J.P.Morgan

WORKPLACE SOLUTIONS

Executive equity compensation: A guide

Join in the executive equity compensation conversation

Intro and Contents

Executives play a vital role in the leadership, strategy, and operations of both public and private companies which is why for HR and Comps & Benefits teams, attracting and retaining these key players is a top priority.

Losing senior people to competitors can be a nightmare scenario, with disruption to plans and loss of knowledge and skills, before you even consider the time, expense and aggravation of recruiting to find suitable replacements for such critical roles.

A key factor in retaining executives is the nature of the benefits you can offer, with the equity compensation component of any offering often a central part of the jigsaw and a unique point on which employers can set themselves apart from the competition.

Executive equity compensation plans for private and public companies

Whether you're with a private or public company staff retention lies at the core of success. That can include developing long term goals, maintaining consistency and establishing a sense of continuity and stability.

As such you will want to keep your top performers satisfied in their work and content to stay with you to help you achieve your business goals well into the future, even if competitors reach out to them. This can be achieved by striking the right blend of salary, benefits, and bonuses.

Long term incentive plans and liquidity

Executives in public companies tend to fare noticeably better than their private sector counterparts.

While the cash element of the respective compensation packages may not diverge greatly, with public companies usually paying just slightly more, the real driver of difference will be in equity awards and long-term incentive plans (LTIPs), with public companies normally able to offer more than private companies.

One of the main differences with private companies is that when it comes to disposing of shares there might be a smaller market than for public stocks and there may be some restrictions.

These potential liquidity issues may be of concern to some potential employees, who might prefer publicly traded stocks.

On the flipside, where employees are issued private company stock options (aka pre-IPO stock) there may be limitations around access but the potential for financial benefits are more significant if the stock value appreciates a lot post-IPO. As such private companies may find themselves in a strong negotiating position on just this point alone.

Key differences between public and private companies in terms of equity-based rewards:

Private Companies	Public Companies
Little or no liquidity	Tend to be more liquid
Offer equity less often	Offer equity more often
Smaller numbers of executives receive equity stakes	Higher number of executives and managers receive equity stakes
LTIP relies more on cash	LTIP relies more on restricted stock and performance shares

Retention over replacement: The benefits of ‘golden handcuffs’

Handcuffs may seem like a needlessly confrontational term, however having the movement of high level personnel restricted can bring benefits to both employer and employee.

When companies lose a key executive to competitors, it constitutes a setback on many levels. You not only lose an individual with expertize, know-how, and perhaps intimate knowledge of your business operations but a rival company gets to benefit from all of that – a significant double blow in of itself.

When you retain the services of senior executives, not only do you continue to benefit from their talent and experience, but you deny any would-be suitors from gaining access to that human asset – a double benefit.

Golden handcuffs

This is where the concept of golden handcuffs arises. Usually designed as an attractive set of deferred incentives, customized specifically with individual needs in mind, this approach can go a long way towards protecting the integrity of your high-performing senior teams.

Golden handcuffs can take many forms, for example, lucrative bonuses, generous pension provisions, or favorable terms on employee equity.

The main thing to keep in mind is the restrictions imposed around access are normally tied into long-term company or personal goals and targets, or other requirements.

A simple example might be to award stock options with a five-year cliff vesting schedule. Under such an arrangement, all options would vest at the same moment, and anyone holding those options would need to remain with the company for the five years before receiving the full benefits of 100% vested options. Employees with high value awards are usually deemed to be less likely to move employers where they are potentially leaving a substantial payout behind.

Positive outcomes:

Effective equity-based golden handcuffs can lead to many positive outcomes from the employer's perspective, including:

- Continuing to benefit from having a high performer on your payroll and, by extension, denying competitors access to that individual.
- Hopefully reducing executive turnover, saving on the time and cost involved in replacing key individuals.
- Aligning individual goals with company goals. Enabling employee ownership gives senior executives an actual stake in the company, which can lead to greater alignment between the business and those individuals, encouraging greater engagement, motivation, and commitment.
- An attractive golden handcuffs package can also be an effective way to attract new talent, when required.
- Similarly, you can also use equity-based compensation to create a strong corporate glue.

Positive corporate culture:

When we refer to corporate glue, we are mainly talking about positive corporate culture, i.e., the beliefs, ethics, and values of a company and how those steer it with regard to the goals and overall mission of unifying staff.

Basically, within a healthy corporate culture, you create a positive workplace, with a happy and motivated workforce, from senior executive level down, by encouraging teamwork. If people believe in and enjoy the work they do, then they are more likely to want to continue working with their current employer, which in turn increases retention.

