

Is 2020 Upending Compensation Committee “Best Practices”?

A Compensation Committee Series Webinar
Presented by NACD and Pearl Meyer

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Meet the Presenters



Howard Brownstein is president of The Brownstein Corporation, specializing in turnaround and crisis management. He is a director with P&F Industries, where he chairs the nominating/governance and strategic planning/risk assessment committees and is on the audit committee. He is a former director with Renew Financial, A.M. Castle, and PICO Holdings. Brownstein is an NACD Board Leadership Fellow and the immediate past president/chair of the NACD Philadelphia Chapter.



Deb Lifshey is a managing director at Pearl Meyer in New York where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters. She is a member of the New York and Florida Bars.



Lianne Richardson is a principal in Pearl Meyer's New York office. She specializes in providing compensation consulting services to public and privately held clients, including market benchmarking, proxy analysis, incentive plan design, executive compensation strategy and philosophy development, and non-employee director compensation

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- Presentation slides are available today at www.pearlmeyer.com/2020-best-practices and within the webinar console.
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Today's Agenda

- Compensation committee's responsibilities are expanding
- Great uncertainty from pandemic and social justice crises
- Outdated benchmarking
- Considerations for core pay elements: base, STI, LTI
- Considerations for non-employee director programs
- Legal considerations of material change in programs
- Proxy advisory firms and shareholder engagement

Compensation Committee's Core Responsibilities



CEO Performance

- Review and evaluate CEO performance

CEO and Senior Management Compensation

- Establish pay levels
- Approve relevant goals
- Approve employment agreements, severance agreements, etc.

Administer Compensation Programs

- Establish a compensation philosophy
- Incentive plan parameters and equity plans
- Recommend plans to submit for shareholder approval

Non-Employee Director Compensation (can sometimes be with Nom/Gov)

- Review market pay levels
- Recommend compensation program to full board

Regulatory Oversight

- Review CD&A and recommend to board
- Review shareholder advisory votes and recommend actions, if any, to the board

Select Independent Outside Advisors

- As appropriate

Emerging Responsibilities

- Succession planning
- Human capital management and ESG
- Expanded authority to adjust compensation

- Unlike 2008/2009, all industries are impacted
- Great uncertainty so long as we are socially distancing
- Balance sheet and cash management are priorities
- To date, company approaches vary by impact

Positively Impacted (e.g., PPE Manufacturers)	Neutrally Impacted (e.g., Pre-Commercial Biotech)	Moderately Negatively Impacted (e.g., Consumer Staples)	Severely Negatively Impacted (e.g., Retail, Restaurants)
<ul style="list-style-type: none"> ▪ Active recruitment ▪ Special incentives ▪ Retention risk 	<ul style="list-style-type: none"> ▪ Supporting newly remote workforce ▪ Evaluating non-critical investments ▪ “Wait-and-see” 	<ul style="list-style-type: none"> ▪ Merit freezes ▪ Hiring freezes ▪ Targeted layoffs/furloughs ▪ Incentive goals are outdated 	<ul style="list-style-type: none"> ▪ Significant layoffs ▪ Executive salary cuts ▪ Board pay cuts ▪ Government assistance

This Crisis is Different

- Before the pandemic, boards were already discussing the purpose of corporations beyond profitability and shareholder value
- Critics will scrutinize “winners” vs. “losers” amid a climate of shared responsibility and duty
- Shareholders have not hit “pause” on ESG discussions
- Compensation committees will consider how all stakeholders, especially employees, are faring during the crisis

BR Business Roundtable

BLACKROCK

Continuing discussion of a corporation's purpose

- Focus beyond profitability and shareholder value
- Recognize broader stakeholders (environment, human capital, etc.)
- Increase disclosure and transparency

Benchmarking and Market Prevalence Studies are Outdated



- Under normal circumstances, compensation committees would spend the summer months benchmarking executive and director pay in preparation for the fall work of developing strategic compensation programs for 2021
- Latest proxy statements include:
 - FY 2019 compensation amounts
 - FY 2019 annual and long-term incentive plan designs, which represent “normal” business conditions before the pandemic
 - Sometimes include prospective changes for FY 2020, which for calendar year companies, were also established before the pandemic

Changing Priorities going into 2021:

