“Organizational Health: The Common Thread in the 2022 Compensation Committee Agenda”

NACD
Empowering Directors. Transforming Boards.

A *Compensation Committee Series* Webinar

Presented by NACD and Pearl Meyer

December 9, 2021

Presenters

Louis Caldera is a former secretary of the Army and former president of the University of New Mexico. He currently serves as a director of Granite Construction and DallasNews Corp and chairs DallasNews Corp.'s management development and compensation committee. Caldera began his career as an Army officer, corporate lawyer, and California legislator. He also served in the White House as an assistant to President Obama and director of the White House Military Office. He has taught law school courses on corporate governance and legislative and political process. A member of the Council on Foreign Relations, Caldera is active civically; he serves on the board of The Corps Network and is cofounder and cochair of The Presidents' alliance on Higher Education and Immigration.

Aalap Shah is a managing director in the New York office of Pearl Meyer. With more than 15 years of experience, Shah advises public and privately held companies on executive compensation issues. His work focuses on pay governance, pay-for-performance alignment, and incentive plan design, with particular interest in the intersection between business strategy, people strategy, and compensation strategy. He advises clients in a variety of industries, including high-tech, health care, financial services, consumer products, retail, manufacturing, real estate, and media, and also consults on special compensation programs for initial public offerings and merger and acquisition transactions.

Kimberly Neil is a vice president in Pearl Meyer's Charlotte office. She is experienced in executive, board, and broad-based employee compensation assessments and strategies and works with clients to develop solutions that achieve desired objectives and help enhance corporate performance.

Housekeeping

- Submit a question and receive your answer directly from the presenters, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.
- Presentation slides are available today at www.pearlmeyer.com/2022-compensation-committee-agenda and within the webinar console.
- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/2022-compensation-committee-agenda.

NACD Credentialing Information

NACD

Your participation in today's webinar earns you credit toward maintaining your NACD credentials.

NACD Board Leadership *Fellowship*

If you're working toward maintaining your NACD *Fellowship*® credential, you will receive **1 skill credit.**

1 Skill
Fellowship Credit

NACD Directorship Certification™

If you're working toward maintaining your NACD Directorship Certification credential, you will receive **1 recertification credit.**

1 CREDIT
DIRECTORSHIP CERTIFICATION

On the 2022 Agenda: Cultivating Organizational Heath

NACD

- The differentiating trait of an organization in the long run is the quality of its people.
- Today, the top-line concern of the compensation committee is how an organization leads and manages its most valuable resource.
- We expect several areas of focus for the compensation committee in 2022

Top 5 Summary:

1. Exploring New Ideas in Executive Compensation Structures

The core responsibility of designing compensation plans that attract, retain, and motivate the right CEO and his/her executive team requires new levels of creativity and flexibility—more customization to each organization's unique circumstances than ever before.

2. Mitigating Risk and Creating Resilience in Goal-Setting

The effects of COVID over the last two years and recent concerns about rising inflation and supply chain deterioration have highlighted some possible areas for improvement when it comes to incentive plan goal-setting. How can compensation committees create plans that are more resilient to external unknowns, while still driving long-term performance?

3. Evolving the ESG Conversation

The exploration of the merits of environmental, social, and governance concerns has matured. The conversation now is about how best to move the needle on the ESG points that matter most to an organization; that may be through incentive plans or perhaps through other equally important actions.

4. Reprising "Servant" Leadership

The nature of the workforce is in significant transition; it is increasingly contractual and everything is up for renegotiation. Organizations are seeing the need for leaders that can foster a sense of inclusion and flexibility in order to maintain a cohesive workforce that can grow the enterprise.

5. Maximizing Board Effectiveness

Finally, the board itself must lead with the same traits it seeks to instill in the organization. How can an evolving board make the most of its diverse composition and skills?

1. Exploring New Ideas in Executive Compensation Structures

NACD

Context and Potential Issues:

Component	Typical Public Company Model
Salary	• Annual review • Annual merit increases • Annual market adjustments
Short-Term Incentives	• One-year performance period • One to three financial metrics • Additional non-financial metrics • Payout range 0-200% of target • Metrics/weights changed regularly
Long-Term Incentives	• Annual grants • No executive investment required • Mix of RSUs, Options, and PSUs • PSUs tied to three-year financial performance with a relative TSR modifier with a payout range of 0-200% of target • Equity mix changed regularly

- The typical executive compensation model for public companies has been stagnant for a decade, with periodic tweaks to incentive plan designs (mix, metrics, calibration, etc.)
- However, the business environment has changed dramatically with increased competition from PE-backed companies and broader views of corporate purpose and accountability
- And the current executive compensation model has significant complexity with annual pay negotiations, multiple and changing metrics, overlapping performance cycles, and multi-year goal setting for financial metrics

Key Question: Is the typical model the most effective and appropriate going forward, or are there alternatives that should be explored and considered?