Effective equity compensation provisions can help to nurture this positive environment and generate further goodwill between a company and senior executives. Generous equity arrangements combined with a genuine sense of mission and purpose can make for a powerful combination when it comes to helping keep your key people on board.

4 things your executive equity compensation plan may be missing

Times change. No matter how detailed and well thought out your executive compensation strategy, there will always be room for some improvement or alteration as different needs and scenarios arise.

When you remain open to fresh thoughts and possibilities, new ideas may well present themselves. Ultimately, it's not about trying to reinvent the wheel, but consciously examining what you offer and looking at what other companies are doing well. This could end up shining a light on elements that your current plan design may not be making the most of.

With all that in mind, consider to what extent your current executive compensation plan incorporates the following:

1. Trading plan (10b5-1)

In line with Securities and Exchange Commission (SEC) regulations, a Rule 10b5-1 trading plan is designed to provide an affirmative defense for employees, officers, and directors of publicly traded companies in the event of their being accused of insider trading on the basis of material non-public information (MNPI). If the specifics of the plan abide by the terms set out by the SEC in Rule 105b-1, then individuals can fall back on that defense if questions about the legality of any transactions are raised.In practice, it is not unusual for large stockholders in a public company to want to buy or sell shares in that business at any given time. Rule 10b5-1 allows them to do so with a measure of security. As long as the conditions specified by the SEC are adhered to, then those individuals can feel confident that no laws on MNPI have been broken.

2. Find and address blind spots

Regularly review your long-term incentive offerings, with a view towards ensuring that they are achieving the desired outcomes and no unforeseen issues or complications are arising.

It's difficult to anticipate what blind spots may become apparent over time – if we knew then they wouldn't be blind spots. So, the point here isn't to go into specifics, but more to emphasize the need to remain vigilant, with a view towards being in a position to act quickly in the event of potential problems coming down the track. Ideally, you will see any issue coming before it arrives and make the necessary adjustments to keep your offering performing efficiently.

3. Greater choice

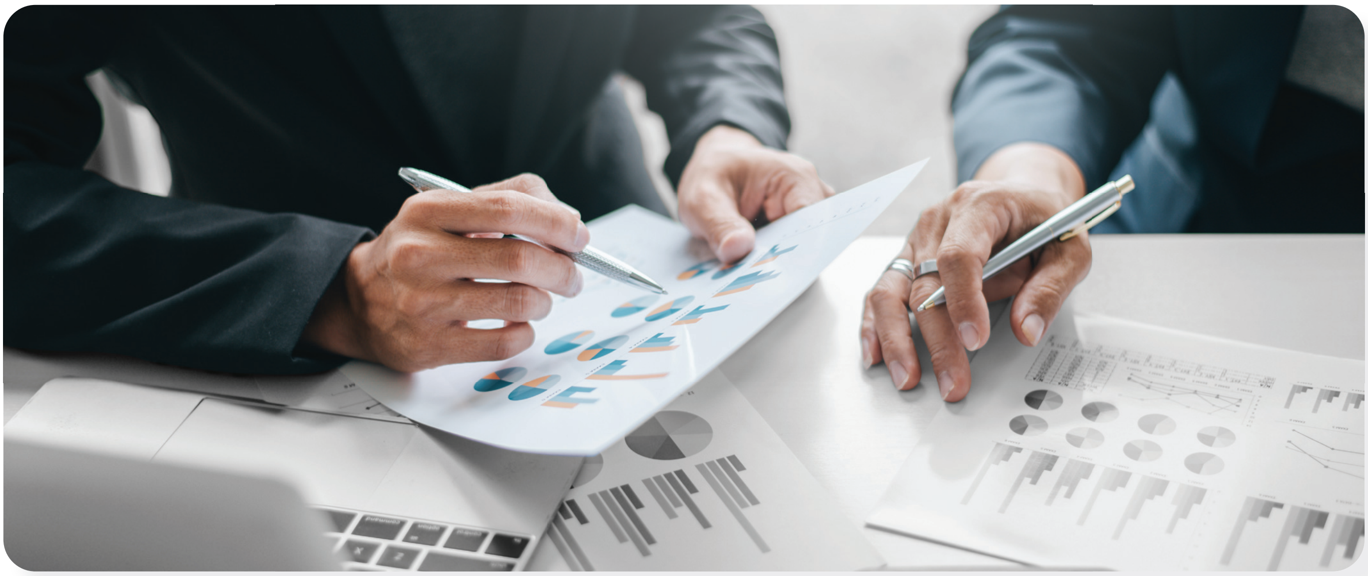
If you can offer executives more flexibility and control over their equity-related choices this could then lead to favorable outcomes. Irrespective of whatever choices are actually made, giving plan participants the power to choose can in of itself build positive sentiment between the company and executives, with this then linked to greater executive satisfaction and more retention. As for how greater choice might be incorporated into plan design, some companies offer what are specifically billed as equity choice programs. In one such scenario, executives might be presented with the ability to choose a ratio combination of stock options and restricted stock, e.g., 100/0, 75/25, 50/50 etc. In some instances, a company might insist on a minimum level of options but leave participants free to choose beyond that.

