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Navigating Executive Compensation Issues in a Volatile Stock Market

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Agenda

- Introduction
- Executive compensation disclosure implications
- Dilution and share plan usage issues
- Employee retention and morale issues
- Potential strategies to mitigate stock price volatility
- Stock price mega grants
- Stock option repricings and exchanges
- Stock ownership guidelines
- Traps associated with pledging

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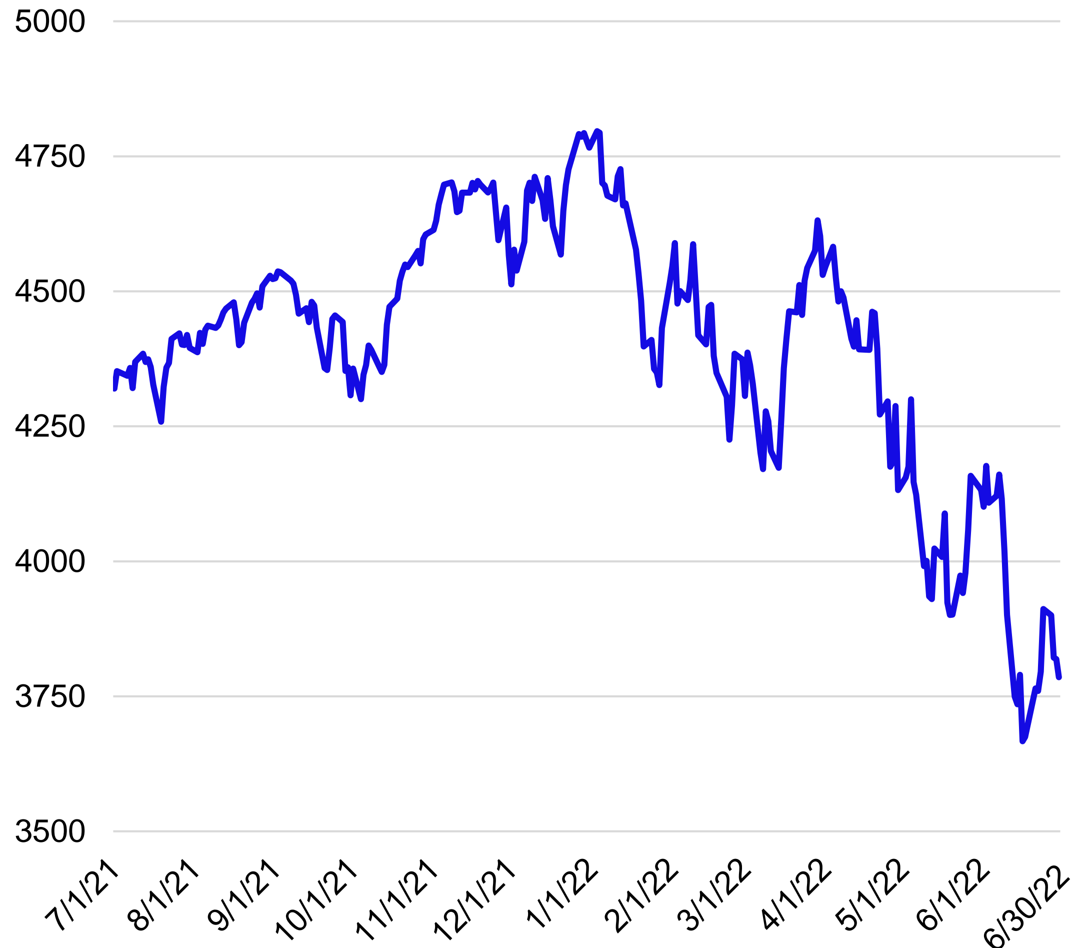
Stock market volatility

S&P 500 (past 12 months)



Source: Bloomberg

THE WALL STREET JOURNAL.

Stock Markets Post Worst First Half of a Year in Over Five Decades

Investors gird for more volatility; almost everything—from stocks to bonds and crypto—falls to start 2022

The New York Times

S&P 500 Falls Into Bear Market

Stocks dropped around the world, investors dumped government bonds, and cryptocurrencies crashed as the U.S. stock market fell more than 20 percent from its January high.

