Fundamentals *of* Executive Compensation

FEBRUARY18, 2025 | PART ONE

HRPA HR POLICY ASSOCIATION CENTER ON EXECUTIVE COMPENSATION

How to Interact During the Session

We encourage you to turn camera on

Raise hand in Zoom and ask questions live

Type a message in “Chat” –
Chat button is located on the webinar menu.

today's presenters

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Fundamentals *of* Executive Compensation

PART ONE
Design Fundamentals

PART TWO
The Regulatory and Governance Context

PART THREE
Finance and Measurement Basics

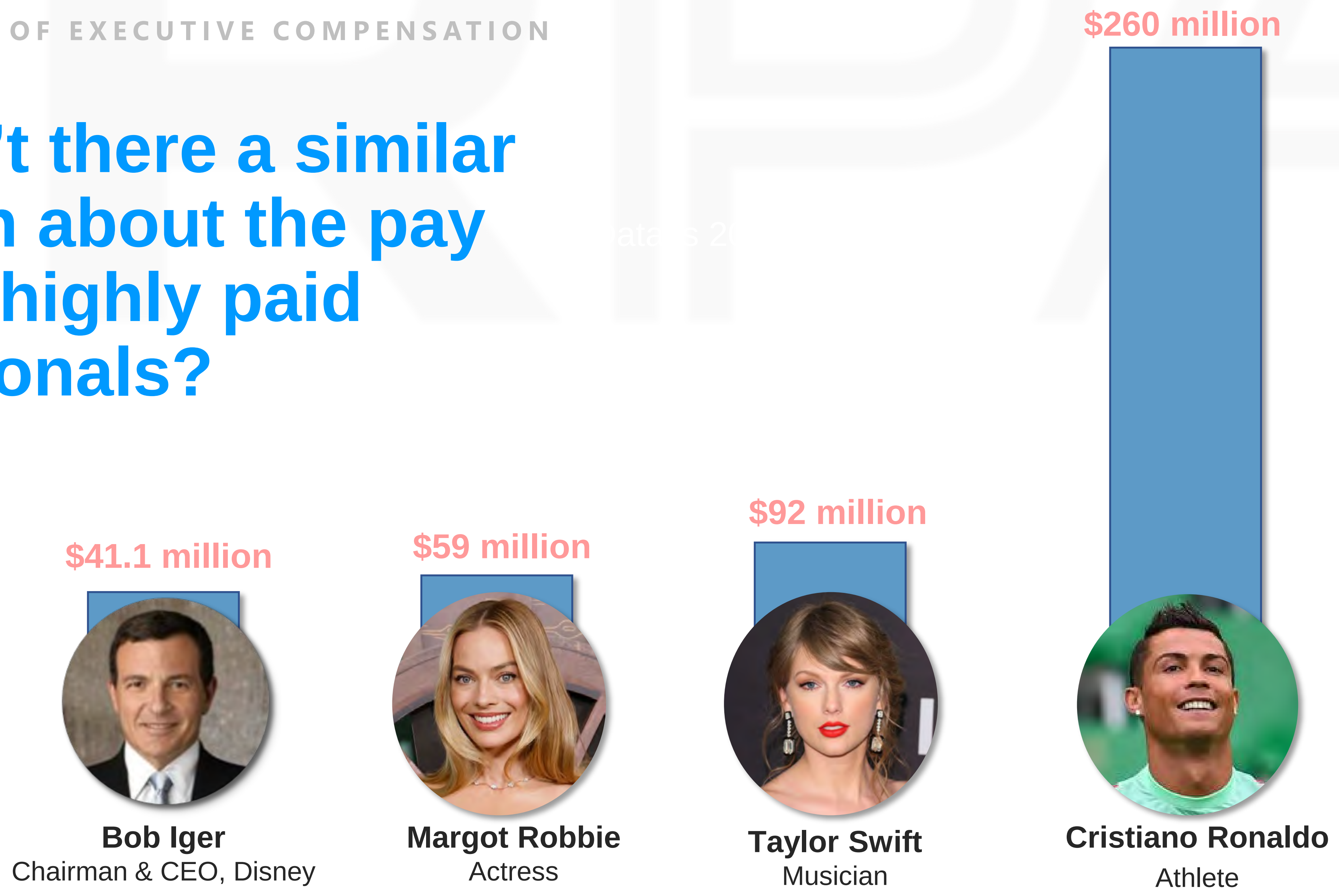
today's agenda

all times Eastern

11:10 a.m. ET	**What makes executive compensation different?**
11:25 a.m. ET	**Executive compensation objectives and philosophy**
11:50 a.m. ET	**Target pay and peer group selection**
12:05 p.m. ET	*Break*
12:10 p.m. ET	**The elements of pay**
1:00 p.m. ET	**Breakout group exercise**
1:40 p.m. ET	**Other forms of pay**
1:55 p.m. ET	**Review and Day 2 assignment**