4. Charity & tax-efficiency

Making financial donations to worthy causes enables executives to contribute to charitable causes they are interested in supporting while also availing of tax deductions. This is a win-win scenario, in that the relevant charities receive a much-needed financial injection, the contributing executives get to maximize the tax-efficiency of their bonus/stock plan-related windfall, while also getting to actively help organizations whose mission and work they believe in. Executives may well be able to explore this area independently, but when the company takes the time to research what can be done and makes participants aware of the possibilities, that too can have the effect of generating further goodwill between the two parties.

Handling tax on executive compensation plans

Equity compensation awards bring with them the potential for significant windfalls, depending on the conditions attached and type of equity involved – but they are not without tax implications. What tax is due, by whom and how this is calculated can vary and will depend on a number of factors, including the type of equity compensation vehicle being used, among other conditions. It is important therefore that all parties – company and executives – are aware of the tax implications of whatever is being proposed when negotiating compensation packages.

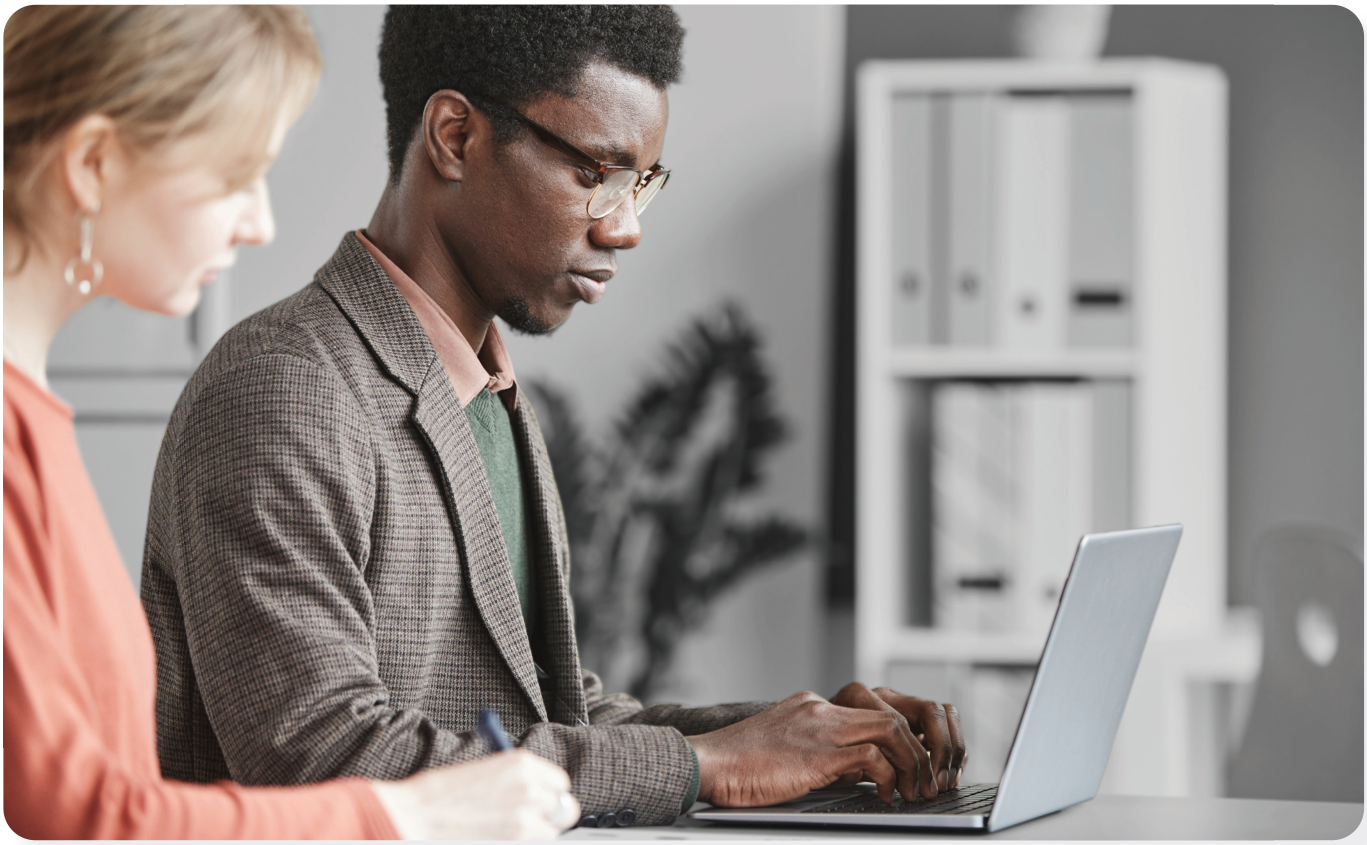


Some examples:

Incentive Stock Options (ISO) – give the holder the right to purchase company stock at a pre-determined strike price. When shares are held for a) more than two years after the initial grant and b) more than one year after the exercise date, the subsequent sale will be treated as a long-term capital gain, otherwise income will be taxed at the less favorable ordinary capital gains rate, and the difference between the strike price and the FMV at exercise will be taxed as ordinary income.

Non-Qualified Stock Options (NSO) - Recipients may be liable for ordinary income tax, however this will depend upon the timing of the transaction:

- Exercise and sell immediately: Ordinary income tax on the difference between strike price and FMV.
- Sell within one year of exercising: Short-term capital gains on profit made.
- Hold for at least one year and then sell: Long-term capital gains on profit made.



