Independent Bankers Association of New York State, Inc.

Hot Topics in Compensation & Employee Benefits

Human Resources Conference

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Who We Are

Luse Gorman, PC is a Washington, D.C. based law firm with a satellite office in Albany, NY 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 275 financial institutions nationwide. Most are community banks ranging from $100 million to $25 billion in assets.

Who We Are

- 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, including 5 attorneys specializing in executive compensation/employee benefits
  - Represent 275+ financial institutions, 100+ mutual institutions, 80+ SEC reporting companies

Agenda for Discussion

1. Corporate Governance for Executive Compensation

2. Hot Legal Topics/Recent Trends

3. Best Practice Tips

CORPORATE GOVERNANCE FOR EXECUTIVE COMPENSATION

The New Reality – Regulatory Landscape

- Regulatory Landscape for Community Banks has changed dramatically:

  1. Began with financial crisis in 2008, intensified with Dodd-Frank.

  2. Courts, investors, legislators and regulators are more focused on governance/risk management issues.

  3. Regulators, burned by market failures, have pro-actively responded.

  4. Rise of "risk management culture."

Compensation Practices – Current Landscape

- 2007/2008 Financial Crisis – Flawed compensation practices were one of the many 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 corporate governance related to comp.

What is Corporate Governance?

- The structure through which the objectives of a company are set, and the means for attaining those objectives and monitoring performance are determined.
- Enterprise Risk Management – It is the governance process of identifying, measuring, monitoring and managing risk of the bank.

Today’s Expectations – Risk Management

- Must have effective integration of risk management and compliance systems into overall “enterprise risk management.”
- Not just about identifying risks, but what are the systems in place to respond to risks.
- Effectively documenting procedures, roles/responsibilities and reporting mechanisms.
- Training – directors, officers and staff
- Monitoring – proper communication between management and the Board.

Foundation of Corporate Governance – Executive Compensation

- Role of Management
  CEO/COO/CFO
  Human Resources

- Role of Advisors
  Legal Counsel
  Comp Consultant
  Third Party Recordkeeper/Trustee

- Full Board vs. Committee
  Who recommends?
  Who gives final approval?

Corporate Governance – Executive Compensation

- Processes and procedures:

  Keep minutes and records

  Review is part of regulatory examinations

  Need transparency and clear line of sight so everyone knows how comp decisions are made

  Is discretion permitted?

  Have a "checks and balances" mindset

Nuts and Bolts of Executive Compensation

- How often is compensation addressed?

  Create a baseline
  - Base Salary
  - Short and long-term targets for variable comp
  - Benefits and perks

  Review at least annually
  - Assess performance
  - Determine outcome
  - Recalibrate as needed

Nuts and Bolts of Executive Compensation

- Creating a baseline
  - Benchmark against peers
    New peers may be needed every year
  - Look at each position/duties
  - Consider entire package, not just cash
  - Review surveys or hire comp consultant or advisors

Do We Need a Comp Consultant?

- Comp Consultant not legally required, although can provide fiduciary protections.

- If Comp Consultant hired, the Bank/Board is not required to follow recommendations.

- Best practice for comp consultant to be hired by the Board/Comp Committee.

HOT LEGAL TOPICS/RECENT TRENDS

1. Incentive Compensation

- **<u>Interagency Guidance on Incentive Compensation</u>**- In June 2010 – federal bank regulators jointly published final rules on "Sound Incentive Compensation Policies" for banks of all sizes, public and private.
- General purpose is to link incentive payouts to bank's risk exposure. Need to balance risk with financial results.
- Helps banks identify and address "traditional" compensation arrangements that offer large payments to employees to produce sizable increases in short-term revenue/profit without regard to risk.
- Incentive compensation is now a "safety and soundness" issue for the federal bank regulators.

