

# The Executive Edition

Your resource on executive pay and governance

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# RESPONDING TO SAY-ON-PAY VOTES.

**By Chris Fischer** | Chicago | [chris.fischer@kornferry.com](mailto:chris.fischer@kornferry.com) | 312-526-0594 and  
**Laura Balser** | Atlanta | [laura.balser@kornferry.com](mailto:laura.balser@kornferry.com) | 404-222-4041

After seven years of say-on-pay votes, how are companies' responses to this annual assessment by shareholders continuing to evolve? A brief lookback over this period illustrates that most publicly-listed companies have changed their pay programs either to eliminate perceived problematic pay practices (e.g., tax gross-ups, excessive severance and perquisites, single-trigger equity acceleration) or, at a minimum, to prospectively commit to never implement such practices again. In general, the prevalence of both performance-based equity and total compensation has increased during this same period.



## Impact of say-on-pay voting

Due to the continued application of investor, market, proxy advisor, and other external policies and pressures, lower vote results often triggered a higher rate of subsequent company-initiated pay program changes. In short, say-on-pay legislation yielded many of the compensation and governance policies under which companies now operate. Absent disclosure of a compelling business rationale to justify a company's specific outlier position(s) or practice(s), any company looking to obtain a high level of shareholder approval generally needs to fall in line. As a result, a substantial majority of companies that have so aligned their pay programs now receive average and median say-on-pay approval levels of at least 90 percent.

When a publicly-listed company receives a negative say-on-pay vote recommendation from a proxy advisory firm and/or shareholder voting results fall below a certain threshold, the compensation committee essentially is put on alert and should learn the main cause(s) behind the vote recommendation and/or results. As part of this process, committee members should consider whether changes to the company's compensation programs are warranted. With at least 90+ percent approval in say-on-pay voting generally considered today's norm, what level causes concern? Clearly organizations that fail to secure majority shareholder approval, as well as those with less than 70 percent favorable tallies, need to take steps to improve results. However, even outcomes in the 70 and 80 percentiles, while certainly passing, suggest that

there are still significant percentages of displeased investors and that changes to compensation programs should at least be considered.

## Communications with shareholders

Another change in company behavior driven by say-on-pay voting is the increased importance of effective shareholder communications that typically occurs during an annual shareholder engagement or outreach process. It is now commonplace for an organization facing a negative say-on-pay vote recommendation – and/or lower (than desired) voting results – to begin evaluating its current situation by first reaching out to, and engaging in dialogue with, their shareholders to openly discuss executive compensation pay issues. After listening to the expressed concerns and recommendations of shareholders at these meetings, many companies choose to recalibrate their pay programs to better align with the identified investor and proxy advisor issues while balancing the underlying tenets of the company's pay program, including competitiveness and alignment with business strategy and shareholders.



## Most common compensation program changes

Korn Ferry Hay Group examined the 2016 and 2017 proxy filings of the top 300 U.S. public companies (median fiscal year 2016 revenues of \$17.2 billion) to identify the most prevalent changes in compensation programs implemented in response to negative say-on-pay vote recommendations and/or results. We found the most common types of changes involved in revising the design of short-term incentive (STI) and long-term incentive (LTI) programs, including:

- Continued use or enhancement of performance-based equity vehicles at the expense of time-vested equity vehicles
- Redesigned STI and LTI programs with new performance metrics
- Revised LTI mix with an increased emphasis on performance-based incentives
- Extended length of LTI performance periods to better align with the time horizon to execute on the intended business strategy
- Simplification of STI and LTI designs to enhance transparency and perceived value
- Greater proxy disclosure and transparency

The determination of these common design changes is consistent with the longer trend of say-on-pay's influence on compensation programs. Again, after hastening the removal of most problematic pay practices, the remaining focus of any say-on-pay assessment should continue to be on

the “how” (i.e., time- vs. performance-based, short-term vs. long-term, performance metric selection and setting, business rationale and disclosure) and the “how much” (i.e., payouts aligned with performance). Absent any significant changes in executive compensation policy-making considerations, legal and regulatory constraints, or overall market sentiment on the design of an appropriate pay program, we expect the above compensation design elements will continue to be at the center of annual say-on-pay assessments and voting tallies.

## Multiple changes to compensation programs

Of those companies addressing say-on-pay issues, after reviewing the findings of their shareholder outreach efforts, we found that most implemented multiple changes in their compensation programs, resulting in a higher rate of year-over-year say-on-pay support.





## Industry-Specific Company Examples

INDUSTRY	MANUFACTURING	ENERGY	RETAIL
STI PLAN CHANGES	<ul style="list-style-type: none"> <li>■ Improved transparency</li> <li>■ Eliminated upward discretionary components</li> <li>■ Reduced maximum individual performance-modifier</li> </ul>	<ul style="list-style-type: none"> <li>■ Capping STI awards at 200% of target</li> <li>■ Provided more transparency in determining awards</li> </ul>	<ul style="list-style-type: none"> <li>■ Enhanced scorecard</li> <li>■ Addition of defined performance and financial metrics and weightings</li> </ul>
LTI PLAN CHANGES	<ul style="list-style-type: none"> <li>■ Shift from one to two equity vehicles</li> <li>■ Measurement period for performance share units (PSUs) increased to three years</li> <li>■ Elimination of PSU performance retesting</li> <li>■ Establishment of payout curves for PSUs</li> </ul>	<ul style="list-style-type: none"> <li>■ Enhanced emphasis on performance shares (PS)</li> <li>■ Addition of S&amp;P 500 index as an additional comparator group to determine PS payouts</li> <li>■ Introduction of restricted stock units (RSUs)</li> </ul>	<ul style="list-style-type: none"> <li>■ Extension of the performance period from 1 to 3 years</li> <li>■ Switch from absolute to relative total shareholder return (TSR) as the primary performance metric</li> <li>■ Change to double trigger equity vesting following a change in control</li> <li>■ Enhanced disclosure of rationale for the specific LTI equity vehicle mix, describing each component's function in attracting, retaining and motivating the leadership team</li> </ul>
OTHER PROGRAM CHANGES	<ul style="list-style-type: none"> <li>■ N/A</li> </ul>	<ul style="list-style-type: none"> <li>■ Increase of CEO equity holding requirement from five times to six times base salary</li> </ul>	<ul style="list-style-type: none"> <li>■ Elimination of excise tax gross-ups</li> </ul>
SHAREHOLDER OUTREACH	<ul style="list-style-type: none"> <li>■ Ongoing throughout the process</li> </ul>	<ul style="list-style-type: none"> <li>■ Ongoing throughout the process</li> </ul>	<ul style="list-style-type: none"> <li>■ Ongoing throughout the process</li> </ul>
2016 TO 2017 SAY-ON-PAY VOTE RESULTS	<ul style="list-style-type: none"> <li>■ 84% to 98%</li> </ul>	<ul style="list-style-type: none"> <li>■ 54% to 94%</li> </ul>	<ul style="list-style-type: none"> <li>■ 56% to 96%</li> </ul>

## Pay-for-performance alignment

Most efforts to align pay and performance continue to be “top of mind” for compensation committees, with an emphasis on incentive design and mix of pay. Coupled with an ongoing elimination of problematic pay practices, the influence of say-on-pay may be making compensation programs more homogeneous.