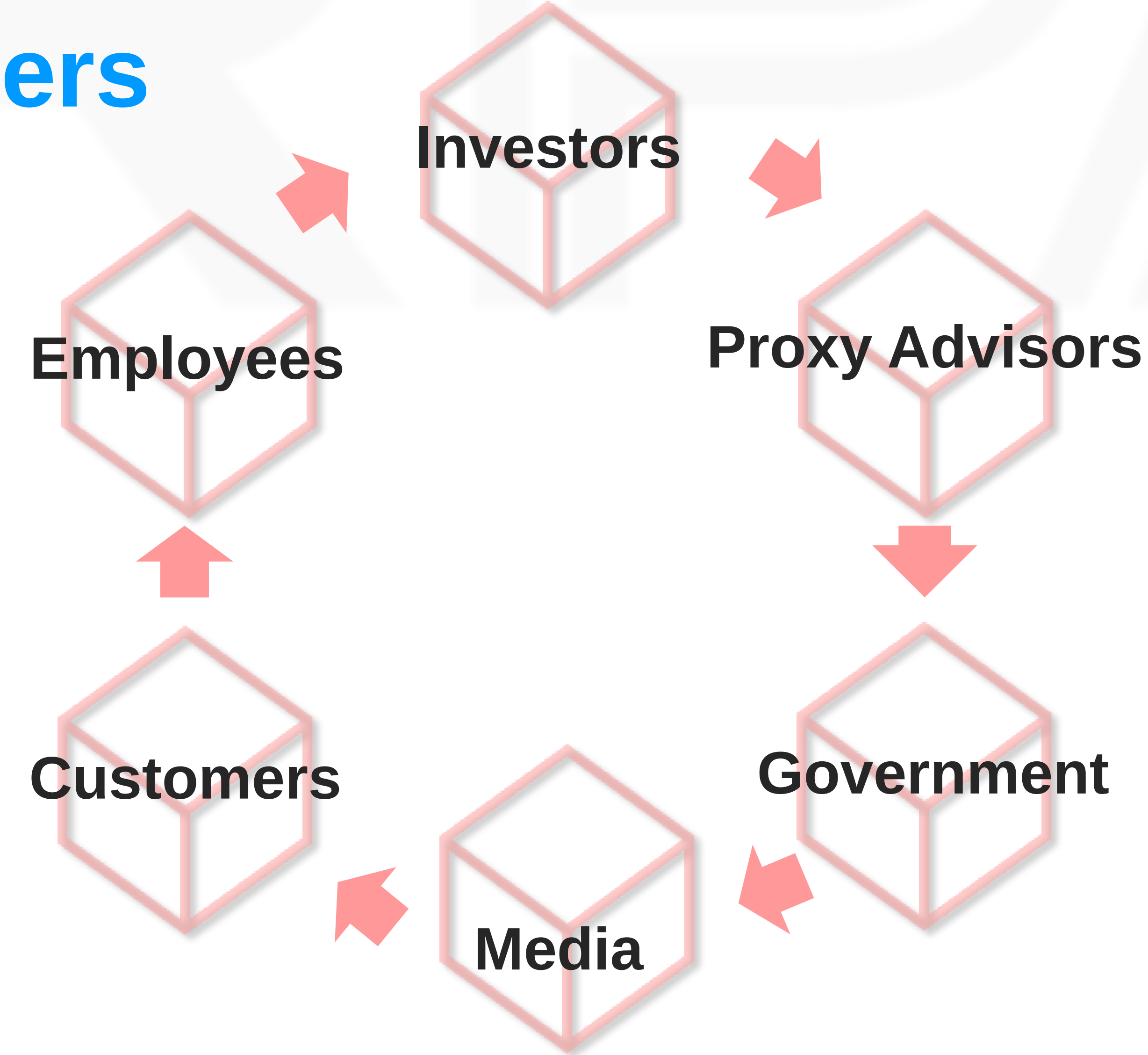
What Makes Executive Compensation *different?*

Why isn’t there a similar backlash about the pay of other highly paid professionals?



