EXECUTIVE COMPENSATION
HONORS

May 16–17, 2023

Generously Hosted By:

American Express Corporation
200 Vesey Street
New York City, NY 10285

HRPA HR POLICY ASSOCIATION CENTER ON EXECUTIVE COMPENSATION

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TUESDAY, MAY 16 *Note: all times are Eastern Time*

11:45 a.m. – 12:30 p.m.	**Lunch Buffet & Networking**
12:30 p.m. – 1:30 p.m.	**Exploring our "Why?"** Informal conversation designed to introduce participants and instructors to each other and to explore each participant's goals and motivations for the session.
1:30 p.m. – 2:30 p.m.	**Where Are We Now?** A review of the historical context influencing the practice of executive compensation.
2:30 p.m. – 2:40 p.m.	**Afternoon Break**
2:40 p.m. – 3:10 p.m.	**Stakeholder Spotlight** A discussion and contrast of how two key stakeholders – policy makers and investors – view executive pay.
3:10 p.m. – 4:30 p.m.	**Group Challenge: Re-Imagining Executive Pay** Participants will work in small groups to examine the current state of executive compensation design and consider what changes - evolutionary or revolutionary – might be in order.
4:30 p.m. – 5:30 p.m.	**Present Group Findings**
6:30 p.m.	**Cocktails and Dinner** Dinner Conversation: What's on Your Mind? Manhatta 28 Liberty Street, 60^{th} floor

WEDNESDAY, MAY 17

8:00 a.m. – 8:45 a.m.

Breakfast Buffet & Day One Reflections

Review the key conclusions from the team presentations.

8:45 a.m. – 9:45 a.m.

Group Challenge: Implications for the Profession

What are the implications for practitioners of executive compensation based on our conclusions about the future?

9:45 a.m. – 10:00 a.m.

Morning Break

10:00 a.m. - 10:30 a.m.

Shareholders or Stakeholders?

A discussion of how the doctrine of shareholder primacy has influenced executive pay, and how current trends are challenging this convention.

10:30 a.m. – 12:00 p.m.

Bringing It All Together: The Future of Executive Compensation

The full group will reconvene to discuss the path forward for executive compensation, and how the Center can continue to build the community of practice.

12:00 p.m. – 12:30 p.m.

Reflections and Wrap Up

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PARTICIPANTS

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Where Are We Now: Changes in the Legal and Regulatory Environment Influencing Executive Compensation

MOTIVATION

IMPACT

1950

Revenue Act of 1950

Desire of a business-friendly Congress to provide a more tax effective form of equity compensation in view of high marginal tax rates (up to 91%).

Prior to 1950, stock options were taxed upon exercise. The 1950 Act created "restricted stock options" for which tax was not due upon exercise but upon sale. If held for at least six-months from exercise, upon sale the gain was taxed as capital gains rate of 25%. Following the passage of the 1950 Act the use of stock options in executive pay packages increased dramatically and the size of option grants increased, accounting for roughly half of after-tax compensation.

1954

Revenue Act of 1954

The post-Korean War recession caused many of the restricted stock options granted in the early 1950s to be significantly underwater.

Congress modified restricted stock to allow variable-price options, in which the exercise price of a previously granted option could be lowered if it turned out that the market price of the optioned stock declined subsequent to the granting of the option. Once again, the prevalence of stock options increased significantly.

1964

Revenue Act of 1964

Public concern over the significant gains realized by executives and pressure from the Kennedy administration to repeal the favorable tax treatment of restricted stock options.

Congress replaced restricted stock options with qualified stock options that required a post-exercise holding period of three years, eliminated the ability to lower exercise prices after date of grant, options would have maximum term of 5-years and no option could be exercised while a prior award was outstanding and unexercised.

1969

Tax Reform Act of 1969

Congress reacted to displeasure with high tax rates and lower the top marginal individual rate

The top marginal tax rate was gradually reduced to 50% and the capital gains rate was increased from 25% to 36.5%. Restricted and Qualified stock options now became tax preference items subject to the Alternative Minimum Tax.

MOTIVATION | **IMPACT**

1976

SEC exempts Stock Appreciation Rights from the short-swing profit rules

The required six-month holding period post-exercise of an option required the executive to pay tax upon exercise but not be able to monetize the gain. Prior to the 1976 rule, SARs were view as a violation of the short-swing profit rule (the six-month holding period was changed in 1991 to be from date of grant not date of exercise, thereby making SARs less attractive).

Increased the use of SARs as a form of equity-based compensation.

