2018 **DIRECTORS CONFERENCE**

Board Strength, Industry Sustainability

WESTERN BANKERS ASSOCIATION

Recent Developments in Executive Compensation

Jeffrey M. Cardone, Esq.
Partner
Luse Gorman, PC

Who We Are – Luse Gorman

Luse Gorman is a Washington, D.C. based law firm that specializes in representing community banks and other financial institutions.

We are a national leader in representing community banks in mergers and acquisitions, capital raising transactions, corporate governance, executive compensation, regulatory and enforcement and general corporate and securities law.

We represent over 250 financial institutions nationwide. Most are community banks ranging from $100 million to $25 billion in assets.

Some of our Accomplishments

- Top 10 law firm in M&A every year since 2001
  - No. 1 in 2009, 2011, 2012, 2015, 2016 and 2017
- No. 1 law firm nationally in community bank capital raising transactions and mutual-to-stock conversions since 2000
- Largest practice group nationally dedicated exclusively to representing financial institutions
  - 25 Attorneys
  - Represent 250+ financial institutions, 100+ mutual institutions, 70+ SEC reporting companies

Topics Covered

- Corporate Governance Trends
- Changes in Proxy Disclosures under SEC Rules
- Mergers and Acquisition Compensation Planning
- Changes to IRC 162(m)
- New Case Law – Director Compensation
- Equity Plan Considerations
- Shareholder Activism
- Gender Pay
- Succession Planning

Regulatory Environment – Post 2008 Crisis

- Since Dodd-Frank – corporate governance has received intense focus from Congress, activist shareholders and proxy advisory firms, which led to the adoption of substantial reforms
- Regulators, burned by market failures, have pro-actively responded, particularly in M&A approval process, cybersecurity, vendor management and compensation
- Good news – the pendulum is swinging back with (1) passage of S.2155; (2) "change in tone" at the leadership levels of regulatory agencies; and (3) joint policy statement from the federal regulators down playing role of supervisory guidance in enforcement

Compensation Practices – Current Landscape

- 2007/2008 Financial Crisis – Flawed compensation practices were perceived by regulators and many in Congress as one of the factors contributing to the financial crisis
- SEC issued many rules under Dodd Frank in response to the financial crisis, including: (1) say on pay; (2) say on golden parachute; (3) listing standards/independence requirements for compensation committees; and (4) conflicts of interests for compensation consultants
- Rise of "Governance Experts" related to compensation practices: ISS, Glass Lewis, others. Proxy advisory firms typically revise base standards annually
- Regulators have become pro-active, particular emphasis on incentive compensation

Incentive Compensation

- Regulators are focused on incentive compensation – Incentive compensation is now a "safety and soundness" issue for the federal bank regulators
- 2010 Joint Interagency Guidance on Incentive Compensation, making sure that banks are appropriately balancing risk and reward with respect to their compensation practices
- Wells Fargo scandal (i.e., employees opening millions of phony accounts, selling unauthorized credit insurance and not addressing continued regulatory criticism) a "game changer" with respect to incentive compensation/risk management

Incentive Compensation – Key Takeaways

- "Top to bottom" review of incentive compensation is a must.
  - ➢ Commissions paid to lenders
  - ➢ Branch employee incentives
  - ➢ Executive compensation
- Important for boards/compensation committees to know each of your bank's incentive compensation arrangements and how they work. Regulators will be focused on all incentive plans and practices
- Conduct annual risk assessments and present results to Board/compensation committee
- Keep it simple. Problems arise if a bank does not fully understand the mechanics of the incentive arrangements

Incentive Compensation – Key Takeaways

- Balance risks and rewards for incentive plans
  - ➢ Consider non-financial performance objectives, such as adhering to risk management policies
- Consider practices that make compensation more sensitive to risk:
  - ➢ Clawback Policy/Automatic Risk Adjustment to Rewards – Make sure executives/employees understand the mechanics and it is contractually specified
  - ➢ Deferral Payment Beyond Performance Period (so payments can be more easily adjusted if actual losses or other aspects of performance are realized)
  - ➢ Longer Performance Periods

Incentive Compensation – Executive STI Trends (2019 Executive Compensation Planning Survey)