- Base salaries – new cutbacks, restoration, or merit freezes?
- Depending on business impact level, different business priorities and metrics for incentive plans
- Low stock prices and potential retention/engagement issues vs. affordability and burn rate

- **To date, very few market examples of prospective changes for 2021**

Base Salaries

As of July 31st, ~310 companies disclosed executive salary cuts:

- Represents only 10% of Russell 3000
- Most negatively impacted industries (consumer discretionary) took immediate action after initial social distancing policies
- 5% of companies have begun to restore them but 40% of other companies already have a pre-determined sunset date

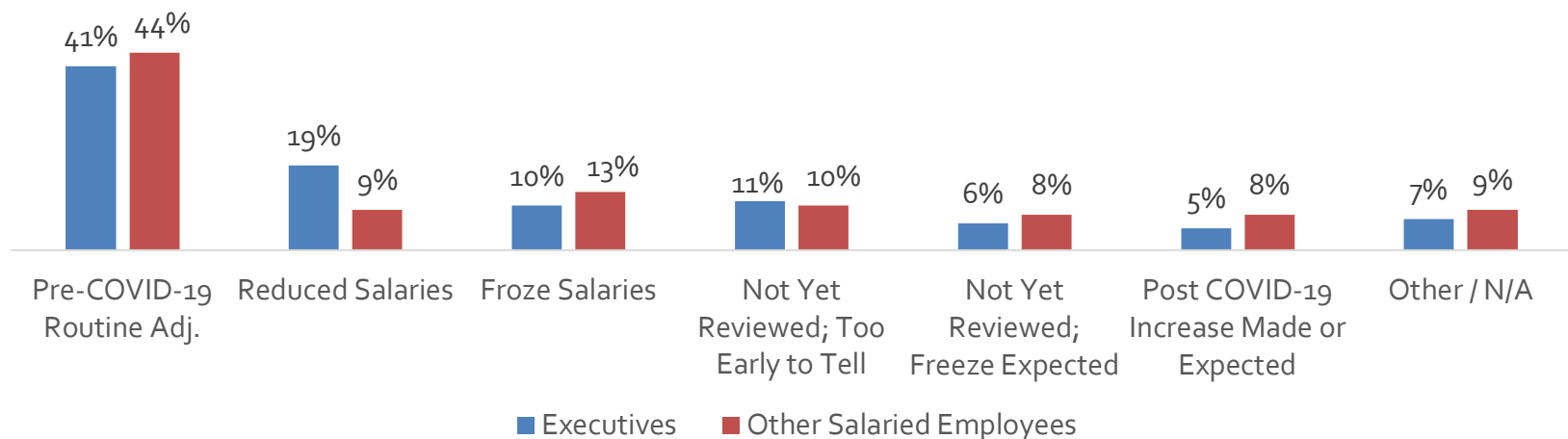
2021

Companies will likely assess business conditions immediately before 2021 merit increase considerations

- Base salary represents a small portion of the overall senior executive pay mix
- We may see merit increases reserved for next level/middle management

A June Pearl Meyer On Point Survey provides additional insight:

