Welcome

Agenda

Tuesday, May 16

12:30 pm	**Exploring our "Why?"**
1:30 pm	**Where Are We Now?**
2:30 pm	*Break*
2:40 pm	**Stakeholder Spotlight**
3:10 pm	**Group Challenge #1: Reimagining Executive Pay**
4:30 pm	**Present Group Findings**
6:30 pm	**Cocktails and Dinner**

EXECUTIVE COMPENSATION
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Agenda

Wednesday, May 17

8:00 am	**Breakfast and Day One Reflections**
8:45 am	**Group Challenge #2: Implications for the Profession**
9:45 am	*Break*
10:00 am	**Shareholders or Stakeholders?**
10:30 am	**Bringing It All Together: The Future of Executive Compensation**
12:00 pm	**Reflections and Wrap Up**

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Exploring our “Why?”

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Where Are We Now?

EVENTS THAT HAVE SHAPED EXECUTIVE COMPENSATION

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In your view, what were the three tax, accounting or legislative/ regulatory requirements that had the most significant impact on the design of executive compensation?

For each of the three requirements, answer the following:

- What was the impact of this event/change?
- Do you believe it improved the design of executive compensation?

What do you think may be the next major change that would impact the design of executive pay?

KEY LAWS AND REGULATIONS IMPACTING EXECUTIVE COMPENSATION

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)

1950 Revenue Act of 1950

Motivation

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%).

Impact

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 at capital gains rate of 25%. Following the passage of the 1950 Act 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.

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1954 Revenue Act of 1954

Motivation

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

Impact

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 after grant. Once again, the prevalence of stock options increased significantly.

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1964 Revenue Act of 1964

Motivation

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.

Impact

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.

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1969 Tax Reform Act of 1969

Motivation

Congress reacted to public displeasure with high tax rates and lowered the top marginal individual rate.

Impact

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

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1976 SEC exempts Stock Appreciation Rights from short-swing profit rules

Motivation

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 viewed as a violation of the short-swing profit rule (the six-month holding period for options was changed in 1991 to be from date of grant not date of exercise, thereby making SARs less attractive by comparison).

Impact

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

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1976 SEC exempts Stock Appreciation Rights from short-swing profit rules
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1978 SEC Proxy Disclosure rules requiring disclosure of perquisites

Motivation

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

Impact

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 to less than the required threshold for disclosure while other companies did not change their approach. Certain perquisites were reduced in prevalence (golf club memberships, luncheon clubs, etc.). There were also some high-profile tax cases of companies failing to disclose and impute income for executive perquisites.

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1981 Economic Recovery Tax Act of 1981

Motivation

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

Impact

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.

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1981 Economic Recovery Tax Act of 1981
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1984 Deficit Reduction Act of 1984 adopting IRC §280G and §4999

Motivation

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

Impact

IRC §280G: non-deductibility of "excess parachutes" for payments that exceed 2.99 times the 5-year average W-2 of 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.

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1984 Deficit Reduction Act of 1984 adopting IRC §280G and §4999
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Founding of ISS and United Shareholders Association

1985-86

Motivation

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

Impact

Increased investor pressure on the governance of executive pay.

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1991 Revised SEC Proxy Disclosure Rules of 1991

Motivation

Required tabular disclosure of executive compensation.

Impact

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

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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)

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

Motivation

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

Impact

For proxy executives (NEOs) company deduction for pay above $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.

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1993 Omnibus Reconciliation Act of 1993 adopting IRC §162(m)
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2000 Introduction of 10b5-1 plans

Motivation

Provide an affirmative defense for executives against claims of insider trading.

Impact

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

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2002 Sarbanes Oxley Act of 2002

Motivation

Reaction to the collapse of Enron and others accused of non-compliant financial disclosures and the call for clawback of executive pay in the face of financial misstatements.

Impact

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.

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2004 American Jobs Creation Act of 2004 adopting IRC §409A

Motivation

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

Impact

§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.

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2004 FAS123R (Now ASC718)

Motivation

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.

Impact

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.

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2006 SEC Revised Proxy Disclosure Rules of 2006

Motivation

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.

Impact

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.

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2008 Troubled Asset Relief Program (TARP)

Motivation

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.

Impact

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.

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2009 SEC Mandated Compensation Risk Disclosure

Motivation

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.

Impact

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 excessive risk. In the financial sector, stock option use has declined dramatically due to the view that stock options motivate excessively risky behavior.

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2010 Dodd-Frank Act

Motivation

In reaction to the financial crisis of 2008/2009 and the belief that excessively risky executive incentives contributed to the financial crisis.