That said, even if a company aligns its pay programs with market and with “best (compensation and governance) practices,” there will be a consistent ebb and flow of what, when, and how scrutiny will be applied to executive compensation pay programs. For instance, the rigor of performance goal-setting and the corresponding payouts likely will continue to be a major focus of any underlying incentive compensation program assessment. Therefore, demonstrating appropriate pay-for-performance alignment will be critical to securing favorable vote recommendations and achieving any desired higher vote results.

## Looking ahead

At the same time, organizations must be mindful of the potential shift in the attention of proxy advisors and investors towards pay quantum, as favorable stock market performance has resulted in increased LTI payouts. The recent bull market has benefited many executives with above-target payout of units associated with performance awards combined with higher stock values. If (and when) the stock market experiences a period of flat to decreasing shareholder returns, will we see any notable change in proxy advisor and investor sentiment toward executive compensation pay

programs (i.e., is another level of heightened scrutiny always lingering right around the corner)?

As compensation programs evolve, it is critical for organizations to furnish more explanation, rationale, and clarity on current and prospective pay decisions within the Compensation Discussion & Analysis (CD&A) of their annual proxy. Greater depth and disclosure on annual incentive and performance-based LTI programs can educate shareholders and score points with proxy advisors. Effective communication is an essential tool to mitigate the risk of poor say-on-pay results.

While most companies continue to receive strong shareholder support for their pay programs, continued perseverance, adaptability, and more effort will likely be required to stay on top. It is a tricky balance to implement what is ideal for shareholders while also driving the right performance for the business. While not required, continuing to engage in shareholder (and proxy advisor) outreach meetings is extremely beneficial in both identifying potential design issues and providing organizations with recommendations on how to improve their overall compensation programs. Listening and responding to such discussions regularly may enable companies to avoid a negative vote recommendation and/or lower say-on-pay vote results in future years.

As shareholders and proxy advisors continue to redefine the “ideal” pay program, companies will face more pressure to conform and redesign pay programs that fall within those guard rails while balancing the alignment of executive pay with what is appropriate for the business as well as for shareholders.



# KEEPING IT PRIVATE: THE SHRINKING WORLD OF PUBLIC COMPANIES.

By Kevin McLaren | Chicago | [kevin.mclaren@kornferry.com](mailto:kevin.mclaren@kornferry.com) | 312-228-1826

In recent years we have observed a decline in the number of companies going public in an initial public offering (IPO). Accordingly, we have explored key factors contributing to this decrease and its impact on organizational leadership and talent. As discussed in more detail below, we examined factors relevant to this decline and the impact on talent strategy.

## Historical comparisons

This summer new SEC Chairman Jay Clayton acknowledged the reduction in the number of U.S.-listed public companies, declaring it a “serious issue for our markets and the country more generally.” He also noted the lost opportunity for “Main Street” to participate in the growth of the public markets.

The magnitude of the decline is quite staggering – simply put, half as many companies today are publicly-traded, but worth twice as much, compared to 20 years ago. A Credit Suisse analysis of the U.S. Stock Market found a 50 percent decline in the number of publicly-traded companies over the last 20 years, from 7,322 in 1996 to 3,671 in 2016. During that same period, the total market capitalization of those U.S.-listed companies doubled from \$12.3 trillion in 1996 to \$25.3 trillion in 2016.<sup>1</sup>

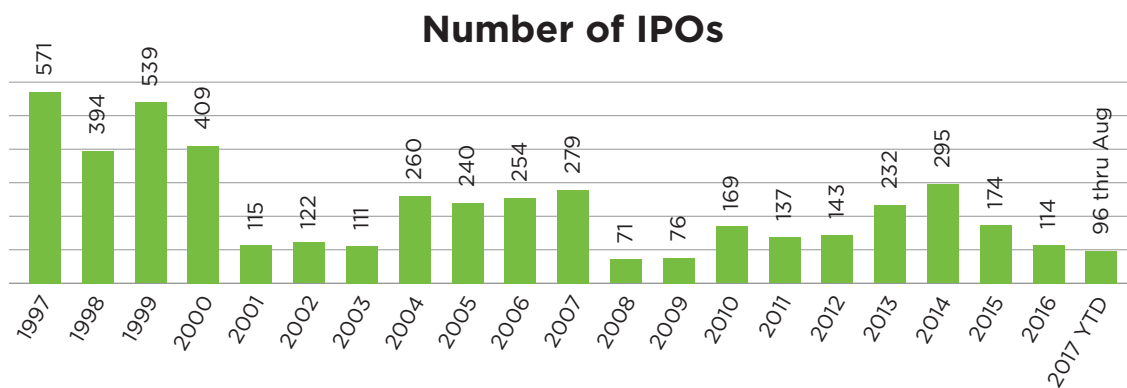
<sup>1</sup>Credit Suisse – The Incredible Shrinking Universe of Stocks: [http://www.cmgwealth.com/wp-content/uploads/2017/03/document\\_1072753661.pdf](http://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf)



Companies simply aren't going public at the rate they did 15 – 20 years ago, with the number of companies entering the public markets (i.e., via IPO, spin-off, etc.) far outpaced by the number exiting (i.e., via M&A, bankruptcy, etc.) in 17 of the last 20 years. According to Korn Ferry Hay Group's IPO Pay Reporter, the number of IPOs has fallen by 78 percent over the last 20 years, from approximately 573 in 1997 to 129 in 2016.

Several factors have driven this decline:

- Expansion of private capital markets and increasing competition for deal financing
- Growing appetites of deep-pocketed strategic buyers
- Equity market volatility for newly public companies
- Public company cost of governance and compliance



## Private Equity

Global private equity (PE) has been very active in recent years, raising capital in excess of half a trillion dollars annually since 2013 – that is 10 times the amount of capital raised in IPOs<sup>2</sup> in 2013, and 30 times the amount raised in 2016. Committed but undeployed capital reached an all-time high in 2016 with dry powder reserves of over \$1.4 trillion – that is 50 percent more than the amount of capital raised in the last 20 years of IPOs.