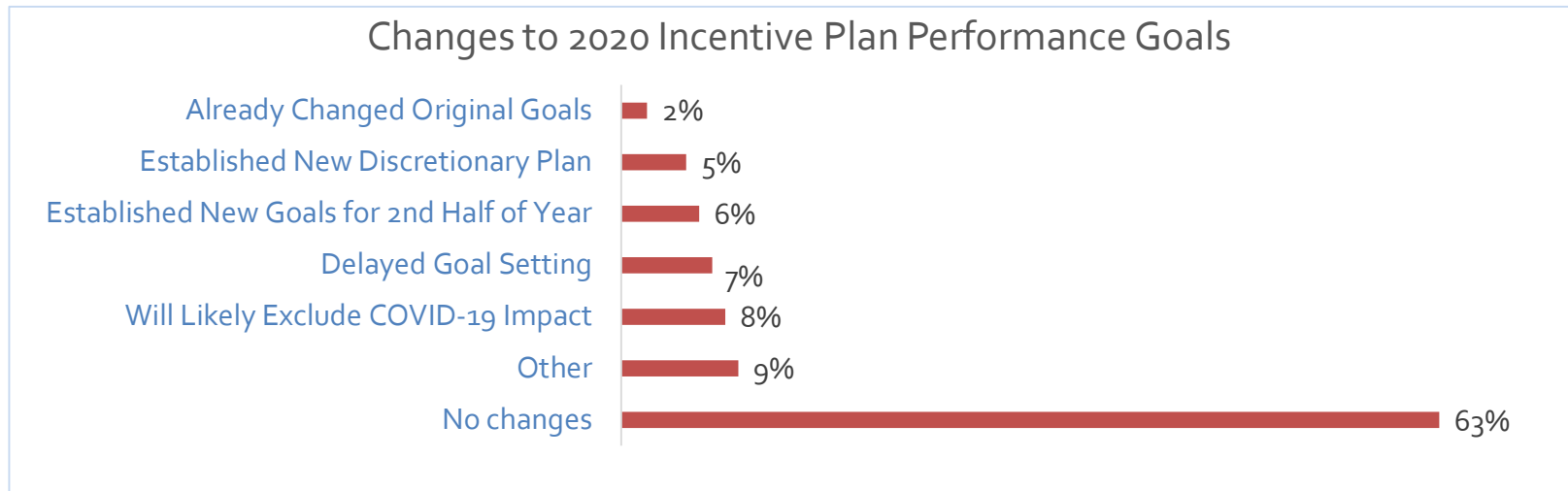
Base Salary Actions Taken or Anticipated



Annual Incentive Plans - 2020



The June Pearl Meyer On Point Survey indicates that most companies are taking a “wait and see” approach to the 2020 plan



- Can performance prior to the pandemic be assessed?
- Replace the first half-year bonus with a new plan focused on cost containment/cash flow or other measures?
- Reduce initial performance targets based on current macroeconomic factors?
- What factors should be considered at year-end to support use of discretion?

Polling Question #1: Annual Incentive Plans



- Has your compensation committee agreed to exercise discretion to determine annual incentive plan year-end incentive awards?
 - Yes
 - No
 - Still evaluating

Polling Question #2: Annual Incentive Plans



- If the answer to the previous question is “No” or “Still evaluating”, has your compensation committee agreed to **consider** exercising discretion to determine annual incentive plan year-end incentive awards?
 - Yes
 - No
 - Still evaluating

- **What we might see for 2021:**
 - Less emphasis from financial metrics toward strategic metrics on a temporary basis
 - Widening of performances range to increase the possibility for participants to “get in the game”
 - Splitting of the annual plan into a semi-annual or quarterly plan with payout delayed until year-end
- **Darden Restaurants recently disclosed information on its annual incentive plan:**

2020

- Bonus payout of 94% of target based on performance over the 1st three quarters
- No merit increases or change to target bonus and LTI values for 2021

2021

- Bonus will be based on financial results for 2nd half of year
- Final measures can be adopted later, when there is better visibility
- Non-financial measures for the 1st half of the year will be a modifier to financial performance results

Long-Term Incentive Plans – Outstanding Awards



Modifications to outstanding equity award cycles is unattractive to many companies due to negative accounting and disclosure implications

Outstanding Awards	Key Considerations
PSUs ending in 2020	<ul style="list-style-type: none"> ▪ Understand earning level thru latest completed year (2019) ▪ Understand potential impact of 2020 on final payout level ▪ Understand the (a) ability to use and (b) potential consequences of applying discretion to the earning level at the end of the performance period ▪ Evaluate truncating the performance period, locking in the earning level, while preserving the full period vesting schedule
PSUs ending in 2021 and 2022	<ul style="list-style-type: none"> ▪ Same as above, but more time to assess and resolve ▪ Could eventually re-set performance goals once forecasting visibility is restored
Underwater stock options	<ul style="list-style-type: none"> ▪ In most cases, no action necessary (given term) or advisable (given constraints on option re-pricing and exchanges)

Polling Question #3: Long-Term Incentive Plans



- Has your compensation committee agreed to exercise discretion to determine long-term incentive plan year-end awards?
 - Yes
 - No
 - Still evaluating

Polling Question #4: Long-Term Incentive Plans



- If the answer to the previous question is “No” or “Still evaluating”, has your compensation committee agreed to **consider** exercising discretion to determine long-term incentive plan year-end awards?
 - Yes
 - No
 - Still evaluating

Long-Term Incentive Plans – 2021 Grants



Companies that pay zero/modest bonus and/or zero for PSUs in 2020 may be challenged with retention concerns, particularly for next generation leadership and high performers below the NEO group.

