



# GUIDE TO REIT EXECUTIVE COMPENSATION

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*An introduction and clarification of executive compensation principles providing  
REIT boards of directors, compensation committee members and senior  
management teams a practical understanding of key concepts.*

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2019

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## INTRODUCTION

Executive compensation matters for public REITs require a delicate balance of designing an effective program that incentivizes and properly rewards key employees while being mindful of external pressures. Non-binding Say-on-Pay proposals required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “**Dodd-Frank Act**”) have resulted in an increase in the influence of investors and proxy advisory firms, whose preferences at times may diverge from what is necessary from the perspective of the company’s strategic objectives and priorities.

Given the context in which REIT executive compensation is scrutinized, it is important for boards of directors, compensation committee members and senior management teams of REITs to understand their respective roles in establishing and implementing compensation policies and to keep apprised of trends and developments relating to REIT executive compensation. Executive compensation that is viewed by external stakeholders as excessive or inconsistent with recent performance can have significant ramifications for public REITs and their management teams, and often leads to negative voting results for Say-on-Pay and the election of directors tasked with the oversight of compensation matters. In fact, sustained investor dissatisfaction relating to executive compensation can encourage activist stockholders and could result in litigation.

One size certainly does not fit all when it comes to executive compensation— compensation programs should be tailored to each REIT’s particular circumstances and strategic objectives. Because matters relating to executive compensation can be challenging under even the best circumstances, REITs and their boards of directors must be thoughtful when designing and implementing executive compensation programs that create appropriate incentives for executives to achieve both short- and long-term business goals. When done correctly, a REIT’s executive compensation program can be a critical tool in recruiting, motivating and retaining executive talent and achieving corporate objectives, while at the same time encouraging behavior that generates long-term value for stockholders.

In this inaugural *Guide to REIT Executive Compensation*, we attempt to demystify REIT executive compensation by addressing a variety of topics, including, among others:

- the various components of REIT executive compensation;
- key compensation trends in the REIT industry;
- the respective roles of the board, the compensation committee and outside advisors;
- governance matters relating to executive compensation, including best practices and provisions viewed as problematic by investors; and
- SEC reporting and other obligations relating to executive compensation.

We note that the topic of executive compensation is too complex and too nuanced to address comprehensively in this *Guide*. Rather, this *Guide* is intended to introduce and clarify executive compensation principles so that boards of directors, compensation committee members and senior management teams understand key concepts. This *Guide* also does not constitute securities law, accounting, tax or other advice, and readers are encouraged to seek appropriate counsel from their advisors before making executive compensation decisions.

# KEY COMPONENTS OF EXECUTIVE COMPENSATION FOR REITS

## BASE SALARY

Base salary provides a predictable stream of fixed cash compensation designed to recognize an executive's role, scope of responsibility and experience. Base salaries for executives are generally not adjusted regularly according to performance, but performance may be taken into account for future adjustments.

## INCENTIVE COMPENSATION

### Cash

Cash incentive compensation provides variable compensation that is designed to reward executives, generally for annual performance relating to key operational and financial measures. It is more common for short-term or annual incentive compensation for REIT executives to be settled in cash, but some companies may provide for awards to be settled in equity (either at the REIT's or the executive's election). Cash incentive compensation may be determined based on a formula, but, at most companies, at least some portion of cash incentive compensation takes into account subjective performance assessments, such as individual performance and the achievement of non-financial objectives.

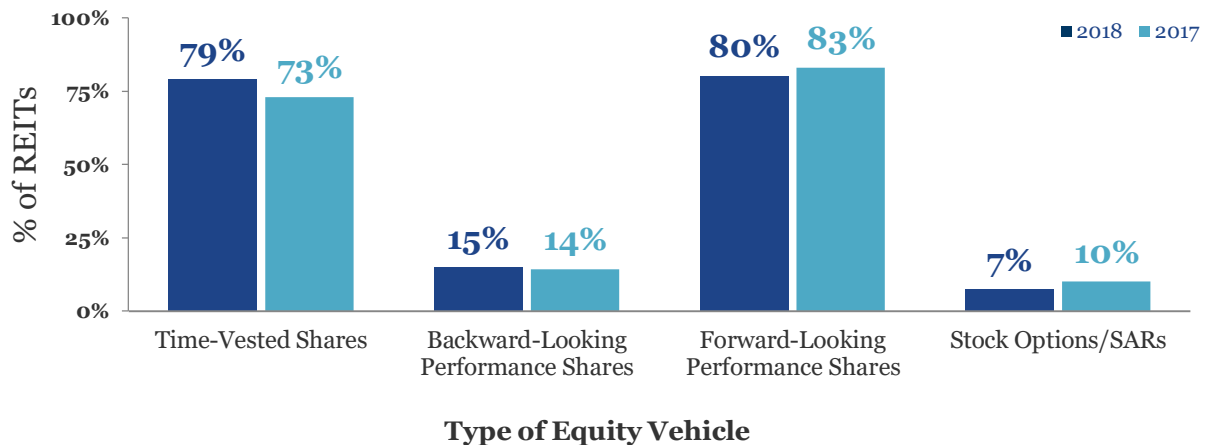
**PRACTICE POINT:** When settling incentive compensation in equity, special attention must be paid to deferral election rules under Section 409A ("Section 409A") of the Internal Revenue Code of 1986, as amended (the "Code") if the arrangement will result in the deferral of income recognition.

### Equity

Equity incentive compensation provides variable compensation that is designed to promote retention, drive long-term value creation and align the interests of management with those of stockholders by subjecting executives to the same market fluctuations as stockholders. Due to the retentive properties of long-term compensation, it is generally awarded as equity. These awards are most commonly granted as "full-value" equity awards, which can be in the form of restricted stock, restricted stock units ("**RSUs**") or units of limited partnership interest designated as LTIP units. Typically, the vesting terms associated with full-value equity awards may include the following (with most REITs using a combination of multiple equity vehicles):

- Time-Vested Shares **vest** on a future date contingent upon remaining an employee through a specified date
- Forward-Looking Performance Shares are **earned** on a future date contingent upon the satisfaction of pre-determined performance goals
- Backward-Looking Performance Shares are **granted** based on the achievement of pre-determined performance goals and then are subject to additional time-based vesting criteria

Only a limited number of REITs use stock options or stock appreciation rights (“**SARs**”), with the utilization of these awards steadily decreasing due to a number of factors, including (i) dividends or dividend equivalents are generally not paid on these awards (and dividends represent a meaningful portion of REIT value creation) and (ii) Institutional Shareholder Service (“**ISS**”) generally does not consider these equity vehicles to be performance-based unless they are granted out-of-the-money.



See “[Key Terms of Equity Incentive Plans and Award Agreements](#)” below.

**PRACTICE POINT:** Accounting treatment for equity awards varies with type and performance factors. In general, time-based awards receive fixed, equity accounting that is valued at fair market value on the date of grant (with no subsequent adjustments except for forfeitures). Depending on the type of metric that is used for performance-based equity, these awards may have fixed, equity accounting treatment if the award is subject to a market-based vesting condition (such as total stockholder return) or variable, equity accounting treatment if the award is subject to a company financial or operational performance condition (fair value is set on grant and the number of shares expected to be earned are subject to quarterly adjustment). The accounting treatment should be considered when REITs evaluate any plan design changes. As an added factor, some awards (including time-based) are subject to additional accounting discounts for certain features, such as illiquidity discounts for post-vest holding periods or book-up risk.

## Perquisites

Executive perquisites, or “perks,” are fringe benefits awarded to executives that are neither broad-based nor directly related to the performance of the executive’s duties. These can include executive benefit plans, aircraft or automobile allowances, club memberships, personal benefits and relocation benefits. Generally speaking, an item is considered a perquisite for disclosure purposes if:

- the benefit is not directly and integrally related to the performance of the executive’s duties (i.e., the executive needs the benefit to perform his or her job); and
- it confers a direct or indirect benefit that is personal to the executive, unless the benefit is generally available on a non-discriminatory basis to all employees.

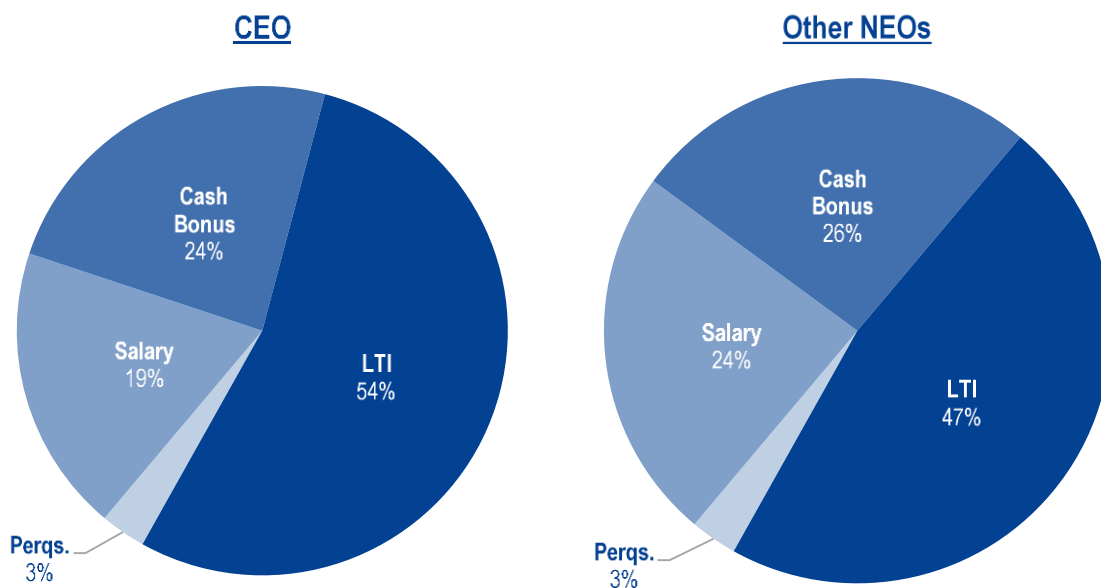
The SEC takes a very narrow view of whether a benefit is directly and integrally related to job performance, and a valid business purpose or convenience to the company does not affect the

characterization of a benefit as a perquisite. On July 2, 2018, the Securities and Exchange Commission (the “SEC”) issued a cease-and-desist order finding that Dow Chemical Company’s disclosure of executive perquisites in its annual proxy statements understated the value of perquisites and omitted disclosure of perquisites received by its chief executive officer because the company applied an incorrect “business purpose” test for determining perquisites. In light of enhanced scrutiny of perquisite disclosures, REITs should ensure that employees responsible for executive compensation disclosures understand the SEC’s disclosure standards for perquisites—a task that is made difficult by the fact that much of the SEC’s guidance relating to perquisite disclosures is nuanced and challenging to apply in practice.

## COMPENSATION TRENDS IN THE REIT INDUSTRY

### PAY MIX

Over the past several years, the pay mix between base salary, cash incentive compensation, equity incentive compensation and perquisites in the REIT space has remained relatively stable, with fixed compensation representing approximately 25% of total target compensation (slightly lower for the CEO) and variable compensation representing the largest component of total target compensation. Perquisites represent a relatively small portion of the total pay mix—generally less than 5% of total compensation for most REITs.



## FORMULAIC BONUSES

Formulaic bonuses continue to be the most commonly utilized plan design for REITs, with approximately 75% of REITs utilizing a formulaic cash bonus program. However, the use of entirely formulaic bonuses has been steadily decreasing since 2016, as REIT boards look to balance quantitative metrics with operational and strategic priorities that may not be quantifiable.

Bonus Plan Structure			
Plan Type	2016	2017	2018
Entirely Discretionary	13%	22%	23%
Entirely Formulaic	25%	20%	17%
Formulaic with a Subjective Component	62%	58%	60%

There has been an increased focus on goal setting from proxy advisory firms, with a particularly high focus on REITs with declining profitability. For REITs that lower the bonus plan performance targets, disclosure of the goal-setting rationale is all the more important, as ISS guidelines state that a “clear disclosed rationale for lowered financial performance targets” is necessary. Rigor of performance goals (for both cash and equity incentives) was a contributing factor for more than half of the self-managed REITs that received a negative Say-on-Pay vote recommendation. See “[Stockholder Advisory Votes on Executive Compensation—Say-on-Pay.](#)”

## LONG-TERM INCENTIVE DESIGN

Following the adoption of Say-on-Pay, the use of performance-based equity in long-term incentive (“**LTI**”) programs has soared. Relative total stockholder return (“**TSR**”) has overwhelmingly been favored as the primary performance metric for REIT LTI programs, which has led to additional scrutiny on programs using this metric. For instance, ISS continues to criticize programs based on relative TSR when payouts target only median performance (i.e., awards pay out at target for TSR at the 50th percentile relative to the comparator group) and are not capped during periods of negative absolute TSR.

Performance Metric	Prevalence
Relative TSR	89%
Absolute TSR	27%
Funds from Operations (“ <b>FFO</b> ”)	17%
Net Operating Income (“ <b>NOI</b> ”)	8%
Other Operational Metrics	18%
Discretionary	7%

Despite this scrutiny, most REITs continue to utilize relative TSR as the primary performance metric, but, in response to ISS and stockholder criticism, many REITs are adopting performance share modifiers that serve as a secondary performance metric. Modifiers can limit, multiply, reduce or set minimum payout



levels after the primary or initial payout calculation. The most commonly used modifier is absolute TSR, and over 50% of modifiers limit payouts if absolute TSR does not meet a certain threshold, typically 0%. Consider the following example: a REIT's relative TSR performance was at the top of its peer group, but absolute TSR over the same period was -2%. In this scenario, performance shares based on relative TSR would be earned at the maximum payout level (e.g., 200% of the target shares earned), but, if the REIT had an absolute TSR modifier that capped payouts at the target payout level for negative absolute TSR performance, the actual payout would be 100% of the target level.

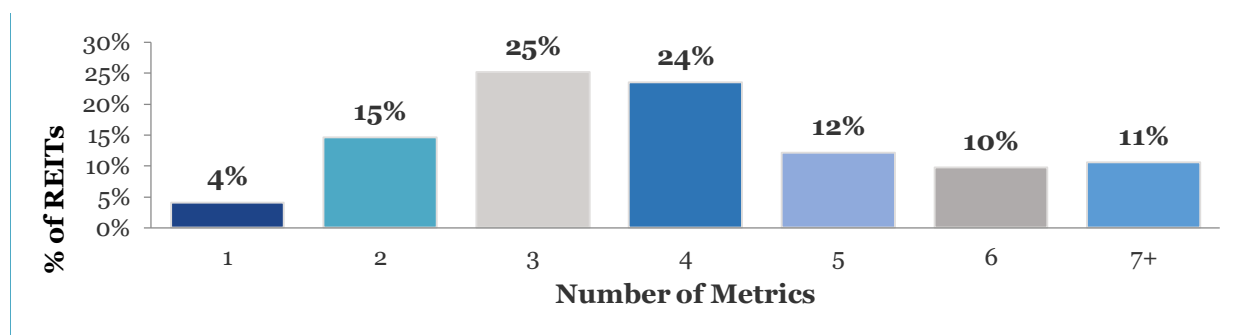
Modifier Type	Prevalence
Absolute TSR	69%
Relative TSR	16%
Absolute and Relative TSR	6%
Other/Discretionary	8%

Not all REITs are remaining complacent in their LTI design, with more REITs conducting extensive reviews of their performance share plans as non-TSR metrics are gaining traction. In particular, many REITs have been reviewing existing plans to ensure that the relationship between pay and performance are properly correlated. Accordingly, we have seen more innovation in LTI design in the past several years, including time-based equity awards with added performance conditions to provide an upside for the achievement of operational and/or financial goals.