Analysis: Traders ready for wilder swings as rate rises stoke volatility

Executive compensation disclosure implications

- Equity awards often represent the largest component of executive compensation, and many public companies make annual grants to senior executives (and other employees) on a single grant date
- Compensation expense attributable to equity awards is determined for financial accounting purposes based on the grant date fair value pursuant to FASB Accounting Standards Codification Topic 718
  - The closing stock price on the grant date is one of the main factors in determining the relevant financial accounting expense associated with an award
  - Stock price volatility at the time of grant can also inflate the grant date fair value of certain awards (e.g., stock options, awards that vest based on share price performance)
- The grant date fair value of equity awards also dictates the value of equity awards reflected in the Summary Compensation Table, which has numerous highly visible implications with respect to the pay of a public company's CEO and other named executive officers, including:
  - Consequences for say-on-pay vote
  - Institutional Shareholder Services (ISS) assessment of pay for performance
  - Pay ratio disclosure

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Dilution and share plan usage issues

- Stock price volatility leads to significant challenges in budgeting for future equity awards
- When seeking approval of an equity plan or increased share pool, companies often disclose how the board determined the size of the requested pool, including projections of how long the pool is expected to last
  - Market practice for companies without a controlling shareholder is to seek approval for a pool projected to last 3-4 years
- ISS assesses plan cost and grant practices in determining whether to recommend "FOR" approval of an equity plan. Areas of ISS focus include:
  - Dilutive impact of proposed plan plus existing "overhang" (i.e., currently outstanding equity awards) relative to ISS-identified peers
  - Three-year "burn rate" (i.e., dilution attributable to equity grants)
  - Size of prior grants to the CEO
  - Share ownership or retention requirements
- Returning to shareholders for increased share authorization earlier than expected due to a declining stock price can be challenging

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Employee retention and morale issues

- The volatile market can have a significant impact on the number of shares underlying an employee's equity award
- Granting annual equity awards at an inopportune time can have a very real impact on the perceived value of the awards to employees, which can significantly impact employee retention
  - Workforce mobility is currently high and many companies (especially in the technology and life sciences industries) are facing an extreme talent war
  - Equity compensation is often the most powerful tool to fend off poaching
- New hires may have received commitments to grant awards with a particular dollar value based on the start date; stock price volatility can result in "winners" and "losers" based on start date
- Strategies to address the decline in value and bolster retention may include one-time supplemental grants, taking the lost value into account in the upcoming year's annual grant or paying other compensation
  - Disclosure implications should be considered if applicable to executive officers
  - Share usage constraints may also prove limiting

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Use of stock price averaging for grants to potentially mitigate volatility

- Using an average stock price over a period to determine the size of grants can help to mitigate the impact of day-to-day fluctuations, but if a company's stock price is declining, later hires will likely receive larger numbers of shares even if averaging is used
  - The perception that those who came later got a "better deal" can be particularly challenging and may be something to consider in determining the size of future equity grants
- Many plans hardwire their definition of "fair market value" and averaging may not be available, especially for stock option exercise prices
- Using an average stock price to determine the size of grants will also result in a disconnect between the value of the award, as determined through averaging, and the grant date fair value for accounting purpose, which will be the value reflected in the Summary Compensation table for named executive officers

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Use of multiple grant dates to potentially mitigate volatility

- Smaller, more frequent, equity grants (e.g., semi-annual or quarterly grants) can be a useful strategy to respond to the numerous challenges attributable to stock price volatility
  - This approach is similar to a dollar cost averaging investment strategy, where investments are made regularly over time
- While it can be an effective approach, use of multiple grant dates does present potential challenges that should be carefully considered, including:
  - The possibility that one of the projected grant dates precedes or follows announcement of positive or negative market moving news, which can lead to assertions of spring loading or bullet dodging, which has been an area of recent SEC focus, including through Staff Accounting Bulletin No. 120 and proposed revisions to Rule 10b5-1
  - If multiple grant dates result in multiple vesting dates (followed by multiple sale dates), difficulties with proposed revisions to Rule 10b5-1, which would allow only one trading plan every 12 months
  - Administrative challenges
  - Multiple grant dates generally do not work well for performance-based awards, which tend to be based on goals tied to one or more fiscal years