Restricted Stock - The default position is that no liability becomes due until the shares vest. The taxable amount of income is assessed based on the difference between the FMV at vesting minus the amount paid at the outset. Once the stock vests, the holding period formally begins and if the stock is held for more than one year is taxed as long-term capital gain. Doing a Section 83(b) election brings forward the moment of tax liability from exercise to grant.

Restricted Stock Units (RSU) - No stock is issued at the outset and no Section 83(b) election is allowed. Individuals with RSUs become liable for tax at vesting. As with restricted stock, tax withholding is assessed based on the supplementary wage rate or payroll tax, however the taxable amount at that point will be the FMV of the entire award.

Performance Shares - Similar to restricted stocks however, the number of shares ultimately received by the employee is linked to the company's overall performance. A performance shares award is taxed as ordinary income at the point they vest. As with RSUs, capital gains tax will apply if the eventual sale price of the shares exceeds FMV at the time of vesting.

As should be clear the tax situation can be complicated and vary depending on a number of factors. It is always recommended that you seek advice from a qualified tax adviser.

Rule 10b5-1: A defense against insider trading

Falling significantly into the corporate governance space all companies that issue equity to employees and officers need to have an insider trading policy and controls in place. Often this policy will include Rule 10b5-1 guidelines.

Created by the SEC in 2000 as a reaction against the rise of insider trading concerns throughout the 1990s a Rule 10b5-1 Plan is a useful tool not only as a form of security for companies and those executives or individuals who are party to privileged, sensitive or material non-public information (MNPI) themselves but also for the public, as it can help instill confidence and trust that everything is above board.

A Rule 10b5-1 plan is the name, taken from the legislation, given to the plan type established under this ruling. It is a proactive defense for both the corporation and the executive against allegations of insider trading.

Every company that issues equity to employees, and officers, should have an insider trading policy.