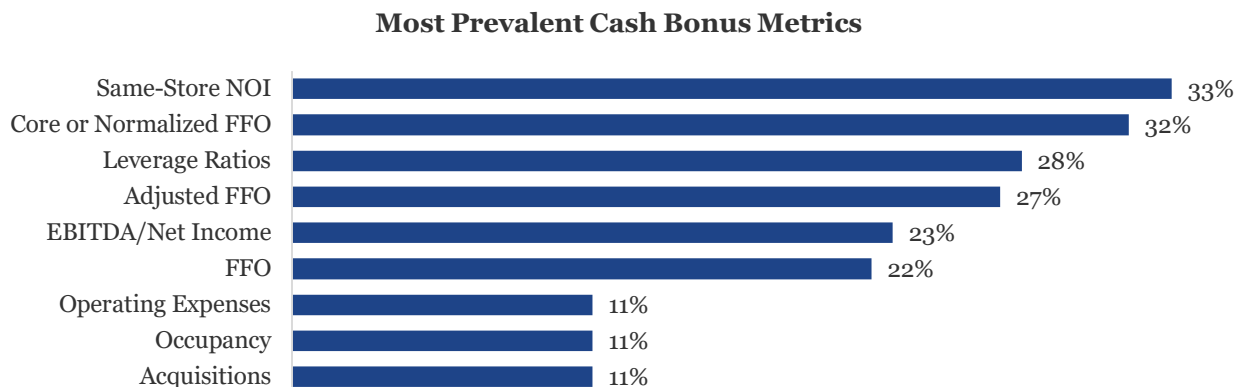
## PERFORMANCE METRICS FOR REITs

Incentive compensation is often based on an assessment of both qualitative and quantitative performance. Performance metrics relating to the quantitative assessment of performance vary based on the performance horizon, with short-term incentive compensation favoring operational metrics and LTI compensation favoring metrics relating to stockholder return. Qualitative metrics are usually added to incorporate strategic initiatives or individual performance into the incentive compensation program.

Most REITs utilize between two and five metrics in the cash bonus program in order to balance the simplicity of using too few metrics (which may motivate excessive risk-taking) and focusing management on key business objectives.



The most common performance metrics include same-property NOI, FFO-based metrics<sup>1</sup> (including Core FFO and Adjusted FFO) and profitability metrics (e.g., EBITDA). REITs should assess cash bonus metrics each year to ensure that they continue to align with the company’s short-term objectives and strategic plan.



As noted above, for performance-based equity compensation, the most common performance metric is TSR, specifically relative TSR. REITs generally utilize a sector-based comparison group to assess their relative performance. Non-TSR metrics, such as FFO and NOI, are increasing in prevalence as REITs try to balance maximizing both stockholder value and operational success, which may not always be captured in the REIT’s stock price.

## Goal Setting for Performance Metrics

Appropriate goal-setting is a key factor in supporting pay for performance; accordingly, performance metric goals should be reviewed regularly to ensure continued alignment of strategic and operational objectives. This is particularly true for cash bonus program goals, which are assessed on an annual basis. Cash bonus goals should be set at levels that are challenging, yet attainable, with metrics based on a REIT’s strategic plan. Goals for cash bonus programs are generally based on the REIT’s outlook for the year, using guidance or budgeted amounts. Goals should be set higher than budgeted amounts for maximum payouts to ensure that executives are not being unduly rewarded for merely ordinary performance.

The combination of both internal perspective and external factors in setting appropriate goals represents the most balanced approach.

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<sup>1</sup> FFO, or Funds from Operations, is a non-GAAP financial measure of a REIT’s performance. For more information about FFO, see our publication entitled “[Frequently Asked Questions about Non-GAAP Measures for REITs](#).”



As scrutiny surrounding goal-setting increases, it is becoming more common for REITs to disclose their goal-setting methodology (e.g., the metrics based on reported guidance or internal budget) in the annual proxy statement. This is especially true for REITs that have lowered their performance goals relative to the performance goals established for the prior year. Lowering performance goals for the cash bonus program may be appropriate given forecasted performance, but care must be taken to show stockholders and proxy advisory firms the rationale behind the goals.

Goal-setting for LTI programs can be more challenging because REITs and compensation committees must balance incentivizing long-term performance, while setting goals that will properly reward executives for that performance. If goals are set at levels that are excessively challenging, executives may not be properly incentivized, but if goals are set too low, executives may be rewarded for average performance.

## SEVERANCE POLICIES

Given the recent uptick in M&A activity, many REITs have been reviewing their severance policies to ensure that severance provisions are in line with the market and that key employees are properly remunerated in the event of a Change in Control (“**CiC**”). Severance payments in connection with a CiC are generally slightly higher than those outside of a CiC (e.g., from 2x without to 3x in connection with a CiC); this serves to protect executives in the case of a change in ownership or control. This step-up in payment often impacts other components of severance, including benefits continuation, which is becoming more prevalent for REIT executives in both CiC and non-CiC scenarios.

Many companies are moving away from employment agreements and are instead favoring simplified severance and CiC agreements. Additionally, many companies are establishing these severance agreements as more broad-based policies when reviewing executive severance provisions. Regardless of where severance provisions are housed, there are certain provisions that are considered poor governance, which can lead to negative voting recommendations from proxy advisory firms and are highly scrutinized by most institutional investors. These include:

- cash severance payments in excess of three times the executive’s then-current base salary plus cash bonus (target, average or most recent cash bonus; *cannot* include equity).

- single-trigger or modified single-trigger (i.e., resignation without good reason or walk-away) severance payments (see “[Single-Trigger Change-in-Control Provisions](#)” below).
  - REITs should not have single-trigger cash severance payments under any circumstance, but it is not uncommon to see single-trigger treatment for the acceleration of equity awards, which is not considered best practice but is common market practice.
- If equity awards vest automatically upon a CiC (i.e., the board of directors or compensation committee lack discretion to determine the treatment of unvested equity awards upon a CiC, ISS believes that a disconnect in pay for performance may result and that executives may be incentivized to pursue transactions that are not in the interests of stockholders.
- 280G excise tax gross-ups.
  - It is important for companies to understand their 280G exposure to mitigate any excise tax penalties that could arise in the event of a CiC.

Generally, if these problematic provisions are part of grandfathered agreements, it is not considered an overriding factor that would result in a negative voting recommendation by proxy advisory firms. However, REITs should keep these provisions in mind when renewing any agreements or executing new agreements. Even in cases where material terms are not amended in a renewed employment or severance agreement, proxy advisory firms will no longer consider these terms to be grandfathered.

## EXECUTIVE COMPENSATION DESIGN PROCESS

### OVERVIEW

Setting executive compensation is a dynamic and iterative process that requires a team of experts with a wide array of functional expertise, particularly given that a properly designed executive compensation program requires a balance of financial, human resources, legal, strategic and governance considerations. Accordingly, it is important to understand the role of the board of directors, management and outside advisors, along with SEC and stock exchange requirements to ensure that the process both meets legal standards and represents an effective process that supports the implementation of a well-designed program.

### ROLE OF VARIOUS PARTIES

#### Board of Directors

A public REIT’s board of directors is responsible for all director and officer compensation, including compensation plans, policies and programs. To develop and maintain a sustainable compensation structure, the board of directors delegates its authority to establish and administer compensation matters to an independent compensation committee. The board of directors, in consultation with the nominating and corporate governance committee, as applicable, is responsible for appointing and, if necessary or appropriate, removing compensation committee members, and is responsible for affirmatively determining the independence of compensation committee members. The additional independence requirements for compensation committee members is discussed below under “[Stock Exchange and SEC Independence Rules](#).” The board of directors is also responsible for ensuring that the compensation committee is provided the funding and resources it needs to satisfy its responsibilities. As described below under “[Compensation Committee](#),” the compensation committee typically has the exclusive authority

under its charter to approve CEO compensation and the authority to approve and/or recommend compensation for the company's other named executive officers ("NEOs"). See "[Proxy Statements—Determination of Named Executive Officers](#)" for more information on determining a company's NEOs. Then, if applicable, upon recommendation from the compensation committee, the company's full board of directors will then vote on whether to approve the recommendations. When voting to approve director and executive compensation, board members should keep the statutory duties owed to the company's stockholders under applicable state law at the forefront of their decision-making. The board of directors must also ensure that their compensation is set to attract, retain and incentivize talent best suited for their organization.

Executive compensation matters are increasingly important to institutional investors and proxy advisory firms, and a company's compensation practices can draw positive or negative feedback from the investor community. In light of the scrutiny placed on compensation matters, the board of directors and compensation committee should make all compensation decisions only after thoughtful deliberations and processes. Boards of directors and compensation committees should also consider engaging consultants and independent legal counsel to assist in the determination of compensation policies in order to demonstrate the integrity of the decision-making process.

## **Compensation Committee**

The compensation committee plays a critical role in the design, administration and oversight of a public REIT's executive compensation plans and arrangements. As a general matter, the compensation committee is responsible for:

- developing and implementing the REIT's compensation philosophy, including determining the various components of executive compensation and establishing appropriate incentives to align compensation with performance;
- approving and administering any equity incentive plans (as well as the related award agreements) in which the REIT's executive officers are eligible to participate (see "[Key Terms of Equity Incentive Plans and Award Agreements](#)" below);
- approving, or recommending that the board of directors approve, grants of equity awards to officers;
- determining whether, and the degree to which, the REIT's executive officers have achieved the performance goals applicable to their respective incentive compensation arrangements;
- if permissible under the terms of the applicable plans, exercising upward or downward discretion to adjust the amount of incentive compensation paid or granted to executive officers based on actual performance;
- engaging, retaining and compensating any independent compensation consultants, legal counsel or other advisors to assist the compensation committee in satisfying its responsibilities; and
- to the extent applicable, reviewing and discussing the REIT's Compensation Discussion and Analysis ("CD&A") disclosure in its annual proxy statement and producing the Compensation Committee Report required under SEC rules to be included in the REIT's annual proxy statement. See "[Compensation Discussion and Analysis](#)" and "[Compensation Committee Report](#)" below.

In designing a REIT's executive compensation program, the compensation committee should consider a variety of factors, including, among others:

- the REIT's short- and long-term business needs and objectives;
- the mix of compensation that will appropriately incentivize executive officers to achieve the REIT's short- and long-term business needs and objectives;
- the individual and company-wide performance measures that will appropriately encourage activities that are in the best interests of the REIT and its stockholders and that align with the REIT's business needs and objectives;
- how the REIT's compensation programs promote the creation of long-term value for stockholders;
- the levels of compensation necessary to recruit and retain qualified executive officers, including the levels of compensation paid to executive officers at similarly situated REITs;
- the tax, accounting and public reporting implications of executive compensation-related decisions, including the proxy statement disclosures that may result from the compensation committee's decisions;
- how the REIT's executive compensation programs, including the individual components of executive compensation, may create incentives for executive officers to take significant risks that are detrimental to the REIT, as well as measures that may be implemented to mitigate those risks<sup>2</sup>; and
- how stockholders and other stakeholders will perceive the REIT's executive compensation programs, including any potential adverse impact on future Say-on-Pay votes (see "[Say-on-Pay Proposals](#)") and the election of directors.

Although the list of factors enumerated above is instructive for compensation committees, it is by no means an exclusive list of factors, and compensation committees should also consider other factors unique to their company's particular circumstances. For instance, the compensation committee at a smaller REIT that is focused on growth and achieving scale may consider factors that will incentivize management to make accretive acquisitions, while the compensation committee at a mature REIT may consider factors that will incentivize management to focus on organic growth opportunities and portfolio management.

In designing and administering the REIT's executive compensation program, the compensation committee should consult with appropriate employees at the company to ensure that it has access to information necessary to make informed executive compensation-related decisions. Under the Maryland General Corporation Law (the "**MGCL**"), directors may rely on information, opinions, reports or financial statements prepared by an officer or employee of the company. Accordingly, the compensation committee should consider whether, and the extent to which, it should consult with, or seek information from, employees serving in the REIT's legal, financial reporting, accounting and human resources departments.

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<sup>2</sup> Item 402(s) of Regulation S-K requires a company to discuss its compensation policies and practices as they relate to risk management practices and risk-taking incentives. See "[Compensation Discussion and Analysis](#)" below.

## ***Stock Exchange Requirements for Compensation Committees***

As an initial matter, the New York Stock Exchange (“NYSE”) and The Nasdaq Stock Market (“NASDAQ”) both maintain listing rules mandating the minimum role and responsibilities of compensation committees. First and foremost, all members of a listed REIT’s compensation committee must be independent, subject to limited exceptions. In addition, the NYSE’s listed company manual and NASDAQ’s listing rules set forth various corporate governance standards, including standards specifically applicable to the compensation committee’s composition, responsibilities and authority.

### ***NYSE Compensation Committee Requirements***

The NYSE’s listed company manual<sup>3</sup> requires that the board of directors of a company listed on the NYSE affirmatively determine that each member of the compensation committee is independent<sup>4</sup> (see “[Stock Exchange and SEC Independence Rules—NYSE](#)” below) and that every NYSE-listed company maintain a written charter that addresses the following minimum responsibilities of the REIT’s compensation committee with respect to executive compensation:

- reviewing and approving corporate goals and objectives for the REIT’s CEO and evaluating the CEO’s performance in light of those goals and objectives;
- either as a committee or together with the other independent directors, determining and approving the CEO’s compensation<sup>5</sup>;
- making recommendations to the board of directors with respect to compensation of executive officers other than the CEO;
- making recommendations with respect to incentive compensation and equity-based plans that are subject to approval by the board of directors;
- preparing the Compensation Committee Report to the extent required to be included in the REIT’s annual proxy statement (see “[Compensation Committee Report](#)” below); and
- appointing, compensating and overseeing the work of any independent compensation consultant, independent legal counsel or other advisors that the compensation committee deems necessary or appropriate.

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<sup>3</sup> See Sections 303.01, 303.02 and 303A.05 of the [NYSE Listed Company Manual](#).

<sup>4</sup> Subject to certain exceptions for “controlled companies.”

<sup>5</sup> In determining the LTI component of CEO compensation, the NYSE suggests that a compensation committees consider (1) the company’s performance and relative stockholder return, (2) the value of similar incentive awards to CEOs at comparable companies, and (3) the awards given to the CEO in past years.



## ***NASDAQ Compensation Committee Requirements***

NASDAQ's listing standards<sup>6</sup> require that the board of directors of a company listed on NASDAQ affirmatively determine that each member of the compensation committee is independent (see "[Stock Exchange and SEC Independence Rules—NASDAQ](#)" below) and that every NASDAQ-listed company maintain a written charter that addresses the following:

- the scope of the compensation committee's responsibilities and how it carries out those responsibilities, including structure, process and membership requirements;
- that the compensation committee is responsible for determining, or recommending that the board of directors determine, the compensation of the CEO and all other executive officers of the company;
- that the CEO may not be present during deliberations or voting with respect to his or her compensation;
- that the compensation committee has the authority, in its sole discretion, to retain or obtain the advice of a compensation consultant, legal counsel or other adviser, and that the company must provide appropriate funding to compensate any compensation consultant, legal counsel or other adviser;
- that the compensation committee must be directly responsible for the appointment, compensation and oversight of the work of consultants or advisers retained by the compensation committee; and
- that, prior to engaging consultants or advisers, the compensation committee must consider a variety of factors relating to the independence of the consultants or advisers.

