

HEALTH WEALTH CAREER

TRENDS IN EXECUTIVE COMPENSATION

JUNE 8, 2016

MAKE TOMORROW, TODAY  MERCER

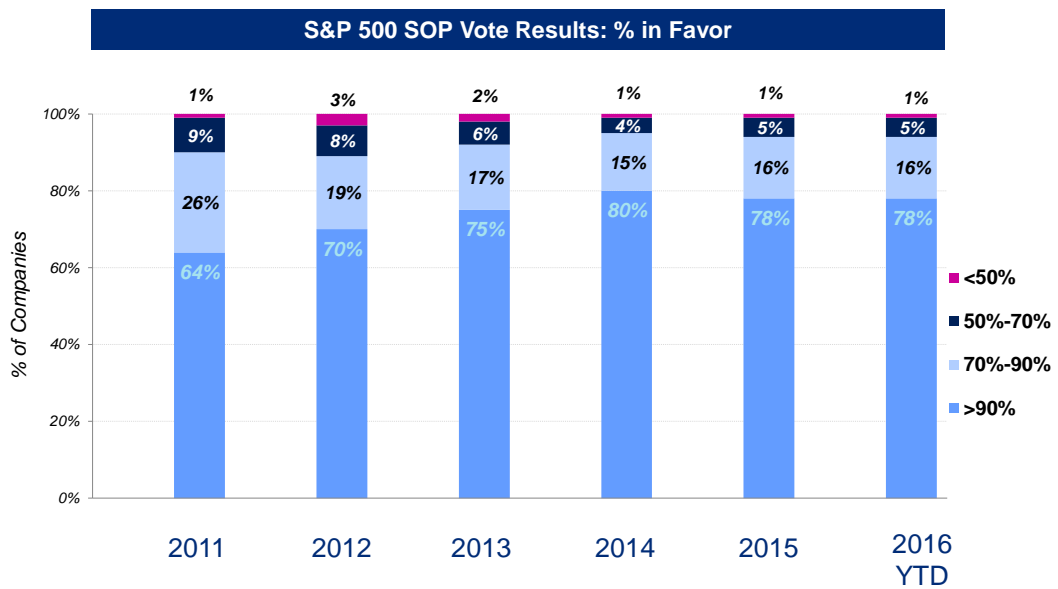
TRENDS IN EXECUTIVE COMPENSATION AGENDA

- 2016 Proxy Season Observations
- Dodd-Frank Rulemaking Status
- New Accounting Rules for Share-Based Compensation
- Final DOL Overtime Regulations
- Questions