Impact

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

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2011 Effective Date of Dodd-Frank Act Say on Pay

Motivation

Following the financial crisis, the SEC implemented rules that require companies to allow shareholders to vote on the frequency with which they 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.

Impact

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 advisors has led to greater engagement with investors, phasing out problematic pay practices, homogenization of long-term incentive plans with 50% or more in performance-based equity with relative shareholder-return as the most prevalent metric.

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2017 Tax Cut and Jobs Act of 2017

Motivation

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.

Impact

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.

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KEY LAWS AND REGULATIONS IMPACTING EXECUTIVE COMPENSATION

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)

2018 Effective Date of Dodd-Frank Act Pay Ratio Disclosure

Motivation

Companies must disclose the ratio of CEO pay to that of the median employee as well as the pay of the median employee.

Impact

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.

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2018 Effective Date of Dodd-Frank Act Pay Ratio Disclosure
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KEY LAWS AND REGULATIONS IMPACTING EXECUTIVE COMPENSATION

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)

2021 American Rescue Plan Act of 2021

Motivation

The ARPA provides that 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.

Impact

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

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2021 American Rescue Plan Act of 2021
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KEY LAWS AND REGULATIONS IMPACTING EXECUTIVE COMPENSATION

2023 Effective Date of Dodd-Frank Act Pay Versus Performance Disclosures

Motivation

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

Impact

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

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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Effective Date of Dodd-Frank Act Pay Versus Performance Disclosures

KEY LAWS AND REGULATIONS IMPACTING EXECUTIVE COMPENSATION

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2023 Effective Date of Dodd-Frank Act Clawbacks

Motivation

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).

Impact

Most large companies have adopted clawbacks but there may need to be adjustments to comply with the Dodd-Frank 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.

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2023 Effective Date of Dodd-Frank Act Clawbacks
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KEY LAWS AND REGULATIONS IMPACTING EXECUTIVE COMPENSATION

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2023 Effective Date of Changes to 10b5-1 Plans

Motivation

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 the board may be timing option grants to avoid the grants prior to the release of unfavorable information ("bullet dodging") or in advance of the release of favorable information ("spring-loading").

Impact

The 10b5-1 rules will reduce the attractiveness of such plans due to the 90-day cooling-off period and required certification that the director or officer is not aware of MNPI and 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.

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2023 Effective Date of Changes to 10b5-1 Plans

Stakeholder Spotlight

STAKEHOLDER SPOTLIGHT

EXECUTIVE COMPENSATION
H·O·N·O·R·S

The Politics of Executive Pay

Jerry Markham, Professor of Law (2011)

- **Basic premise: the liberal ideology of wealth distribution is the real motivating force attempts to restrain executive pay and populist appeals to the unfairness of pay disparity are used to conceal this true motive**
- **Also: the effect of almost all attempts at legislating/regulating pay has resulted in higher pay and greater disparity**

"The dream of wealth redistribution from the business class was a disaster under the harsh lash of communist ideology. It has also failed to date under the modern doctrine of "social justice." Despite all the efforts of the wealth redistribution crowd, the concentration of wealth in the United States is now at the highest level since 1929."

STAKEHOLDER SPOTLIGHT

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Age of Stakeholder Capitalism

Sarah Murray, Moral Money Forum, Financial Times (2022)

- Basic premise: massive pay inequality is inherently bad because it is a destabilizing factor and societal risk
- High CEO pay detaches executives from reality, negatively affects judgement, and may work against intrinsic motivation to "do the right thing" for society and the planet
- Solutions could include:
  - Selecting fewer ESG metrics and tying more long-term pay to them
  - Eliminating performance shares and sticking with long-term restricted stock
  - Increasing ways frontline workers can benefit from equity growth or overall company success

Discussion Topics

STAKEHOLDER SPOTLIGHT

EXECUTIVE COMPENSATION
H·O·N·O·R·S

- Discussion Topics
  - What are the risks of pay inequality long-term?
  - Which stakeholders should be prioritized? How do we make this decision?
  - Is there a difference between the stakeholders we should consider when setting public goals (for example, to increase diverse leadership representation) and when setting incentive-specific goals (which are primarily financial in nature)?
  - What does it mean to maximize stakeholder value versus shareholder value?