## **Independent Compensation Consultants**

Compensation committees or boards of directors of REITs often engage an independent compensation consultant to advise on compensation-related matters, including the following:

- providing competitive benchmarking information for executive management and non-employee director compensation;
- assessing executive compensation program design features, including, but not limited to, pay levels, mix of pay and pay-for-performance;
- providing guidance on equity incentive plan design, including plan document review and assistance with plan approval;
- designing and implementing short-term and long-term incentive plans to ensure proper alignment of incentives;
- assessing accounting and tax implications of short-term and long-term incentive plan design;
- reviewing award agreements and forecasting and/or confirming payments relating to incentive compensation payable under the REIT's executive compensation plans and policies;

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<sup>6</sup> See Rule 5605(d) and IM-5605-6 of the [NASDAQ Listing Rules](#).



- providing guidance on the terms and best governance practice for employment agreements, severance agreements or similar arrangements between the REIT and its executive officers;
- reviewing and drafting, or assisting in drafting, the REIT's CD&A and tabular disclosures, including calculation of potential severance payments; and
- providing guidance on institutional investor and proxy advisor policies.

REITs may have an internal human resources department that is tasked with handling broad-based compensation-related matters, but executive compensation matters often require outside expertise. Compensation consultants can bring a breadth and depth of knowledge on executive compensation-related matters to assist compensation committees in efficiently and thoughtfully designing and assessing executive compensation programs.

Although compensation committees are not required to engage a compensation consultant that is "independent," they must take into consideration six independence factors when selecting a consultant (see "[Stock Exchange and SEC Independence Rules—NASDAQ](#)" and "[Stock Exchange and SEC Independence Rules—NYSE](#)" below). Companies are required to disclose if compensation consultants are engaged for purposes other than consulting on a broad-based compensation matters that are generally applicable to all salaried employees. Additionally, if fees for any additional services, such as benefits administration, exceeded \$120,000, companies must disclose (i) aggregate fees paid for compensation-related items or any additional services, (ii) whether the decision to engage a compensation consultant was made or recommended by management and (iii) whether the compensation committee or the board of directors approved the other services provided.

## Outside Law Firm

REITs often engage outside legal counsel to address a variety of matters relating to executive compensation. For instance, it is common for outside legal counsel to handle the following compensation-related matters for REITs:

- drafting the REIT's equity incentive plans, deferred compensation plans, non-equity incentive compensation plans and similar plans;
- drafting the forms of award agreements relating to incentive compensation payable under the REIT's executive compensation plans and policies;
- drafting and/or negotiating employment agreements, severance agreements or similar arrangements between the REIT and its executive officers;
- drafting, or assisting the REIT in drafting, the REIT's executive compensation disclosures for its annual proxy statement, including the CD&A and tabular disclosures (see "[Proxy Statements – Compensation Discussion and Analysis](#)" and "[Proxy Statements – Tabular Compensation Disclosure](#)" below);
- drafting, or assisting the REIT in drafting, any executive compensation-related proposals to be included in the REIT's proxy statement, including proposals seeking the approval of new or amended equity plans (to the extent required under stock exchange listing rules) and proposals related to "Say-on-Pay," "Say-on-Frequency" and "Say-on-Golden Parachutes" (see "[Stockholder Approval of Equity Plans](#)" and "[Stockholder Advisory Votes on Executive Compensation](#)" below);
- assessing the tax implications of the REIT's compensation plans and policies, including the tax implications of different forms of equity awards and tax withholding obligations;

- drafting the REIT's registration statement on Form S-8 relating to the registration of offers and sales of securities under the REIT's equity incentive plan and drafting the plan prospectus required under Form S-8 (see "[Form S-8](#)" below); and
- drafting or reviewing drafts of board of director and compensation committee resolutions and minutes relating to compensation-related matters.

REITs that have an internal legal department or other employees with expertise in executive compensation matters, including securities law and tax law expertise, may address many of the foregoing matters themselves, rather than engaging outside legal counsel to handle those matters. However, even in those instances where internal legal counsel takes the lead on many compensation-related matters, it is still common for outside legal counsel to be consulted, particularly with respect to complicated tax matters, the nuances of the SEC's disclosure rules relating to executive compensation and "best practices" in corporate governance relating to compensation matters. Each REIT's circumstances are unique and will dictate whether, and the extent to which, outside legal counsel should be engaged to address matters relating to executive compensation.

Outside legal counsel also may be engaged directly by the REIT's compensation committee to the extent the compensation committee determines that it is advisable to have its own counsel to address compensation-related matters. As discussed in the section entitled "[Stock Exchange Requirements for Compensation Committees](#)" above, both the NYSE and NASDAQ require listed companies to permit the compensation committee to engage its own counsel and to provide appropriate funding for the payment of reasonable compensation to independent legal counsel. A compensation committee may determine that it is advisable to engage its own legal counsel for a variety of reasons, including the desire to demonstrate the compensation committee's independence from management and, by extension, the company's existing outside legal counsel, who may have real or perceived conflicts of interest due to their desire to maintain good relationships with members of senior management.

## Company Management

While it is important that executive compensation, particularly with respect to the CEO, is analyzed and discussed independent of significant management influence, it would be ineffective and impracticable to entirely exclude management participation. Indeed, management has the best insight into the company's strategy and factors impacting the organization and, accordingly, getting management's input is imperative to designing an effective compensation program. While the role of executives varies from company to company, it is critical that the process is fully transparent and that compensation for the CEO is always discussed in an executive session outside of the presence, and without the participation, of the CEO. The most common roles for management in the executive compensation process include:

- management often provides input related to the company's most comparable competitors as part of the peer group selection process;
- the CEO should provide input into the performance of the other NEOs and often provides recommendations for any discretionary compensation components for this group of individuals;
- the finance department (including the CFO) often provides budgeting and forecasting information to assist in the establishment of performance goals for the cash bonus and performance-based equity programs; and

- individuals in the human resources and/or legal departments often facilitate the overall process and serve as the liaison between all parties.

## STOCK EXCHANGE AND SEC INDEPENDENCE RULES

### Rule 10C-1 of the Exchange Act

The SEC is particularly concerned with the independence of, and resources available to, a company's compensation committee. Rule 10C-1 of the Exchange Act ("**Rule 10C-1**") requires the national securities exchanges to adopt and enforce rules concerning compensation committee independence and the compensation committee's ability to engage external advisers, such as compensation consultants. Rule 10C-1 prohibits securities exchanges from initially listing or permitting the continued listing of companies that are not in compliance with Rule 10C-1 and the related rules adopted by the NYSE and NASDAQ.

Rule 10C-1 requires that all members of the compensation committee be independent members of the board of directors. Relevant factors in determining independence include (i) the source of compensation of the committee member, including any fees paid by the company, and (ii) whether the committee member is an affiliate of the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

Additionally, a company's compensation committee must have the autonomy to engage an independent compensation consultant, independent legal counsel or other adviser. The compensation committee, rather than the company or its board of directors, must be responsible for the appointment, oversight and compensation of the adviser. Rule 10C-1 also requires public companies to provide reasonable funding (as determined by the compensation committee) to pay the compensation committee's independent advisers. Rule 10C-1 enumerates certain factors to consider in their totality when assessing the independence of advisers, including the following:

- the provision of other services to the company by the person that employs the compensation consultant, legal counsel or other adviser;
- the amount of fees received from the company by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;
- the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;
- any shares of the company owned by the compensation consultant, legal counsel or other adviser; and
- any business or personal relationship of the compensation consultant, legal counsel, other adviser or person employing the adviser with an executive officer of the issuer.

In recognition of the extensive independence requirements each member of the compensation committee must satisfy, the SEC instructs the stock exchanges to provide companies an opportunity to cure defects in independence prior to delisting a company's securities. If a compensation committee member fails to satisfy the independence requirements for reasons outside their control, the company will have until the earlier of the next annual stockholder meeting or one year from the occurrence of the event impacting independence to find a new independent member or affirmatively determine that the member has been able to regain independence.

## NYSE

The board of directors of each company listed on the NYSE must annually make an affirmative determination that each member of the compensation committee does not have a material direct or indirect relationship with the company that would impair independence. In determining independence, the board “must consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director’s ability to be independent from management in connection with the duties of a compensation committee member.”<sup>7</sup> The two factors enumerated in the NYSE-listed company manual to determine independence are identical to the factors required to be considered pursuant to Rule 10C-1. The NYSE explains that the board of directors should not only look at the director’s affiliation with the company, but also any other organizations with which the director may be affiliated. The NYSE-listed company manual expressly states that stock ownership in the company alone does not bar a determination that a director is independent. Companies are encouraged to consider any compensation the director receives from a person or entity that may impair their ability to make independent judgments regarding executive compensation. Additionally, any affiliations with individuals or organizations that put the director in a position of control over, or create a relationship with, the company or senior management may preclude the board of directors from determining that such committee member is independent.

## NASDAQ

Each company listed on NASDAQ must have an independent compensation committee comprised of a minimum of two members<sup>8</sup>. Members of the compensation committee must not be executive officers or employees of the REIT and may not have any relationships that “would interfere with the exercise of independent judgement in carrying out the responsibilities of a director.” For purposes of compensation committee member independence specifically, NASDAQ adopted the Rule 10C-1 independence standard as one of the factors the board of directors must consider in connection with the board of directors’ independence analysis. NASDAQ’s overarching guidance is that the board of directors “must consider all factors specifically relevant to determining whether a director has a relationship to the company that is material to that director’s ability to be independent from management in connection with the duties of a compensation committee member.”<sup>9</sup>

NASDAQ has adopted the Rule 10C-1 rules regarding engaging and funding of compensation committee advisers. NASDAQ-listed companies are also granted the Rule 10C-1 cure period to resolve independence issues of committee members, with the addition that, if the annual stockholder meeting is 180 days or less from the date a member failed to satisfy with the independence requirements, the company will have 180 days to re-gain compliance.

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<sup>7</sup> See [NYSE Listed Company Manual Rule 303A.02 \(ii\)](#).

<sup>8</sup> The NASDAQ listing standards for compensation committees provides that, if the compensation committee is comprised of at least three members, then, under exceptional and limited circumstances and subject to certain conditions, one director who is not independent (and not an executive officer of the company or family member of an executive officer) may be appointed to the compensation committee if the board of directors determines that the appointment of a non-independent member to the compensation committee is required by the best interests of the company and its stockholders.

<sup>9</sup> See Rule 5605(d)(2)(A) of the [NASDAQ Listing Rules](#).

# KEY TERMS OF EQUITY PLANS AND AWARD AGREEMENTS

## OVERVIEW

Equity plans and the award agreements governing any equity awards issued pursuant to such plans are legal documents that govern equity compensation awarded to employees and directors. Equity plans (or equity incentive plans) cover various programs that are designed to reward and incentivize key employees of a REIT. These plans typically provide for the grant of restricted stock awards, RSU awards, LTIP awards, stock options, SARs and other awards, generally excluding any cash incentive compensation. The various forms of award agreements are usually filed with the SEC in conjunction with the equity plan, each of which specifies terms relating to a particular type of award (e.g., a performance-based restricted stock award would not use the same award agreement that is used for a time-based restricted stock award).

## Equity Plans

Key matters that are covered in equity plans include the following:

- purpose of the plan;
- administration of the plan (typically vested in the REIT's compensation committee) and any eligible participants who may be covered under the plan;
- types of awards covered under the plan and any defined terms relating to each award;
- how many shares are reserved under the plan, including any limits for certain employees (e.g., limits on equity awarded to non-employee directors);
- form and timing of settlement;
- treatment of forfeited awards and any share recycling provisions;
- the various performance metrics that the REIT and the compensation committee may utilize in connection with grants of performance-based equity awards; and
- severance-related provisions, including, but not limited to, CiC, "good reason" or "cause" definitions and treatment of awards under certain termination scenarios.

## Award Agreements

Key items that are covered in award agreements include the following:

- vesting conditions (e.g., number of years and rate of vesting, any performance conditions tied to vesting);
- for performance-based awards, the particular performance criteria for vesting, including payout levels; and

- severance-related provisions, including, but not limited to, change-in-control, “good reason” or “cause” definitions and the treatment of awards under certain termination scenarios (if not addressed in the underlying equity plan).

**PRACTICE POINT:** Addressing severance-related vesting provisions (e.g., accelerated vesting upon a CiC and other termination scenarios) in award agreements gives REITs more flexibility to modify provisions as investor sentiment shifts without having to amend the entire equity plan, which typically requires stockholder approval.

## TYPES OF AWARDS

### Restricted Stock

Restricted stock is a form of equity compensation that represents actual shares of stock subject to restrictions and risk of forfeiture until the vesting conditions have been satisfied. Restricted stockholders have voting rights and typically receive dividends as they are paid during the vesting period. The vesting period for restricted stock may cease at the end of the specified time period (i.e., cliff vesting) or in installments over the specified time period.

### Restricted Stock Units (RSUs)

RSUs are similar to restricted stock awards, but instead of the participant receiving actual shares of stock, the participant receives a contractual right to receive shares of stock upon vesting or at a later date. Accordingly, because RSUs are not outstanding shares of stock, they do not come with voting rights or rights to receive dividends. Often, however, recipients of RSUs will receive dividend equivalent rights during the vesting period. Dividend equivalent rights entitle the recipient to receive credits equal to the distributions (e.g., cash or stock dividends) that would have been received if the underlying shares had been issued on the dividend record date. Subject to considerations under Section 409A, these rights may be settled at the time the dividends are paid to stockholders or may be settled once the RSU is settled.

### Options and Stock Appreciation Rights (SARs)

Stock options represent the right (but not the obligation) to purchase shares of company stock over a set exercise period at a specified price (the “strike” price), which is generally set as the share price on date of grant. Dividends are not paid on stock options or SARs since the underlying shares are not issued and outstanding, and dividend equivalents are generally not granted in conjunction with stock options.

SARs are similar to options in that they allow the holder to benefit from stock price appreciation over a period of time. SARs represent the right to receive the cash or stock equivalent of the price appreciation on a specified number of shares over a specified period of time.

### LTIP Units

A REIT that is structured as an UPREIT may award equity grants in the form of LTIP units, which are a class of units of limited partnership interest in the REIT’s operating partnership. LTIP units are structured to qualify as profits interests for tax purposes, thereby making them eligible for capital gains tax treatment, as long as certain terms and conditions are fulfilled, the most important of which is the “book-up” event.

In order for the LTIP units to be convertible into common units in the operating partnership (“**OP Units**”) and have a capital interest, a “book-up” event must occur. The “book-up” event requires the appreciation

of the operating partnership's "assets" above the value of the operating partnership at the time the LTIP units are granted (the operating partnership's "assets" for this purpose may be defined as either the value of REIT shares based on the stock price or net book value).

Similar to restricted stock and RSUs, LTIP units may be granted with time-vesting restrictions or performance-vesting criteria. Time-based LTIP units are entitled to partnership distributions that are equivalent to REIT dividends and performance-based LTIP units are entitled to partial distributions (e.g., 10%) with the remainder of the distributions accruing until the LTIP units are earned. Once the LTIP units have vested and assuming the book-up event has occurred, the LTIP units may be converted into common OP Units, which the holder may then tender to the REIT for redemption in exchange for cash or, at the REIT's election, for shares of the REIT's common stock.

UPREITs may also grant appreciation-only LTIP units or "AO" LTIP units. AO LTIP units are economically similar to stock options (or SARs) in that (i) the recipient is entitled to the increase in the stock price between the grant date and the exercise date and (ii) the recipient may elect when to exercise (which may be any time after the vesting date and before the end of the exercise period).