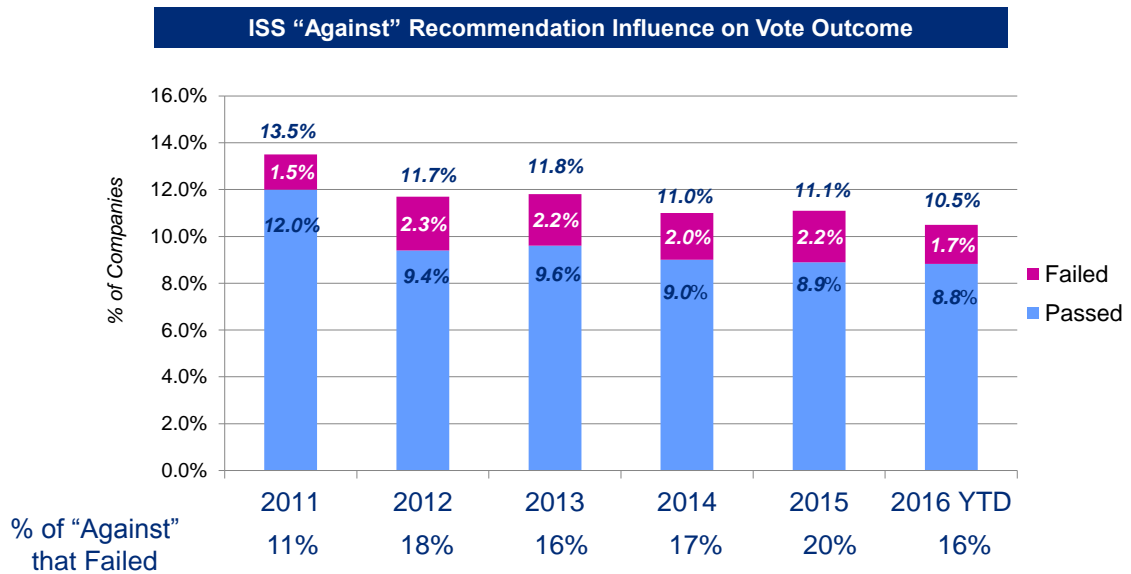
2016 PROXY SEASON OBSERVATIONS



SAY ON PAY: 2016 YEAR-TO-DATE VOTE RESULTS CONTINUE TO BE FAVORABLE



SAY ON PAY: 2016 YEAR-TO-DATE MOST COMPANIES ARE ABLE TO OVERCOME AN ISS AGAINST RECOMMENDATION



OBSERVATIONS FROM 2016 PROXY SEASON SAY ON PAY AND OTHER GOVERNANCE TOPICS

For ISS – RDA test continues to be most important
ISS/GL continue to provide inconsistent and differing recommendations for some companies
GL – increased influence for negative recommendations
Election impact: Repeal Dodd-Frank? Other potential issues?
BlackRock – SH proposal on SOP policies
Stock buyback programs – disclosure and impact on incentive plans

PROXY ADVISORY FIRMS SPOTLIGHT INCENTIVE PLANS



Metrics

- Appropriate measures?
- Definition – potential exclusions
- TSR – modifier or actual metric
- AIP/LTI metric alignment – same metrics?

Goal Setting

- Absolute or relative – appropriate balance?
- Goal vs. prior year(s) performance
- Amount of stretch performance
- Pay for below-median performance

Design

- Pay Calibration – where to peg compensation
- Level of Discretion
- Rationale and Disclosure
- “Holy Cow” alignment
- 2016 actions will impact 2016/2017 reviews

ON THE HORIZON ITEMS TO KEEP TOP OF MIND FOR 2017 AND BEYOND



STOCK BUYBACKS

Key Issue	Impact of Stock Buybacks on Compensation
Shareholder Proposal	<ul style="list-style-type: none"> • <i>Adopt policy to adjust incentive plans to neutralize the impact of share buybacks (Illinois Tool Works, 3M and Xerox)</i>
Investor Reaction	<ul style="list-style-type: none"> • <i>ISS/GL appear to review on case-by-case basis; generally recommended "Against" so far in 2016</i>
Future Impact	<ul style="list-style-type: none"> • <i>Impact on company incentive plan payouts and Committee decision-making process</i> • <i>Enhanced proxy disclosure regarding buybacks – rationale and impact on results</i> • <i>Stock Plan – new share request relative to number of shares repurchased</i>

Compensation Committees should consider how stock buybacks affect executive pay and determine whether to limit or exclude their impact on incentive plan metrics

ON THE HORIZON ITEMS TO KEEP TOP OF MIND FOR 2017 AND BEYOND



PROXY ADVISORS

- Not all about pay levels – **increased focus on plan design**, metric rigor, “workings” of incentive plans, special/one-off awards
- “Yes, but...” – increased use of “**qualifiers**” with respect to compensation programs even if P4P test results are favorable; may affect future years
- Succession planning – CEO pay for incoming CEO including special grants; exit pay for outgoing CEO (focus on “**pay for failure**”)

INVESTORS

- Continued increase in use of **in-house proxy voting guidelines** – as a result, important to understand investors’ wants via shareholder outreach
- 2017 **SOP frequency** vote – what will institutions want?
- Potential criticism/shareholder proposals regarding institutions being **too “easy” on SOP voting**

ON THE HORIZON ITEMS TO KEEP TOP OF MIND FOR 2017 AND BEYOND



PROXY DISCLOSURE

- Robust discussion of **shareholder outreach efforts**; list program changes made and rationale – to help combat poor P4P test scores from ISS/GL
- Striking the **balance** between length of CD&A and providing relevant details – use of tables and graphs balanced with streamlined disclosure; emphasize key points that will appeal to ISS/GL and key investors
- Separate **pay ratio section** discussing: Dodd-Frank CEO pay ratio, alternative CEO pay ratios, gender pay equity

USE OF CEO (AND OTHER) PAY RATIOS CURRENT AND FUTURE YEARS

- Sample current Glass Lewis disclosure (current and prior two years)

	2015	2014	2013
CEO to Avg NEO Pay	3.3:1	3.3:1	2.1:1
CEO to Peer Median	1.4:1	1.2:1	2.1:1