Interagency Guidance on Incentive Compensation

- **<u>3 Principles of Interagency Guidance</u>:**
- Incentives that appropriately balance risk and reward.
- Effective controls and risk management.
- Strong corporate governance, including active board oversight.

Dodd-Frank Proposed Incentive Compensation Rules

- **<u>Dodd-Frank Incentive Compensation Proposed Rule -</u>** In April 2011– 7 federal agencies issued proposed rules for "covered financial institutions," which were then reissued in 2016. Rules are in addition to (not instead of) the 2010 Interagency Guidance.

- "Covered financial institutions" are those with more than $1B in assets, including banks and credit unions.

- Even more stringent rules for a $50B or larger in assets.

- Proposed rules still not finalized.

Dodd-Frank Proposed Incentive Compensation Rules

- **<u>Prohibits</u>** "covered financial institutions" from maintaining incentive comp for "covered persons" that either (1) provides "excessive" comp" or (2) encourages inappropriate risk.
- "Covered person" means executive officers, employees, directors or principal shareholders.
- **"Excess" comp requires peer group analysis.**
- **Incentive comp must have non-financial measures that balance risk and reward** (e.g., adherence to risk policies).

NYDFS – Incentive Compensation Guidance

- In response to the Wells Fargo scandal, DFS issued incentive compensation guidance on October 11, 2016 to address concerns that "misaligned compensation, coupled with a lack of effective oversight, may harm customers and adversely affect banking institution's safety and soundness."

- NY-regulated banks must develop incentive compensation arrangements that do not provide incentives to employees to engage in unacceptable conduct.

- If incentive compensation is linked to employee performance/metrics (such as number of accounts opened), must ensure that such arrangements are subject to effective risk management, oversight and control.

Incentive Compensation – Key Takeaways

- "Top to bottom" review of incentive compensation is a must.
  - Commissions paid to lenders
  - Branch employee incentives
  - Executive compensation
- Know each of your bank's incentive compensation arrangements/how they work. Regulators will be focused on all incentive plans and practices.
- Keep it simple. Problems arise if 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.

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Incentive Compensation – Key Takeaways

- Monitor Performance of Incentive Compensation Program - revise as necessary if there are high levels of risk.

- Demonstrate to regulators strong corporate governance practices (**what's your story?)**
  - Proper channels of communication between Human Resources Department and the Board/Compensation Committee. "I didn't know" is not acceptable.

  - Make sure Board has appropriate information to effectively monitor incentive compensation plans.

  - Written records/certifications of the Compensation Committee/Managers regarding the satisfaction of performance metrics.

2. Expect Continued Merger Activity

- Consolidation is continuing as the volume of transactions is now on par with pre-Great Recession levels – higher as a % of the current banking sector.
  - ➢ 273 M&A transactions in 2007; 270 in 2014; 267 in 2015; 241 in 2016; and 252 in 2017.
- Aggregate deal value is lower as more M&A involves smaller Sellers and Buyers (<$5 billion in assets) building greater scale – Smaller Institutions Looking for Strategic Partners.
  - ➢ $69.7B aggregate deal value in 2007; $26.0B deal value in 2017.

The Drivers of Consolidation

- Revenue Headwinds in the Banking Industry
- Low Growth Economic Environment
- Interest Rate Environment – Continued Margin Compression
- Increased Regulatory and Compliance Costs
- Rising Costs of Technology
- Overcapacity/Intense Competition in the Banking Industry
- **Shareholder/Management/Board Succession Issues**
- Shareholder Activism
- Strong Currencies of Acquirors

All of these have increased pressure to consolidate and improve economies of scale.

Mergers – Compensation Planning

M&A Transaction Planning Phase –Get Your Executive Compensation House in Order!

- Executive compensation and employee benefits are critical components of an M&A transaction.
- Quantification of costs of various plans and arrangements is critical – complete analysis before contacting a potential buyer.
- Golden Parachute Rules (Part 359; IRC §280G); Deferred Compensation Limitations (IRC § 409A); Employment and Change in Control agreements.
- 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.