### Prevalence of Award Type in the REIT Industry

Equity Vehicle	Prevalence in REIT Industry
Time-Based Restricted Stock/RSUs	79%
Performance-Based Restricted Stock/RSUs	88%
LTIP Units	25%
Stock Options/SARs	7%

### Advantages and Disadvantages of Commonly Used Equity Awards in the REIT Industry

Equity Vehicle	Concept	Frequency	Advantages	Disadvantages
Time-Based Restricted Stock	Grant of actual shares of stock subject to restrictions and risk of forfeiture until vested, contingent upon remaining an employee through a specified date; typically, dividends or dividend equivalents are paid during the vesting period	High	<ul style="list-style-type: none"> <li>Full owner benefits (right to receive dividends and right to vote)</li> <li>Grantee has ability to make a Section 83(b) election</li> </ul>	<ul style="list-style-type: none"> <li>100% of potential shares must be granted on day one (i.e., no ability to convert up to 150% or 200% of target)</li> <li>Company must withhold income taxes at the time the tax liability arises (vesting or a Section 83(b) election is made even if cash or liquidity is unavailable)</li> <li>Dividends paid on unvested stock are reportable as compensation</li> </ul>
Time-Based RSUs	Right, denominated in shares of company stock, to receive a future payment, which may be contingent on future service, with the	High	<ul style="list-style-type: none"> <li>Provides more flexibility in plan design (i.e., units may convert at 150%</li> </ul>	<ul style="list-style-type: none"> <li>No voting rights until units have vested</li> <li>Grantee does not have the ability to make a Section 83(b) election</li> </ul>



	<p>payment equal to the number of shares earned or the then-equivalent cash value (economic value and vesting criteria are the same as equity granted in REIT shares)</p>		<p>or 200% the target)</p> <ul style="list-style-type: none"> <li>• May be settled in stock or cash</li> <li>• Can allow for the deferral of taxes under Section 409A. See <i>"Section 409A of the Internal Revenue Code"</i> below.</li> </ul>	
Performance-Based Restricted Stock/RSUs	<p>Can be applied to any type of equity-based award, or cash award, in which vesting or payment is dependent on the satisfaction of performance criteria</p>	High	<ul style="list-style-type: none"> <li>• Can provide incentives to accomplish a wide range of company and individual goals and objectives</li> <li>• Can encourage a longer-term focus compared to the short-term focus of stock price</li> <li>• Positively viewed from a governance perspective</li> </ul>	<ul style="list-style-type: none"> <li>• Grantee may not have voting rights, and accrued dividends are only paid on earned shares</li> <li>• Executives will receive no shares if company does not achieve minimum threshold</li> <li>• Company may recognize an accounting expense even if no shares are received</li> </ul>
LTIP Units	<p>Issuance of equity awards in the form of OP Units (or LTIP Units) as opposed to restricted stock that have special terms in order for them to qualify as "profits interest" for U.S. federal income tax purposes, including a "book-up" event requirement and holders being entitled to a portion of "profits"</p> <p>Can also be used to replicate stock options/stock-settled SARs</p>	Moderate	<ul style="list-style-type: none"> <li>• Highly tax efficient equity vehicle for executives because it allows for tax deferral until the time of conversion at the grantee's election</li> <li>• Effective tax rate upon conversion is more favorable than ordinary income tax rate afforded to restricted shares/RSUs</li> </ul>	<ul style="list-style-type: none"> <li>• Full benefit of the award is dependent upon future appreciation of the company's assets (i.e., "book-up" event)</li> <li>• Requires units to be held for three years to recognize the full tax benefits</li> <li>• Increased costs of tax compliance and administration of the operating partnership</li> </ul>



Stock Options/SARs	Right (but not the obligation) to purchase shares of company stock at a specified price over a specific period of time (or the right to receive the value of the appreciation in the stock price)	Low	<ul style="list-style-type: none"> <li>Provides a risk-free right to appreciation in stock price</li> <li>Highly levered and may yield meaningful value in periods of significant stock price growth</li> <li>Receives lower valuation for accounting purposes</li> </ul>	<ul style="list-style-type: none"> <li>No dividend distributions</li> <li>No value earned if the stock price does not appreciate</li> <li>Company may recognize an accounting expense even if no shares are received</li> </ul>
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## Vesting, Acceleration and CiC

Thoughtfully structured vesting provisions, and vesting acceleration provisions in particular, are critical to an equity award's effectiveness in achieving desired retention and business objectives. Careful consideration must be given not only to vesting periods and conditions, but also to when and how exceptions to vesting requirements will apply in connection with various termination/transaction scenarios, including:

Termination Scenario	Common Acceleration Alternatives	
	Time-Based Equity	Performance-Based Equity
<ul style="list-style-type: none"> <li>Death</li> <li>Disability</li> <li>By the Company, with and without "Cause"</li> <li>By Employee, with and without "Good Reason"</li> <li>CiC (single-trigger)</li> <li>CiC and qualifying termination (double-trigger)</li> <li>Retirement</li> </ul>	<ul style="list-style-type: none"> <li>Forfeit all unvested awards</li> <li>Immediate and full vesting of all outstanding time-based awards</li> <li>Pro-rata vesting for the time elapsed during the vesting period</li> </ul>	<ul style="list-style-type: none"> <li>Forfeit all unearned awards</li> <li>Accelerate all unearned awards at target</li> <li>Accelerate all unearned awards at target and pro-rate for time elapsed during the performance period</li> <li>Accelerate all unearned awards based on actual performance (either at time of termination or at the end of the performance period)</li> <li>Accelerate all unearned awards based on actual performance and pro-rate for time elapsed during the performance period</li> </ul>

The most appropriate acceleration treatment often varies under each termination scenario. Consideration must also be given to tax, accounting and, if applicable, proxy statement or other disclosure implications. As with other design aspects of an equity award, the more thought and planning that go into an award's

vesting provisions, the more effective the award will be in achieving desired objectives and avoiding messy interpretive, tax and other pitfalls.

**PRACTICE POINT:** Allowing for acceleration at maximum is considered a poor governance practice and is subject to criticism from institutional investors and proxy advisory firms.

## APPLICABILITY OF SECTION 162(M) IN AN UPREIT STRUCTURE

Section 162(m) (“**Section 162(m)**”) of the Internal Revenue Code of 1986, as amended (the “**Code**”) generally precludes a publicly held corporation from taking a federal income tax deduction for annual compensation in excess of \$1 million provided to certain of its executive officers. Before the Tax Cuts and Jobs Act of 2017 (the “**TCJA**”) was signed into law, compensation that qualified as “performance-based” under Section 162(m) was not subject to the tax deduction limitations in Section 162(m). Under the TCJA, this performance-based exception (other than with respect to compensation pursuant to a “grandfathered” arrangement — generally a written binding contract in effect on November 2, 2017, that is not renewed or modified) was repealed and, among other changes, the coverage of Section 162(m) was expanded significantly to include individuals who, at any time during the year, serve as the CEO or CFO, as well as the three highest paid employees other than the CEO and CFO, and to provide that any officer who *was* a “covered employee” of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016, will remain a covered employee in all future tax years, even if the employee is terminated, resigns or retires. These changes generally apply to taxable years beginning after December 31, 2017, with limited exception for payments under a grandfathered arrangement.

**PRACTICE POINT:** If a written binding contract was “grandfathered” because it was in effect as of November 2, 2017, but it is subsequently renewed or materially modified, the contract generally would be treated as a new contract entered into on the effective date of the renewal or modification with payments under the contract subject to the rules of Section 162(m), as modified by the TCJA.

As a result of these changes, REITs that are subject to Section 162(m) may no longer be able to deduct performance-based compensation and other amounts that were previously exempt from Section 162(m). This could increase taxable income and corresponding amounts that are required to be distributed (and taxed as dividend income rather than return of capital) to comply with the REIT distribution requirements and to eliminate U.S. federal income tax liability at the REIT level

Historically, REITs that had implemented compensation policies to fit within the performance-based exception under Section 162(m) were required to establish objectively determinable performance goals no more than 90 days into the performance period, and they could only make downward adjustments to compensation based on actual performance relative to the pre-determined performance goals. As a result of the elimination of the performance-based compensation exception under the TCJA, subject to restrictions on administrator discretion under applicable plan documents and public disclosures regarding

### **Section 162(m) and UPREITs**

In REITs that utilize the UPREIT structure, often much of the compensation paid to executive officers relates to services the executive officer provides to the Operating Partnership, rather than the REIT. The IRS has issued private letter rulings in which the IRS concludes that Section 162(m) does not apply to an Operating Partnership with respect to compensation paid for services performed as an employee of the Operating Partnership.

Helpfully, the private letter rulings also state that Section 162(m) does not apply to the REIT with respect to its distributive share of income or loss from the Operating Partnership that includes the compensation expense to the extent that such compensation expense is attributable to services performed as employees of the Operating Partnership. Consistent with these rulings, many REITs have taken the position that compensation expense for services performed for the Operating Partnership is not subject to the Section 162(m) deduction limit when the Operating Partnership is a regarded entity for tax purposes. The IRS specifically noted that it expressed no opinion regarding the allocation of the compensation between the Operating Partnership and the REIT. Because private letter rulings are applicable only for the taxpayer who obtains the ruling and may not be cited as precedent by other taxpayers, there can be no assurance that the IRS will not challenge the position that Section 162(m) does not apply to compensation paid for service performed to an Operating Partnership. Accordingly, some public UPREITs disclose in their proxy statements that, while they have not obtained their own private letter ruling, they nonetheless believe that the same conclusions expressed in the private letter rulings apply to them and, accordingly, that compensation paid to their executive officers for services performed on behalf of the Operating Partnership is not subject to the deductibility limitations of Section 162(m).

the plans and the company's administrative practices, REIT compensation committees generally (i) are no longer restricted from establishing performance goals more than 90 days into the performance period, (ii) can exercise discretion upward and downward and (iii) can grant awards without regard to individual award limits that are applicable only to awards intended to qualify for the performance-based compensation exception under Section 162(m). Additionally, the REIT generally will no longer need to seek stockholder re-approval of performance goals every five years. Nevertheless, before taking actions that would have been prohibited under the pre-TCJA rules applicable to performance-based compensation, potential reactions by stockholders and proxy advisors, such as ISS and Glass Lewis, should be considered, and plan documents and prior public disclosures describing plan provisions and administrative practices should be carefully analyzed to determine whether the actions are permitted.

## **SECTION 409A OF THE INTERNAL REVENUE CODE**

Under Section 409A, amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent not subject to a substantial risk of forfeiture, unless the plan complies with the requirements of Section 409A, in both form and operation. To the extent any amounts do not comply with the requirements, they may be subject to severe penalties, including an additional 20% federal tax.

Employers are often surprised by the reach of Section 409A, as the term “nonqualified deferred compensation plan” reaches far beyond traditional deferred compensation plans. Indeed, Section 409A covers any plan, agreement, method, program or other arrangement that provides for deferral of compensation, and it can apply to compensation arrangements with consultants and directors, as well as employees. A plan generally provides for the “deferral of compensation” if the recipient has a “legally binding right” to compensation during a taxable year that is or may become payable in a later year.

Accordingly, an employment agreement, offer letter, severance agreement or plan, consulting agreement or any other plan or agreement providing for compensation of any nature that may be paid in a future year may potentially be subject to Section 409A.

Provisions encountered in employment agreements, offer letters and severance plans and agreements that typically raise the most prominent Section 409A issues are those relating to severance payments, as they almost invariably provide for a legally binding right to compensation that is or may be payable in a later year. Thus, such severance payments must either (i) comply with the requirements of Section 409A or (ii) be structured to fall within an exemption from Section 409A (e.g., the “short-term deferral” exemption or the “involuntary separation pay” exemption).

**PRACTICE POINT:** Unless an exemption applies, severance payments and benefits generally constitute deferred compensation under Section 409A and thus are subject to the entire body of regulations under Section 409A. There are a number of conditions that must be met for an exemption to apply, and modification of an agreement can cause otherwise exempt severance to become subject to Section 409A. Accordingly, Section 409A implications should be considered any time an employment or severance agreement is amended, particularly if the amendment affects the conditions required to trigger severance or the time or form of payment of the severance.

Bonuses and certain types of equity incentive awards may also be deferred compensation under Section 409A, depending on the terms of the arrangements. Restricted stock, operating partnership profits interests (e.g., LTIP units) and stock options and SARs that meet certain requirements generally are exempt from Section 409A under current Section 409A guidance, but RSUs and phantom equity awards, as well as cash bonuses, will be subject to Section 409A unless they qualify as “short-term deferrals.”

**PRACTICE POINT:** Special care must be taken when an award provides special treatment upon “retirement,” as the award (or the portion of the award that would not be forfeited upon retirement) will generally no longer be considered subject to a substantial risk of forfeiture once the retirement condition is satisfied, even though the company might not consider the award “vested” unless and until the employee actually retires. Employers are often surprised to learn that this can cause awards issued to employees who are retirement eligible (or who become retirement eligible during the award term) not to qualify as short-term deferrals.

Generally, awards will only qualify as short-term deferrals if payment will, in all events, be made (or, in the case of stock-settled RSUs or stock-settled phantom equity awards, stock will, in all events, be issued) not later than the 15<sup>th</sup> day of the third month after the later of the company’s or the individual’s tax year in which the right to the payment or issuance of stock is no longer subject to a substantial risk of forfeiture. This is one reason many annual bonuses are payable no later than March 15<sup>th</sup> of the year after the bonus is earned. If the short-term deferral exemption does not apply, RSUs and phantom equity arrangements, as well as cash bonuses, must comply with Section 409A in form and operation. This means payment terms need to be limited to permitted Section 409A payment times or events and changes to payment timing may only be made in limited circumstances, following specific rules under Section 409A.

## SECTION 83(B) ELECTIONS

Section 83(b) of the Code offers a choice to recipients of restricted stock (or other property issued for services) to be taxed upon vesting (or more precisely, in tax parlance, when the “substantial risk of forfeiture lapses”) or at the time of the grant. To be taxed at the time of the grant, the recipient must file a written election (commonly referred to as an “83(b) election”) with the IRS within 30 days of the grant date. If filed, the election may not be revoked. Information that must be included in the election includes the taxpayer’s name, address and taxpayer ID, a description of property, the date of grant, the nature of the restriction that creates the risk of forfeiture, the fair market value of the property at the time of grant and the amount, if any, paid for the property. Recognizing the practical difficulty of filing a paper copy of a Section 83(b) election when a tax return is electronically filed, the IRS recently eliminated the requirement that taxpayers file a copy of the election with their tax return for the year of grant; however, the initial election must still be filed within 30 days of grant with the IRS office where the taxpayer files his or her tax return.

**PRACTICE POINT:** Since Section 83(b) elections can only be made when “property” is transferred, and RSUs, stock options and SARs do not constitute property for purposes of Section 83, Section 83(b) elections may not be made in connection with the grant of RSUs, options or SARs. Limited partnership interests (e.g., LTIP units), however, do constitute property, so recipients of compensatory transfers of such interests in an operating partnership may file Section 83(b) elections with respect to those awards.

The primary potential advantage of filing a Section 83(b) election on restricted stock is that if the stock price appreciates between grant and vesting, taxes will have been paid based on the grant date value of the shares, and no additional taxes will be owed upon vesting. Other advantages are that the capital gains holding period begins at the time of the grant (rather than upon vesting), and dividends may qualify for reduced tax rates since they will be treated as true dividends for tax purposes (rather than just as additional compensation). However, filing a Section 83(b) election on restricted stock is a gamble, with potentially severe downside risk. Two primary risks are: (1) if the stock declines in value between grant and vesting, the taxpayer will have paid taxes on the higher value; and (2) if the stock is forfeited (e.g., the vesting conditions are not satisfied), the taxpayer will have paid tax on shares that the taxpayer forfeits, and the Code generally does not allow the taxpayer to take a loss deduction or otherwise recoup the taxes paid on the shares. For these reasons, it is rare to see Section 83(b) elections filed with respect to restricted stock other than in the case of startups, where stock prices are nominal, or when restricted stock is purchased at full value.