- Sample current ISS disclosure (current year only)

CEO PAY MULTIPLES

Compared to	Multiple
2nd highest active executive	1.46
Average active NEO	2.07
ISS peer median	0.68
Company peer median	0.66

Source: ISS

- Potential additional ratios added in future years
 - CEO pay ratio (SEC mandated and alternatives)
 - Gender pay equity

CURRENT

1. ISS uses only CEO Multiple of Median (MOM) ratio in its P4P tests
2. Other ratios are primarily informative (at best)

FUTURE

1. How will CEO pay ratios be disclosed in proxy advisor reports?
2. Impact on SOP (or other) recommendations?

SHAREHOLDER PROPOSALS GENDER PAY EQUITY

Company	Proponent	AGM Date	Status
Adobe Systems Inc.	Arjuna Capital	April 13	Omitted; filed too late for inclusion
Alphabet Inc.	Arjuna Capital	June 8	Vote pending
Amazon Inc.	Arjuna Capital	June 10	Withdrawn; reported 99.9% parity
American Express Co.	Trillium Asset Management	May 2	Withdrawn; report pending
Apple Inc.	Arjuna Capital; Pax World Fund	Feb. 26	Withdrawn; reported 99.6% parity
Citigroup Inc.	Trillium Asset Management	April 26	4.9%
eBay Inc.	Arjuna Capital	April 27	44.6%; report pending
Exxon Mobil Corp.	Eve S. Sprunt	May 25	8.5%
Expedia Inc.	Arjuna Capital	June 16	Withdrawn; report pending
Facebook Inc.	Arjuna Capital	June 20	Vote pending; reported 100% parity
Intel Corp.	Arjuna Capital	May 21	Withdrawn; reported 100% parity
Microsoft Corp.	Arjuna Capital	Dec. 2016	Withdrawn; reported 99.8% parity

Companies may want to gather and analyze gender pay equity data to prepare for the EEOC rule or a shareholder request

DODD-FRANK RULEMAKING STATUS



DODD-FRANK RULEMAKING STATUS EXPECTED TIMING



Topic	Requirement	Status
Pay ratio	<ul style="list-style-type: none"> Annual total compensation of CEO Median annual total compensation of all employees (other than CEO) Ratio of first to second 	Final Aug. 5, 2015 <ul style="list-style-type: none"> Effective for 2018 proxies (fiscal 2017 compensation)
Pay versus performance (P4P)	<ul style="list-style-type: none"> Relationship between executive pay and company performance (defined as TSR) 	Proposed Apr. 29, 2015 <ul style="list-style-type: none"> Final rule pending (no date specified)
Hedging	<ul style="list-style-type: none"> Whether employees or directors can hedge company stock holdings 	Proposed Feb. 9, 2015 <ul style="list-style-type: none"> Final rule pending (no date specified)
Clawback policies	<ul style="list-style-type: none"> Listed companies must have policies to recover incentive pay from current and former executives in the event of certain financial restatements 	Proposed July 1, 2015 <ul style="list-style-type: none"> Final rule pending (no date specified) Will require stock exchange action after SEC finalizes rule

Finalization pending

CEO PAY RATIO REPORTS OFFER CONFLICTING VIEWS OF RATIOS

- **Media:** Often cite pay ratios of 300:1 or more for companies in the S&P 500 Index
- **MSCI** study:
 - Consumer staples companies = 123:1 (highest)
 - Energy companies = 40:1 (lowest)
- **American Enterprise Institute (AEI)** report = 5:1
- **Mercer | Comptryx** study on technology companies = 95:1
 - Revenue < \$1 billion: 40:1
 - Revenue >\$3B = 155:1
 - Both the Mercer | Comptryx study and the AEI analysis suggest that ratios may be lower at smaller companies

NEW ACCOUNTING RULES FOR SHARE-BASED COMPENSATION




ACCOUNTING FOR SHARE-BASED COMPENSATION OVERVIEW OF ASC 718

- How is it settled?
 - Cash-settled
 - Stock-settled
- What are vesting and other conditions?
 - Service
 - Performance
 - Market

ACCOUNTING FOR SHARE-BASED COMPENSATION DISTINGUISHING BETWEEN EQUITY AND SHARE- BASED LIABILITIES

Liability

- *Generally* – awards settled in cash
- Remeasure fair value (not intrinsic value) at each interim period (quarterly) until settled – changes from period to period; flows through income statement
- Some features may (surprisingly) cause awards to be classified as liabilities
 - Not enough shares in plan
 - Certain buy-back provisions (mostly private companies)
 - Withholding more than required minimum tax  included as 718 simplification