Massive capital reserves have drawn the attention of companies in need of capital and liquidity, particularly when met by multiple PE suitors on the hunt for yield. Increased competition continues to drive up acquisition

multiples in buyout transactions, from approximately 8x – 9x earnings in 2010 to 10x – 11x in 2016. A competitive PE market has also resulted in more relaxed company terms, with investors more likely to accept lower hurdle rates and minimum returns that trigger carried interest.<sup>3</sup>

Companies are unlikely to turn away from simpler access to a cheaper, growing pool of capital in favor of a more costly and complex one.

## Strategic buyers

PE is not the only buyer at the table. With organic growth lagging expectations, more and more cash-heavy companies are looking to deploy capital to acquire strategic assets with

<sup>2</sup> Capital raised in IPOs reflects offering values, or the number of shares offered in the IPO multiplied by the IPO price per share

<sup>3</sup> Bain & Company – Global Private Equity Report 2017: <https://www.preqin.com/docs/reports/Bain-and-Company-Global-Private-Equity-Report-2017.pdf>





hopes of fueling growth and capturing cost synergies. Companies like Apple (Beats), Alphabet/Google (Apigee) and Amazon (Whole Foods) are other prime examples, using cash amassed since the downturn to purchase companies to fuel growth into new markets and capture synergies.

As investors look to exit certain assets, corporate buyers have become an attractive alternative to the public markets, offering a better understanding of asset value, a clearer ability to realize it, and a less strenuous and more timely process compared to an IPO.

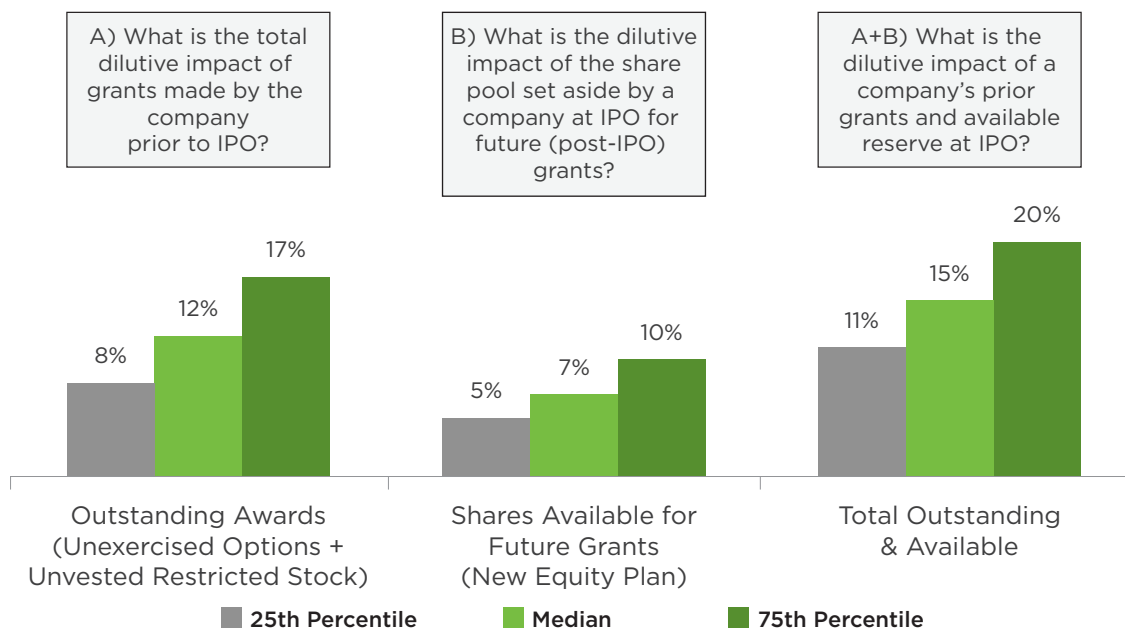
## Volatility

2015 and 2016 brought heightened volatility in equity markets. Global economic and political uncertainty and anticipated changes in the regulatory environment drove skittish investors to strongly consider the timing of an IPO.

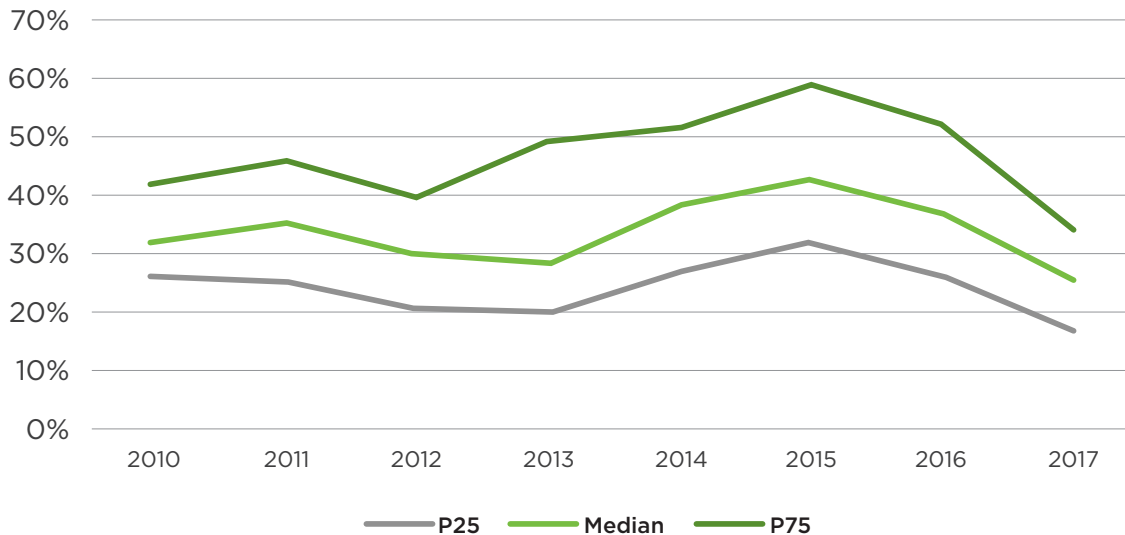
Initial prices have also been significant point of contention, with implied valuations predicated on a company's ability to communicate its strategy and business objectives to shareholders that are evaluating the company for the first time. The stakes are further raised by ownership stakes held by executives and other employees, the liquidity of which is tied to whether new shareholders understand and buy into the company's direction.

*According to KFH's IPO Pay Reporter, companies that went public in 2016 allocated a median of 8 percent of their post-IPO market capitalization (12 percent pre-IPO) to employees via stock options and restricted shares. Those companies set aside an additional 7 percent (at median) to fund grants at IPO and beyond, for a total dilutive impact of around 15 percent. The size of these programs typically varies based on the size and structure of the organization (i.e., revenue, market capitalization, founder vs. PE-controlled, etc.).*

## Equity Pool Size



## 6 Month Post-IPO Volatility (i.e., IPO + 6 months)



Judging by the decline in 6-month volatility of new IPOs in 2016 and again in 2017, the data suggests an improving environment for newly public companies. Certain industries, however, still face considerable economic and regulatory headwinds (e.g., energy, financial services, etc.) that will continue to deter some for the time being.