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Stock price mega grants

- A trend in recent years, particularly among newly public companies, involves the use of one-time mega grants subject to vesting based on achievement of ambitious stock price growth
  - A mega grant is often made to a founder or CEO in the context of an IPO or de-SPAC and may be intended to take the place of annual equity grants over a multi-year period
  - As the popularity of mega grants has increased, their usage has also expanded beyond the founder/CEO to other members of senior management
- Recent stock price declines may have caused goals that were already ambitious at grant to be perceived by award holders as virtually unattainable today
- Additional unwanted side effects of deeply underwater mega grants include:
  - Overhang that drains share pool resources
  - Accounting expense associated with grants that are unlikely to vest
- Resetting performance goals for mega grants can lead to criticism from investors, ISS and rank-and-file employees and also has accounting expense and Summary Compensation Table consequences
- Fortunately, resetting stock price goals is not considered a “repricing” for NYSE or Nasdaq purposes
- Even canceling a mega grant for no consideration may have unexpected accounting consequences

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Stock option repricings and exchanges

- While challenges associated with underwater mega grants generally affect only a select few, underwater stock options often affect a much broader group of employees, leading some companies to consider a stock option repricing or exchange program (which involves replacing underwater options with options with a lower strike price or some other award)
- Both NYSE and Nasdaq require shareholder approval of an option repricing or exchange program, unless specifically permitted by the relevant equity compensation plan (which is highly unusual)
- ISS will consider a repricing or exchange on a case-by-case basis, taking into account factors such as whether the decline was due to factors beyond management's control, and will not recommend "FOR" such a program unless directors and executive officers are excluded from participating
  - ISS will generally recommend "AGAINST" a say-on-pay vote for a company that engages in a repricing or exchange without shareholder approval, even if specifically permitted under its equity compensation plan
- A repricing or exchange also has financial accounting implications and Summary Compensation Table consequences and may need to be treated as a tender offer for securities law purposes
- A rebound in stock price shortly after a repricing or exchange can also create significant IR issues

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Stock ownership guidelines

- Stock ownership guidelines applicable to directors and executive officers are a common element of current compensation practices and are strongly supported by ISS and institutional investors
- Stock ownership guidelines can be denominated in either shares or in dollars, with the required dollar amount frequently reflected as a multiple of annual base salary or annual retainer
  - A significant decline in stock price can cause a failure to comply with stock ownership guidelines
- In light of the current market volatility, it may be advisable to revisit stock ownership guidelines and give consideration to the following:
  - Revising the methodology for calculating compliance with stock ownership guidelines, including the use of an average stock price
  - Allowing a grace period (e.g., one year) for an individual who falls out of compliance with stock ownership guidelines to get back into compliance
  - Establishing an exception for failure to meet the guidelines due to a decline in stock price
  - Permitting the board (or the board committee that oversees stock ownership requirements) to exercise discretion not to assess penalties in the event of noncompliance
  - Setting ownership requirements in shares, rather than in dollars

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Traps associated with pledging

- Many companies prohibit pledging company stock as collateral for a loan, but some companies permit it with board consent
- Pledging by insiders can raise a number of legal issues, and those issues can be amplified in a volatile stock market
- Lenders will generally require that if the value of the pledged stock falls too low, the lender will be permitted to require immediate repayment of the loan and, if the borrower fails to repay, the lender will be permitted to foreclose on the pledged shares and sell them
- Although an insider's pledge of shares and default on a loan are not reportable on a Form 4 and are not considered to be a disposition for Section 16(b) purposes, foreclosure on the shares will result in a disposition, which can be matched with an acquisition for short-swing liability purposes
- If the insider is in possession of material nonpublic information, the insider also has potential 10b-5 liability in respect of a pledge, both to the lender, at the time that the pledge is made, and to the purchaser of the shares, if the lender forecloses on the shares and sells them
- The pledge also needs to be disclosed in the beneficial ownership table of the proxy statement, and if the insider defaults on the loan, even in the absence of foreclosure, the lender will become the beneficial owner of the shares for Rule 13d-3 purposes

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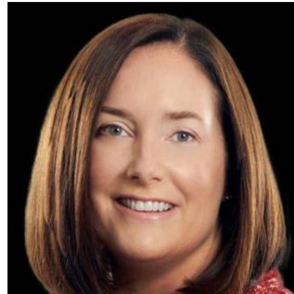
Thank you for joining us!



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