Ex: Cash-settled RSU

Equity

- *Generally* – awards settled in shares
- Measure and fix fair value at grant date
- Awards settled in shares OR cash: sometimes equity, sometimes liability
 - At company's election: **equity**, unless company usually settles in cash
 - At employee's election: **liability**

Ex: Stock-settled RSU

ACCOUNTING FOR SHARE-BASED COMPENSATION VESTING CONDITIONS FOR SHARE-BASED AWARDS CLASSIFIED AS *EQUITY*

Type of condition	Example	Treatment of equity award
Service-based	RS award with 3-year cliff vesting	
Performance-based	Stock-settled performance-based RSU earned based on EPS, ROE, etc. (any metric other than a market-based goal)	Modified grant date: fair value per share fixed at grant, total expense “trued-up” based on number of awards that vest
Market-based	Stock-settled performance-based RSU earned based on relative TSR	Grant date: total fair value fixed at grant, no expense true-up for missed goals—even if no awards vest Grant date fair value reflects probability of meeting goals and projected stock price paths using binomial or Monte Carlo simulation models

ACCOUNTING FOR SHARE-BASED COMPENSATION CLASSIFICATION OF SHARE-BASED AWARDS

		LIABILITY	EQUITY	
TYPE OF AWARD		Remeasured ¹	Modified Grant Date ²	Grant Date ³
APPRECIATION ONLY	Option/stock-settled SAR with service or perf condition		X	
	Stock option or stock-settled SAR with market condition			X
	Cash-settled SAR	X		
FULL VALUE	RS or stock-settled RSU with service or perf condition		X	
	RS or stock-settled RSU with market condition			X
	RSU settled in cash	X		
	Perf shares settled in stock with service or perf condition		X	
	Performance shares settled in stock with market condition			X
	Performance shares settled in cash	X		

¹ Total cost equal to value on settlement date, with "fair value" remeasured at each reporting date until then

² Cost per share fixed at grant date; total cost based on number of awards that are earned and is adjusted for any service-based forfeitures

³ Total cost fixed at grant date, regardless of outcome of market condition, but is adjusted for any service-based forfeitures

Compensation expense for all share-based awards are adjusted
for any service-based forfeitures ➔ included as 718 simplification

FASB ASC TOPIC 718 CHANGES



- Final amendments released March 2016
- Effective date
 - Public companies: 1/1/17
 - Private companies: 1/1/18
 - Early adoption is permitted, as long as all the amendments are adopted in the same period
- **Mostly good news for administration:** simplifies compliance – but could trigger earnings volatility and reduce EPS

Significant Issues

- Excess tax benefits and deficiencies
- Net settlement of shares to pay withholding taxes
- Forfeitures

Presentation in Cash Flow Statements

- Tax-related amounts arising from share-based payments

Private Company Simplifications

- Expected term
- Intrinsic value

Companies with incentive plans that use after-tax income statement metrics should consider the potential impact of the updates on their plans

EXCESS TAX BENEFITS AND DEFICIENCIES REQUIRED

Background	
Excess tax benefit: actual tax deduction > award's accounting cost Tax deficiency: actual tax deduction < award's accounting cost	
Accounting treatment	
CURRENT	NEW
All excess tax benefits and <i>most</i> tax deficiencies: Recognized in equity (APIC pool) on balance sheet	All excess tax benefits and all tax deficiencies: Recognized as tax expense on income statement
Treasury stock method allows offsetting the potential dilution from unvested/unexercised awards by assuming you can repurchase shares with the hypothetical tax benefits from awards that are vesting or were exercised	Eliminates hypothetical tax benefit offset

Impact

- Simpler administration: reduces burdensome recordkeeping
- More income statement volatility, possibly significant
- May reduce diluted EPS

Action: Review incentive plans to determine impact of new rules, especially for plans using after-tax earnings or EPS as metric

NET SETTLEMENT OF SHARES TO PAY WITHHOLDING TAXES OPTIONAL

Background

Companies are required to **withhold the minimum amount** to meet employee tax withholding when shares vest or options are exercised

Accounting treatment

CURRENT

If shares withheld from equity award can exceed **minimum statutory withholding tax requirement**: treat award as a *liability*