On the other hand, Section 83(b) elections are almost always filed in connection with the receipt of LTIP units or other partnership interests that are intended to qualify as “profits interests” for tax purposes. Although the IRS states in Rev. Proc. 2001-43 that it will not treat the vesting of a profits interest that satisfies the conditions set forth in Rev. Proc. 93-27 and Rev. Proc. 2001-43 as a taxable event and, therefore, the taxpayer need not file a Section 83(b) election, Section 83(b) elections are, nevertheless, almost always filed. The reasons for filing are: (1) the potential that the safe harbor provided in Rev. Proc. 2001-43 may be lost if the conditions therein are not satisfied (e.g., if the interests are disposed of within two years of issuance); and (2) it is generally believed that there is little to no risk in filing the election, since the taxpayer will take the position that the value of a profits interest at the time of the grant is zero and, based on current tax laws, it is generally believed that value is unlikely to be challenged even if Rev. Proc. 2001-43 is not applicable. This is true even when the interest would otherwise be treated as vested

for purposes of Section 83 of the Code at the time of grant (e.g., where there are no time-based or performance-based vesting conditions imposed on the interest), but there is a potential for the interest to be forfeited or for less than fair value to be paid pursuant to a punitive call right (e.g., upon a for-cause termination or pursuant to a clawback policy).

In contrast, though it is rare, if an award is granted in the form of a restricted capital interest (that is, an interest that does not qualify as a “profits interest”), the stakes are raised, with the tax consequences and risks of filing a Section 83(b) being similar to those noted above with respect to restricted stock. Additionally, filing a Section 83(b) election on a restricted capital interest will cause the holder to be treated as a partner for tax purposes as of the grant date, bringing with it all the attendant complexities of being a tax partner.

Finally, it is also worth noting that Section 83(b) elections are disregarded under Section 280G of the Code. Consequently, if restricted stock or profits interests vest in connection with a CiC or related employment termination, the fact that a Section 83(b) election was filed will not prevent the vesting of the restricted stock or profit interest from potentially constituting a parachute payment.

## **PROBLEMATIC EQUITY PLAN PROVISIONS**

### **Evergreen Plans**

An “evergreen” provision in an equity plan provides for automatic, typically annual, increases in the number of shares available for future issuances over the life of an equity plan. Evergreen plans are more prevalent for companies going public to avoid continuously seeking stockholder approval to increase the share reserve. This feature, however, is viewed negatively by proxy advisory firms and institutional investors.

### **Excessive Share Reservations**

Equity plans with excessive share reservations have the potential to trigger an “Against” recommendation from ISS with respect to a proposal to stockholders to approve or amend an equity plan. When the shares reserved for issuance (including new shares requested) exceed 25% of the REIT’s total outstanding shares for Russell 3000 companies or 20% for S&P 500 companies, ISS may recommend a vote against the equity plan proposal, regardless of the Equity Plan Scorecard (“**EPSC**”) outcome. The EPSC is the model that ISS uses to assess the number of shares a company can request from stockholders, taking into account: (i) plan cost or the amount of “wealth” (i.e., market value of requested shares) being “transferred” to employees and directors; (ii) plan features, including minimum vesting requirements and liberal share recycling, among others; and (iii) grant practices, including average burn rate or dilution, plan duration and features of equity granted to the CEO. REITs should analyze the potential dilution of any shares requested in the equity plan or subsequent upsizing to ensure that the equity plan is not overly dilutive to stockholders.

### **Liberal Share Recycling**

Liberal share recycling refers to the practice of allowing vested shares, such as shares withheld to cover taxes or unissued shares to satisfy the exercise price, to be automatically added back to the plan reserve for future grants. Although it is common for forfeited or cancelled shares to be “recycled” back into the equity plan, liberal share recycling is generally viewed as problematic by proxy advisory firms. This feature has a dilutive impact in the future and, accordingly, it reduces the initial number of shares that may be requested for stockholder approval, even though it may increase future capacity under the plan.



## **Single-Trigger CiC Provisions**

Single-trigger change-in-control provisions provide for CiC benefits (e.g., settlement of unvested equity or higher severance multiples) to be paid upon a CiC even if an executive is neither terminated nor experiences a substantial diminution in duties after the CiC. In contrast, double-trigger CiC provisions provide for increased compensation only if the executive is terminated without cause, or the executive resigns for good reason, within a certain period after the occurrence of a CiC. Single-trigger provisions are very uncommon for cash severance payments, as ISS and stockholders do not consider this a good governance practice. These provisions, however, can commonly be found in equity plans or award agreements that provide for any unvested equity awards to vest immediately upon a CiC without an associated termination of employment. These provisions are considered problematic to investors and proxy advisory firms because they may result in a windfall to the executive, even if the executive's employment is continuing after the CiC, and may create perverse incentives for executives to pursue transactions that are not in the best interest of stockholders.

## **GOVERNANCE MATTERS AND PROXY ADVISORY FIRMS**

### **PROXY ADVISORY FIRMS**

Proxy advisory firms are organizations that specialize in providing proxy voting advice for stockholders, particularly institutional investors. They provide data, research and recommendations on proxy proposals submitted for vote at a company's annual meeting to help institutional investors make voting decisions. Many institutional investors utilize this information and recommendations from proxy advisory firms to vote on matters subject to stockholder approval, although some larger institutional investors rely more heavily on internally formulated governance standards rather than focusing on the information and recommendations of the proxy advisory firms. Accordingly, the recommendations of proxy advisory firms can have a significant bearing on a company's Say-on-Pay result and the election of directors, and their policies must be taken into consideration on compensation-related matters. The two largest proxy advisory firms are ISS and Glass Lewis, both of which annually publish their voting guidelines and prepare governance scorecards.

### **PAY-FOR-PERFORMANCE ALIGNMENT**

The primary assessment made by proxy advisory firms revolves around a company's pay-for-performance alignment. In order to assess this alignment, proxy advisory firms benchmark executives' pay and company performance against their peers across several performance metrics, which include both operational and market-based performance assessments. This pay-for-performance assessment is scored by each proxy advisory firm and serves as the basis for their voting recommendations, outside of certain stand-alone problematic pay practices. The most common assessment includes executive pay to TSR, generally viewed over a three-year period, with a particular focus on CEO compensation.

### **TRANSPARENCY**

The adoption of Say-on-Pay has served as a catalyst for the evolution of proxy statements from a mandatory SEC reporting document into an investor relations tool. Institutional investors and proxy advisory firms are continuously increasing their demands for transparency and disclosure preferences, resulting in many public companies spending a substantial amount of time and resources to create state-of-the-art proxy statements. Over the past several years, this has included an increased use in visuals and

graphics in various sections of the proxy statement and enhanced disclosure surrounding the rationale behind compensation decisions. Key areas where REITs should consider enhancing disclosure include company performance factors, any individual performance factors considered for incentive awards and the rationale for any compensation changes.

## BOARD COMPENSATION

Excessive board compensation has become a hot button issue with stockholders in recent years. In response to this sentiment, ISS has begun to issue adverse voting recommendations relating to non-employee director compensation. Beginning in the 2020 proxy season, ISS will vote “Against” or “Withhold” for members of the committee responsible for setting director pay if the company’s non-employee director pay is above the top 2-3% of all non-employee directors within the same index and sector.

2018 REIT Board Compensation		
Fee/Retainer	Prevalence	Median Pay
Lead Independent Director	48%	\$25,000
Non-Executive Chair	43%	\$75,000
Committee Meeting Fees (per meeting)	22%	\$1,500
Committee Membership Fees		
Audit - Chair	94%	\$20,000
Audit - Member	55%	\$10,000
Compensation - Chair	91%	\$15,000
Compensation - Member	52%	\$8,000
Nominating & Governance - Chair	86%	\$13,000
Nominating & Governance - Member	49%	\$6,500

Additionally, largely as a result of the demands of institutional investors and proxy advisory firms, disclosure relating to board compensation is expected to become more robust and more closely mirror executive compensation disclosure, including having more focus on the board’s process for determining director compensation and the rationale for any changes to director compensation programs.

## CLAWBACK PROVISIONS

Clawback provisions provide for the recoupment of incentive compensation paid to executives under certain conditions. Section 304 of the Sarbanes-Oxley Act (“**SOX**”) authorized the SEC to seek the recoupment of incentive compensation from the CEO and CFO if the company is required to prepare an accounting restatement as a result of misconduct. Since the adoption of SOX, many public companies, including approximately 72% of listed REITs, have adopted their own clawback provisions that would allow for the company to recoup incentive compensation above and beyond the SOX conditions. Company-adopted clawback policies generally apply to executives beyond the CEO and CFO, and



triggering events vary from any accounting restatement regardless of misconduct to misconduct even without an accounting restatement.

## HEDGING AND PLEDGING POLICIES

Anti-hedging and anti-pledging policies are governance provisions that prohibit executives from hedging or pledging shares of the company's stock. Anti-hedging policies prohibit executives from entering into short sales or derivative transactions to hedge their exposure to fluctuations in the company's stock price. Anti-pledging policies prohibit executives from using shares as collateral for a loan or holding company shares in a margin account. Some companies also use partial anti-pledging or anti-hedging policies that allow executives to pledge or hedge shares with the approval of a board committee. REITs that adopt anti-hedging and anti-pledging policies often extend these policies to directors and non-executive employees.

Following the finalization of the hedging disclosure requirements under the Dodd-Frank Act, effective for fiscal years beginning on or after July 1, 2019, public companies must disclose any hedging practices or policies in their annual proxy or information statements. Many public companies, including public REITs, already disclose their hedging policies in their proxies, with only three REITs allowing insiders to engage in hedging transactions with board approval.

Governance Policy	Prevalence in REIT Industry
Anti-Hedging Policy	88%
Partial Anti-Hedging Policy (with board approval)	2%
Anti-Pledging Policy	52%
Partial Anti-Pledging Policy (with board approval)	25%

## EQUITY OWNERSHIP GUIDELINES

Equity ownership guidelines are adopted by companies to promote ownership of company shares to further align executives' interests with those of stockholders. Ownership guidelines require executives to maintain a certain level of ownership of the company's shares at any point in time, usually expressed as a multiple of the executive's base salary. To reduce the burden of achieving the prescribed ownership levels, companies often provide a grace period (typically five years) during which the executive can accumulate ownership. In addition, companies can also require that executives retain a certain percentage of any equity granted as compensation until the ownership requirements are met. Equity ownership guidelines also frequently apply to a company's non-employee directors. Companies often allow for unvested time-based restricted shares, common OP Units and/or LTIP units to count towards satisfying ownership guidelines. Equity ownership guidelines are prevalent among REITs, with approximately 91% of REITs having ownership guidelines in place and almost half of those REITs requiring executives to retain equity awarded to them until the ownership requirements have been met.

# SEC FILINGS

## FORM S-8

Unless an exemption is available, companies are required to register securities offerings with the SEC. Form S-8 is a simplified, short-form registration statement used by public companies to register offers and sales of securities under an employee benefit plan to employees and certain other service providers<sup>10</sup>. Companies typically file Form S-8s for equity plans, employee stock purchase plans and certain types of 401(k) plans. To be eligible to use Form S-8, a company must be subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”), and must have filed all required Exchange Act reports due during the 12 months immediately preceding the filing of the Form S-8 (or such shorter period in which the company was required to file such reports and materials).

When securities issuable in connection with an employee benefit plan are registered on Form S-8, the company is required to provide to each person eligible to participate in the plan (or selected by the company to participate in the plan, in the case of a plan with selective participation) certain information and documents, which, taken together, constitute a prospectus that meets the requirements of Section 10(a) of the Securities Act of 1933, as amended (the “**Securities Act**”). There are several different approaches that companies take to meet these prospectus delivery requirements. One approach is preparation of an integrated prospectus document that the company delivers to all plan participants. The most common alternative to this approach is to deliver a series of different documents that, taken together, satisfy all of the requirements for a prospectus.

The prospectus must be delivered to plan participants on a timely basis (i.e., generally before the offer and sale of securities under the plan to the participant). If more than one document is used to convey the required prospectus information, each document must be distributed to plan participants on a timely basis. For an equity plan, this generally means that employees who are eligible to participate in the plan should receive the required prospectus documents at the time they join the company or first become eligible to participate in the plan through receipt of an award.

There are several methods to satisfy the prospectus delivery requirements. The company may deliver a paper copy of the prospectus to each participant (e.g., by mail or hand delivery). Alternatively, the company may satisfy its obligations by means of electronic delivery, such as by email, if certain conditions are met.

**PRACTICE POINT:** If a NYSE-listed REIT files a Form S-8 registering the issuance of securities under an equity incentive or similar plan, it must also file a supplemental listing application with the NYSE to list those securities on the NYSE. NASDAQ does not require a supplemental listing application as long as the awards are granted under a stockholder-approved plan.

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<sup>10</sup> Form S-8 allows the registration of grants of awards to consultants and other advisors as long as (i) the awards are made to natural persons (i.e., not entities), (ii) the consultant or advisor provides bona fide services to the company and (iii) the bona fide services provided by the consultant or advisor are not in connection with capital-raising activities. As a result, awards cannot be granted under the Form S-8 to entities that perform services for the REIT or to persons who promote or maintain a market for the REIT's securities.

## ITEM 5.02(E) OF FORM 8-K

Item 5.02(e) of Form 8-K requires disclosure when: (i) a company enters into, adopts or commences a material compensatory contract, plan or arrangement (collectively, a “**compensation arrangement**”), as to which the company’s principal executive officer, principal financial officer or another NEO participates or is a party; (ii) a compensation arrangement is materially amended or modified; or (iii) the company makes a material grant or award under any such compensation arrangement. Generally speaking, if any of the enumerated items discussed above are triggered, the company must file an Item 5.02(e) Form 8-K—within four business days of the triggering event—that provides a brief description of the terms and conditions of the compensation arrangement and the amounts payable under the compensation arrangement or any amendment or modification to the compensation arrangement.

**PRACTICE POINT:** Any compensatory arrangement that requires stockholder approval is material for the purpose of Item 5.02(e), and therefore is subject to disclosure. The disclosure requirement for such plans is triggered when the compensation plan or arrangement receives stockholder approval, rather than upon the date on which the compensation arrangement is approved by the board of directors or a duly authorized committee.

Additionally, the SEC staff (the “**Staff**”) has adopted an interpretative position that the cancellation of a material compensatory arrangement triggers a disclosure requirement under Item 5.02(e) of Form 8-K if the termination constitutes a material amendment or modification.<sup>11</sup> This obligation exists in lieu of reporting under Item 1.02 of Form 8-K (i.e., Termination of a Material Definitive Agreement). The Staff has taken the position that an automatic renewal of covered executive officers’ compensation arrangements does not give rise to Item 5.02(e) disclosure requirements.

Disclosure on Form 8-K is not required for any grant, award or modification made pursuant to a plan or arrangement that is materially consistent with previously disclosed terms of the plan or arrangement. Exchange Act Rule 12b-2 defines “previously reported” broadly to include, among other filings, Form 8-Ks, Form 10-Qs, Form 10-Ks, proxy statements and registration statements.