Key Stakeholders

influencing executive pay



Investors

- One of the most influential stakeholder groups with differing interests and objectives
- Institutional investors have largest share of ownership
  - Mutual funds
  - Pension funds
  - Sovereign entities
- Activist investors challenge pay if excessive or misaligned with performance

Proxy Advisors

- Analyze and advise institutional investors on proxy voting
- Two firms control most of the market
  - Institutional Shareholder Services (ISS)
  - Glass Lewis
- Large investors develop custom voting policies; smaller investors vote according to proxy advisor recommendation
- Criticized by public companies (more on this later in the course)

Government

- Increase in government oversight of pay over the past 20 years
- In the U.S., regulations typically included as part of broader legislation or tax code revisions
- Government agency with most direct impact is the Securities and Exchange Commission
- The SEC's influence resulted from increased disclosure requirements: expansion in what companies must disclose about the process used to determine pay and the actual amounts paid

Media

- Both business and non-business media are important stakeholders
- Business media focus mainly on financial, business and governance issues
- Non-business media more likely to view executive pay negatively
- Social media activism can use executive pay issues to cause reputational damage

Customers

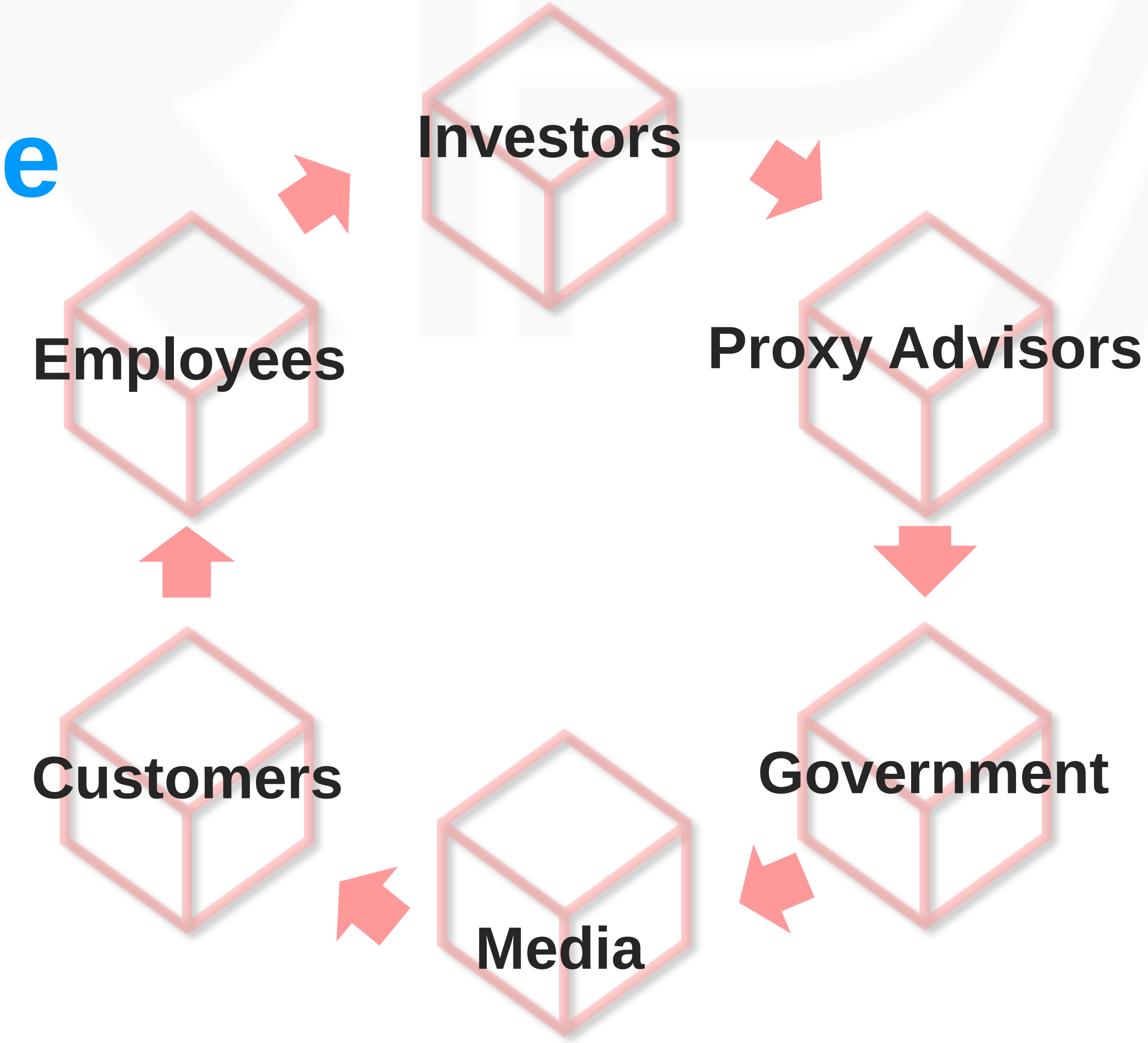
- Customers are an increasingly important stakeholder, especially for companies who sell products and services directly to consumers
- Brand reputation influences consumer behavior
  - A 2019 study found that 69% of consumers considered governance practices such as the level of executive compensation to be significant in their decision-making