### Cost

The total cost of an IPO and the ensuing public company compliance and governance involved is one of the most widely voiced criticisms of “going public” and “being public”. Underwriting discounts and legal and accounting fees incurred in preparing SEC filings account for approximately 10 percent of the value of an IPO alone, with average underwriter fees of \$11.9M and IPO related expenses (i.e., legal and accounting) of \$4.7 million, according to a study by the Proskauer<sup>4</sup> law firm.

Operating as a public company and complying with rules of the Securities and Exchange Commission (SEC) requires more significant investment, including new and updated financial systems and internal control processes to comply with Sarbanes-Oxley requirements (accounting, tax, legal, internal audit, IT, investor relations, etc.), the establishment and recruitment of an independent board, implementation of new human resource processes, executive compensation and employee benefit programs, etc. While difficult to quantify, the incremental cost of operating as a company will vary based on the size and complexity of the organization. Regardless, the increased administrative burden on the organization is seen as a major deterrent and criticism of the SEC’s policies – one that its new chair and administration seem receptive to fix.

<sup>4</sup> Proskauer – 2017 IPO Study: <http://www.proskauer.com/files/uploads/Proskauer-2017-IPO-Study.pdf>

## Talent

Going public or private can be both exciting and stressful for those involved, whether it is progressing towards IPO, bringing on an/another outside investor, or selling to a strategic buyer. Based on its experience in each type of deal, Korn Ferry Hay Group notes the following major areas of impact to consider as it relates to talent strategy:

### ■ Reward

Compensation structures and programs evolve naturally over time, but a deal has the potential to drive an abrupt change in how people view their pay opportunities. Our research has found that companies experience a pronounced shift, particularly in migration towards PE-driven (option-based) and public company equity models, more professionalized pay structures and formulaic “pay-for-performance” incentive structures.

The introduction of equity-based compensation is a major focus for companies going through transaction, adding “market risk” to incentive programs (e.g., with stock options, restricted stock and performance shares) that are based on financial and operational performance. When using stock as currency, companies must manage the inherent shift in pay mix and risk profile of their incentive programs. Companies must adopt policies and practices at the board level to administer such programs, including disclosure and maintenance of shareholder-approved and equity-based long-term incentive plans.

As noted earlier, KFHG’s IPO Pay Reporter data indicates that companies arrive at the liquidity event having granted 8 percent of their post-IPO capitalization at median. As those grants become liquid in a deal, companies must calibrate their reward strategies to continue to retain, motivate, and attract talent effectively.

### ■ Engagement and Enablement

While a big transaction can be an inspiring time for employees as they experience their organization at an inflection point in its life cycle, this energy can wear off quickly. In a newly public company, for example, employees soon begin to feel the pressures of quarterly earnings expectations and performance. The heightened focus on earnings and controlling cost naturally results in a decline in enablement (people pushed to do more with less), which can compound and/or counteract post-IPO engagement levels.

Employees can be energized or demotivated by an impending transition and the uncertainty it brings. Simply focusing on engagement and enablement can send powerful signals to employees that how they feel matters, and can identify problem areas within an organization before they become counterproductive.

### ■ Personnel and Talent Management

People ultimately drive change in an organization. But change doesn’t necessarily drive all people. An organization needs to have the right teams in place at the right time to execute a successful deal. Whether it’s hiring a new chief financial officer to shepherd the



organization through an IPO or private investment, or building-out finance and IT functions to cater to the demands of a public company, acquiring the right leadership and talent takes investment and strategy.

Organizations that understand where people investment is needed and how to fill the gaps (e.g., development, hire from outside, engage consultants/search firms, etc.) are ultimately more successful in executing a smooth transition.

While we may see a slight uptick in IPOs coming out of some down years, it remains to be seen whether a relaxation in SEC policies would be enough to entice companies to test the public markets. For the time being, most expect a healthy private equity market, cheap debt and active corporate buyers to dampen any near-term rebounds.

#### ABOUT KORN FERRY HAY GROUP'S IPO PAY REPORTER


Korn Ferry Hay Group's IPO Pay Reporter is a database covering compensation and incentive design in more than 1,500 IPOs since 2000. Data is sourced from public filings and includes information related to the IPO, company financials and performance, named executive officer compensation and ownership levels, and the aggregate dilutive impact of equity plans and awards made prior to and in connection with an IPO.

Contact Kevin McLaren  
([kevin.mclaren@kornferry.com](mailto:kevin.mclaren@kornferry.com)) for more information.



# GOLDEN PARACHUTES: PLANNING AROUND POTENTIAL TAX CONCERNS.

By **Matthew Kleger** | Philadelphia | [matthew.kleger@kornferry.com](mailto:matthew.kleger@kornferry.com) | 215-861-2341



When an organization considers the merits of an acquisition offer, decision-making is typically viewed through a shareholder lens. Thus, most companies begin their discussions around any potential transaction by asking: is the deal in the best interests of shareholders and other key stakeholders? If the answer is positive, one of the “checklist items” from a due diligence perspective is an examination of any potential exposure to Internal Revenue Code (IRC) sections 280G (section 280G) and 4999 (section 4999) regarding the determination of excess parachute payments and the consequences for the company and affected employees.

While sections 280G and 4999 technically can apply to both public and private companies, our focus is on publicly-listed U.S. firms since private companies often can avoid this issue through use of statutory exceptions. For a company’s decision-makers to understand potential adverse implications of these complex rules, they must be proactive in assessing any tax exposure and possible planning and mitigation strategies, as well as the expected reaction from institutional shareholders and proxy advisory firms (especially ISS and Glass Lewis).

## Tax law considerations

Section 280G denies an income tax deduction to a corporation for “excess parachute payments” made in connection with a change in control (CIC). A related provision, section 4999, imposes a 20 percent excise tax on any “disqualified person” who receives compensation that, under section 280G, is deemed to constitute an excess parachute payment. Any payment that is deemed to be contingent upon a CIC is included in excess parachute calculations; these amounts often include cash severance, accelerated vesting of outstanding equity awards, continuation of health and welfare benefits, outplacement services and additional “service credit” for retirement programs.

If the total value of all CIC amounts (as determined under the section 280G regulations) triggers an excess parachute payment, then the company will lose valuable income tax deductions to the extent planning strategies have not eliminated this exposure. To compound matters, if an executive is “grossed-up” for any excise tax that may be imposed, this gross-up protection could potentially cost the company almost three times the initial excise tax, as the gross-up payments are considered additional excess parachute payments that become subject to the excise tax as well.