1978

SEC Proxy Disclosure Rules requiring the disclosure of perquisites

Perquisites were thought to be a form of stealth compensation hidden from investors and public outrage over the "three martini lunch."

Companies must now disclose perquisites if the total value exceeds $25,000 or 10% of pay. The IRS in 1979 issued new audit guidelines for auditing and taxing perquisites. Some companies decided to limit the value of perquisites to less than the required threshold for disclosure while other companies did not change their approach due to disclosure. Certain perquisites were reduced in prevalence (golf club memberships, luncheon clubs, etc.). There were also some high-profile tax cases of companies failing to disclosure and impute income for executive perquisites

1981

Economic Recovery Tax Act of 1981

Qualified stock options were phased out and Incentive Stock Options were allowed.

ISO grants were limited to $100,000 of stock and must be held for one year before exercise and cannot be sold within two years of grant. Gains were taxed at capital gains rates, but the company could not take a deduction for the gain.

1984

Deficit Reduction Act of 1984 adopting IRC §280G and §4999

Reaction to Bendix Golden Parachute for Michael Blumenthal that equaled five years' pay.

IRC §280G: non-deductibility of "excess parachutes" for payments that exceed 2.99 times the 5-year average W-2 of the executive §4999: 20% excise tax on excess parachute payments above one-times the 5-year average W-2 in addition to the executive's income tax. Initially, it was not uncommon for companies to gross-up the excise tax liability. Due to investor and proxy advisory pressure, companies no longer gross-up excise tax liability and have generally adopted a net best approach to dealing with excess parachute payments. There also has been a move to double trigger parachutes.

MOTIVATION | **IMPACT**

1985-86

Robert Monks founded ISS and Boone Pickens founded United Shareholders Association

In reaction to take-over activity and a view that the governance of executive compensation needed to be improved.

Increased investor pressure on the governance of executive pay.

1991

Revised SEC Proxy Disclosure Rules of 1991

Required tabular disclosure of executive compensation.

Refocused attention away from the narrative section of the pay disclosure and increased attention to the levels of pay ("the numbers").

1993

Omnibus Reconciliation Act of 1993 adopting IRC §162(m)

To encourage performance-based executive compensation in response to the declining competitiveness of American manufacturers and public concern over high pay.

For proxy disclosed executives (NEOs) company deduction for pay about $1MM was not deductible unless performance- based. Added the total pay column to the Summary Compensation Table, even though the total is a mix of actual pay and the accounting expense of contingent pay and the actuarial change in the expense associated with interest changes in defined benefit pension plans. The total pay column has resulted in pay for performance analysis being conducted based on this erroneous concept of total pay.

2000

Introduction of 10b5-1 plans

To provide an affirmative defense for executives against claims of insider trading.

Facilitated the trading of company equity by directors and officers by providing a potential way to trade without the appearance of timing trades based on material non-public information.

2002

Sarbanes Oxley Act of 2002

In reaction to the collapse of Enron and other companies accused of non-compliant financial disclosures and the call for clawback of executive pay in the face of financial misstatements.

SOX requires CEO and CFO certification of filed financial reports. The Act prohibits loans to executives and introduced an SEC-enforced clawback applied to CEO and CFO in the case of willful misconduct in financial filings.

MOTIVATION | **IMPACT**

2004

American Jobs Creation Act of 2004 adopting IRC §409A

Collapse of Enron and the withdrawal of deferred compensation by top executives as the company finances declined while employee stock holdings in 401K plans tanked.

§409A imposed significant limitations on access to funds in nonqualified deferred compensation arrangements, imposed a six-month waiting period for post-employment payments to a "specified employee" which generally includes the 50 most highly compensated officers.

2004

FAS123R (Now ASC718)

Reaction to the increased use of stock options requiring companies to recognize a compensation expense for stock options. Previously, stock options only factored into fully diluted EPS, as calculated under the Treasury Stock method

Companies generally cut back participation in stock options below the executive level and the percentage represented by stock options in executive long-term awards was reduced. In addition to the change in accounting, proxy advisory firms and certain investors do not view stock options as performance-based pay which was an additional contributor to the reduction in the use of stock options. Unfortunately, the reduced participation in stock options by employees below the executive level excluded them from the significant stock price appreciation experience of recent years.

2006

SEC Revised Proxy Disclosure Rules of 2006

Addition of the Compensation Discussion & Analysis section of the proxy statement and the Total Pay column in the Summary Compensation Table. The CD&A is intended to make shareholders feel as if they were in the room when pay decisions were made. The "what, why and how "of pay should be clearly explained in plain English.