NEW

If amount withheld does not exceed **highest marginal tax rate**: the award keeps *equity* classification

Impact

- Companies can allow employees to elect to withhold more than minimum without triggering unfavorable variable accounting (subject to payroll tax rules)

Action

- Consider amending plan documents to allow for share withholding above minimum statutory requirement

ACCOUNTING FOR FORFEITURES OPTIONAL

Background

Under Topic 718, no expense is recognized for shares forfeited if an employee fails to provide the service required for the shares to vest

Accounting treatment

CURRENT

Calculate expense using ***estimated*** service-based forfeitures; revise as appropriate, true-up when ***actual*** forfeitures are known

NEW

Company may choose to (i) use current method or (ii) recognize forfeitures ***as they occur***

Impact

- Simpler administration
- More income statement volatility if companies opt to recognize forfeitures as they occur

PRESENTATION OF SHARE-RELATED TAX IN CASH FLOW STATEMENT REQUIRED

CURRENT	NEW
Classify excess tax benefits from share-based payments as financing cash flow	Classify excess tax benefits as operating cash flow
No guidance exists on classifying cash paid to taxing authorities by employer for withholding shares for tax withholding purposes	Classify cash paid by an employer when withholding shares for tax purposes as a financing activity

FINAL DOL OVERTIME REGULATIONS



FINAL DOL OVERTIME REGULATIONS EMPLOYERS PREPARING FOR 2016 IMPLEMENTATION



Up to 4.2 million currently exempt employees to be reclassified as non-exempt



Salary threshold effectively doubled from previous \$23,660
New threshold is \$47,476



Highly Compensated Employee (HCE) threshold increased from \$100,000 to \$134,004



Supervisors and managers may require increases to compensation to maintain sufficient job level progression

*Updates expected every three years beginning January 1, 2020
based on percentile of wages for full-time employees in lowest income census region*

FINAL DOL OVERTIME REGULATIONS EMPLOYERS PREPARING FOR 2016 IMPLEMENTATION



**Must still meet
duties test**

**No changes
to duties tests**

**Many companies
still not in
compliance with
2004 changes**



**Non-discretionary bonuses
and incentives (including
commissions):**

- can now count for up to 10% of salary threshold if made on a quarterly or more frequent basis
- can still be counted toward HCE threshold if the standard salary threshold is met through salary alone and can include annual payments



**Final rule
released
May 18, 2016**

**Effective
Dec. 1, 2016**

FINAL DOL OVERTIME REGULATIONS WHITE COLLAR EXEMPTION FRAMEWORK

CURRENT	NEW
<p>1. Salary-level test – currently, an employee must be paid above \$455 per week (\$23,660 per year)</p>	<p>1. Salary-level test – effective December 1, 2016 an employee must be paid above \$913 per week (\$47,476 per year)</p>
<p>2. Salary- or fee-basis test</p> <ul style="list-style-type: none"> – <i>Salary-basis test</i> – employee must be paid a predetermined, fixed salary that is not subject to reduction due to quality or quantity of work – <i>Fee-basis test</i> – employee must receive an agreed sum for a single job, regardless of time spent 	
<p>3. Duties test – employee’s primary duties fit one or more exemptions</p> <ul style="list-style-type: none"> – Executive or business owner – Administrative employee or academic administrator – Learned, creative, or teaching professional – Computer employee – Outside sales employee 	

FINAL DOL OVERTIME REGULATIONS WHAT CAN YOU DO TO PREPARE?

- ✓ **Identify jobs with incumbents below the salary threshold** and also consider those that may be below the threshold when the DOL updates the threshold in 3 years
- ✓ Determine **payroll schedule adjustments** – may need to adjust salary before December 1, 2016, depending on pay period that includes effective date
- ✓ **Identify overtime patterns** to get a sense of how much overtime, if any, is worked
- ✓ Confirm that jobs you plan to keep salaried exempt **meet duties tests**
- ✓ **Review pay structures** including target rates, grade assignments, career progressions and geographic differentials
- ✓ **Assess operational capabilities** and consider changes in job duties and scheduling to minimize potential overtime
- ✓ Determine **communication strategy**
- ✓ **Review impacted policies** – e.g., telecommuting, use of mobile devices
- ✓ **Model your options** for increasing salary or reclassifying to non-exempt and paying overtime or eliminating/reducing overtime work

QUESTIONS?

