants)

# Tax Considerations and Issues

- The cancellation or repricing of underwater options is generally treated as a nontaxable exchange under U.S. federal income tax laws
  - Not required to recognize income upon the cancellation of stock options or the grant of new equity awards that are subject to future vesting
  - Cash payments made in exchange for options are immediately taxable, unless the cash is subject to vesting or other forfeiture conditions
- Code Section 409A regulations do not preclude repricing of underwater options provided the exercise price per share of the replacement option is at or above the fair market per share on the new grant date
- The cancellation of an underwater stock option or the exchange of an underwater stock option for an alternative equity security will generally not raise Code Section 409A implications

# Tax Considerations and Issues - ISOs

- Replacement ISO resets two-year holding period measured from grant date of replacement ISO
- $100K limit on initial exercisability of ISOs
  - Any shares for which the cancelled option would first become exercisable during the year of cancellation, whether before or after the date of actual cancellation, count against the $100K limit
  - Any shares that become exercisable under the replacement ISO in the year of cancellation also count against the $100K limit
- Cashout of underwater ISOs held by employees will trigger the withholding of applicable income and employment taxes

# International Considerations

- Tax issues
  - Taxability of exchange
  - Previously taxed awards
  - Employer tax issues
  - Approved/qualified plans may not permit repricing
  - Structure of replacement awards
- Local compliance
  - Prospectus/registration
  - Exchange control
  - Labor law
  - Electronic signature

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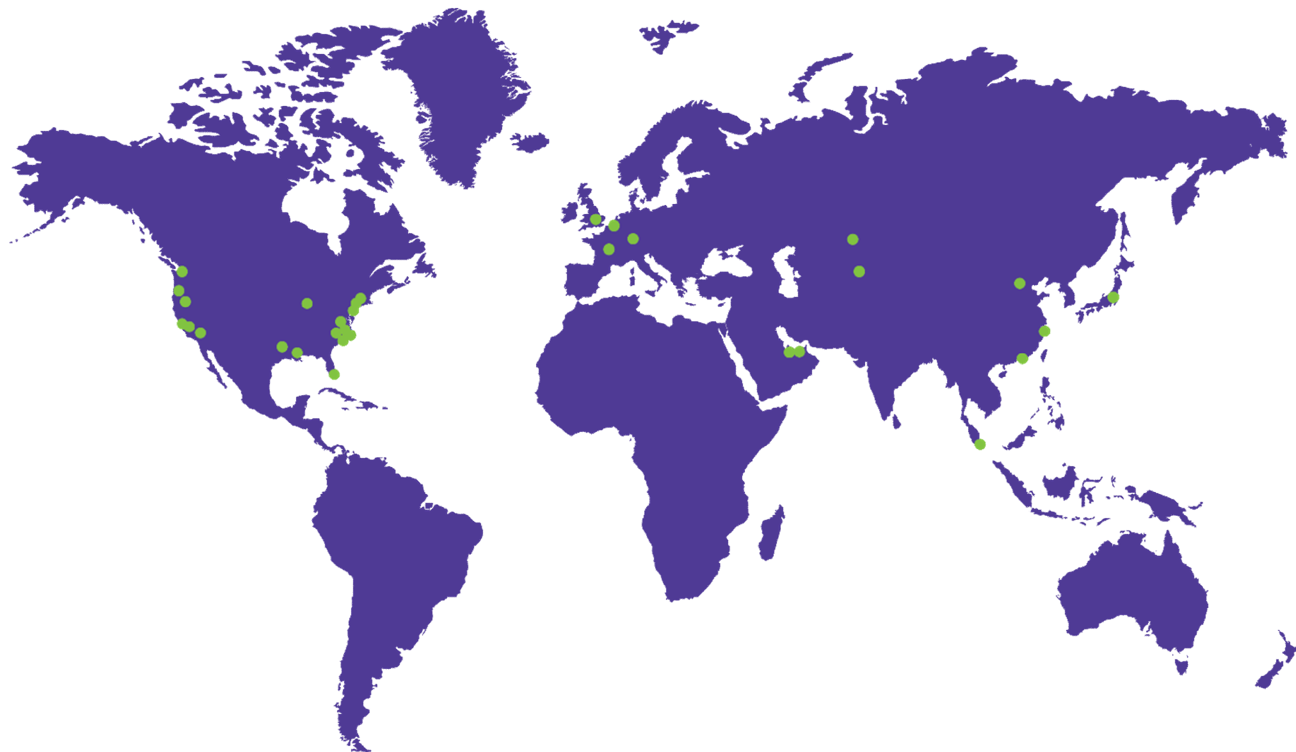

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