Not long after section 280G was enacted, many corporations determined that a gross-up for the effect of the parachute excise tax was the preferred approach for working around the excise tax; after all, this tactic seemed to be logical in context of the inequity of the parachute excise tax (see example below) and ensuring that executives, while acting in the best interests of shareholders, would not

be adversely affected from a personal income tax perspective.

However, in recent years, excise tax gross-ups have attracted significant negative attention and been criticized as “poor” or “problematic” pay practices. With the advent of say-on-pay and say-on-parachutes, combined with the increased influence of shareholder advisory groups, excise tax gross-ups became quite uncommon for new awards and agreements. These tax gross-ups can be extremely costly to shareholders as they require paying amounts that are not deductible by the company to make the executive whole for all excise taxes (and the income taxes thereon) payable on his/her excess parachute amounts.

While excise tax gross-ups are unlikely to once again become common, some high-profile companies recently implemented such “make whole” payments for their executives after a CIC was agreed-upon. The main reasons given for such actions involved significant share price appreciation that would result in substantial excise tax bills for executives or a sizable cut-back in executives’ CIC payments needed to eliminate excise taxes. Since the gross-up provisions are added in connection with an approved sale, any negative result in a “say-on-parachute” vote is ineffective.

## Inequity of section 280G

To provide additional context around planning and mitigation strategies, an understanding of the inequities in the operation of section 280G is important. In determining the amount (if any) of parachute payments subject to the 20 percent excise tax, the tax regulations start with an individual’s “base amount.” The base amount is the average – for the five years (or such lesser number of





years of the individual's employment) immediately before the year of the CIC – of an employee's box 1 income from Form W-2. If the aggregate present value of all payments made to an executive that were contingent upon the CIC is at least three times the base amount, then all payments in excess of one times the base amount are subject to the 20 percent excise tax. The following example illustrates how the workings of the excise tax can be unfair.

**Example.** Executives A and B both earn \$1,000,000 in base salary and

receive a \$2,000,000 bonus for each of the five preceding years. In addition, both A and B could exercise stock options worth \$500,000 per year. A exercises his stock options every year during the five-year period, while B does not exercise any of her stock option awards. Also, A does not defer any of his base salary or bonus while B defers 25 percent of both base salary and bonus on an annual basis. In the year of a CIC, both A and B receive a \$10,000,000 golden parachute package.

	BOX 1 W-2 AVERAGE	2.99* X BASE AMOUNT	PARACHUTE PAYMENTS (\$10M) GREATER THAN 2.99* X BASE AMOUNT?	SUBJECT TO 20% EXCISE TAX	AMOUNT SUBJECT TO 20% EXCISE TAX	20% EXCISE TAX
A	\$3,500,000	\$10,465,000	No	No	\$0	\$0
B	\$2,250,000	\$6,727,500	Yes	Yes	\$7,775,000	\$1,555,000

\*2.99 used as short-hand approximation of calculating just below 3 times the base amount

While this example may be extreme, it highlights the potential inequity of the excise tax.

- A took out all of the funds that he could from the company each year and did not align his interests with those of the shareholders. As a reward for “cashing out” annually, A pays \$0 in excise tax.
- On the other hand, B does everything that a company and shareholder would like – she defers cash and does not exercise stock options immediately upon their grant, thereby aligning her long-term interests with those of the company. By doing the “right”

thing from a corporate governance perspective, as well as taking less cash annually, B gets hit with an excise tax bill of \$1,555,000.

This example illustrates why excise tax gross-ups originally became prevalent in senior executive employment agreements. These tax gross-ups “leveled the playing field” for similarly-situated executives who may have acted differently with respect to stock option exercises and deferrals of compensation. Given that excise tax gross-ups in new agreements now are uncommon, the need for careful planning in advance of a CIC has become that much more important.



## **Advance planning and mitigation strategies: minimizing adverse consequences under sections 280G and 4999**

If an organization is prepared for the potential reach of IRC sections 280G and 4999 well in advance of a potential CIC, it can take advantage of opportunities to minimize the adverse implications of these tax provisions. However, if a company doesn't address these issues prior to a CIC, achieving an optimal outcome may become more difficult and/or expensive. Some common mitigation strategies for addressing sections 280G and 4999 (not intended to be an all-inclusive list and assuming that excise tax gross-ups are not a viable alternative) are outlined below. In any event, consultation with tax, legal and regulatory advisors is recommended as some approaches can be very complicated. Finally, while helpful from a section 280G perspective, there can be material disadvantages/drawbacks to some of these alternatives.

- Cease any deferral of compensation to the extent compliant with IRC section 409A; this will increase box 1 of the Form W-2 (used as the basis for the base amount calculation)
- If a company normally pays annual incentives (bonuses) within 2½ months following the end of the fiscal year, accelerate the payment to December 31st of the current fiscal year (assuming the company's fiscal year is the calendar year); this will increase box 1 of the Form W-2 (recall that the base amount is the five years preceding the date of the CIC)
- Exercise vested stock options in the year prior to the CIC as this will increase box 1 of the Form W-2
- For stock options and time-based restricted stock/restricted stock units (RSUs), change from a cliff vesting schedule to one that is pro-rata (which will shift income into box 1 of Form W-2 earlier)
- For performance-based restricted stock/RSUs, include provisions that performance will be measured on an actual (rather than target) basis upon CIC; this structure may obtain a more advantageous valuation under the applicable tax regulations
- Voluntarily waive the right to certain payments and benefits due at the time of a CIC; the most common use of this technique is to waive the right to accelerated vesting on equity awards for the purpose of excluding the value from the section 280G calculation
- Include non-compete provisions within agreements that provide for cash severance benefits in the event of a CIC; the value of these provisions (up to the cash severance amount) may be excluded from the section 280G calculation and the value of the non-compete may be considered compensation for services rendered post-CIC and thus excluded from the excess parachute calculation
- In lieu of certain payments that are included in the section 280G calculation, provide for a post-CIC consulting agreement as payments thereunder may be considered compensation for services rendered post-CIC and thus excluded from the calculation



- Include provisions in agreements that provide an executive with the better after-tax result after either (i) cutting-back total parachute payments to a level where no excise tax is triggered or (ii) making the parachute payments in full (and paying applicable income and excise taxes)

## Summing up


Given that the “easy answer” (i.e., gross-ups) for dealing with any excise tax issue has largely disappeared, it is critical that companies understand, plan and prepare for the effects of sections 280G and 4999 upon a CIC. If a company waits until the year of the CIC to begin its due diligence, many of the alternatives to mitigate the adverse consequences of these tax rules are no longer possible (i.e., those relating to increasing the base amount of a disqualified person). Also, companies should view each potential mitigation alternative through various lenses – shareholders, executives, shareholder advisory groups, the media, etc. – as often the objectives of these various constituencies conflict. No affected party should be surprised by these tax rules at the “eleventh hour.”