Through informal guidance, the Staff has further refined the exception for previously disclosed compensatory plans and arrangements. For example, the Staff’s interpretations explain that, if the company has already disclosed a cash bonus plan, it would be unnecessary to disclose a cash award made under the plan if it is determined that the performance criteria have been satisfied. In accordance with the Staff’s view, a company would need to file an Item 5.02(e) Form 8-K if the recipient received a payment notwithstanding that the recipient did not satisfy the previously disclosed performance criteria. Disclosure is required under these circumstances because payment is materially inconsistent with the previously disclosed terms of the plan (i.e., the recipient failed to meet the merit-based goals, yet still received the bonus). Further, for plans involving target levels with respect to specific quantitative and qualitative performance-related factors, the Staff has taken the position that the company need not disclose targets if they consist of confidential trade secrets, commercial information or financial information that could result in competitive harm for the company.

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<sup>11</sup> See [SEC Compliance and Disclosure Interpretations—Exchange Act Form 8-K Question 117.14](#).

Finally, a company is not liable under Section 10 or Rule 10b-5 of the Exchange Act for failure to timely file an Item 5.02(e) Form 8-K. This is a significant distinction from other Items of Form 8-K which, if not timely filed, may result in securities fraud claims against the company.<sup>12</sup> Additionally, companies will not lose eligibility to use Form S-3 solely as a result of the failure to timely file an Item 5.02(e) Form 8-K.

**PRACTICE POINT:** To avoid the requirement to file an Item 5.02(e) Form 8-K at the time of each grant or award, you should provide robust disclosure of the types of awards that are authorized under your compensation arrangements and file the associated forms of award agreements as exhibits to a periodic or current report.

## PROXY STATEMENTS

A brief summary of proxy statement disclosure requirements is presented below. This discussion is meant to give a high-level overview of the requirements, but it is not meant to be comprehensive. Companies should consult with legal counsel when making certain determinations and when preparing the tables and related narrative and footnote disclosures.

### Determination of Named Executive Officers

Information for a company's NEOs must be included in CD&A and the required compensation tables. A company's NEOs are its principal executive officer, principal financial officer and the three other most highly paid executive officers of the company; however, smaller reporting companies and emerging growth companies are afforded relief in the form of scaled disclosure requirements, and, for those issuers, the NEOs are limited to the principal executive officer and the other two most highly paid executive officers. A company, other than a smaller reporting company or emerging growth company, will need to include up to two additional NEOs in CD&A and the compensation tables if the individuals would have been among the three most highly paid executive officers, but for the fact that they were not serving as an executive officer at the end of the last completed fiscal year.

The SEC defines "executive officer" as any president, vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs policy-making function or any other person (including any employee of a subsidiary) who performs similar policy-making functions for the company. It is common for REITs to identify, each year, those individuals who are designated as executive officer.

## Disclosure Requirements

### *Compensation Discussion and Analysis (CD&A)*

The CD&A is the discussion and analysis of a company's executive compensation policies, practices and decision-making with respect to NEOs that accompanies a company's tabular executive compensation disclosure.<sup>13</sup> The CD&A must include material information about a company's executive compensation program, and it is similar in concept to Management's Discussion and Analysis of Financial Condition and

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<sup>12</sup> See <https://www.sec.gov/rules/final/2006/33-8732a.pdf> (Section III.B.).

<sup>13</sup> See Item 402(b) of Regulation S-K. Smaller reporting companies and emerging growth companies are not required to provide a CD&A.

Results of Operations (the “**MD&A**”). The two reporting requirements serve similar objectives, in that the MD&A is meant to provide a discussion and analysis of the data in a company’s financial statements through the eyes of management, while the CD&A is meant to provide a discussion and analysis of the data in a company’s tabular compensation disclosures, largely through the perspective of the company’s compensation committee. Both disclosure requirements seek to provide context for the quantitative information that is reported to investors.

The CD&A should not merely be a narrative of the information that is provided in the tabular disclosure. The Staff has emphasized that companies should focus in particular on the “analysis” portion of the CD&A. In this regard, the CD&A should avoid over-reliance on boilerplate language or recitations of company policies, and should instead focus on the compensation committee’s decision-making process when considering and determining executive compensation. More specifically, the CD&A is meant to provide investors with transparency regarding the factors used in making compensation decisions and how those factors were specifically applied to the company’s NEOs.

**PRACTICE POINT:** Because the CD&A can be long, it is advisable to include an executive summary that summarizes key information about the company’s executive compensation plans, policies and practices, the company’s corporate governance practices with regard to executive compensation and the alignment of NEO pay with company performance.

The CD&A requirement is a “principles-based” rule, outlining principles for disclosure while providing guidance to help companies determine what items are material and must be disclosed. Specifically, the rule identifies the following factors that a company must address when preparing the CD&A disclosure:

- the objectives of the company’s compensation policies;
- what the compensation program is designed to reward;
- each element of compensation;
- why the company chooses to pay each element of compensation;
- how the company determines the amount and, where applicable, the formula for each element of compensation;
- how each element of compensation and the company’s decisions regarding that element fit into the company’s overall compensation objectives and affect decisions regarding other elements of compensation; and
- whether, and, if so, how, the company has considered the results of the most recent Say-on-Pay vote in determining compensation policies and decisions, and, if so, how that consideration has affected the company’s executive compensation decisions and policies.

The CD&A requirement provides further guidance through the following examples of matters that will often be material for a company:

1. the policies for allocating between long-term and currently paid-out compensation;
2. the policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
3. for long-term compensation, the basis for allocating compensation to each different form of award;
4. how the determination is made as to when awards are granted;

5. what specific forms of corporate performance are taken into account in setting compensation policies and making compensation decisions;
6. how specific forms of compensation are structured and implemented to reflect the items of corporate performance, including whether discretion can be exercised;
7. how specific forms of compensation are structured and implemented to reflect the NEO's individual performance and/or individual contribution to items of corporate performance;
8. the company's policies and decisions regarding the adjustment or recovery of awards or payments if relevant corporate performance measures are restated or adjusted;
9. the factors considered in decisions to increase or decrease compensation materially;
10. how compensation or amounts realizable from prior compensation are considered in setting other elements of compensation;
11. with respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payment at, following, or in connection with any termination or CiC, the basis for selecting particular events as triggering payment;
12. the impact of accounting and tax treatments on the particular form of compensation;
13. the company's policies regarding equity or other security ownership requirements or guidelines, as well as any company policies regarding hedging the economic risk of ownership of the company's securities;
14. whether the company engages in benchmarking of total compensation, or any other material element of compensation; and
15. the role of executive officers in determining executive compensation.

While the foregoing list provides some guidance to companies about the topics to be discussed in the CD&A, the ultimate determination of what must be included depends on a company's particular facts and circumstances. The compensation committee and management must assess the company's policies, practices and decision-making with regard to executive compensation to determine what information is material and therefore must be disclosed.

**PRACTICE POINT:** Shareholders often find the compensation information concerning NEOs important even if it does not have a substantial impact on a company's financial performance. Shareholders often view executive compensation as indicative of a company's corporate governance; therefore, it is important for a company to provide material information that is relevant for voting and investment decisions.

All personnel within a company that can add value and provide the relevant information should be included in the process of drafting the CD&A. Typically, the following groups may be included in the CD&A drafting process:

- employee benefits and stock administration;
- human resources;
- accounting and financial reporting;
- legal;
- investor relations;
- members of the senior management team; and
- internal audit.



Companies will often engage outside advisers to assist with the preparation of the CD&A, including legal counsel, compensation consultants and proxy design firms. The compensation committee of the board of directors should also be involved in the preparation of the CD&A, reviewing and consulting on drafts and recommending that the board include the final CD&A in the company's proxy statement. The SEC's rules require that a company provide a "Compensation Committee Report," which discusses whether the compensation committee has reviewed the CD&A, discussed the CD&A with management and recommended to the board of directors that the CD&A be included in the proxy statement. The rules also require the company list the names of each member of the compensation committee below the Compensation Committee Report. See "[Compensation Committee Report](#)" below.

**PRACTICE POINT:** Assign a CD&A "Quarterback." Although it may be difficult for one person within a company to draft the entire CD&A, it is advisable to have one person appointed as the CD&A "quarterback" who can coordinate the drafting, reviews and comments across the groups within the organization and with outside advisers.

Companies must carefully consider the manner in which the CD&A is presented to ensure that it effectively explains the company's executive compensation philosophy, policies and practices and decision-making. For this reason, it is important for companies to utilize a plain English writing style and to employ, where appropriate, charts and graphs that demonstrate key points, such as the relationship between pay and performance. The ultimate goal of the disclosure is to provide investors with meaningful insight into how the company made its compensation decisions in the last fiscal year. Boilerplate language or quotes from company policies or employee agreements are generally not appropriate; instead, companies should discuss *how* and *why* they arrived at specific compensation decisions, including identifying the goals of the compensation program, as well as the reasons for individual awards to NEOs and how those awards fit into the overall compensation objectives.

An area of Staff focus has been the disclosure of performance targets. The CD&A must include disclosure of any specific items of corporate performance that are taken into account in setting compensation policies and making compensation decisions. As a result, the CD&A is expected to include material performance targets and the extent to which those performance targets have been achieved; however, no disclosure is required for performance targets that are not material or that would cause competitive harm to the company. If a company relies on the competitive harm exclusion to omit specific performance targets, the Staff may request that the company describe the nature of the competitive harm that it would suffer if the specific performance targets were disclosed, including the specific ways in which the company's competitors would actually use the information. The Staff has generally been more accepting of an argument that disclosure of a performance target would cause competitive harm when a performance target relates to non-financial operational performance, or performance goals for specific business units. In general, the Staff does not expect companies to disclose financial performance targets for the current or a future period, if a company is able to argue that performance targets for the current or a future period are not material to an understanding of compensation policies and decisions with respect to the fiscal year being discussed in the CD&A. When a company uses performance targets that are based on a non-GAAP financial measure, an explanation of how the non-GAAP financial measure is calculated must be provided, but a reconciliation to GAAP and related disclosures are not required.

The Staff has also focused on disclosure of individual performance goals for NEOs, requesting details as to how the level of individual achievement affects the actual compensation received by the executive, or why

the compensation committee adopted a particular individual performance goal and how achievement is measured. Companies are expected to identify the extent to which achievement of individual performance goals affects the compensation for each NEO, and if such individual performance goals were a material factor in determining compensation, then the specific performance goals and achievements must be disclosed, even if the goals are subjective and not quantifiable. When the compensation committee approves compensation in excess of or less than what is provided for in the company's compensation plans, or when the amount of compensation for an NEO has been increased or decreased due to an NEO's individual performance, companies are expected to discuss the individual performance that was considered in making those decisions.

A frequent area of consideration when preparing the CD&A is determining whether disclosure of the use of "benchmarking" is required. For purposes of the CD&A, the term "benchmarking" refers to the tying of specific elements of compensation or total compensation to a benchmark that is based on other companies, as opposed to using comparable company data as a "market check" after arriving at compensation decisions using some other methodology. If a company does engage in benchmarking compensation elements or total compensation, the Staff expects disclosure of all of the companies comprising the peer group or survey, as well as the methodology used when considering that information. A company is also expected to identify where its compensation decisions fall within (or outside of) the benchmarked parameters.

### ***Tabular Compensation Disclosure***

The following tables and related disclosure with respect to executive compensation are required to be presented in a company's annual proxy statement pursuant to Item 402 of Regulation S-K:

- Summary Compensation Table
- Equity Compensation Tables
  - Grants of Plan-Based Awards Table
  - Outstanding Equity Awards at Fiscal Year-End Table
  - Option Exercises and Stock Vested Table
- Post Retirement Benefit Tables
  - Pension Benefits Table
  - Nonqualified Deferred Compensation Table
- Change in Control and Severance Disclosure

### **Summary Compensation Table<sup>14</sup>**

As its name suggests, the Summary Compensation Table is meant to provide a "concise, comprehensive overview of compensation awarded, earned or paid in the reporting period."<sup>15</sup> The Summary Compensation Table is meant to provide a summary of *all* compensation, including cash compensation, equity compensation and perquisites, paid to an NEO for the applicable fiscal years and provides investors

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<sup>14</sup> See Item 402(c) of Regulation S-K.

<sup>15</sup> See Executive Compensation Disclosure, Release No. 33-6940 (June 23, 1992) [57 FR 29582].



with the basic information that is discussed in further detail in the CD&A and the other compensation tables. The Summary Compensation Table should cover compensation paid to each NEO during the last three fiscal years for all companies other than smaller reporting companies and emerging growth companies, which need only to provide information covering the last two fiscal years. Furthermore, if an individual becomes an NEO for the first time during the most recently completed fiscal year, information is required only for that year and not for either of the prior two fiscal years during which the individual was not an NEO.

All compensation received by each NEO falls into one of the categories shown in the table below. A company may omit a column if no compensation paid to any NEO falls into that category. Determining which category to classify certain compensation can be a complex and fact-intensive analysis.

Name and Principal Position <sup>1</sup>	Year <sup>2</sup>	Salary	Bonus	Stock Awards <sup>3</sup>	Option Awards <sup>3</sup>	Non-Equity Incentive Plan Compensation	Change in Pension Value and Nonqualified Deferred Compensation Earnings	All Other Compensation	Total
NEO <sup>1</sup> (PEO) Chief Executive Officer	2019 2018 2017	\$	\$	\$	\$	\$	\$	\$	\$
NEO <sup>2</sup> (PFO) Chief Financial Officer	2019 2018 2017	\$	\$	\$	\$	\$	\$	\$	\$
NEO <sup>3</sup>	2019 2018 2017	\$	\$	\$	\$	\$	\$	\$	\$
NEO <sup>4</sup>	2019 2018 2017	\$	\$	\$	\$	\$	\$	\$	\$
NEO <sup>5</sup>	2019 2018 2017	\$	\$	\$	\$	\$	\$	\$	\$

<sup>1</sup> For smaller reporting companies and emerging growth companies, only the CEO and the next two most highly paid executive officers must be included in the table.

<sup>2</sup> Information is only required for the years in which the individual was an NEO; however, if the individual was a NEO only in the first and third years in the three-year period, but not the second year, information is required to be presented for all three years.

<sup>3</sup> Represents the aggregate grant date fair value computed in accordance with FASB ASC Topic 718.

## Equity Compensation Tables

The following tables give additional color to the information in the Summary Compensation Table with respect to equity awards and non-equity incentive plan awards. Of these three tables, only the outstanding equity awards table is required for smaller reporting companies and emerging growth companies.

### *Grant of Plan-Based Awards Table<sup>16</sup>*

The Grant of Plan-Based Awards Table requires a company to disclose each non-equity incentive plan award and each equity award for the NEO during the last fiscal year. The table supplements information regarding non-equity incentive plan compensation and equity compensation reported in the Summary Compensation Table. A company must disclose the number of shares of stock or units comprising the underlying award granted, as well as additional information about the terms of the awards, including estimated future payouts for both equity and non-equity incentive plan awards. In addition, a company must disclose the grant date fair value of each equity award granted during the last completed fiscal year.

### *Outstanding Equity Awards at Fiscal Year-End Table<sup>17</sup>*

The purpose of the Outstanding Equity Awards at Fiscal Year-End Table is to provide investors with an understanding of the unrealized value of each NEO's outstanding equity awards. Companies are required to disclose the number of shares of stock and stock options, and associated values, granted to each NEO that remain unvested or unexercised. The awards must be disclosed on a grant-by-grant basis.

### *Option Exercises and Stock Vested Table<sup>18</sup>*

The Option Exercises and Stock Vested Table requires disclosure, on an aggregated basis, of the amounts realized by each NEO upon the vesting of stock awards and exercise of stock options during the last completed fiscal year.

