Executive Compensation Trends: What's Next?

Published on Alvarez & Marsal (https://www.alvarezandmarsal.com)

Over the last two years, the scrutiny and examination of corporate executive compensation has increased exponentially. The increased scrutiny began during the banking crisis and the economic downturn in late 2008 to early 2009. Shareholders wanted to increase the alignment between their interests and the compensation paid to executives running the companies. Regulators wanted to develop a set of standards to deter executives from taking risks that might increase their compensation but hurt the company's long–term stability.

Some hot topics now affecting executive compensation include:

- "Say on Pay";
- New Securities and Exchange Commission (SEC) disclosure rules for risk management policies;
- Increased emphasis on shareholder advisory groups;
- Changes in severance provisions and "change in control" policies;
- Transformations in long–term incentive plans; and
- Decreases in and the potential elimination of executive perquisites and benefits.

"Say on Pay"

The Dodd–Frank Wall Street Reform and Consumer Protection Act (the Act) imposes the "say on pay" concept on public companies. The "say on pay" concept has been prevalent in Europe for a while. The Act provides that effective for the first shareholder meeting held on or after January 21, 2011, companies must have a non–binding vote for shareholder approval of the named executive officers' (NEOs') compensation. "Say on pay" votes must take place every one, two or three years, the frequency of which is determined by shareholders. Every six years, a company's annual proxy statement must include a separate resolution to determine how frequently the "say on pay" votes will occur.

When shareholders are asked to approve a merger, acquisition, consolidation or proposed disposition of all or substantially all of a company's assets, the shareholders must also vote on golden parachutes. As part of the vote, shareholders must receive disclosure of any agreements or arrangements the company has with NEOs concerning compensation that relates to the transaction, as well as the aggregate total compensation that may be paid and the conditions upon which it may be paid. A separate non–binding shareholder vote should be held to approve any such agreements, unless the agreements were subject to an earlier non–binding "say on pay" vote.

These votes do not bind the company or the board of directors; however, having the majority of shareholders vote "no" on these executive compensation issues should prompt the company and the board of directors to immediately revisit the proposed compensation packages and practices.

The Act also limits voting by brokers of shares they do not beneficially own. The SEC will prohibit brokers from exercising voting shares in any election of directors (other than an uncontested election for an investment company), on executive compensation matters and on other "significant" matters. The voting limitations placed on brokers should be considered by companies prior to "say on pay" votes.

The Act provides for new enhanced independence requirements that will:

- Limit compensation committee members to independent directors only;
- Permit compensation committees, in their sole discretion, to hire compensation consultants, legal or other advisors and have the funds available to pay for the advisors, provided that the committee considers the "independence" of its advisors prior to engagement; the SEC will provide guidance as to how committees should determine independence. Some factors that committees should consider include:
  - Whether other services are provided to the company by the consultant or advisor,
  - The amount of fees received by the individual or consulting firm as a percentage of the individual's or consulting firm's total revenue,
  - Any business or personal relationship with the consultant or advisor and a member of the committee, and
  - Any company stock owned by the consultant or advisor; and
- Disclose in proxy statements (per SEC regulations) of whether the compensation committee has used the advice of a consultant or advisor, whether the work of the consultant or advisor raised any conflicts, and how the conflicts were addressed.

The Act directs the SEC to adopt or amend existing regulations to require the following additional proxy statement disclosures:

- A clear description of "pay for performance" that shows the relationship between executive compensation paid and the company's financial performance, taking into account the value of the company's shares, dividends and distributions;
- An internal pay equity calculation showing the ratio between the median of "annual total compensation" for all employees other than the chief executive officer (CEO) and the "annual total compensation" for the CEO; and
- A disclosure on whether employees and/or directors are permitted to purchase financial instruments designed to hedge or offset decreases in the market value of company stock that was granted to the employee and/or board member as compensation or is held (directly or indirectly) by the employee or board member. This enhances and expands the SEC disclosure requirement put in place in 2006 requiring companies to disclose whether they have a policy governing an executive's hedging of share ownership.

Last, public companies must adopt and implement a qualifying compensation clawback policy. If a company fails to comply, the SEC will direct the national securities exchanges and associations to prohibit the listing of any equity security of the company. The clawback policy expands the requirements in Section 304 of the Sarbanes–Oxley Act of 2002 and requires that in the event of an accounting restatement, the company will recover compensation paid to current or former executives in the three–year period preceding the date of the restatement. The clawback policy must also require the company to recover any amount that exceeds that which would have been paid to the executive after the effect of the restatement. The company must also disclose its policy on incentive–based compensation based on company financial information.