The proxy disclosure of executive compensation is now a management report as opposed to a report of the compensation committee. Companies have increased their focus on telling their pay for performance story and the use of Executive Summaries, graphs and tables to reinforce the linkage of pay and performance.

2008

Troubled Asset Relief Program (TARP)

TARP was established to help stabilize the financial system, including addressing perceived risks in incentives within the financial sector that were believed to have contributed to the financial crisis.

For companies receiving TARP financial relief, TARP mandated say on pay, and reduced deductibility limits under 162(m). These compensation provisions paved the way for the compensation provisions of the Dodd-Frank Act that apply to corporations beyond TARP recipients.

MOTIVATION | **IMPACT**

2009

SEC Mandated Compensation Risk Disclosure

Reaction to the financial crisis of 2008/2009 and the belief that excessively risky executive incentives were a contributing factor to the financial crisis. Companies are required to disclose if incentive arrangements "are reasonably likely to have an adverse material impact on the company" and if so, actions taken to mitigate the potential for such risk.

Compensation Committees undertook a review of incentive plans to ensure pay arrangements do not motivate excessive risk. While not required, companies disclose in their CD&As that the committee has conducted a review of compensation programs and they do not believe the pay arrangements "are reasonably likely to have an adverse material impact on the company" and many companies disclose the mitigating factors that help guard against the potential for excessive risk. In the financial sector, stock option use has declined dramatically due to the view that stock options may motivate excessively risky behavior.

2010

Dodd-Frank Act

In reaction to the financial crisis of 2008/2009 and the belief that excessively risky executive incentives were a contributing factor to the financial crisis.

Increased use of performance-based equity (PSUs), decline in the use of options and a decrease in perquisites. There has been an increase in disclosure, shareholder engagement, and an increase in the influence and power of proxy advisory firms.

2011

Effective Date of Dodd-Frank Act Say on Pay

Following the financial crisis, the SEC implemented rules that require companies to allow shareholders to vote on the frequency with which they are provided the opportunity to vote on the company's compensation disclosure (say on pay). Shareholders can elect to have a say on pay vote every 1, 2 or 3 years. The vote is non-binding.

Shareholders have almost universally adopted annual say on pay votes. The desire by companies to receive strong shareholder support, and a "for recommendation" from proxy advisory firms has led to greater engagement with institutional investors, phasing out problematic pay practices, homogenization of long-term incentive plans with 50% or more of long-term incentives in the form of performance-based equity with relative shareholder-return as the most prevalent performance metric.

2017

Tax Cut and Jobs Act of 2017

Eliminated the performance exception under §162(m) and provided that if an executive officer is a Named Executive Officer the executive will forever be subject to §162(m) even if not a Named Executive Officer in subsequent years.

The elimination of the performance-based exception to §162(m) may have contributed to the continued decline in prevalence of stock options for NEOs and the increase in the use of restricted stock.

MOTIVATION

IMPACT

2018

Effective Date of Dodd-Frank Act Pay Ratio Disclosure

Companies must disclose the ratio of CEO pay to that of the median employee. Additionally, the pay of the median employee must be disclosed.

Aside from the cost and effort required to collect employee pay information globally, there has not been a discernable impact on CEO pay or the pay of employees in general.

2021

American Rescue Plan Act of 2021

The ARPA provides that beginning after Dec 31, 2026, in addition to the CEO, CFO and next highest paid "executive officers," the next five highest paid "employees" will be subjected to the limitations of §162(m) in the year they are among the five highest paid employees.

The impact of the disclosure of the next five highest paid employees will not be known until 2027 when the first proxy disclosures for the five highest paid "employees" will be required.

2023

Effective Date of Dodd-Frank Act Pay for Performance Disclosures

To provide a standardized disclosure of the relationship between NEO compensation and the financial and stock performance of the company.

The Pay for Performance rules are highly prescriptive and require complex annual valuation and disclosure of outstanding and vested equity-based incentives. Companies will also be required to disclose financial metrics required by the rule (TSR and Net Income) and metrics selected by the company as being the most important metrics for compensation decisions and provide a description as to the relationship of pay to these metrics (either graphically and/or as narrative) and the TSR return of peer companies (either companies used for compensation benchmarking as disclosed in the proxy or an industry index as disclosed in the 10-K).

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2023

Effective Date of Dodd-Frank Act Clawbacks

To ensure that executive officers do not benefit from incentive awards based on performance outcomes that are impacted by a material restatement due to non-compliance with financial reporting requirements (big R) or restated financials that do not rise to the level of requiring a material restatement of previously issued financial statements if left uncorrected (little R).