- Variable pay remains a significant portion of executive pay
  - ➢ Salary increase budgets for 2019 in the 3.0% - 3.5%

- Not all about corporate performance - individual performance being incorporated in executive short term incentive comp (“STI”) frameworks
  - ➢ 10% weighting is most common for CEO
  - ➢ Slightly heavier weighting (15% - 20%) for direct reports to CEO

- Expected 2018 STI award payouts are expected to be at target (37.3%) or above target (28.8%)
  - ➢ Majority of banks < $1B expecting to pay out above target while larger banks are estimating target level payouts

LUSE GORMAN

Incentive Compensation – Executive STI Trends

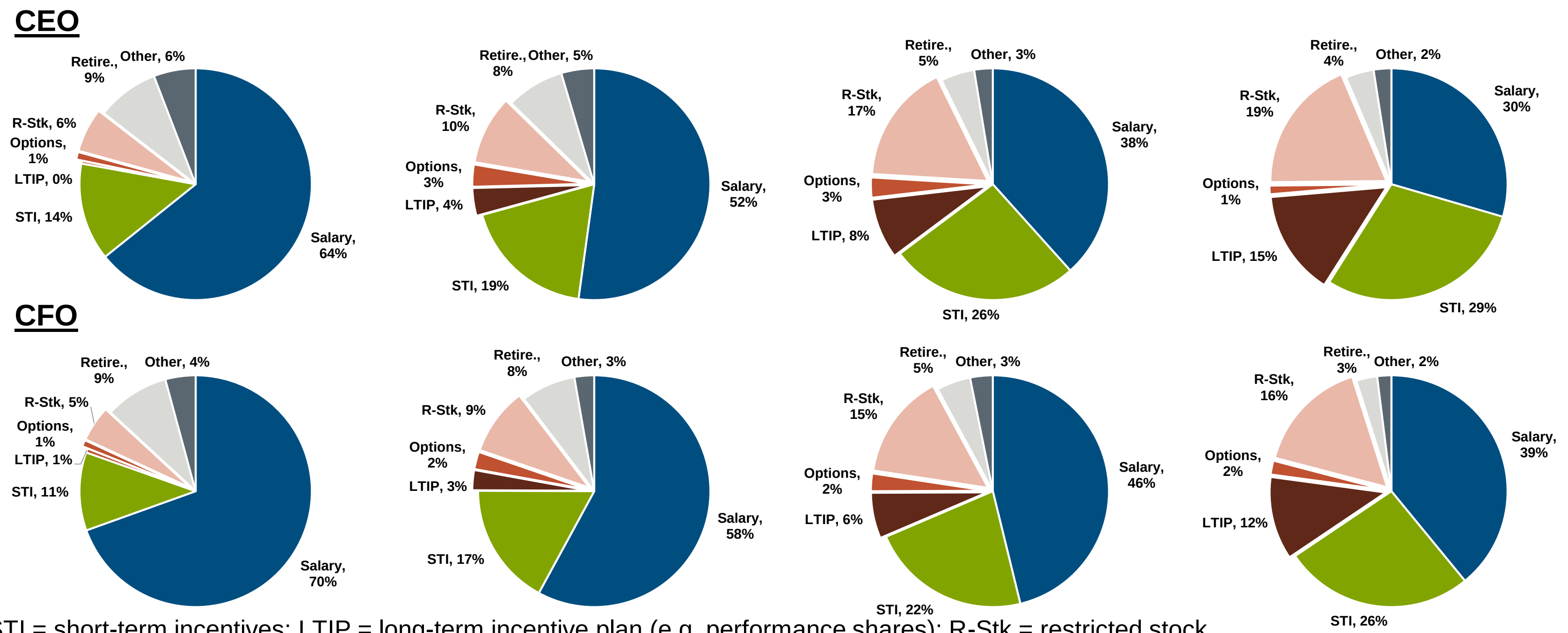
- In designing/implementing short-term incentive pay for performance, it is important that performance goals are rigorous and continuously adjusted upward to the extent maximum payouts are being earned by the CEO/senior management

- Proxy Advisory Firms/Shareholder Activists – They will focus whether performance goals were maintained below achieved results in the prior year, particularly if bonus opportunities are increased