Mergers – Compensation Planning

- New employment or change in control agreements?
- Grant/issuance of new equity awards?
- Severance, retention payments for rank-and-file employees?
- Need to be pro-active in monitoring potential executive compensation issues in connection with a potential M&A transaction.

3. Retention/Attracting Talent

- Attracting and retaining talented employees is one of the biggest challenges facing banks.

- Common retention incentives focus on equity, retirement and change in control/severance protections.

- Seeing more of:
  - Phantom Stock Plans (for community banks with closely-held shares and/or who do not want to dilute current shareholders)
  - ESOPs – very popular retirement benefit tool for community banks.
  - SERPs/non-qualified plans – economy better/more prevalent.

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4. Director Compensation

- Director compensation (particularly for public companies) should be carefully examined in light of enhanced shareholder litigation.

- Boards should take the following steps to reduce exposure to claims:

  - Make sure that draft equity plans have meaningful limitations for awards to directors <u>and</u> seek shareholder approval of that limit or grant.
  - For substantial director grants, should consider shareholder ratification.
  - Develop a factual record of its director compensation program.

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5. More Robust Compensation Disclosures (Public Companies)

- Compensation issues now front and center in Proxy Statements
- Compensation Discussion and Analysis (CD&A) must disclose:
  - Objectives of compensation program;
  - What compensation program is designed to reward;
  - Why Company chooses to pay each element;
  - How Company determines the amount (and where applicable, the formula);
  - How each element fits into the overall compensation objectives
- Since 2006, companies (other than smaller reporting companies) have to report estimated termination payments, including those contingent on a change in control

Why More Robust Compensation Disclosures?

- SEC reporting requirements
  - Say on Pay Vote
  - Say on Golden Parachute Vote
- 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?)

6. CEO Pay Ratio Rule - SEC

- 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 the CEO's compensation.

7. Tax Reform and Executive Compensation

- The Tax Cuts and Jobs Act made substantial changes to Section 162(m) of the Code, effective January 1, 2018.
- The $1.0 million deduction limit expanded the definition of "covered employee" to include the CFO.
- Once a "covered employee," always a "covered employee" for subsequent years (which may result in the non-deductibility of substantial SERP/deferred comp payments upon retirement).
- Performance-Based Compensation Exception Repealed, unless grandfathered (pursuant to a written agreement in effect as of Nov. 2, 2017 that is not materially modified).

8. New DOL Disability Claims Procedures

- New DOL rule is currently in effect and gives new procedural protections that deny employees' claims for disability benefits.

- Rule is noteworthy for executive compensation because it would apply to non-qualified plans/SERPs that provide for a retirement payment upon disability when the determination is made by the employer.

- Some new requirements include:
  - Provide more complete disclosures in benefit denial notices;
  - Give the claimant an opportunity to review and respond to new information; and
  - Provide notices in the appropriate non-English language for claimants in certain counties.

9. ESOPs – Popular for Community Banks

- ESOP is a tax-qualified retirement plan, with two distinct features: (1) assets must be invested primarily in employer stock; and (2) ESOP can borrow money from the bank or a third party lender to fund the plan.

- ESOPs can be used to create a market for the stock by purchasing the shares directly from selling shareholders(s) to fund retirement **(very attractive to family-owned, closely held community banks).**

- If shares are purchased with borrowed funds, the purchased shares serve as collateral to the loan, so shares are held in a "suspense account" pending repayment of the loan by the ESOP.

BEST PRACTICE TIPS

1. Have Severance Arrangements

- Having severance-type arrangements is a common practice for community banks.
- CEO/Senior Management typically have individual employment agreements or change in control agreements.
- Rank and file employees would be subject to a broad-based severance plan or policy.

Why Have Severance Arrangements?