Employees

- To be effective, pay programs need to be understood and viewed as fair by executives
- Although most regulations impact the pay of a small number of executives, the overall climate influences the design of pay programs below the C-Suite
- The pay ratio requirement to disclose median worker pay may generate employee interest and concerns about rising inequality

The Bottom Line

Designing executive pay programs requires balancing the interests of diverse stakeholders with differing objectives, motivations and interests.



Executive Compensation
Objectives and Philosophy

Defining 3 Categories of Executives

Executive Officer

- Section 16 Officers reportable under Securities Exchange Act of 1934
- Also called "Section 16 Officers"; executives in charge of a principal business unit or who perform a policy making function of the company

Named Executive Officers (NEOs)

- Defined by proxy reporting rules
- Compensation is required to be disclosed in the annual proxy
- Consists of CEO, CFO and next 3 most highly paid officers

Company Designated Officers or Executives

- All positions that generally participate in annual and long-term incentives (may not meet criteria for Section 16 or NEOs)
- Number will differ by company
- Provides status and recognition of the person or role and its authority

Objectives of Executive Pay

- What are the one or two most important objectives of your company's executive compensation program?

Chat

Use the Chat button to answer.
Chat is located on the webinar menu.

Common Objectives of Executive Pay

- Align the interests of management and shareholders
- Link pay to performance
- Attract and retain talent
- Create an effective incentive
- Manage risk

Effective design requires tradeoffs between (sometimes) competing objectives.

Pay Philosophy: The Three Questions

- How much should we pay our executives?
  - Setting target pay position and comparator group
- How should pay programs be designed?
  - Pay components and mix
- What should we pay for?
  - Selecting performance measures

Executive Compensation

Target pay and peer group selection

Target Pay

- What is the ’right’ level of pay to attract the talent we need?
- Business and talent context is critical to establishing target pay
- Most public companies target executive compensation at the median of their peer group