- Also, it is considered "best practice" for a component of executive pay to be linked to sustained long-term performance of the company

Mix of total pay opportunity by bank asset size: CEO & CFO

Assets: $500m - $1b | **$1b - $5b** | **$5b - $10b** | **$10b - $20b**



STI = short-term incentives; LTIP = long-term incentive plan (e.g. performance shares); R-Stk = restricted stock

Data source: Main Data Group

LUSE GORMAN

Impact of Proxy Advisory Firms

- Role and influence of proxy advisory firms (ISS and Glass Lewis) on public companies has grown substantially post-Dodd Frank
  - In addition to emphasis on governance/risk management, investment advisers (to comply with their fiduciary duties with respect to proxy voting) often rely on the recommendations of independent third-parties, such as the proxy advisory firms
  - With "Say on Pay" Voting, proxy advisory firms have particularly focused on executive compensation practices of public companies, ensuring that executive compensation is aligned with the interests stockholders
- Critics have argued that there has been an over-reliance on the proxy advisory firms, in effect transforming them into "quasi-regulators." Too much influence – with too little accountability

Impact of Proxy Advisory Firms

- Good news – SEC announced that they are hosting a roundtable on the Proxy Voting Process in November 2018, including proxy advisory firms
- Points of concern with proxy advisory firms:
  - ➢ Whether companies are being given an appropriate opportunity to raise concerns/disagree with the proxy advisory firm's recommendations
  - ➢ Sufficient transparency about the proxy advisory firm's voting policies and procedures
  - ➢ Conflicts of interest with respect to any related consulting services provided by the proxy advisory firms to companies

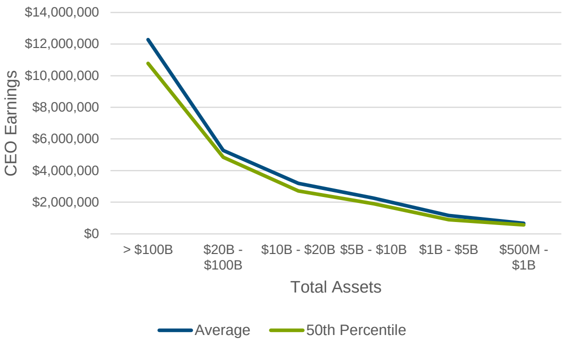
Proxy Advisory Firms - Problematic Pay Practices

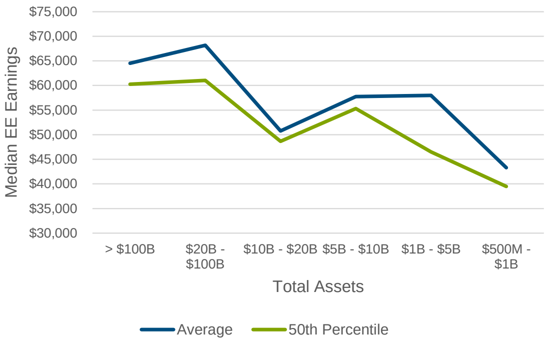
- Pay not aligned with performance (i.e., performance targets set below achieved results during the prior year)
- Pay promoting excessive risk taking (not mitigated by clawback and stockholding guidelines)
- Multi-year guaranteed bonuses
- Options repricing or backdating
- CIC payments over 3x (base and certain bonuses)
- Single trigger CIC payments
- Excessive perks
- 280G tax gross-ups
- Insufficient executive compensation disclosure
- Equity plans too large/dilutive to stockholders and too expensive

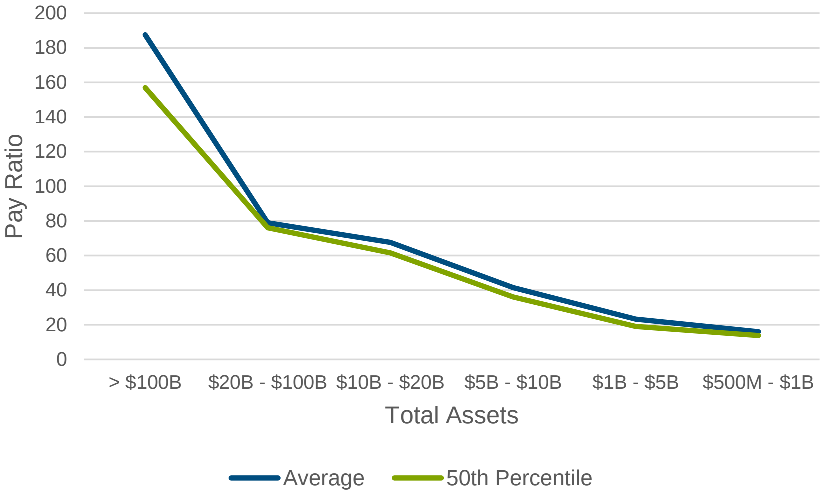
SEC Proxy Disclosure Changes – CEO Pay Ratio