# LESSONS FROM THE 2017 PROXY SEASON: PERFORMANCE EQUITY IS KING, WHILE CASH-BASED PAY RAISES HIT NEW LOW.

By **Tony Wu** | New York | [tony.wu@kornferry.com](mailto:tony.wu@kornferry.com) | 212-896-9934



Following a year where shareholders saw negative returns for the first time in the say-on-pay era, in 2016 the largest U.S. 300 public companies exercised caution on executive pay decisions. Compensation committees turned to longer-term pay vehicles instead of more immediate salary and bonus increases to reward chief executive officers (CEOs). Committee members and shareholders are no longer convinced by near-term solid shareholder returns and profitability growth, but rather are calling for longer-term, sustainable, and more balanced performance before showing CEOs the money.

## 2016 leading practices

Flat cash compensation and modest long-term incentive increases emerged as current leading practices within boardrooms. Increased scrutiny from governance watchdogs, investors, and the media all combined to encourage company restraint in light of indications of market improvement. In 2016, CEOs saw their annual base salary increases hit a new low with the smallest increase in the past six years. Furthermore, their short-term incentives (STIs) and total annual cash compensation remained flat while total long-term incentives (LTIs) grew modestly, driven particularly by performance equity.

## Company performance vs. CEO pay

Following 2015, which was a year of slowing revenue, income and negative shareholder returns, companies rebounded in 2016 as revenue was up modestly at 1.6 percent (versus 0.1 percent in 2015), income also rose slightly at 2.6 percent (versus 3.4 percent), while total shareholder return (TSR) scored a respectable 12.0 percent.

Overall, companies elected to show restraint and keep increases in check in a year when they reasonably could have justified larger pay increases. Median CEO salaries increased 0.8 percent to \$1.25 million which is the lowest increase they have received in six years. Median annual incentives were flat (0.0 percent change) at \$2.3 million, yielding a flat (0.0 percent change) median annual total cash compensation of \$3.5 million. Median total direct compensation (TDC) increased 4.2 percent to \$12.5 million, lifted by a 4.4 percent rise in long-term incentives to \$8.8 million. This increase

was consistent (if not rather low) as compared with a 12.0 percent TSR.

## Compilation of CEO pay data

For the past three years, Korn Ferry Hay Group has reported pay figures that are shown in the Summary Compensation Table (SCT) of a company's annual meeting proxy statement. We continue to report the total direct compensation of the CEO, but we also show the total compensation of the CEO. After adding in nonqualified deferred compensation earnings plus the change in pension value, as well as all other compensation, CEO total compensation is up 4.4 percent to \$13.8 million.

## Findings by industry

The largest pay increases were seen in the basic materials industry, where TDC increased 10.3 percent with a net income decline of -14.3 percent, but a substantial one-year TSR of 15.1 percent. Utilities saw a TDC rise of 9.7 percent, with a 4.4 percent improvement in net income and a one-year TSR of 17.5 percent. On the other end of the spectrum, TDC for oil & gas companies was down -2.3 percent, along with a net income decline of -47.0 percent and a one-year TSR of 10.1 percent. TDC for technology companies was up 0.4 percent, with a net income increase of 8.2 percent, and one-year TSR of 20.9 percent. The financial industry once again had a mediocre year as TDC was only up 0.8 percent, along with a net income increase of 0.8 percent and a one-year TSR of 20.3 percent.

While immediate cash gains were non-existent for CEOs last year, they did, however, continue to realize respectable compensation gains in the form of "realized" or take-home



equity-based pay as the stock market performance improved (a trend that is now six years running). With a 6.5 percent change in gains from the exercise of stock options and only a 0.2 percent change in the value of vested restricted stock and performance equity, the median percent change in realized LTI rose 5.4 percent (versus 17.1 percent in 2015) to \$8.6 million. There were significant differences in median percent change in realized long-term incentives across sectors – telecom had a 38.2 percent increase in realized LTI to \$32.4 million and oil & gas had a 28.4 percent increase in realized LTI to \$5.1 million. On the other side, utilities had a decline of -17.1 percent in realized LTI to \$8.3 million, while technology had a decline of -13.7 percent in realized LTI to \$8.9 million.

### Shareholder engagement

In 2016, executive pay programs and pay mix continued to evolve as companies considered shareholder and proxy advisor feedback from say-on-pay shareholder advisory votes. Compensation committees and boards engaged with shareholders, listened to the feedback they received from these outreach meetings, evaluated the responses and reacted to the suggestions received on ways to improve their executive compensation programs. This exercise isn't meant to "check all the boxes," but instead intended to balance what's best with shareholders with what's best for the business.

### Notable changes in compensation programs

Companies implemented changes to their programs in 2016 that typically included:

- Introducing performance-based equity as a new long-term incentive vehicle (we continue to see companies do this even though the prevalence of performance-based equity has been observed at its highest levels ever in recent years)
- Revising their LTI pay mix, putting more of the mix into performance-based equity (this is one change that companies should not take lightly)
- Adding or revising their annual and/or LTI performance metrics
- Completely redesigning their annual and/or LTI performance programs
- Enhancing the transparency of proxy disclosures

While companies have also made these changes in the past, meeting with their largest shareholders has accelerated this process. These meetings often triggered a company's thorough re-evaluation of their executive compensation programs. Over the past five years, pay mix changes to increase a company's focus on performance awards has been the number one suggestion made by shareholders and proxy advisory groups.

As the pay mix evolves, a few companies have taken this direction one step further and refined their programs to consist of only performance-based grants. However, while this makes shareholders and proxy advisors happy, it doesn't mean it's right for the business. In fact, this type of design can usually come



with its own set of headaches for management and committee members. In 2016, 33 companies among the 300-company sample made only performance-based grants, up from 30 companies in 2015 and 25 companies in 2012. But in comparison, there were 243 companies that made multiple grants of restricted stock, stock options and/or performance awards, up from 232 companies in 2015 and 200 companies in 2012.

### Primacy of long-term incentives

For the seventh straight year, long-term performance-based equity programs (e.g., performance shares, performance restricted stock or performance restricted stock units) were the largest part of the LTI pay mix. Shareholders and proxy advisors continued to emphasize that companies should tie a significant portion of long-term compensation to robust performance objectives. Most companies have now implemented a pay-for-performance feature into their LTI grants, so it is no surprise that such awards continue to grow in prevalence. As performance-based awards continue to increase and outdistance the other LTI vehicles, it should be noted that all vehicles except stock options did increase in grant prevalence in 2016.

In this year's sample, performance awards (sum of performance-based equity and performance-based cash) made up 54.7 percent of CEO long-term incentives, up from 51.0 percent last year, and 47.1 percent in 2014. More companies made performance-based awards in 2016 as well; 86 percent of companies made performance-based grants in 2016, 64 percent made restricted stock or restricted stock unit grants, and 57 percent made stock option grants.

