

# What's New in Executive Compensation:

## The Influence of Pension Funds and Shareholder Advisory Services in Shaping Executive Compensation – U.S. Perspective

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# OVERVIEW

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- Focusing on Executive Pay – Why is it an Issue?
- U.S. Legislative Attempts to Reduce Executive Pay
- Why Pension Plans Care About Executive Pay
- Shareholder Initiatives to Limit Executive Compensation

# FOCUSING ON EXECUTIVE PAY – WHY IS IT AN ISSUE?



# FOCUSING ON EXECUTIVE PAY- WHY IS IT AN ISSUE?

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- Continued growth in executive compensation over the last 30 years
- 2012 study showed that top 1% of wage earners grew 156% from 1979 to 2007 and for the top 0.1%, wages grew 362%
- A study by *Bloomberg* in 2013 found that CEO compensation at large public companies was on average 204 times pay for rank and file workers

# FOCUSING ON EXECUTIVE PAY –WHY IS IT AN ISSUE?

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- *Wall Street Journal*\* article on June 2, 2016 reported:
  - Median CEO compensation slipped 4.6% in 2015
  - Link between annual compensation and shareholder return remained weak
  - Of the 10 highest paid CEOs, only three CEOs led a company in top 10% of shareholder return
  - Best performing CEOs received *lowest* median compensation for the year, at \$10.2 million

\* Theo Francis & Joann S. Lublin, *CEO Pay Shrinks 4.6% but Offers Weak Reflection of Performance*, Wall St. J., June 2, 2016, <http://www.wsj.com/articles/ceo-pay-shrinks-4-6-but-offers-weak-reflection-of-performance-1464880505>

# U.S. LEGISLATIVE ATTEMPTS TO REDUCE EXECUTIVE PAY

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- Congress has made numerous attempts to reduce compensation paid to executives through enacting U.S. Internal Revenue Code provisions:
  - Section 162(m) – Limits company deduction for certain top executives' compensation to \$1,000,000
  - Section 280G – Taxes certain payments received upon a change in control of a corporation if the payments exceed 3 times a “base amount”
  - Section 409A and Section 457A – Developed complex rules for certain deferred compensation arrangements, which can include severance pay and certain types of equity awards

# U.S. LEGISLATIVE ATTEMPTS TO REDUCE EXECUTIVE PAY

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- With Sarbanes Oxley (“SOX”) Section 304, the U.S. securities laws implemented provisions that would require clawback of executive compensation if there is a financial restatement and prohibited loans to executives
  - 12 month look-back
  - Requires misconduct (but not necessarily of the person subject to the clawback)
  - Applies to CEO and CFO for incentive compensation and stock sale proceeds
- Some instances where clawback has been enforced, but has not limited compensation amounts



# U.S. LEGISLATIVE ATTEMPTS TO REDUCE EXECUTIVE PAY

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- Then Dodd-Frank was enacted, which has resulted in:
  - Say on Pay – Requires non-binding shareholder vote not less than once every three years to approve compensation of executives
  - Proposed Pay for Performance Rules – Requires disclosure of relationship between executive compensation actually paid and the financial performance of the company
  - Pay Ratio Rules - Requires disclosure of median of annual total compensation for all employees (other than CEO), compensation of CEO and ratio between the two
  - Compensation Committees and Comp Disclosures - Requires compensation committee independence
  - Proposed Clawback Rules

# U.S. LEGISLATIVE ATTEMPTS TO REDUCE EXECUTIVE PAY

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- Dodd-Frank Clawbacks If Public Company
  - Proposed Rule 10D-1 issued July 1, 2015
    - Clawback triggered by accounting restatement
    - Applies to “incentive-based compensation” received by an “executive officer” during the three fiscal years preceding date of restatement
    - “No-fault” clawback (applies even if no wrongdoing by executive)
    - Clawback on pre-tax amount
    - No indemnification of officer allowed relating to clawback
    - 3 year look-back