- Required by Dodd-Frank and is now in effect for 2018 and beyond for publicly-traded institutions
- Required disclosure in annual meeting proxy statements:
  - Median of the total annual total compensation paid to all employees (excluding the CEO);
  - Annual Total Compensation of CEO; and
  - Ratio of the median employee compensation to CEO’s compensation

SEC Proxy Disclosure Changes – CEO Pay Ratio







Data Source: Main Data Group

SEC Proxy Disclosure Changes – Enhanced Compensation Disclosures

- Compensation issues are front and center in proxy statements due to:
  - SEC reporting requirements
    - Say on Pay Vote
    - Say on Golden Parachute Vote
    - CD&As for accelerated filers
  - Shareholder activism/influence of the proxy advisory firms
- Shareholders want to see the "why" (i.e., why were there base salary increases?) and the "how" (i.e., how were bonuses linked to performance?)
- Proxy advisory firms want enhanced disclosure of how a company responded to a low "Say on Pay" vote (generally < 70% approval)

SEC Proxy Disclosure Changes – Expansion of Companies that Qualify as Smaller Reporting Companies (“SRCs”)

- Effective first fiscal year ending after September 10, 2018 (for calendar year companies, effective for fiscal year ending December 31, 2018):
  - Company will qualify as an SRC if: (1) public float is less than $250 million or (2) annual revenues are less than $100 million for previous year and public float is less than $700 million
- Expansion of companies that qualify as SRCs will significantly reduce required executive compensation disclosures in a proxy statement
  - Not required: CD&A, CEO pay ratio, certain tables (e.g., GPBA, Option Exercises/Stock Vesting, Pension, NQDC), descriptions of retirement benefit plans
  - Two years (vs. three) in the Summary Compensation Table (SCT)
  - Three instead of five named executive officers for the SCT

Mergers and Acquisition Landscape

- S. 2155, along with a more favorable regulatory environment and a strong economy has led to more consolidation/M&A activity for community banks

- The numbers (according to S&P Global Market) demonstrate the increased trend in M&A transactions for community banks:

  - 1/1/2018 – 9/30/2018 - 203 Bank M&A Deals; $25.08 billion aggregate deal value
  - 1/1/2017 – 9/30/2017 – 189 Bank M&A Deals; $22.39 billion aggregate deal value

Strategic Compensation Planning is Critical

- If contemplating selling, it is important to:
  - Review all plans and agreements that would be impacted by a change in control (i.e., employment/change in control agreements, equity plans; short-term/long-term bonus plans and deferred compensation plans/SERPs)
  - Understand payment trigger events (single trigger /double trigger /modified single trigger)
  - Understand if SERPs/non-qualified plans may be unilaterally terminated by an acquirer in connection with a change in control
  - Understand potential tax consequences under the 280G golden parachute rules/impact on change in control benefits (i.e., cutback/silent/gross-up provisions)
  - Quantify potential change in control payments

Strategic Compensation Planning – 280G

- General rule: If payments to a "disqualified individual" that are "contingent upon a change in control" equal or exceed 3x the 5-year average W-2 taxable income, then *all amounts* in excess of the average are subject to a 20% excise tax and are non-deductible to the company

- Example: Company is acquired in 2018 and CEO receives $1.2 million of change in control payments due to employment agreement, unvested equity and unvested SERP benefit

  - CEO's 5-year average W-2 taxable income (or "base amount") is $300,000.