## Post-Retirement Benefit Tables

The following tables are required to be included with respect to pension plans and nonqualified deferred compensation plans. However, most REITs do not provide their NEOs with these post-retirement benefits, and, as a result, the disclosure is not included in their proxy statements. Neither of the following tables are required for smaller reporting companies or emerging growth companies:

### *Pension Benefits Table<sup>19</sup>*

The Pension Benefits Table requires disclosure of the actuarial present value of accumulated pension benefits under each tax-qualified and nonqualified defined benefit pension plans.

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<sup>16</sup> See Item 402(d) of Regulation S-K.

<sup>17</sup> See Item 402(f) of Regulation S-K.

<sup>18</sup> See Item 402(g) of Regulation S-K.

<sup>19</sup> See Item 402(h) of Regulation S-K.

### *Nonqualified Deferred Compensation Table<sup>20</sup>*

The Nonqualified Deferred Compensation Table requires disclosure, on a plan-by-plan basis, regarding contributions, earnings and withdrawals and account balances that have accumulated for each nonqualified deferred compensation plan or arrangement during the last fiscal year.

### **Narrative Disclosure**

The Summary Compensation Table and Grant of Plan-Based Awards Table should be accompanied by appropriate narrative disclosure that provides additional material factors necessary to understand and give context to the quantitative information presented in the tables. This disclosure often includes summaries of the material terms of employment agreements, explanations of the split in cash compensation between salary and bonus, the material terms of equity or non-equity incentive plans, the material terms of awards, and explanations of any perquisites provided to the NEOs. This narrative disclosure differs from CD&A because it focuses on the specific information necessary to understand the tables as opposed to the objectives and design of the company's overall compensation program.

The two post-retirement benefit plan tables also require narrative disclosure to provide the material terms of the relevant benefit plans.

### **CiC and Severance Disclosures**

Companies are required to provide narrative disclosure describing the specific aspects of arrangements that provide for payments at, following or in connection with the resignation, severance, retirement or other termination of employment (including constructive termination) of a NEO, a change in a NEO's job responsibilities or a CiC of the company. In addition, companies are required to disclose the estimated potential payments and benefits that would be provided in a CiC scenario. There is no specific tabular format set forth in the rules with respect to the presentation of this disclosure, and, as a result, the presentation of this disclosure varies. Companies should explain clearly and concisely the relevant assumptions used in populating the table in order to give context to the quantitative information presented. See [\*Item 402\(j\) of Regulation S-K\*](#).

### **Compensation Committee Report**

In accordance with SEC rules, the executive compensation disclosures of a company (other than a smaller reporting company and an emerging growth company) must be accompanied by a Compensation Committee Report<sup>21</sup>. The Compensation Committee Report must state whether the company's compensation committee has reviewed the CD&A, discussed the CD&A with management and recommended to the board of directors that the CD&A be included in the proxy statement. The rules also require companies to list the names of each member of the compensation committee below the Compensation Committee Report. In light of the SEC's rules, the company's management team and its compensation committee should have meaningful discussions regarding the compensation tables and the CD&A in advance of the filing deadline to ensure the accuracy of the Compensation Committee Report.

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<sup>20</sup> See [\*Item 402\(i\) of Regulation S-K\*](#).

<sup>21</sup> See [\*Item 407\(e\)\(5\) of Regulation S-K\*](#).

The Staff expects the text of the Compensation Committee Report to conform to the language set forth in Item 407(e)(5)(i)(A) and (B), with only minor modifications for plain English or to reflect circumstances unique to the company (for instance, reference to a committee that serves the role of a compensation committee under a different title). Accordingly, the Compensation Committee Report should state as follows:

*“The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis that is required by the SEC rules with the Company’s management. Based on such review and discussions, the Compensation Committee recommended to the Company’s Board of Directors that the Compensation Discussion and Analysis be included in the Company’s Proxy Statement.”*

As noted above, smaller reporting companies and emerging growth companies are not required to provide a Compensation Committee Report because they are not required to include CD&A.

## **Stockholder Approval of Equity Plans and Approval of Material Amendments to Equity Plans**

Subject to certain limited exceptions, the NYSE and NASDAQ require stockholder approval of new equity plans and material amendments to existing equity plans.<sup>22</sup>

Whenever a company seeks stockholder approval of an equity plan or an amendment of an equity plan, it must comply with the disclosure requirements of Item 10 of Schedule 14A. Item 10 requires the following:

- **Narrative Description:** a narrative description of the material features of the plan, identifying each class of persons who will be eligible to participate in the plan, the approximate number of persons in such class and the basis of such participation. If the action proposed is only an amendment to an existing plan (e.g., adding shares available for future issuance under a plan or adding a new class of participants), the Item 10 disclosure still must include a complete description of any material features of the plan, as well as the material differences from the existing plan.

**PRACTICE POINT:** The requirement to identify the approximate number of persons in each class of eligible persons (e.g., employees, directors and consultants) should not be overlooked, as plaintiff’s law firms often review equity plan proposals for non-compliance with the SEC rules, and this is one item that they have been known to cite if the required information is not included in the proxy statement.

- **New Plan Benefits Table:** a table disclosing the benefits or amounts that will be allocated to (a) each NEO, (b) all current executive officers as a group, (c) all current directors who are not executive officers as a group and (d) all employees, including all current officers who are not executive officers, as a group, if such benefits or amounts are determinable. If such information is not determinable, then the company should provide information for each of the foregoing as if the plan had been in effect during

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<sup>22</sup> See Section 303A.08 of the NYSE Listed Company Manual and NASDAQ Listing Rule 5635(c). In addition, the Code also requires stockholder approval within 12 months before or after board approval of a plan in order for awards to be eligible for treatment as incentive stock options.

the previous fiscal year.<sup>23</sup> If the information is not determinable (e.g., if grants are not made pursuant to a formula and there are no pre-approved grants that are contingent upon stockholder approval of the plan), the company should disclose that fact and not include a New Plan Benefits Table.

**PRACTICE POINT:** If the compensation committee or the board approves grants under the plan prior to the adoption of the plan but subject to stockholder approval of the plan, those approved grants should be included in the New Plan Benefits Table. Otherwise, it is often the case that grants are not determinable and the New Plan Benefits Table is excluded.

- **Plans Containing Options, Warrants or Rights.** If a plan containing options, warrants or rights (or a specific grant of options, warrants or rights) is submitted for stockholder approval, the company must disclose: (a) the title and amount of securities underlying options, warrants or rights; (b) the prices, expiration dates and other material conditions related to exercise; (c) the consideration received or to be received for the grant or extension; (d) the market value of securities underlying the options, warrants or rights as of the latest practicable date; and (e) in case of options, the federal income tax consequences of the issuance and exercise of such options to the recipient and company. Furthermore, the company must state separately the amount of options received or to be received by the following (if such benefits are determinable): (a) each NEO; (b) all current executive officers as a group; (c) all current directors who are not executive officers as a group; (d) each nominee for election as director; (e) each associate of any such directors, executive officers or nominees; (f) each other person who received or is to receive 5% of such options, warrants or rights; and (g) all employees, including current officers who are not executive officers, as a group. SEC staff interpretations make it clear that this requirement to state the amount of options received or to be received applies to all options received at any time (not just last year) and options to be received (if determinable) by the specified persons and groups, and that the information called for under this item requirement should be given for each individual and group (including those for which the amount of options received or to be received is “0”).<sup>24</sup>

**PRACTICE POINT:** When seeking stockholder approval of an amendment to an existing plan, many REITs take the position that disclosure under Item 10(b)(2)(ii) with respect to options received or to be received by the individuals and groups of individuals named in (a) through (g) above should be included not only for options, but for all awards previously granted under the plan that is being amended. Similarly, although the item only requires a discussion of federal income tax consequences of options, it is common practice to include a discussion of the federal income tax consequences of other types of awards as well.

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<sup>23</sup> See [SEC Compliance and Disclosure Interpretations—Proxy Rules and Schedules 14A/14C Question 161.06](#). Disclosure under this item is only required when action is being taken on an existing plan (as opposed to a new plan) if the existing plan is being amended to alter a formula or other objective criteria to be applied to determine benefits.

<sup>24</sup> See [SEC Compliance and Disclosure Interpretations—Proxy Rules and Schedules 14A/14C Question 161.12](#).

## Pay Ratio Disclosure

Under Item 402(u) of Regulation S-K, companies are required to calculate and disclose the ratio between the median of the annual total compensation of all employees relative to the annual total compensation of their principal executive officer. Smaller reporting companies and emerging growth companies are not required to provide pay ratio disclosure in their proxy statements.

Companies are required to calculate and disclose this pay ratio annually, but they are only required to calculate the median employee compensation figure once every three years. However, in the event that a company incurs a significant change in employee compensation that they reasonably believe would significantly alter their pay ratio disclosure, the rule requires a recalculation of the median employee compensation figure for that year.

A company's calculation and disclosure must be based on a reasonable belief and the result of reasonable estimates, assumptions and methodologies. The SEC permits the use of reasonable estimates, such as statistical sampling, or a consistently applied compensation measure, such as payroll or tax records, to identify the median employee. The SEC does not provide specific parameters for statistical sampling. Instead, companies are instructed to "make their own determinations on what is appropriate based on their own facts and circumstances." The SEC does provide a few explicit areas of guidance, stating: (i) reasonable estimates of the median for companies with multiple business lines or geographic units may be determined using more than one statistical sampling approach; (ii) statistical sampling should draw observations from each business or geographical unit with reasonable assumption on each unit's compensation distribution; and (iii) exact compensation is not required to be calculated for every employee, so outliers on the high and low end may be excluded. Additionally, companies are permitted to make adjustments at their discretion, such as excluding certain benefits. All material adjustments and assumptions must be disclosed in the description of the methodology.

While the mechanics of the calculation are largely left to the company, the SEC has provided a few key guidelines. The pay ratio must account for all employees, including part-time and seasonal workers, as well as employees of consolidated subsidiaries. Companies are not permitted to make "full-time equivalent adjustments" to the compensation of their part-time or seasonal employees. However, annualization of an employee's compensation may be permitted when the employee was not employed for the full fiscal year. The SEC has also created two exclusions that permit companies to exclude non-U.S. employees from the pay ratio calculation. First, the *de minimis* exclusion permits the exclusion of non-U.S. employees if they account for 5% or less of the total employee population. Second, the privacy law exclusion permits the exclusion of non-U.S. employees if they are employed in a jurisdiction where disclosing such information would violate the jurisdiction's privacy laws. The use of the privacy exclusion requires a legal opinion to justify the exclusion.

2018 Pay Ratios in the REIT Industry			
	Lowest Ratio	Median Ratio	Highest Ratio
Diversified	6	45	150
Healthcare	9	52	145
Hotel & Resort	6	32	356
Industrial	8	46	244
Mortgage	5	23	99
Office	3	68	340
Residential	4	94	355
Retail	4	58	477
Specialized	9	96	418
All REITs	3	57	477

## Stockholder Advisory Votes on Executive Compensation

As a result of the enactment of the Dodd-Frank Act, the SEC adopted Rule 14a-21 under the Exchange Act, which provides that companies must submit to their stockholders so-called “Say-on-Pay,” “Say-on-Frequency” and “Say-on-Golden Parachute” advisory votes, each of which is described below. The Say-on-Pay and Say-on-Frequency advisory votes must appear as separate items on the ballots relating to the company’s annual or other meeting of stockholders at which directors are elected. The Say-on-Golden Parachute advisory vote must be included in certain transactional proxy statements, as discussed below. Emerging growth companies are exempted from the Say-on-Pay, Say-on-Frequency and Say-on-Golden Parachute vote requirements as long as they retain emerging growth company status.

### Broker Non-Votes

A broker non-vote occurs when shares held by a broker are not voted with respect to a particular proposal because the broker does not have discretionary authority to vote on the matter and has not received voting instructions from its clients. If that happens, the nominees may vote those shares only on matters deemed “routine.” Where a proposal is not “routine,” a broker who has not received instructions from its clients does not have discretion to vote its clients’ uninstructed shares on that particular proposal. Votes on executive compensation matters are deemed “non-routine,” and, accordingly, brokers are not able to cast votes on Say-on-Pay, Say-on-Frequency or Say-on-Golden Parachute proposals if clients do not provide voting instructions on these proposals.

## ***Say-on-Pay Proposals***

Rule 14a-21 under the Exchange Act requires companies subject to the SEC's proxy rules to provide their stockholders with a non-binding, advisory vote on the compensation of the company's NEOs (see "[Proxy Statement—Determination of Named Executive Officers](#)" above for a discussion regarding the identification of a company's NEOs).

As a non-binding, advisory vote, the failure to obtain majority approval of the company's Say-on-Pay proposal does not require the company's board of directors to modify its executive compensation practices. However, Item 402(b)(1) of Regulation S-K requires the company to disclose in its CD&A whether, and, if so, how, the outcome of the most recent Say-on-Pay vote was considered by the company in setting compensation.

The frequency with which the company submits Say-on-Pay votes to its stockholders is determined by the company's board of directors (subject to the requirement to hold a Say-on-Pay vote at least once every three years), but is typically informed by the results of the company's Say-on-Frequency advisory vote, discussed below.

### **The following is sample disclosure that a company may use in connection with a Say-on-Pay proposal:**

We are asking our stockholders to indicate their support for the compensation of our NEOs as set forth in this Proxy Statement. Accordingly, we will ask our stockholders to vote "FOR" the following resolution at the Annual Meeting:

RESOLVED, that the compensation paid to REIT X's NEOs, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion, is hereby APPROVED.

Companies are not required to use any specific language in asking for stockholder approval. Instead, each company has the flexibility to craft the exact language of the non-binding resolution that its stockholders will vote on, subject to the requirement that the resolution clearly identify that stockholders are being asked to approve the compensation of the NEOs.

It is not uncommon for a company to accompany its Say-on-Pay proposal with a disclosure highlighting the components of the company's compensation policies and practices that tend to demonstrate a strong alignment of interests with stockholders, including NEO compensation that is tied to the achievement of quantitative performance objectives. In addition, many companies engage in regular communications with their largest stockholders to ensure that concerns regarding the compensation of the company's NEOs are addressed prior to making compensation determinations.

Although the Say-on-Pay vote is non-binding, boards of directors (and particularly members of the board's compensation committee) that elect not to address concerns with respect to NEO compensation after a company receives only modest support or a majority against the NEOs' compensation do so at their peril. In particular, stockholders and proxy advisory firms may view the board's decision not to engage with stockholders as an indication of the board's indifference to stockholder concerns, which could adversely affect stockholder support for certain director nominees in subsequent years. Additionally, if a Say-on-Pay vote receives only modest support (70% according to ISS, 80% according to Glass Lewis), proxy advisory firms expect a robust response from the company and disclosure regarding such response in the

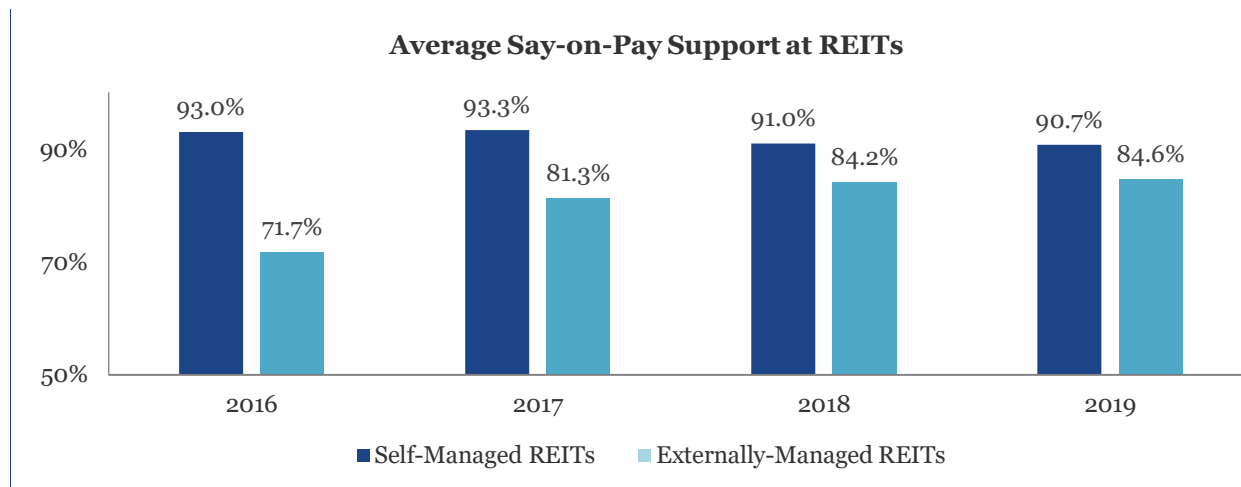


company's proxy statement the following year, including the company's engagement with stockholders regarding their concerns and actions taken to address the issues that led to the low level of support. If a company has not demonstrated adequate responsiveness, proxy advisory firms may recommend voting against the Say-on-Pay vote and incumbent compensation committee members the following year.