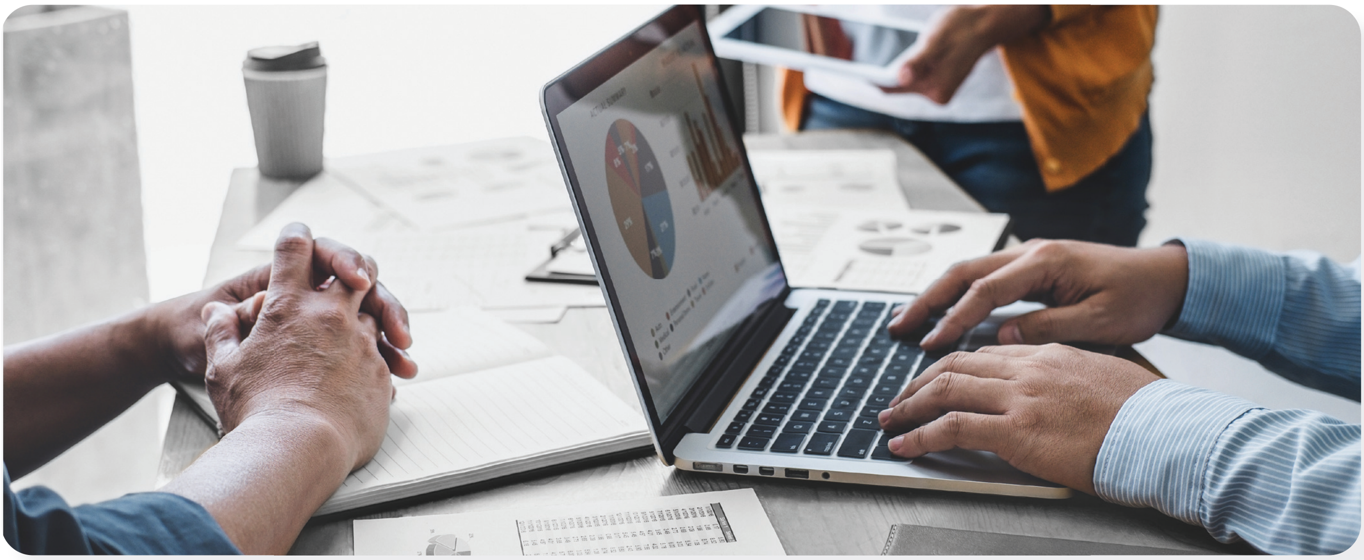
The policy provides guidelines for insiders to set up trading plans for transacting in company holdings.

When an executive is selling pursuant to a 10b5-1 trading plan they are effectively setting up a plan to sell stocks at a future date. A disclosure is required, which includes a trading plan, meaning it's more of a scheduled sale and a planned process.

Most companies will impose blackout periods when officers, directors and other designated persons are barred from trading in the company's securities. The role played by Executive Services teams can help companies to manage this through use of 10b5-1 Plans.

In February 2023 the rules were updated to further address concerns that individuals could use insider knowledge to make opportunistic transactions and have removed loopholes that the existing law overlooked. While the rules are now clearer, it has meant that remaining compliant with 10b5-1 has become more difficult as a result.

Remember, insider trading restrictions can apply to private companies as well as public ones, especially given the level of companies going public, public companies going private and the potential access to sensitive information which executives may be privy to.



The intersection of financial planning, executive services and equity compensation for executives

The role played by Executive Services teams in supporting HR and Comps & Benefits Departments has grown in importance over recent years.

Extending an equity compensation package to executives does not end with simply signing over shares. There are considerations such as what plan type might best suit, insider trading liabilities, the handling of material non-public information and protecting against negative reputational damage that need to be taken into account. With strict regulations to be followed this can be a complex situation for HR departments who may not have the subject matter expertize to manage everything effectively.

Why is it important?

Assistance with education, interconnectedness and taking a holistic view of employee financial wellness is important at all levels of any company, but is often most highly visible at the C-suite and executive levels.

New and ever changing regulations mean there are always challenges and situations for executives to overcome, so whether through financial planning assistance and/or helping executives to manage their equity compensation benefits companies want to be sure that they are looking after these top level employees. Providing that extra level of support is important and could turn out to be a crucial factor when it comes to attracting, nurturing and retaining top talent.

What do Executive Services teams do?

One of the key roles they play is in helping protect against insider trading activities. Anytime an officer of a company makes a sale of stock that becomes public information. An advantage of using an Executive Services team is that they can help your executives with financial planning, which can include putting mitigations in place against insider trading.

Pay transparency laws

Changes to the pay transparency laws in the US mean that different states can have different requirements. In general these pay transparency laws make it a legal requirement for employers to disclose salary ranges on job descriptions. This has been done in a bid to drive salary transparency and make things more equitable while the Say-on-Pay provisions require publicly held companies to disclose executive compensation publicly.

Reporting

Executive Services teams can help companies and insiders with their mandatory reporting requirements by filing the intent to sell and promptly reporting trade execution information.

Proper usage

Rule 10b5-1 plans are rarely just a pure function of trading. Thoughtful investment advice and tax considerations should be a part of the overall planning process.

Assistance with education

Education is a crucial component of any financial planning exercise. Education is not only crucial for employees themselves, but for those who support them too.

- What is a Rule 10b5-1 plan?
- What is your own company’s insider trading policy?
- If you don’t know the answers to these questions do you know where to get them?
- If your executives ask these or other related questions does your HR and Comp & Benefits teams know where to get information required to answer them satisfactorily?

When considering an Executive Services team it’s worth considering what educational supports they offer.

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