  - 280G limit is 3x the base amount = $900,000

Strategic Compensation Planning – 280G

- Since CEOs' change in control payments of $1.2 million exceed the 280G limit ($900,000), 280G penalty taxes are calculated as follows:
  - Change in Control Payments $1,200,000
  - Less: Base Amount $300,000
  - Excess $900,000
  - **Excise Tax (20% x $900,000) $180,000**
  - **Lost Deduction by Company $900,000**
- For employment or CIC agreement with 280G Cutback Provision - CEO must give up $300,000 of benefits
- For employment or CIC agreement with 280G Gross Up Provision – Company is obligated to make additional payments to make executive whole for the 280G excise tax

Strategic Compensation Planning – 280G

280G Exposure Mitigation:

- Increase the base amount if transaction closes in the next calendar year
    - Accelerate bonus
    - Exercise stock options/accelerated vesting of restricted stock
    - Stop deferrals and/or payout deferred compensation
- Re-allocate/restructure the value of change in control payments
    - Ex: Re-allocate payment in the form of a non-compete (which is exempt from 280G as reasonable comp for services rendered after a change in control).
    - Key – the payment must be reasonable (get a valuation of non-compete/non-solicitation restrictions)

Due Diligence of Compensation Arrangements

- Quantification of costs of various plans and arrangements is critical
- Buyer should focus on aggregate potential costs, including:
  - ➢ Payments triggered on change in control (i.e., single trigger)
  - ➢ Payments triggered on termination of employment (i.e., double trigger)
  - ➢ Include impact of 280G in assessing potential costs
  - ➢ Review all "good reason" provisions under target employment/change in control agreements
- What plans can be terminated in connection with change in control?
  - ➢ Termination of SERPs/non-qualified plans could avoid ongoing administration of the plans; however, must avoid IRC 409A problems
- SERP and other benefit plan termination costs could be greater than reflected on balance sheet, e.g., discount rate for early termination of SERP could be greater than that used for accruals

M&A Compensation Planning

Other considerations:

- New employment or change in control agreements for key officers
- Granting/issuing new equity awards (avoid "leaving money on the table")
- Severance, retention payments for rank and file employees
- Best practices for new arrangements/equity awards to be adopted/granted in advance of talking to a potential buyer

Why Do Banks Have Executive Contracts?

Having employment/change in control agreements with key executives is a common practice for community banks. **Reasons**:

- Rules are predetermined in the event of an adverse employment situation
- Serves as a retention tool, particularly in the event of a merger
- Bank is able to get a release of claims from terminated executive and could have protections with respect to non-compete/non-solicitation
- Best practice for new arrangements/equity awards to be adopted/granted in advance of talking to a potential buyer
- Promotes stability of the management team to depositors/stockholders

M&A Compensation Planning – BOLI Changes by Tax Cuts and Jobs Act

- Transfer-for-Value Rule: Life insurance policies/BOLI transferred for valuable consideration may become taxable when death benefit is paid out (this was designed to curb speculative trading of life insurance policies)
- Generally the Transfer-for-Value Rule did not apply in tax-free merger transactions
- Tax Cuts and Jobs Act (“Act”) eliminated this exception, so now if bank acquires a BOLI policy in a merger, the death benefits received by the bank from the policy may be taxable

Changes to IRC 162(m) by Tax Cuts and Jobs Act

- Act made substantial changes to 162(m), effective January 1, 2018
- 162(m) limits the deductibility of compensation paid to certain "covered employees" of a public company to $1 million per year (Prior to Act – the covered employees for 162(m) purposes generally were aligned with the company's named executive officers for SEC proxy disclosure purposes, except that PFOs were excluded from 162(m) limitation)
- Prior to the Act, easy to circumvent 162(m) restriction, due to the exception for "performance-based compensation" and no "end of year" requirement (so amounts paid to a covered employee after termination of employment were generally excluded from the 162(m) deduction limitation)

Changes to IRC 162(m) by Act – Covered Employees

- Definition of "covered employee" has been expanded to include the CEO, CFO, and the next three most highly-compensated executive officers for any prior tax year beginning after December 31, 2016
  - IRS clarified that this definition still applies regardless (1) if public company is a smaller reporting company or emerging growth company; and (2) if the covered employee is employed on the last day of the tax year
- "**Once a covered employee, always a "covered employee**" – covered employee status continues forever, even after termination or death (which means termination pay/deferred comp could be subject to the 162(m) deduction limitation)
- Not clear as to whether "covered employee" status would continue in the event of a merger
  - IRS informal guidance – "covered employee" status would continue if publicly traded company merged with another publicly traded company, but would NOT continue if the merger was with a privately-held company