### Say-on-Pay Results

Overall, average Say-on-Pay results for all REITs has declined slightly since 2016. While average Say-on-Pay support for REITs that received a positive voting recommendation has remained relatively consistent over the past several years (at approximately 95%), average support for all REITs has declined from approximately 93% in 2016 and 2017 to 90.7% in 2019.

The guarantee of +90% stockholder support with a positive ISS voting recommendation is fading as institutional investors and stockholders are relying more on their own due diligence, and, in some cases, institutional voting guidelines, rather than ISS. This is evidenced by the overall decline in stockholder approval for REIT Say-on-Pay proposals, and in the number of REITs failing their Say-on-Pay proposals relative to the number of "against" voting recommendations. In 2019, more REITs received "Against" recommendations, while only two REITs received less than 50% support for their Say-on-Pay proposals, compared to four in 2018.



In the 2019 proxy season, 19 self-managed REIT received a negative Say-on-Pay voting recommendation from ISS (up from 15 in 2018). A perceived pay-for-performance misalignment continues to be the main precursor of negative voting recommendations from ISS, with 89% of self-managed REITs that received an "Against" voting recommendation cited for CEO pay-for-performance misalignment. Other factors cited by ISS as contributing to the negative voting recommendation included the following:



**63%**

had **outsized equity awards**, either annual grants or **supplemental one-time awards**, often despite sustained TSR underperformance



**21%**

provided **significant perks** – automobile-related or large enhanced life insurance perks



**26%**

had **outsized STI targets** and/or **outsized base salary amounts** (or significant increases without compelling rationale)



**58%**

had **problematic STI (Cash Bonus) program design** features, including largely discretionary plans or lack of pre-set financial metrics



**68%**

were cited for the **rigor of their performance goals** (STI or LTI), including relative TSR targets at or below median and uncapped payouts for negative absolute TSR



**53%**

had **problematic LTI (Equity) program design** features, including annual performance periods, insufficient performance-based awards or retesting features



**58%**

had **problematic severance-related provisions**, including excise tax gross-ups, excessive severance and single-trigger equity vesting

### ***Say-on-Frequency***

In addition to the Say-on-Pay proposal, Rule 14a-21 under the Exchange Act requires companies subject to the SEC's proxy rules to provide their stockholders with a non-binding, advisory vote on the frequency with which the company should present a Say-on-Pay vote to its stockholders. This "Say-on-Frequency" proposal must be presented to the company's stockholders at least once every six years and must give stockholders four voting options for the frequency of Say-on-Pay votes: every year, every two years, every three years or to abstain. As a result, a company could elect to hold Say-on-Pay votes every year, but only hold Say-on-Frequency votes every six years. Furthermore, because the Say-on-Frequency vote is non-binding, the company's board of directors could elect to hold Say-on-Pay votes every three years, for instance, notwithstanding that a majority of the stockholders voting on the Say-on-Frequency proposal

voted for annual Say-on-Pay votes. Companies are required to disclose in their proxy statements the current frequency of Say-on-Pay votes and when the next scheduled Say-on-Pay vote will occur.

Say-on-Frequency among REITs*		Say-on-Frequency Vote among REITs*	
One Year	93%	% of REITs with >1 Frequency Vote Since Dodd-Frank Enacted	74%
Two Years	0%	Years between Frequency Votes (most prevalent)	6 years
Three Years	7%		

\*Excludes emerging-growth and micro-cap companies

The SEC allows some flexibility with respect to the wording of the proposal. For instance, instead of saying “every year,” “every two years,” “every three years” or “abstain,” companies may use “every 1, 2 or 3 years, or abstain.”

**The following is sample disclosure that a company may use in connection with a Say-on-Frequency proposal:**

*“RESOLVED, that the stockholders of REIT X determine, on an advisory basis, whether the stockholders of REIT X shall conduct an advisory vote every one year, every two years or every three years regarding the compensation of REIT X’s NEOs as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, executive compensation tables and narrative discussion, as set forth in REIT X’s annual proxy statements.”*

After the completion of the annual meeting, companies are required to file an Item 5.07 Form 8-K briefly describing the matters that were voted upon by stockholders and the number of votes cast for, against or withheld. In addition, Item 5.07(d) of Form 8-K requires companies to disclose their decision with respect to the frequency of Say-on-Pay votes within 150 days of the meeting. Most companies elect to disclose the board of director’s determination with respect to the frequency of Say-on-Pay votes at the time the initial Item 5.07 Form 8-K is filed, although some companies defer the decision.

### ***Say-on-Golden Parachutes***

If a company is required under state law or its governing documents to solicit votes from its stockholders in favor of the approval of an acquisition, merger, consolidation, proposed sale of all or substantially all of its assets or a similar transaction (a “**golden parachute transaction**”), the company must include a separate ballot item in its proxy statement relating to so-called “golden parachute” payments. The term golden parachute generally refers to compensation arrangements with the company’s NEOs that are based on or otherwise relate to a golden parachute transaction. In connection with a golden parachute transaction presented for the approval of the company’s stockholders, Item 402(t) of Regulation S-K requires companies to provide a tabular presentation (including footnotes) and related narrative disclosure of any golden parachute compensation payable to each of the company’s NEOs, as follows:

Name	Cash	Equity	Pension and Non-Qualified Deferred Compensation	Perquisites / Benefits	Tax Reimbursement	Other	Total
NEO 1 (PEO) Chief Executive Officer	\$	\$	\$	\$	\$	\$	\$
NEO 2 (PFO) Chief Financial Officer	\$	\$	\$	\$	\$	\$	\$
NEO 3	\$	\$	\$	\$	\$	\$	\$
NEO 4	\$	\$	\$	\$	\$	\$	\$
NEO 5	\$	\$	\$	\$	\$	\$	\$

Note: The rules requiring disclosure in this table are nuanced and beyond the scope of this publication. Companies should refer to Item 402(t) of Regulation S-K, including the instructions, and consult with legal counsel with respect to the required disclosures.

The footnote disclosure should, among other things, quantify each separate form of compensation included in the aggregate total reported, and amounts attributable to single-trigger arrangements and amounts attributable to double-trigger arrangements. The narrative disclosure of any golden parachute compensation should address, among other things, the circumstances under which the payments will be made, including a discussion of any reasonable estimates or assumptions applicable to the payments and any material conditions that must be satisfied prior to the receipt of payment (i.e., non-compete, non-solicitation, non-disparagement and similar obligations, see “[Change-in-Control and Severance Disclosures](#)”). In this respect, the disclosure of potential golden parachute compensation payable to the company’s NEOs is similar to the disclosure required to be included in proxy statements relating to annual meetings of stockholders in accordance with Rule 402(j) of Regulation S-K (i.e., potential payments upon termination or CiC). Making changes to the compensation arrangements of its NEOs in advance of a golden parachute transaction, such as changing double-trigger CiC arrangements to single-trigger CiC arrangements (see “[Vesting, Acceleration and CiC](#)” above), providing additional compensation to the NEOs, accelerating vesting of unvested equity award, or providing excise tax gross-ups increases the likelihood that proxy advisory firms such as ISS and Glass Lewis will recommend a vote against the company’s Say-on-Golden Parachute advisory proposal.

**The following is sample disclosure that a company may use in connection with a Say-on-Golden Parachute proposal:**

In accordance with Section 14A of the Exchange Act, we are providing our stockholders with the opportunity to cast a vote on a non-binding, advisory basis, on the compensation that may be paid or become payable to our NEOs that is based on or otherwise relates to the mergers. As required by those rules, we are asking our stockholders to vote on the adoption of the following resolution:

RESOLVED, that the stockholders of REIT X hereby approve, on a non-binding, advisory basis, specified compensation to be paid or that may become payable by REIT X to its NEOs that is based on or otherwise relates to the mergers as disclosed pursuant to Item 402(t) of Regulation S-K in the section of the proxy statement entitled “Proposal 2: Proposal to Approve, on an Advisory Basis, the Merger-Related Compensation—‘Golden Parachute’ Compensation.”

As with the required Say-on-Pay and Say-on Frequency votes, the Say-on-Golden Parachute vote is non-binding and advisory in nature and does not require the company to take any action as a result of a positive or negative vote. However, the failure of the company to obtain a majority vote on Say-on-Golden Parachute could subject the company to stockholder litigation during the pendency of the golden parachute transaction and the acquirer to stockholder litigation post-closing.

## **SECTION 16**

### **General**

Section 16 of the Exchange Act and the rules promulgated thereunder are intended to deter insiders (including directors, executive officers and certain other officers of a public company, as well as any person or entity that beneficially holds more than 10% of any class of the company’s equity securities) from misusing confidential information for personal trading gain. Section 16 generally operates to restrict trading activities of insiders by (1) requiring public disclosure of their ownership of, and transfers involving, the issuer’s equity securities (including securities acquired as compensation) under Section 16(a) and (2) permitting recovery by the issuer under Section 16(b) of any profits realized by the insiders on certain purchase and sale transactions.

### **Disclosure Requirements**

Section 16(a) requires that each Section 16 reporting person file electronic reports regarding their transactions and holdings in the common stock or other equity security of the company. An initial report on Form 3 must be filed by every reporting person within 10 calendar days after he or she becomes an insider (or, if a filing is being made in connection with an initial public offering of the company, at the time of effectiveness of the registration statement with respect to such initial public offering). For instance, if a public REIT promotes or hires a person that will be designated a Section 16 reporting person, the reporting person must file a Form 3 within 10 calendar days of the promotion or hiring, as applicable, and disclose his or her beneficial ownership of the REIT’s equity securities.

Thereafter, unless exempt from reporting or eligible for deferred reporting, any subsequent change in the beneficial ownership by a reporting person (not just purchases and sales) must be reported on a Form 4 within two business days after the change occurs. Subject to certain limited exceptions, the grant, exercise, conversion, transfer or divestment by any reporting person of any employee stock options, RSUs,

restricted stock, SARs, LTIP units or other derivative securities of the company triggers the Section 16(a) reporting requirement, and a Form 4 must be filed within two business days following such change.

In addition, Form 5 is a “clean-up” report that is due within 45 days after the end of a company’s fiscal year with respect to transactions by the reporting person (primarily gifts) that were otherwise exempt from the two-business-day Form 4 filing requirements. Often, however, reporting persons choose to voluntarily file a Form 4 to report these Form 5-eligible transactions in order to maintain continuity in the reporting person’s equity holdings and to avoid an inadvertent filing violation because of the delayed reporting.

### **Section 16(b) and Rule 16b-3**

In general, Section 16(b) under the Exchange Act is intended to prevent the Section 16 reporting persons, each of whom is presumed to have access to inside information regarding the issuer, from profiting on such confidential information through short-term trading in an issuer’s equity securities.

Unlike general insider trading prohibitions and unless an exemption applies, Section 16(b) subjects the Section 16 reporting persons to potential adverse monetary consequences regardless of whether the person possesses or misuses material non-public information. Under Section 16(b) of the Exchange Act, any profits realized by a Section 16 reporting person on any non-exempt purchase and sale, or any non-exempt sale and purchase, of the issuer’s equity securities within a period of less than six months are recoverable by the company as “short-swing profits.” Notably, the calculation of profits under Section 16(b) is complex, and insiders and issuers should consult with counsel regarding any potential Section 16(b) violation. Applicable law prohibits the issuer from waiving or releasing any claim that it may have under Section 16(b) and from indemnifying the insider for any Section 16(b) violations.

An important, and frequently used, exemption to Section 16(b) short-swing trading liability is available for transactions between an issuer and its officers and directors under Rule 16b-3. Rule 16b-3 exempts any transactions between an officer or director of an issuer and the issuer if certain conditions are met. This exemption is often used in respect of (but is not limited to) compensatory arrangements between the officer or director and the issuer, including acquisitions of securities pursuant to equity award grants, exercises of stock options (including cashless exercises), delivery of stock to pay withholding taxes, participation by the director or officer in a dividend reinvestment plan, contributions to, or diversifications in, the issuer’s 401(k) plan and acquisitions pursuant to a qualified employee stock purchase plan, in each case, so long as certain criteria are met.

Notably, when relying on Rule 16b-3, an issuer and its directors and officers must take care to ensure all required actions are properly and timely taken and reflected in board or committee resolutions. If the requirements under Rule 16b-3 are not met and no alternative exemption is available, then the Section 16 reporting person could be subject to short-swing trading liability and, armed with information gleaned from Section 16(a) reports and other public disclosures, the plaintiffs’ bar may target any deficiencies (often by means of sophisticated computer programs) in the applicability of Rule 16b-3 to cause an issuer to recover any amounts that may be payable under Section 16(b).



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## CONTRIBUTORS

Katie Gaynor  
(704) 972-4145  
[katie.gaynor@fticonsulting.com](mailto:katie.gaynor@fticonsulting.com)

Megan Blankemeyer  
(704) 972-4146  
[megan.blankemeyer@fticonsulting.com](mailto:megan.blankemeyer@fticonsulting.com)

Grace Kim  
(704) 972-4142  
[grace.kim@fticonsulting.com](mailto:grace.kim@fticonsulting.com)



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Because of the generality of this guide, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal or other advice based on particular situations.

## CONTRIBUTORS

Justin Salon  
(202) 887-8785  
[justinsalon@mofo.com](mailto:justinsalon@mofo.com)

David Slotkin  
(202) 887-1554  
[dslotkin@mofo.com](mailto:dslotkin@mofo.com)

Lauren Bellerjeau  
(202) 887-8772  
[lbellerjeau@mofo.com](mailto:lbellerjeau@mofo.com)

Dom Bozzetti  
(212) 468-8003  
[dbozzetti@mofo.com](mailto:dbozzetti@mofo.com)

David Lynn  
(202) 778-1603  
[dlynn@mofo.com](mailto:dlynn@mofo.com)

Andy Campbell  
(202) 887-1584  
[andycampbell@mofo.com](mailto:andycampbell@mofo.com)

Emily Beers  
(202) 887-8726  
[ebeers@mofo.com](mailto:ebeers@mofo.com)

John Hensley  
(202) 778-1654  
[jhensley@mofo.com](mailto:jhensley@mofo.com)

Meredith Carr  
(202) 887-1537  
[mcarr@mofo.com](mailto:mcarr@mofo.com)

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