- We may see the following actions for 2021:
 - Slightly higher LTI grant values or retention awards with longer vesting
 - Temporary change in LTI mix to provide heavier emphasis on RSUs and stock options in lieu of PSUs
 - PSUs metrics may focus on operational/strategic measures in lieu of financial measures or greater use of relative metrics, including TSR
 - Companies adopting relative measures will evaluate whether they have the right performance peer group

However, at lower grant date stock prices, some will assess whether dollar-based grants are affordable or appropriate.

- We could see some actions to limit burn rate:
 - Grants under “modified” methodology (e.g., switch from \$ value to # of shares, adopt/lengthen average trading days, switch to quarterly grant practice, etc.)
 - Delay grants until stock price recovers
 - Settle awards in cash
 - Limit use of stock options

FedEx recently disclosed information on their 2021 equity plan

- No annual incentive plan for 2021
- Special retention RSUs grant for executives other than the CEO (4-year step vest)
- Special FMV options grant for CEO (4-year step vest)
- LTIP measures updated to assess efficiency and capital deployment
 - New Measures: 75% EPS / 25% CapEx to Revenue
 - Prior Measure: 100% EPS

Non-Employee Director Compensation



In contrast to executive pay cuts, fewer companies (~225) disclosed board cash compensation reductions

~75% of companies that reduced executive salaries also reduced board cash retainers

- The most common approach is a percentage reduction in the annual cash retainer (e.g., 25%-100%)

Many companies considered whether the most recent 2020 annual grant should be adjusted based on a lower grant date stock price

- Make grants following standard methodology
- Delay grants until stock price recovers
- Make grants under a unique methodology in recognition of unique circumstances
 - Grant the same number of shares as last year
 - Convert value into a number of shares using (1) A pre pandemic stock price; (2) the stock price used for executive grants in Q1; or (3) an average stock price (30, 60, 90 days, etc.)
- Convert value into a number of shares using the grant date stock price, but subject to a maximum grant level, perhaps based on a percent of CSO for aggregate share usage for NED awards

For 2021, companies will likely choose to maintain the existing compensation structure

- Annual increases in recent years have been modest, single-digit increases
- Equity awards and share usage will be evaluated. If executive grants are cut-back, directors may follow suit

Legal Considerations of Material Change in Programs



Committee Charters

- Is there ample discretion or authority to change plans and programs? Is full board review warranted?

Contractual Issues

- Good-reason triggers
- Trickle down impact from reduction of base salary on targets or other benefits

Stock Ownership Guidelines

Tax Issues

- Impact on 280G and 409A
- Payroll deductions and tax withholding

CARES Act Restrictions (if assistance taken)

Disclosure

- Form 8-K
- Proxies
- Internal communications

Proxy Advisory Firms and Shareholder Engagement



- Proxy advisory firms have offered little guidance for 2020
- Direct shareholder engagement will likely increase in 2021 and 2022 as companies explain pay actions for 2020 and 2021
- 2021 will likely be an outlier year where we see a temporary change in incentive plan designs
- Some companies may emphasize alignment of the business and human capital strategy to incentive plans over proxy advisory firm “best practices” to retain and motivate key talent during uncertain times, requiring strong leadership to successfully manage the company through the crises
- Disclosure should explain the committee’s decision-making process and describe how pay actions were aligned with long-term shareholder value

Topic	Guidance
Annual Bonus	<ul style="list-style-type: none"> Any changes to metrics/measures should be contemporaneously disclosed
LTI	<ul style="list-style-type: none"> Case-by-case review but generally not supportive of changes to in-flight awards; will be reviewed for appropriate director discretion and adequate disclosure
Repricing	<ul style="list-style-type: none"> No relief; will be assessed under current standards which recommend against repricing that occurs within one year of precipitous drop
Attendance	<ul style="list-style-type: none"> Alternative forms of attendance at meetings should be disclosed
Changes to Board	<ul style="list-style-type: none"> May be some relief on independence, overboarding, and diversity standards if companies need to fill critical vacancies due to death, disability, incapacity, etc.
Postponement of Annual Meeting	<ul style="list-style-type: none"> Preference for companies to use some form of communication to engage with shareholders, even if annual meetings are delayed
Virtual-Only Meetings	<ul style="list-style-type: none"> If you hold one, explain why
Dividends	<ul style="list-style-type: none"> Support broad discretion to set payout ratios
Share Repurchases	<ul style="list-style-type: none"> ISS will monitor to see if directors managed risks in responsible fashion