- Rules are predetermined in the event of an adverse employment situation (e.g., “cause” is explicitly defined)
- Serves as a retention tool, particularly in the event of a merger.
- Provides protection to management/employees.
- Bank is able to get a release of claims from the terminated executive/employee and could have protections with respect to non-compete/non-solicitation.
- Promotes stability of management team to shareholders/investors.

2. Make Sure Severance Arrangements Have No Problematic Pay Practices

- Severance amount should not exceed 3x base salary and certain bonuses for senior management and no more than 1x base salary for rank and file employees.
- Employment Agmt/Change in Control Agmt should not have a term of more than three years.
- No multi-year guaranteed bonuses.
- No single trigger change in control payments.
- No tax-gross ups.

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3. Watch out for IRC 409A!

- Internal Revenue Code Section 409A (“409A”) applies to non-qualified deferred comp plans (i.e., SERPs, deferral arrangements, employment agmts, change in control agmts, severance plans).

- 409A requires that employees state ahead of time exactly when the deferred comp will be paid in the future, with very limited flexibility to modify/change.

- Failure to comply causes the employee to (1) recognize immediate income tax of the deferred comp; plus (2) pay a 20% penalty tax and other related penalties.

409A – Basic Rules

- **Elections to Defer**: Must be made prior to the year in which services will be performed.
- **Permitted Distributions**: Generally paid only upon: (1) separation from service; (2) specified date; (3) change in control; (4) death; (5) disability; or (6) an unforeseeable emergency. <u>These terms are explicitly defined by 409A</u>.
- **Six-month wait**: Specified employees of public companies must wait 6 months if payment is triggered due to separation from service.
- **No change to time and form of payment**: Once amount is deferred, time of payment generally cannot be accelerated or deferred further.

409A – Basic Rules

- **Good news! –** There is a 409A Correction Program to voluntarily fix plan documents that fail to comply with 409A <u>without</u> penalty.

- **But –** 409A correction program generally can only fix plan document failures without penalty if it is corrected at least one year prior the employee's distribution triggering event under the plan. **Don't wait to check!**

4. ERISA – Limit the Board's Fiduciary Exposure

- ERISA requires that fiduciaries of ERISA plans (i.e., tax-qualified plans) must act solely in the interests of plan participants.

- Banks sponsoring ERISA plans are always ERISA fiduciaries.

- Banks act through their Boards, which makes Boards ERISA fiduciaries (potential conflict of interest between plan participants and shareholders)

Form a Benefits Committee

- Limit the Board's liability by creating a "Benefits Committee" to serve as the fiduciary to all of the bank's tax-qualified retirement plans.

- Benefits Committee would oversee the administration of the ERISA plans and would report to the Board/Compensation Committee.

- While Board always has a duty to monitor the Benefits Committee, this would limit the Board's exposure (and better protect the bank) in the event of an ERISA lawsuit.

5. ERISA – Make Sure Plan Documents Are Accurate

- ERISA fiduciaries must follow the written terms of the ERISA plans.

- Common error is that definition of “compensation” in the plan is not consistent in operation (e.g., plan document provides for elective deferrals to a 401(k) plan for all compensation, but employees only have an opportunity to defer salary).

- Plan errors can be voluntarily corrected through the Internal Revenue Service’s EPCRS VCP Program.

6. Understand Today's Expectations – Risk Management

- Risk management of compensation program should be a part of the bank's overall "enterprise risk management."
- Effectively documenting procedures, roles/responsibilities and reporting mechanisms.
- Training – directors, officers and staff
- Monitoring – proper communication between management and the Board.

7. Understand Your Responsibilities – Plain English

- Be skeptical and diligent.
- Ask tough (sometimes basic) questions.
- Understand the answers (or ask again).
- You may rely on:
  - Experts (attorneys, accountants, financial advisors), management and employees (always have duty to monitor).
  - Reliance must be in good faith and have a reasonable basis.
- Bottom line: make sure information is properly communicated so appropriate person can make an informed decision.

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