# U.S. LEGISLATIVE ATTEMPTS TO REDUCE EXECUTIVE PAY

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- Increased securities disclosures required by SOX and Dodd-Frank have resulted in more detailed information regarding executive pay practices being available to shareholders
- Has the increased disclosure worked?
  - Proxies and public filings are difficult to read and can be overwhelming to a non-institutional shareholder
  - Shareholder advisory firms and institutional shareholders have used the say on pay vote to voice issues with executive compensation practices

# WHY PENSION PLANS CARE ABOUT EXECUTIVE PAY

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- While executive compensation has grown, pension fund assets have also continued to grow:
  - 1993:      Public pension funds – approximately \$1.3 trillion  
                Private pension funds - approximately \$2.3 trillion
  - 2011:      Public pension funds - approximately \$4.3 trillion  
                Private pension funds - approximately \$6.3 trillion
  - 2013:      Total pension assets - approximately \$18 trillion
  - 2015:      Total pension assets - approximately \$24.9 trillion

# WHY PENSION PLANS CARE ABOUT EXECUTIVE PAY

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- A Willis Towers Watson\* study of global pensions published in 2016 found:
  - Global pension assets equaled approximately USD \$35,316 billion and accounted for 80.0% of the GDP of the countries in the study
  - The study reviewed 19 major pension markets, including, Australia, Canada, Japan, Netherlands, Switzerland, UK and US (which comprised 92.9% of total assets)

\*Nicholas Tan, CFA, Global Pension Assets Study 2016, Willis Towers Watson (Feb. 2, 2016), <https://www.slideshare.net/fullscreen/TowersWatson/global-pension-assets-study-2016/1>

# WHY PENSION PLANS CARE ABOUT EXECUTIVE PAY

- Various studies indicate that the largest asset class held by both public and private pensions is equities.
- In 2015, typical asset allocations were:
  - 50% – 55% equities
  - 35%– 40% bonds
  - 10% – 15% other
  - 2% – 5% cash



# WHY PENSION PLANS CARE ABOUT EXECUTIVE COMPENSATION

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- The U.S. Employee Retirement Income Security Act (“ERISA”) requires that a fiduciary, among other things: discharge his duties:
  - solely in the interest of the participants and beneficiaries
  - with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims
- U.S. Department of Labor has stated that fiduciary act of managing assets that are shares includes voting proxies relating to those shares



# SHAREHOLDER INITIATIVES TO LIMIT EXECUTIVE COMPENSATION

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# SHAREHOLDER INITIATIVES TO LIMIT EXECUTIVE COMPENSATION

- Institutional Shareholders Services will recommend a “no” vote if there are “problematic pay practices”
  - Gross up provisions
  - Single trigger vesting upon a change in control
  - Multi-year guaranteed payments
  - Excessive perquisites
  - Change in control payments in excess of 3x
  - Severance upon voluntary termination
  - Multi-year guaranteed pay increases
  - Large bonuses without performance component
  - Tax reimbursements
  - Allowing retired NEOs to continue to participate in the plans for performance period during which retirement occurred



# SHAREHOLDER INITIATIVES TO LIMIT EXECUTIVE COMPENSATION

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- The pressure from these shareholder advisory groups has caused many changes in executive compensation:
  - Rarely do new programs have gross ups
  - Many single trigger change in control vesting provisions have been replaced with double trigger payments
  - Most plans now contain repricing prohibitions
  - Many companies have requirements that executives own a certain amount of company stock

# SHAREHOLDER INITIATIVES TO LIMIT EXECUTIVE COMPENSATION

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- In addition, these shareholder advisory groups also have a heavy hand in the design of equity compensation programs:
  - If the number of shares to be granted under the plan exceeds an amount that ISS deems appropriate, they will recommend a no vote on the plan
  - Many plans have removed more liberal change in control definitions
  - Vesting can only be accelerated on death, disability or termination of employment following a change in control (though usually there is a carve-out for a percentage of shares to be granted under the plan)
  - Minimum one year vesting on full value performance-based awards and three year vesting on full value time-based awards
  - No acceleration of awards on a change in control if successor is willing to assume the awards

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