Changes to IRC 162(m) by Act – Other Changes/Grandfather Rule

- Performance-Based Compensation Exception Repealed: Stock options and performance-based awards are now subject to the 162(m) deduction limitation, unless grandfathered

- Grandfather Rule: The Act's changes to 162(m) do not apply to compensation paid pursuant to a written binding contract existing on November 2, 2017, provided that it is not materially amended thereafter

  - ➢ Payments under employment/change in control agreements in effect as of November 2, 2017 are grandfathered, but the grandfather status will cease if the agreements are renewed after November 2, 2017

Changes to IRC 162(m) by Act – Key Takeaways

- Know/keep inventory of "Covered Employees" (remember, once a covered employee, always a covered employee)
- Consider potential 162(m) implications/costs in potential merger transaction
- Be mindful of changes when designing new employment/change in control agreements, SERPs, and other deferred compensation plans. Consider installment payments instead of lump sum to increase the likelihood that payments are below the $1.0 million deduction threshold

Changes to IRC 162(m) by Act – Key Takeaways

- Understand the extent to which current compensation arrangements are grandfathered from the new rules and avoid inadvertent material modifications that could jeopardize the grandfathered status
- For existing contracts/award agreements; Act's changes to 162(m) apply to contracts that are renewed after November 2, 2017
  - Contracts that are either renewed by the Board/Company or automatically renewed pursuant to an "evergreen provision" after November 2, 2017 would lose their grandfathered status as the date of renewal
- Recent IRS guidance emphasized that only payments to which a covered employee has a contractual right as of November 2, 2017 are grandfathered from the Act's changes to 162(m)
  - Payments that are subject to "negative discretion" by a Compensation Committee/Board are not viewed as grandfathered by the IRS because the covered employee does not have a contractual right to the payments

Director Compensation

- Much higher scrutiny by shareholders on awards issued to non-employee directors because of conflict of interests
- Recent Delaware/Maryland court cases – the courts will not apply the deferential "business judgment rule" in reviewing challenges to director awards granted pursuant to a stockholder-approved plan
  - ➢ Discretionary awards to directors are subject to the entire fairness standard of review – burden of proof on directors if awards are challenged
- Should consider providing for grants to directors pursuant to a stockholder-approved formula or via grants of awards specifically approved by stockholders
- Recurring, excessive non-employee director ("NED") pay may trigger negative vote recommendations by ISS starting with 2019 voting
- *ISS Draft policy for 2019:* Board Gender Diversity - ISS would issue negative recommendations on directors if there are no women on the board (would be effective 2020, after a one-year grace period)

Equity Plan Considerations

- Types of Awards to be offered – Generally restricted stock and stock options
- Understand/consideration potential financial expense to the Company (no expense is triggered due to the adoption of the plan. A financial expense is only triggered when awards are granted
- Number of Shares Available – Most critical decision of the Board because the shares issued will dilute existing stockholders.
- Award Type Limitations – "Fix Number of Each Type of Awards" v. "Alternative Share Counting"

Equity Plan Considerations

- Limitation on Awards to Non-Employee Directors/Employees
- Be careful/mindful of “best practices” of equity plans from ISS/Proxy Advisory Firms.
- Grant Practices/Decisions:
  - ➢ Which specific officers will receive awards?
  - ➢ Need to weight the importance of keeping awards in reserve for future grants
  - ➢ Director grants – does everyone get the same number of awards?
- Should Compensation Committee engage Compensation Consultant/Independent Legal Counsel?
- Governance Issues – Grants should (or must if stock is listed on an exchange) be made by “independent directors,” and how much input should directors receive from management with respect to grants?