Peer Group Selection: Stakeholder Perspective

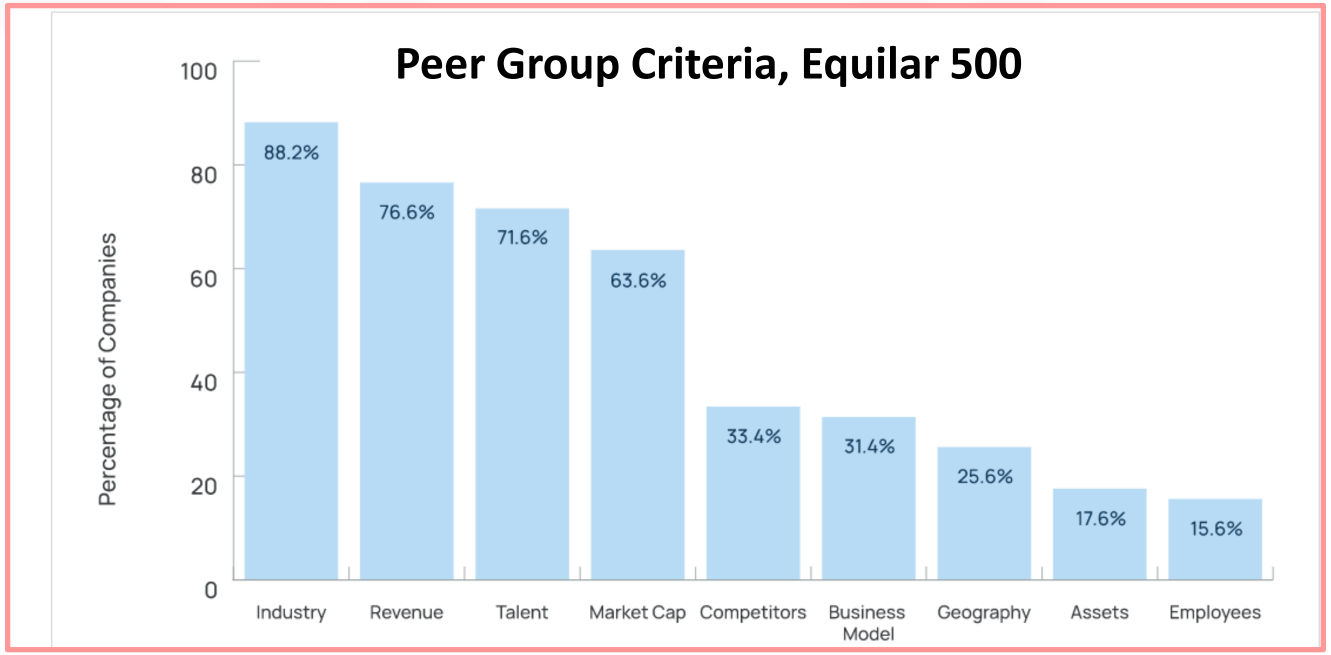
Establishing the Peer Group

- Peer groups are used in three primary ways:
  - Compare the amount of pay being delivered
  - Compare pay program design and practices
  - Compare performance in incentive plans

- Peer group selection often a source of tension between management and stakeholders, such as proxy advisory firms

Peer Group Characteristics

- According to data from Equilar[1]:
  - 70% of companies have between 11 and 20 peers
- Industry is the most common criterion, followed by size (measured by revenue and talent market)



[1] *Equilar Institute Blog, April 2023*

Homework: Who are your company's executive compensation peers?

- Get a copy of your company's most recent proxy statement and find the section disclosing the peer group
- Be prepared to answer the following questions at tomorrow's session:
  - How many peers are listed?
  - Is the peer group used for comparing pay, performance or both?
  - What criteria is used to select the peer group?
  - Are there any companies you expected to see that didn't make the list? Any that made the list that were surprising to you? Why?

INTERMISSION

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Our session will resume shortly

Please read Day 1 Case Study if you have not already done so

The Elements of Pay

Building a Pay Program

The Components of Executive Pay

- Base salary
- Annual incentives
  (mostly cash)
- Long-term compensation
  (mostly stock-based)
- Other
  (benefits, perks, severance)

Source: Equilar CEO Pay Trends, July 2023

Stock-based compensation is the largest component of executive pay

Base Salary

- Smallest component of the total pay package, paid in cash
- Increases typically modest and infrequent
- Benchmarked to peer company data
- May be subject to symbolic cuts – for example, during recessions or company-specific financial distress

Annual Incentives

- Significant portion of total compensation, paid in cash
- Target opportunity typically set as a percentage of base salary
- Actual amount earned based on performance

Annual Incentives: Design Elements

- Performance metrics: pay for what?*
- Line of sight: corporate, business unit, or individual performance
- Structure:
  - ***Components*** – award is "sum of the parts," each earned independent of the other
  - ***Multiplier*** – performance on one metric can influence (modify) the amount earned based on performance of another metric
  - ***Pool*** – performance determines a 'pool' of funding to be distributed; amounts often determined based on individual performance

** To be covered in Part Three*

Long-term Compensation

- Aligns interests of management with shareholders
- Largest component of total compensation
- Most frequently paid in equity, but can be cash-based
- Accounting, tax and financial considerations can be complex*
- Prevailing forms of LTI include:
  - Performance plans
  - Stock options
  - Restricted stock

** To be covered in Part Three*

Top 250 CEO Equity Mix

- Performance awards: over half of the LTI opportunity
- 75% is at risk (Performance Awards + Stock Options/SARs)
- Stock options declined in prevalence over the past decade and held constant in recent years, while use of performance awards is nearly universal

FW Cook, 2023 Top 250 Report

Performance Plans

- Most common form of long-term incentive
- Amount earned depends on performance against an established metric over time
- Most common performance period is three years
- Paid in stock or cash

Stock Options

- The right to purchase a share of stock at a specified price for a set period of time
- Provides partial alignment of management with shareholders
  - Recipient receives upside benefit but not downside risk
- Stock Appreciation Rights (SARs) operate in a similar fashion
  - No underlying right to purchase stock; right to receive gain from the share appreciation

Restricted Stock

- Grant of shares of stock with vesting contingent only on the passage of time and continued employment

- Value depends on stock price performance

Your Breakout Rooms

- **You’ll each be assigned to a Breakout Room for a team exercise: ”Navigating CEO Pay Issues”**

- **Review the short case exercise and discuss**

Group Discussion

How would you handle the situation with the CEO of SmartCo?