Glass Lewis Policy Guidance



Topic	Guidance
Compensation	<ul style="list-style-type: none"> ▪ Peremptory warning that executive compensation should not be protected at the expense of employees and shareholders <ul style="list-style-type: none"> • Open invitation for activists and lawsuits onto a company’s back for years to come • Even those who project a “business as usual” approach to executive pay will face opposition if employees and shareholders see their own paychecks cut ▪ Expect a marked increase in shareholder concerns on repricing, dilution, burn rates, hurdle adjustments, changes to vesting periods, caps and cuts on incentives, and the quality of disclosure concerning the limits and exercise of board discretion ▪ Responsible companies hit hard by the crisis should take early and decisive action to roll back planned salary increases or above-target bonus outcomes
Disclosure	<ul style="list-style-type: none"> ▪ Effective disclosure and rationales will be critical to assess whether their actions are justified and address material shareholder concerns ▪ Expects boards to proactively seek changes that align with employee and shareholder experiences, recognizing that executives might need to take a pay cut ▪ Companies that have a good track record on governance, performance, and the use of board discretion prior to the pandemic will be afforded more discretion in their analysis than those that do not
Virtual-Only Meetings	<ul style="list-style-type: none"> ▪ For companies opting to hold a virtual-only shareholder meeting due to COVID-19 between March 1, 2020 and June 30, 2020, GL will generally refrain from recommending to vote against members of the governance committee on this basis, provided that the company discloses, at a minimum, its rationale for doing so, including citing COVID-19

SEC Adopts Rule Amendments and Provides Guidance for Proxy Advisor Voting



- On July 22, the SEC voted 3-1 to adopt final securities rule changes and related supplemental guidance on the proxy voting advice process
 - The final rules, which are intended to be principles-based, were welcomed by companies, but strongly opposed by the proxy advisors (PAs)
 - No immediate action, but companies should be aware that proxy voting process has likely shifted in their favor with easier access to PA reports that contain voting recommendations and a better chance for their reaction to the PA advice to be heard directly by institutional investors and other voting shareholders

Securities Rule Changes

Applicable to Proxy Advisors

(Amended rules effective 60 days after publication in Federal Register. However, PAs not required to comply until 12/1/2021)

- **PAs are Engaged in Soliciting** - therefore, PAs are subject to onerous filing and information requirements unless they meet certain exemptions
- **Conflict of Interest Disclosure** - PAs will need to provide clients with their conflicts policy, including methodology and sources of information
- **Companies have Access to PA Reports and a Meaningful Rebuttal Opportunity** - Companies must have access to free PA reports at the same time they are made available to Investment Advisors (IAs), and IAs should ensure they are able to review any company responses to the PA report prior to the vote. Companies should be prepared to review PA reports, as well as provide comment to the extent that they disagree with the methodology or facts underlying the recommendation

Supplemental Advice

to Investment Advisors

(Not subject to review and comment and is effective upon publication in the Federal Register)

- **Review of Company Rebuttals** - IAs should have a procedure in place to review supplemental filings made by a company following the IA's receipt of the PA voting recommendation report
- **Robovoting Disclosure** - If IAs chose to use a PA for robovoting (pre-populating ballots using PA voting methodologies), the IA should let its clients know that voting is done in this manner

- **Uncertainty across industries due to the pandemic**
 - This crisis is different from all others – we are all impacted
 - Many companies still taking a “wait and see” approach; moderately and critically impacted industries may exercise discretion at year-end
- **Compensation benchmarking is outdated with respect to 2021 decisions**
- **Considerations for 2021**
 - Does the company have enough visibility to establish annual and/or three-year goals?
 - How does the company keep participants engaged in the plans?
 - Are there any retention concerns?
 - Are proposed compensation actions affordable?
- **Compensation committee’s oversight role was increasing before the pandemic**
- **ISS and Glass Lewis policy guidance is limited as of now**
- **What is the shareholder communication and engagement strategy?**
- **Have you reviewed the legal implications?**

Questions

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