Shareholder Activism

- Shareholder activism continues to be an effective catalyst for change, and Compensation Committees need to be prepared to engage, listen, and respond appropriately
- Common Themes Among Activists:
  - Corporate strategy (M&A transactions in particular)
  - Executive leadership (CEOs in particular)
  - Board experience and diversity
  - Expansion of shareholder powers (e.g. Proxy Access)
  - Annual director elections
  - Other shareholder-friendly governance changes
  - Board responsiveness
  - Executive compensation

What Makes Companies Vulnerable to Shareholder Activists?

- Stock Ownership Profile
  - Low percentage ownership by insiders directly and through stock benefits plans
  - Significant institutional holdings
  - Shares widely held by smaller investors
- Corporate Governance/Board and Management Issues
  - Weak or under-qualified board of directors
  - Absence of best corporate practices
  - Negative voting recommendations from proxy advisory firms (ISS and Glass Lewis)

Gender Pay - Gaining Attention

Shareholder Activism

The list of firms impacted is growing: Starbucks, TJ Maxx, Walmart, Amazon, Google, Expedia, Facebook, Adobe, Microsoft, Apple, Intel, eBay, JP Morgan, Wells Fargo, Bank of America, Bank of New York Mellon, AmEx, Mastercard, Progressive Insurance

ISS Policy Guidance

- Focus is on how to vote on gender pay gap shareholder proposals. Consider the following:
  - disclosures on fair and equitable compensation practices;
  - whether the firm has been the subject of recent controversy or litigation;
  - whether the company's reporting regarding gender pay gap policies or initiatives is lagging behind peers

In the News

Starbucks achieves pay equity in the United States CNN

Amazon says there's no gender or ethnic pay gap in its ranks

The Seattle Times

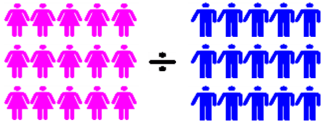
New Legislation

MA, NJ, and CA are leading the way with new Equal Pay for "Comparable Work" legislation. Most states have some form of active or proposed legislation

Employers with more than 250 employees in the UK must disclose and report on their UK Gender Pay Gap

Gender Pay - Two Different Issues to Understand

Pay Gap



Median pay of all women divided by median pay of all men, regardless of position

UK Legislation, Shareholder Activism, ISS Focus

- There is a well-documented pay gap in the U.S. – Women earn 78¢ to every $1 for men
- Key reason for the gap – lower % of women in management
- Know your company's pay gap:
  - How does it compare over time and to national/peer group data?
  - Is your company at risk of an activist shareholder?
  - Develop a communications plan

Pay Equity

Equal Pay for Equal Work

Teller = **Teller**

Software Engineer = **Software Engineer**

Federal Legislation
(Equal Pay Act 1963; Title VII of Civil Rights Act 1964, Lily Ledbetter Fair Pay Act 2009)

Equal Pay for Comparable Work

No specialized Training = **No specialized training**

Janitor = **Cafeteria worker**

State Legislation
(MA, NJ, and CA)

- Equal pay inequities are more limited; comparing women and men in similar jobs shows women earn 98¢ for every $1 for men
- There are acceptable factors for paying employees differently (i.e., performance ratings, supervisory responsibility, etc.)
- Identifying and addressing pay inequalities is important:
  - Comply with state laws
  - Prevent lawsuits and minimize damages
  - Develop a communications plan

Succession Planning

- Critically important and can negatively impact the bank if leadership transitions are not handled well (increased risk of sale)
- A major concern in today's banking environment:
  - Aging workforce
  - Key skill sets needed for continued success (types of skills needed are changing/evolving)
  - Talent shortage and cost of talent is rising

Succession Planning

- Important that it has a "home" and that the Board understands its roles and responsibilities with the process
  - Be proactive; look two to three years ahead
  - Encompass both possible internal and external candidates (more expense to hire talent externally)
  - Proactively and explicitly link the succession discussion with the compensation discussion (high performer should receive higher compensation opportunities and bank should consider providing long-term retention arrangements, such as a SERP)

Shareholder Succession Planning

- Shareholder succession impacts family-owned, closely-held community banks
- Management/key executives may be concerned as to who will be the future stockholders of the bank
- Consider shareholder succession planning; consider transferring ownership to executives/employees
- ESOPs (tax-qualified plan, the assets of which are invested in employer stock) are a great tool that can be used to purchase shares directly from selling shareholder(s) to fund employee retirement benefits

QUESTIONS?