### Say-on-pay

Over the course of the past seven years, say-on-pay stockholder advisory votes have quickly become a way of life during a public company's annual proxy period. Most companies have been receiving high levels of support from their shareholders, but prior shareholder support doesn't suggest continued future shareholder support. But while the typical goal is to receive at least a 90 percent approval rate annually, some of the 300 companies did receive disappointing votes during the 2016 voting season.

Companies should know that they need to monitor what their shareholders and proxy advisories are saying; they need to listen and react accordingly – shareholder outreach isn't an exercise just in bad times, but is necessary and equally important in good times as well. Most large companies have adopted shareholder outreach programs to communicate with their shareholders throughout the year to identify issues of concern. This continued dialogue can help companies understand and respond to shareholder concerns on executive compensation issues before they impact a say-on-pay vote. We want shareholders and advisory groups to be able to fully contextualize pay decisions.

Following and building up to their say-on-pay votes, companies often:

- Contact and hold outreach meetings throughout the year with their largest 25 to 50 shareholders
- Meet with shareholders that are not in the first group but still represent a significant number of shares
- Open and maintain a dialogue with proxy advisory firms
- Consider communications received directly from shareholders





Such feedback received from these efforts continues to influence compensation design changes. Compensation committees and company management continue to seek ways to improve their executive compensation program and feedback from shareholders is just one of the methods that they employ to do so.

Companies have gained from the experiences of other companies. They have listened to their shareholders and have increased the prevalence of performance-based equity such that the LTI pay mix is now dominated by such awards. Even after 2015, when company performance was down, companies came back in 2016 to have a slightly better year when pay continued to track performance.

Say-on-pay is also working well. Companies are soliciting feedback from their shareholders and even when there is a respectable voting result, they have continued to be open to suggestions that they received during those meetings. They have modified compensation programs, considered shareholder concerns and closely aligned executive compensation with company performance. Companies are electing to be conservative when it comes to compensating their chief executive officers. We can expect to see further evidence of moderation in the coming year as companies try to stay on top of say-on-pay and shareholder outreach interaction.



# EXECUTIVE PAY REGULATION – LESS IS MORE?

By **Rob Burdett** | London | [rob.burdett@kornferry.com](mailto:rob.burdett@kornferry.com) | +44 (0) 7979 537326



The government of the United Kingdom (UK) recently published its latest guidance on reforms to the country's corporate governance regime. Unsurprisingly, and perhaps somewhat depressingly, of the twelve specific actions that the government has required, nine relate directly or indirectly to executive pay. Key points are:

- There will be greater and clearer sanctions for companies that receive significant opposition to their pay-related annual general meeting (AGM) resolutions, including being publicly listed in a "rogues' gallery" compiled by a major proxy advisory service
- The voice of employees will be strengthened at the board level, with companies having to either (i) appoint a designated independent director to represent their views, (ii) establish a formal employees' advisory council, or (iii) appoint an actual employee to act as an additional independent director
- Companies will have to disclose the ratio of chief executive officer (CEO) pay to average employee pay and explain any changes to that ratio over the prior year
- Long-term incentive plans should operate with vesting periods of no less than five years

So, does this mean that executive pay in the UK is facing a new era of direct government intervention via rafts of new legislation that will prescribe exactly how – and how much – executives can be paid? Are we to see statutory caps on pay, the outlawing of traditional long-term incentive plans and the like?

## Whose job is it anyway?

The answer is a resounding "No." Despite much saber-rattling from both Theresa May's new Conservative Government and the Prime Minister herself ("[My] Government will build an economy that works for everyone, not just the privileged few"), very few of these new rules will be backed up by new law. Of the issues listed above, only the CEO vs. employee pay disclosure ratio requirement will be an actual legal requirement. In addition, the government's guidance falls a long way short of what was considered possible when it originally consulted on potential reforms (e.g., an annual binding vote on pay was mooted but has not materialized).

Instead, controlling executive pay in the UK will continue to be left largely to the companies themselves, their shareholders and the corporate governance regulatory bodies that operate a regime in the UK that is built on the twin pillars of (i) detailed disclosure and (ii) "comply or explain." As a result, some commentators have accused the government of "ducking the issue/passing the buck" by not trying to legislate pay down. It is not for us to say whether these criticisms are valid. However, what is clear is that the current government is adopting pretty much the same approach as has been taken by previous administrations. The received wisdom in the UK is that it is not the role of the government to intervene directly on how and how much privately-(i.e., not state-) owned companies pay their executives. However pernicious executive pay may or may not be, the underlying principles of the free market dictate that governments simply don't have the authority to meddle.

Instead, it is to their shareholders that companies should be accountable, with investors made able to reach an informed decision on pay issues with the benefit of transparent disclosure. This was certainly the approach taken by Tony Blair's Labor government back in 2002 which introduced "say-on-pay" in the UK for the first time, in tandem with significantly increased disclosure requirements. This was followed by the introduction of enhanced shareholder voting powers and even more onerous disclosure requirements in 2013.

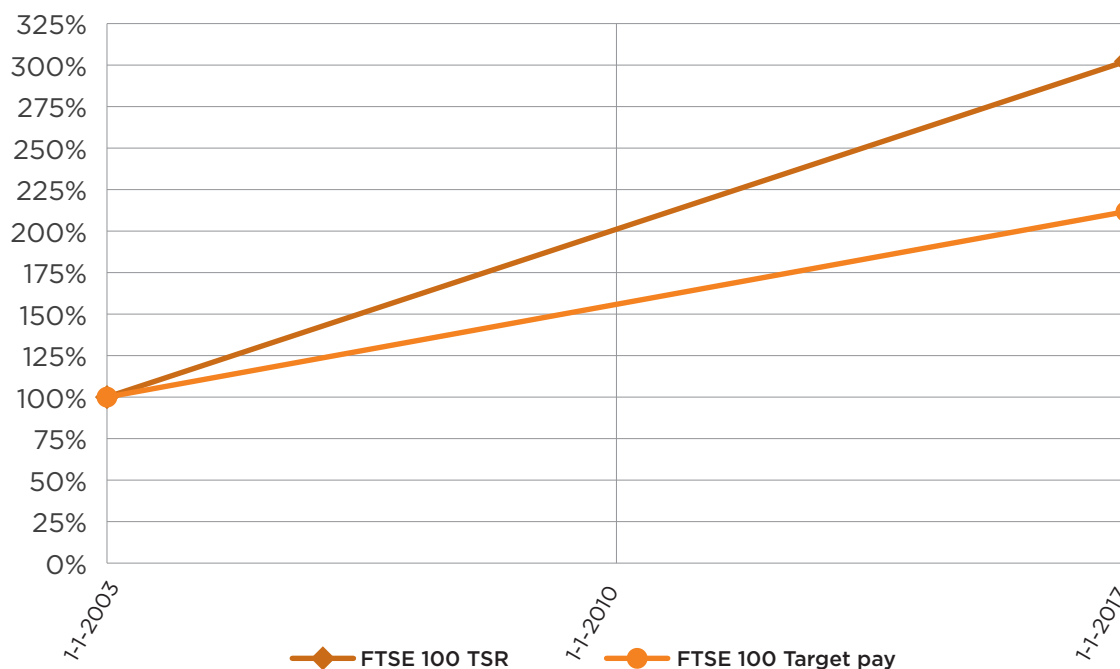
### How bad actually is it?