Risk Management Policies

New SEC disclosure rules now require companies to disclose details about compensation programs in the 2010 proxy season that were "reasonably likely to have a material adverse effect" on the company. This requirement applies to compensation programs for all employees, not just for named executive officers. Companies should look at how their compensation programs could drive internal and/or external risks to the company. The company could have risk in the outcomes the compensation plans' drive and in the process on which they are based. All types of risk associated with compensation plans and their outcomes should be reviewed.

Many companies are conducting audits of their existing compensation programs to determine the types of risk associated with their programs and how company risk might be minimized based on their overall compensation program and its balance between short– and long–term incentives. In addition to audits, companies are trying to mitigate risk through a variety of methods, like reviewing incentive plan measures, incorporating different types of incentive vehicles and reviewing incentive award opportunity.

Out of 100 large public companies (with revenues of $14.5 billion and greater) surveyed in a recent study, the vast majority cited tying long–term performance to compensation as a risk management policy. Many companies also said that stock ownership guidelines for executives contributed to their company's risk management strategy. Large numbers of companies also cited the balance between short– and long–term incentives and compensation clawbacks as ways to control compensation risk.

Shareholder Advisory Groups
Institutional shareholder advisory groups such as RiskMetrics Group and Glass Lewis continue to influence executive compensation trends by continually redefining "best practices." These advisory groups typically update their "best practices" each year based on regulatory changes and provide detailed commentary and descriptions for member companies. These groups provide models that help companies compare their company practices to other companies. The advisory groups also perform "pay for performance" reviews. With the advent of the "say on pay" rules, these advisory groups will become even more critical to companies in determining the acceptability of their compensation packages to shareholders. Boards of directors, independent consultants and advisors typically rely on much of this information to provide guidance on compensation and other governance decisions.

Beginning in 2010, RiskMetrics Group launched its "Governance Risk Indicators" (GRId) risk assessment tool to assess companies in four areas: board of directors' structure, compensation, shareholder rights and audit. The GRId tool highlights the impact of particular areas under each of the four areas and provides an overall assessment of concern. These tools tend to start trends and set standards among companies.

Severance and Change in Control Policies
Heightened public awareness and pressure from shareholder advisory groups has led to changes in severance and change in control policies among companies. Shareholder advisory groups and "best practices" established by many independent consultants view severance and change in control payments that exceed three times base salary plus target bonus a "poor" pay practice. There has also been a trend to disapprove of new or materially amended arrangements that provide for excise tax gross–ups. The public has a poor view of high–level executives receiving extremely high payments upon departing companies no matter the reason.

The shows that the prevalence of severance arrangement for CEOs (i.e., CEOs of top 500 companies as gathered through proxy statements) in excess of three times base salary plus target bonus decreased 10 percent from 2007 to 2009. This trend was the same for other named executive officers. This report also revealed that excise tax gross–ups decreased by 5 percent for CEOs and 2 percent for other named executive officers from 2007 to 2009. Most companies continue to review their severance and change in control practices in light of changing practices in their industry and peer groups as well as heightened public scrutiny.

Long-Term Incentive Plans
Over the past few years, companies have changed some of their long–term incentive plan design practices. Some of the changes companies have made include:

- Shifting to performance–based vesting of awards versus time–based vesting, something that many shareholder advisory groups believe supports a true pay for performance strategy;
- Shortening performance periods to assist with more accurate goal setting based on market uncertainty;
- Moving to index performance measures versus peer group measures to take into account the overall movement of the market and a company's relative movement to others;
- Adopting multiple types of long–term incentive vehicles versus having only one vehicle to provide greater balance in goals and risk; and
- Incorporating cash–based long–term incentive plans to conserve shares and target specific long–term goals that might not be captured through stock growth (the accounting treatment of these plans is viewed as less attractive, so many companies use these plans not as a main component of their long–term incentive program, but typically as a smaller component).

Long–term incentive plan design continues to change based on shareholder alignment, market uncertainty, pay for performance linkage and risk considerations. Companies should continue to review their long–term incentive plans based on their business strategy, pay philosophy and market conditions. However, it is important for companies to keep all of their incentive programs simple and focused to yield the desired results from executives.