Other Forms of Pay

- Inducement or “hire on” pay: Hiring executive talent from outside the company often requires granting significant amounts of compensation to address two factors:
  - Risk to the executive
  - Replacement of existing awards

- Risk Considerations: new company culture, nature of the business challenge, reputation and history of person being replaced, reputation of the management team and board

Inducement Compensation

- Buyout of existing LTI awards is complex and depends not only on establishing value of compensation being forfeited but also the philosophy of the organization.

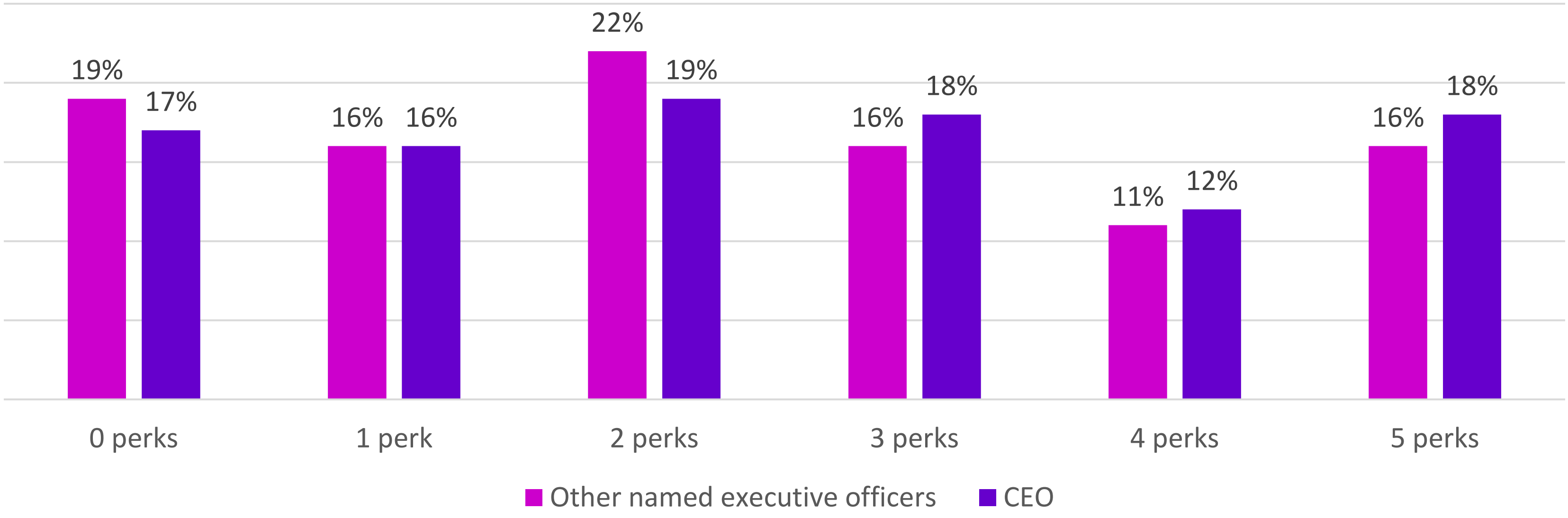
- Inducement packages generally comprised of time-based equity
  - Performance conditions becoming more common

Severance Packages

- Typically three basic components:
  - Cash payment(s)
  - Treatment of outstanding awards under existing compensation arrangements
  - Continuation of benefits and other perquisites
- Severance typical when the executive’s exit is involuntary
- Severance arrangements are also used in conjunction with corporate transactions (mergers, acquisitions, divestitures)

Benefits and Perquisites

- Benefits provided exclusively to executives have declined significantly in the past decade
  - 83% of S&P 500 companies provide at least 1 perk to CEOs; 81% for other NEOs
  - The median aggregate spend for all NEO perks was $223,000 in 2023



Source: WTW's Global Executive Compensation Analysis Team research; reflects a review of 496 S&P 500 companies that filed a proxy statement in fiscal 2023.

Benefits and Perquisites

- Personal use of corporate aircraft
  - Often provided for security and efficiency purposes
  - Most prevalent perk, provided to 46% of S&P 500 CEOs
  - Median annual limit: $190,000 or 75 hours
- Home/personal security services
- Executive physicals
- Financial / tax planning
- Non-qualified deferred comp/supplemental retirement plans

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Part One Recap

Thank You