Reviewing a country's corporate governance regime every now and then to ensure it remains fit for its purpose is clearly necessary. However, the high frequency of reviews of governance as specifically related to executive pay, allied to the seemingly never-ending debate in the press on senior compensation in the UK, suggests that past solutions – based

on enhanced disclosure and self-regulation rather than statutory curbs on pay – are deemed by some not to have worked. Supporters of tighter controls on executive pay via greater direct government intervention and formal legislation delight in citing, as evidence that executive pay continues to run unchecked, that the median on-target remuneration of a FTSE 100 CEO (ignoring pension benefits) has more than doubled since 2002 (when the rules were first tightened as explained above) to around £3million, with general workforce pay (and underlying corporate performance) lagging further and further behind. Therefore, the argument goes that the existing controls on pay are toothless and need to be dramatically strengthened.

This obviously ignores some important points. Yes, CEO pay in the UK has increased since 2002. However:

- It is simply wrong to say that corporate performance has not kept up, at least to a degree:





- Far less of a CEO's pay is fixed, with the vast majority (approximately 70 percent) now variable.
- Equity plays a far greater role than was once the case, with share-based long-term incentives now comprising over two-thirds of variable pay, plus bonus share deferral and share ownership guidelines now virtually universal practice. Malus/clawback provisions also offer further checks and balances.
- Over 90 percent of UK companies receive very high (i.e., 90 percent plus) support for pay resolutions from their shareholders, with the main proxy voting services (such as Institutional Shareholder Services [ISS]) giving around 80 percent of companies a clean bill of health from a pay perspective. All this suggests that the actual owners of the businesses are not entirely unhappy with pay design.
- There is a huge over-focus on how a very small number of individuals are paid (i.e., executive directors of UK-listed PLCs). Pay in private equity (PE) and professional services rarely attracts such ire, even though rewards can be much higher (with the tax paid on what is earned often much lower in the PE world).

However, the fact remains that the general view is that there is a major problem with executive pay in the UK, with the impact this has on the public's perception of UK PLCs – and industry generally – neutral at the very best.

### Regulation across Europe

Casting the net wider, it is interesting to note that rest of Europe largely lags significantly behind the UK

in terms of scope of regulation and overall corporate governance framework relating to executive pay. The objectives, however, are aligned in terms of introducing regulation to improve transparency and disclosure to enable European investors to make informed decisions on executive pay (although the expectations of investors in Europe in terms of both disclosure and implementing best practice have traditionally been much lower than those in the UK).

Also, within the rest of the European Union (EU) there is a considerable difference between what governments in the individual member states consider an acceptable level of regulation, transparency and disclosure and the extent to which this should be achieved by legislation and/or “soft law.” The focus of the European Commission after the collapse of Lehman Brothers (and the perceived associated corporate governance failings) was to try and raise corporate governance standards throughout the EU with improved soft law and “comply or explain” corporate governance code disclosure. However, member states did not consider that it was the role of the Commission to directly intervene in what they view as a domestic matter and one over which they have historically been responsible.

Notwithstanding this, we have recently seen the introduction of the Shareholder Rights' Directive which will provide say-on-pay throughout all EU member states. Countries must (by June 2019) implement legislation that will require companies headquartered and listed in the EU to obtain a shareholder vote on their executive remuneration policy and to provide detailed disclosure in their annual

remuneration report in a similar way to the UK. What remains to be seen is the extent to which European investors will take advantage of the improved disclosure and hold companies accountable.

### The future of pay regulation in the UK

Ultimately, for various reasons, we believe that more direct governmental intervention on pay in the UK is unlikely (absent a left-wing Labor government coming to power at the next general election):

- As mentioned above, in a free market economy, is it “right” for a government to legislate how much directors of privately-owned companies should earn? While the Trump administration is not necessarily viewed as a bellwether for emerging best practice in the UK, it’s interesting to note that the direction of travel in the US is for less regulation generally, with a number of proposed pay-related regulations (e.g., claw-backs of compensation, hedging of compensation, pay-for-performance using TSR as the metric for disclosure, etc.) unlikely to be adopted in anything close to their originally proposed form.
- While it is fair to say that most of the controls on executive pay in the UK are based on high levels of disclosure and comply or explain rather than black letter law, it would take a very brave company to try and explain away non-compliance of some of the fundamental pillars of executive pay best practice that are set out in the UK’s Corporate Governance Code. Few attempt to do so.
- Be careful what you wish for – capping executive pay could well lead to a stampede towards the new cap by companies that may feel they are “underpaying” by not remunerating at the maximum allowable (see the US experience when income tax deductibility was removed from non-performance-based pay above \$1 million).
- Post-Brexit, the UK is a critical point in its history. If it is to make a success of life outside the EU, it must be viewed by current and potential new trading partners as an attractive place in which – and with which – to do business. Clearly part of this involves having a robust regulatory framework, of which a strong corporate governance code is a key feature. However, over-regulation on pay is surely to be avoided by a country that is opening its doors to trade.

And are we trying to solve a decreasing problem? High levels of pay inflation in the UK are a thing of the past; base salary increases in 2002 were 9 percent at the median, compared to around 2.5 percent now which shows that few companies feel able to increase quantum significantly, even if they want to do so. This, together with ever-increasing levels of disclosure of bonus and long-term incentive plan target-setting with the enhanced remuneration committee accountability that brings, are likely to result in a stabilization or even reduction in the level of executive pay. Let’s not forget that median CEO earned pay in the FTSE 100 has actually fallen over the last few years. Perhaps the UK’s lighter- (and more self-) regulatory touch has worked after all?



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**Learn more at:** <http://www.kornferry.com/rewards-benefits-overview/executive-pay-governance>.

#### **For more information:**

Irv Becker, Vice Chair –  
Executive Pay & Governance  
+1.215.861.2495  
[irv.becker@kornferry.com](mailto:irv.becker@kornferry.com)

Bill Gerek, Editor and U.S.  
Regulatory Expertise Leader  
Executive Pay & Governance  
+1.312.731.1244  
[bill.gerek@kornferry.com](mailto:bill.gerek@kornferry.com)