Executive Perquisites and Benefits
Based on new change in disclosure regulations and increased disclosure of executive perquisites in proxy statements over the

last two years, the public has heavily scrutinized this element of executive compensation. Executive perquisites and benefits can include car allowances, country club memberships, executive physical examinations, executive pension benefits, supplemental executive retirement plans, personal use of corporate airplanes and related tax gross–ups. Perquisite values reported in proxy statements can range from nothing up to millions of dollars; however, from 2008 to 2009 the value of perquisites in Fortune 100 companies dropped over 28 percent, and over 34 percent of companies mentioned eliminating some perquisites in their 2009 proxy statements (based on information from actual proxy statements).

As a result of public perception and the visibility of executive perquisites, many companies have eliminated many perquisites. Some companies have provided additional cash to executives to make up for the loss of the perquisites, while others have not. Some companies provide very limited perquisites and offer substantiation in the proxy statement as to why continuing to offer the perquisites is important.

Personal use of aircraft is one perquisite that has decreased drastically in prevalence and value over the last two years in most companies. Tax gross–ups or the practice of companies paying the taxes on particular forms of compensation incurred by executives has also declined in prevalence, but is still being offered in some form at many Fortune 100 companies.

Only two types of perquisites experienced an increase in value in the 2009 proxy statements for Fortune 100 companies: accumulated pension benefits and nonqualified deferred compensation plans. The majority of Fortune 100 companies offer both of these types of plans to executives.

Most companies want to minimize the attention that executive perquisites receive from the public in their proxy statements, even though the associated value is usually not as great as other forms of compensation.

Alvarez & Marsal Taxand Says:
We believe regulatory guidance on executive compensation will continue to evolve over the next few years, especially as companies implement “say on pay.” It is important for companies to be flexible and stay nimble when reviewing their compensation programs and pay practices. Many of the disclosure regulations tend to influence compensation design practices, but they should not be the sole driver of compensation design. Companies need to continue to move toward a path that clearly shows the connection between pay for performance and company results, while balancing the risk to the company.

Disclaimer
As provided in Treasury Department Circular 230, this publication is not intended or written by Alvarez & Marsal Taxand, LLC, (or any Taxand member firm) to be used, and cannot be used, by a client or any other person or entity for the purpose of avoiding tax penalties that may be imposed on any taxpayer.

The information contained herein is of a general nature and based on authorities that are subject to change. Readers are reminded that they should not consider this publication to be a recommendation to undertake any tax position, nor consider the information contained herein to be complete. Before any item or treatment is reported or excluded from reporting on tax returns, financial statements or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisors. The information reported in this publication may not continue to apply to a reader's situation as a result of changing laws and associated authoritative literature, and readers are reminded to consult with their tax or other professional advisors before determining if any information contained herein remains applicable to their facts and circumstances.

About Alvarez & Marsal Taxand
Alvarez & Marsal Taxand, an affiliate of Alvarez & Marsal (A&M), a leading global professional services firm, is an independent tax group made up of experienced tax professionals dedicated to providing customized tax advice to clients and investors across a broad range of industries. Its professionals extend A&M's commitment to offering clients a choice in advisors who are free from audit–based conflicts of interest, and bring an unyielding commitment to delivering responsive client service. A&M Taxand has offices in major metropolitan markets throughout the U.S., and serves the U.K. from its base in London.

Alvarez & Marsal Taxand is a founding member of Taxand, the first global network of independent tax advisors that provides multinational companies with the premier alternative to Big Four audit firms. Formed in 2005 by a small group of highly respected tax firms, Taxand has grown to more than 2,000 tax professionals, including 300 international partners based in nearly 50 countries.

To learn more, visit www.alvarezandmarsal.com [2] or www.taxand.com [3].

Source URL: https://www.alvarezandmarsal.com/insights/executive-compensation-trends-whats-next

Links
[1] https://www.alvarezandmarsal.com/insights/executive-compensation-trends-whats-next
[2] https://www.alvarezandmarsal.com/
[3] http://www.taxand.com/

Authors:
J.D. Ivy, jivy@alvarezandmarsal.com, +1 214 438 1028
Brian Cumberland, bcumberland@alvarezandmarsal.com, +1 214 438 1013