1. Exploring New Ideas in Executive Compensation Structures

NACD

New Ideas to Explore and Consider:

A Bit Radical – "New Ideas" to Explore Within the Typical Model	
Eliminate Merit-Based Salary Increases for Executives*	• Executives already have substantial performance-based pay, so base salary does not need to be performance-based
Increase Use of Relative Metrics in STI and LTI Plans	• Although sometimes difficult to ensure comparability across companies due to differing accounting policies, does reduce "pressure" on the annual budgeting process for short-term incentives and alleviate some concerns with absolute multi-year goal setting for long-term incentives
Reduce or Eliminate PSUs in the Long-Term Incentive Plan*	• Many PSU designs have high levels of complexity that can mitigate their effectiveness – multiple and changing metrics, multi-year goal setting, finite performance periods overlapping performance periods, feast or famine payout cycles, required adjustments for M&A, etc. • A simple mix of options and RSUs may provide more tangible retention and performance incentives; with premium-priced options available where an even stronger alignment between pay and performance is desirable
Are You Crazy? – "New Ideas" to Explore Outside the Typical Model	
Provide Up Front Equity Grants in Lieu of Annual Equity Grants*	• Consider changing from annual grants to up-front grants that cover three to five years, which is more easily adopted when PSUs are not in the grant mix
Put the CEO on a Different Pay Program and/or Pay Cycle*	• Consider a "once and done" approach to CEO pay upon hire that would cover the first five years of the CEO's tenure (e.g., no salary increases, no changes to target STI opportunities, no additional equity grants, etc.) • Establishes "the deal" up front and allows the CEO to have more of a shareholder perspective when addressing annual executive compensation adjustments for the leadership team

2. Mitigating Risk and Creating Resilience in Goal-Setting

- Traditionally, setting performance goals involves:
  - Multiple analytic perspectives (budget, cost of capital, shareholder expectations, etc.)
  - Calibration of performance to appropriate pay levels (threshold, target, maximum)
  - Consideration of other relevant factors known to the Board and management, especially company-specific factors and historical context
- But things have become a bit more complicated:
  - Increased uncertainty of business results and share price performance (COVID-19, supply chain disruptions, the environment, social movements, politics, etc.)
  - The expanding performance scorecard—ESG is not a fad
  - The intensifying war for talent—the Great Resignation
- How can companies better ensure “practical and adaptive” pay-for-performance?

2. Mitigating Risk and Creating Resilience in Goal-Setting

NACD

Good “blocking and tackling”

Control for highly volatile inputs

More measures

More use of time-based equity

Relative performance metrics

Discretion; judgement

Wider performance ranges

Shorter performance periods

Target as a range

3. Evolving the ESG Conversation

- Investors increasingly seek to hold boards accountable for environmental, social and governance objectives
  - Sustainability is important, not just current financial results
  - Climate change and DE&I lead concerns currently
  - Proxy advisors are evaluating quality of ESG disclosure
  - This is a topic at every compensation committee meeting
  - The signaling effect of incentive plan metrics is especially powerful
    - We communicate through incentive plans that which is important to the organization; what we pay for sends a very strong message to stakeholders
  - While many call for ESG to be added to incentive plans, the real question is “How is the company addressing sustainability of the business?”
    - Incentive plans support strategy, but don’t drive it. Leadership does.
  - Incentives may be part of the answer, but…
    - Everything you add to incentive plans dilutes focus on something else

3. Evolving the ESG Conversation

NACD

- Should ESG be an incentive plan measure? Some would ask "When?" and not "If?"

Companies evaluating whether or not to include ESG-based incentive metrics should ask:

What is the company's culture and its strategic priorities?	Are ESG goals critical to business success and value creation?	What do investors, customers, and employees want?	What are peers doing? Should XYZ be a leader or a fast follower?
Is there a robust process in place to collect and analyze relevant data?	Is it possible to set specific goals and make progress on ESG metrics?	What is the desired time frame for making progress?	What are the assurance processes? Can results be audited?