Most large companies have adopted clawbacks but there may need to be adjustments to comply with the Dodd-Frank clawback rules (e.g., remove the requirement of fault and limit board discretion to situations where a clawback would be impractical). Companies must formally adopt and disclose in the 10-K their compliant clawback policy. In the event of a restatement, companies must disclose in the proxy the date of the restatement, the amount of the clawback and how it was calculated, and the aggregate amount of uncollected amounts to be clawed back

2023

Effective Date of Changes to 10b5-1 Plans

Based on the belief that executives are using 10b5-1 plans as a shield to benefit from the timing of trades in company stock-based on the possession of material non-public information (MNPI) and that board may be timing the granting of options to avoid the granting of awards prior to the release of unfavorable information ("bullet dodging") or in advance of the release of favorable information ("spring-loading").

The 10b5-1 rules will reduce the attractiveness of such plans due to the 90-day cooling-off period, required certification that the director of officer is not aware of MNPI, and they acted in good faith. Additional restrictions on single-trade plans and disclosure requirements of 10b5-1 plans adopted or terminated in the year and the company policy on insider trading or why the company has not adopted and such a policy. There is also a requirement for stock options granted to NEOs in the four business days preceding the release of MNPI (including earnings) or one business day afterward. Executives will also be required to check a box on Forms 4 if trades were made pursuant to a compliant 10b5-1 trading plan. Similar disclosure on Form 5 is required for gifts of equity.

Sources: Murphy, Kevin J., ***Executive Compensation: Where We are, and How We Got There*** (August 12, 2012). George Constantinides, Milton Harris, and René Stulz (eds.), Handbook of the Economics of Finance. Elsevier Science North Holland (Forthcoming), Marshall School of Business Working Paper No. FBE 07.12, Available at SSRN: https://ssrn.com/abstract=2041679 or http://dx.doi.org/10.2139/ssrn.2041679, and Center On Executive Compensation, ***Long-Term Incentive Design: Where We Are, How We Got Here and An Assessment of Calls for Change*** (2017)

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Group Challenge #1: Reimagining Executive Pay

At the beginning of our session, we reviewed the various laws, regulations and rules that have helped shape the prevailing structure of executive compensation programs among large publicly traded companies. In many ways, the legislative, regulatory, accounting and tax influences have resulted in an overall lack of creativity and new ideas from the executive compensation firms. While not all the ideas promoted by consultants have been as helpful as hoped (think junior stock and reload options), the current state of practice, due in part ot the influence of proxy advisory firms, has led to increasing homogenization of incentive practices.

In view of prevailing “best practices” (orthodoxy), we want to challenge ourselves and explore potential new thinking and alternative ways (heresy) to structure executive pay. Given the newly introduced pay-for-performance disclosure mandated by the SEC, the complex and burdensome calculations corresponding to the valuation of long-term incentive awards, and the recent decline in favorable say on pay votes which may reflect decreased support of shareholders for the current structure of pay, the time may be ripe for new thinking and experimentation in the design of executive incentives.

You’ll be divided into three groups to provide your analysis, recommendations and rationale relating to the current and alternative approaches to the design of executive compensation. Once you’ve developed your recommendations and supporting arguments, the groups will reconvene and take turns presenting their ideas. After each group’s presentation, we’ll discuss the pros and cons of the recommended approach. Once all three groups have presented, we’ll consider all the ideas discussed and identify potential new ways to structure executive pay that may warrant further research and development by the Center.

Instructions for each Group are presented on the following pages.

Group 1:” I like what we have, if it isn’t broken, don’t try to fix it.”

The prevailing executive compensation model is typically comprised of:

- Salary (10% to 15% of CEO pay)
- Short-term incentives (15% to 25% of CEO pay), based on performance metrics representing a mix of financial and non-financial objectives.
- Long-term incentives (60% to 70% of CEO pay), based on a combination of market metrics (such as relative TSR) and financial metrics over a three-year performance period.

We think the prevailing structure of executive compensation should not change because:

1.

2.

3.

4.

5.

However, there are aspects of the current structure that are subject to criticism:

1.

2.

3.

To help mitigate these criticisms, potential changes to the design of executive pay that may be warranted include:

1.

2.

3.

Group 2:" While the structure of executive compensation is not totally broken, there are some changes we think should be explored."

The prevailing executive compensation model is typically comprised of:

- Salary (10% to 15% of CEO pay)
- Short-term incentives (15% to 25% of CEO pay), based on performance metrics representing a mix of financial and non-financial objectives.
- Long-term incentives (60% to 70% of CEO pay), based on a combination of market metrics (such as relative TSR) and financial metrics over a three-year performance period.