Group Challenge #1: Reimagining Executive Pay

WHAT THE LEADING EXPERTS ARE THINKING

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Ira Kay

Pay Governance

- **Core incentive design structure will remain relatively unchanged**
  - Success of US stock market, strong shareholder support, motivational impact for executives
- **The use of metrics will remain relatively intact**
  - The use of relative TSR and profit measures will plateau
  - ESG metrics will grow and remain controversial, with innovation as data standardization progresses
- **Corporate governance practices will continue - and will face scrutiny relating to:**
  - share buybacks
  - timing of executive stock sales
  - termination pay
  - diversity of C-Suite

WHAT THE LEADING EXPERTS ARE THINKING

EXECUTIVE COMPENSATION
H·O·N·O·R·S

George Paulin

Meridian Compensation Partners

- **Shift in influence from proxy advisors to institutional investors**
  - More sophistication in pay-performance analyses, including real time year over year review
  - Enhanced focus on how above-target pay correlates to revenue, profit and other metrics
- **Counter-offers and special awards will increase as non-competes eliminated**
- **New disclosures (P4P, HCM) will continue to expand proxy, which could create opportunity to reform and streamline**
- **Increased focus on human capital by Comp Committees could:**
  - Have implications for accounting
  - Require more committee member time and advisor expertise, leading to relaxation of independence rules
  - Increase director pay

WHAT THE LEADING EXPERTS ARE THINKING

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Daniel Ryterband

FW Cook

- **Shift away from homogeneous compensation design will require:**
  - Strong shareholder engagement programs with constructive dialogue and building of mutual trust
  - Less reliance on market practice and peer precedents
  - Incremental explanation to investors to describe rationale behind decisions
- **Shareholders will continue to scrutinize certain practices that seem in conflict with a performance-oriented culture**
  - Special awards
  - Severance payments at retirement
  - Excessive severance
  - Use of compensation committee discretion
  - Failure to set robust performance targets

WHAT THE LEADING EXPERTS ARE THINKING

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Blair Jones

Semler Brossy

- **A more “forward-looking” approach to pay/performance focused on wealth creation potential will support better program design**
  - Test the need for special awards
  - Strengthen communication of program value
- **Changes in the use of metrics**
  - Non-financial metrics (including ESG) will grow in prevalence
  - ESG metrics will go beyond DE&I and be more quantifiable
  - Emerging metrics tied to strategic priorities and company mission - innovation, entering new channels, new product development
  - More focus on relative financial metrics (gross margin, EPS, ROIC)
- **Performance share usage remains status quo**
- **Investor frustration with retirement extension and special awards to allow time for success will result in increased Board attention to succession pipeline and rewarding high performers**

Agenda

Wednesday, May 17

8:00 am	**Breakfast and Day One Reflections**
8:45 am	**Group Challenge #2: Implications for the Profession**
9:45 am	**Break**
10:00 am	**Shareholders or Stakeholders?**
10:30 am	**Bringing It All Together: The Future of Executive Compensation**
12:00 pm	**Reflections and Wrap Up**

EXECUTIVE COMPENSATION
H·O·N·O·R·S

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Group Challenge #2: Implications For The Profession

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Shareholders or Stakeholders?

SHAREHOLDERS OR STAKEHOLDERS?

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Milton Friedman

The Social Responsibility of Business is to Increase Profits (1970)

- Seminal work on the role of the corporation
- Corporate executives' primary responsibility is to agents of the individuals who own the company…and to make as much money as possible
- "Social responsibilities" are the obligation of individuals, not business, and spending "social" money is not serving as an agent of stockholders
- "Social interests" are best served in the political process and not through market mechanisms
- Role of corporate executives vs. civil servants

SHAREHOLDERS OR STAKEHOLDERS?

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Business RoundTable

Statement on the Purpose of a Corporation (2019)

- **Each company serves its own corporate purpose, yet share a fundamental commitment to all stakeholders**
  - **Delivering value to our customers**
  - **Investing in our employees (rewards, training, education while fostering diversity, inclusion, dignity and respect)**
  - **Dealing fairly and ethically with our suppliers**
  - **Supporting the communities in which we work (protect the environment)**
  - **Generating long-term value for shareholders**

Discussion Topics

SHAREHOLDERS
OR
STAKEHOLDERS?

- Discussion Topics
  - Does the doctrine of shareholder primacy remain appropriate in today's environment?
  - How does the multi-stakeholder approach impact executive compensation…and where will its impact be felt 3-5 years from now?

EXECUTIVE COMPENSATION
H·O·N·O·R·S

EXECUTIVE COMPENSATION
H·O·N·O·R·S

Bringing It All Together

Thank You

EXECUTIVE COMPENSATION
H·O·N·O·R·S