We think there are aspects of the prevailing structure of executive compensation that should be changed because:

1.

2.

3.

4.

5.

The specific changes we would suggest companies explore include:

1.

2.

3.

While the suggested areas of change are worth exploring, criticism of such changes may include:

1.

2.

3.

Assuming companies are willing to adopt the changes suggested, potential ways to help mitigate criticism may include:

1.

2.

3.

Group 3:" The prevailing structure of executive compensation is flawed and needs a total rethinking. Tinkering around the edges is a waste of time and now is the perfect time to start with a blank sheet of paper."

The prevailing executive compensation model is typically comprised of:

- Salary (10% to 15% of CEO pay)
- Short-term incentives (15% to 25% of CEO pay), based on performance metrics representing a mix of financial and non-financial objectives.
- Long-term incentives (60% to 70% of CEO pay), based on a combination of market metrics (such as relative TSR) and financial metrics over a three-year performance period.

We think the current approach to designing executive compensation is outdated and is not helpful to serving the interests of investors and other stakeholders because:

1.
2.
3.
4.
5.

Starting from scratch, we would recommend the following structure of executive pay:

1.
2.
3.

While these seemingly radical changes to the executive pay model are overdue, such chnges may generate criticisms, including:

1.
2.
3.

Assuming companies are willing to push the envelope in executive compensation design, potential ways to help mitigate the resulting criticism may include:

1.
2.
3.

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Group Challenge #2: Implications for the Profession

During Day One of our session, we examined the factors influencing the current state of executive compensation, focusing on how legislative, regulatory, accounting and tax considerations have contributed to the increasing homogenization of pay design. Using that historical understanding as a basis, we then challenged ourselves to imagine how the time may be right for new thinking in the design of executive pay.

As the practice of executive compensation continues to change, the role of the practitioner will evolve as well. In 2022, the Center published a study that examined how the Head of Total Rewards role has developed over time. The study showed that while the scope of the role had evolved into a true strategic partner, executive compensation remained the primary focus of most incumbents. Today's head of total rewards is expected to be both a trusted advisor and technical expert, playing a pivotal role with both the C-Suite and the Compensation Committee of the Board.

For our second group challenge, we'll focus on thinking about how the future of executive pay may shape the experiences, expertise, and careers of tomorrow's practitioner.

Your Challenge

Part 1: The Future Profile

Considering our discussion about the evolution of executive compensation and thinking five years into the future, create a profile of an ideal candidate to lead executive compensation in a large, US-based, global organization. Address the following and for each identify what will be the same as today and what aspect will be new and why:

- Desired academic background
    - What will be the same? What will be new and why?
- Essential knowledge and skills
    - What will be the same? What will be new and why?
- Required experience
    - What will be the same? What will be new and why?
- Leadership capabilities needed for success
    - What will be the same? What will be new and why?

Profile – Head of Executive Compensation (2028)

Knowledge, Skills, and Capabilities

Experiences

Leadership Competencies

Academic Background

Part 2: Building the Pipeline

Using the profile created in Part 1, identify some key actions companies can take to identify potential talent and provide key experiences that will help prepare them to meet the challenges that will face the future executive compensation practitioner.

Where may future executive compensation practitioners be found – outside of our traditional HR pipeline?

What developmental experiences will we want the future practitioner to have that may not have been part of today's incumbent's career?

For the Center's Executive Compensation training initiatives, what are the new topics/skills we should consider adding to the learning agenda?

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Reflections – Day One

What are the key observations you took away from our discussion about the historical development of executive compensation? How might those influence how we think about the practice of executive compensation in the future?

The presence of multiple influential stakeholders is a defining characteristic of executive pay. What insights or observations do you have about how the relative importance of key stakeholders has shifted over time?

Reflections – Day One

In view of the diversity of stakeholder interests and perspectives, how does/would your company go about deciding which of the stakeholder views should be given greater weight?

Is executive compensation heading into a period of relative stability, transformational change, or somewhere in between? Why?

Reflections – Day Two

Did our conversations on how the practice of executive compensation may change in the future influence how you are thinking about your role going forward? If so, how?

Which aspect of how executive compensation is currently structured or communicated that you feel is most ripe for change? Why, and what would be the most likely change you would foresee?

Reflections

How might the practice of executive pay be influenced by the continuing debate on the purpose of the corporation?

What are your key takeaways from our time together?

What can the Center do to continue to advance our profession?