3. Evolving the ESG Conversation

NACD

How are ESG metrics incorporated and measured?

- Inclusion of ESG in incentive programs remains a minority practice although prevalence is quickly increasing
- Most are typically found in annual incentives (vs. long-term incentives)
- Mixed practice as to:
  - Included in individual performance element or as a separate metric;
  - If separate metric, as a modifier or weighted element;
  - Quantitative vs. qualitative goals; and
  - Full payout curve vs. “all or nothing” vs. subjective evaluation.

Individual Performance Consideration	Team-Wide Scorecard	Formulaic Metric or Modifier
ESG metrics incorporated into the individual performance assessment often with metrics varying by individual	ESG metris are incorporated into a scorecard by which all NEOs are evaluated. The ESG metrics are not a formally-weighted component of the scorecard, but rather are considered as part of a holistic evaluation of performance	ESG metrics are formally weighted and achievement is considered as part of a formulaic determination of the incentive

Greater Impact on Payout →

No ESG-Specific Performance Disclosure	Qualitative Performance Disclosure	Quantitative Performance Disclosure
ESG metrics are listed among the factors that are considered in arriving at an incentive payout, but specific performance achievements are not described. Most common among companies using ESG qualitatively as an individual performance consideration	ESG performance is described qualitatively without any quantitative performance results disclosed. Includes companies that disclose a payout score for ESG measures without disclosing the underlying quantitative performance criteria used to calculate the payout	ESG performance that was considered in arriving at a payout is disclosed quantitatively. Most common among companies using a formulaic ESG metric or modifier

Greater Tranpsarency →

4. Reprising "Servant" Leadership

- In these times of great organizational upheaval and change, company leaders and their boards are helping people find greater belonging and inclusion, achieve more flexibility and focus on inner health and wellbeing in the workplace so that their full potential can be realized.
- Leadership teams are shedding their former selves in pursuit of a greater purpose, known as servant leadership – the desire to serve and be of service to others and it is creating a stickiness factor in an employee's desire to stay with a company.
- When done as a team, leaders are creating an ethos of a "servant culture" and it is serving their companies well even more than simply creating a pleasant work climate.
- When leadership teams create a servant culture they are emphasizing the development of employees so that their full potential can be realized. And it positively relates to performance both at the individual and organizational levels.

What Does a Servant Culture Look Like?

- It is not an individual style of leading; it is the art of teaming to liberate people to do what is required of them in the most effective and humane way possible
- It begins with a heavy dose of empathy, putting other's needs above one's own personal needs
- It is the show of humility
- It is encouraging others to become fully engaged in their work
- It is about building trusting relationships and active listening

4. Reprising “Servant” Leadership

NACD

Ten Things Your Leadership Team can do to Build a Servant Culture in Your Organization

1. **Deeply Listen.** Practice the discipline of hearing, acknowledging, validating and being open to others’ views
2. **Show Empathy.** Stand in someone else’s shoes and their unique circumstance – spend time in their world
3. **Promote Well Being.** Care about the well-being of others and help them overcome challenges
4. **Increase Self Awareness.** Take note of your own impact on others – seek feedback from others
5. **Promote Diversity of Views.** Practice debate without judgment
6. **Be Visionary.** Focus on the bigger picture and get on the balcony
7. **Scout New Ideas and Experiment.** Actively seek new opportunities and new ways of looking at the world around you
8. **Provide Stewardship.** Take personal responsibility for others and the organization’s well being
9. **Commit to the growth of others.** Help each person in the organization grow – personally and professionally
10. **Build an ESG Community.** Allow people to identify with something greater, -do what is right for our society and our planet

When leadership teams place a priority on building a servant culture, it yields exponential positive gain, allowing the organization to thrive in times of great change and uncertainty.

5. Maximizing Board Effectiveness

- The board itself must lead with the same traits it seeks to instill in the organization.
- Boards are broadening their playing field and learning to build and leverage their diversity
- Boards are being asked to step up and lead in new and different ways and its work has evolved and broadened; beyond the traditional focus on profitable growth, the most effective boards today are also doing the following:
  - Ensuring a strong, diverse leadership talent bench, beyond traditional aspects of governing the organization
  - Keeping up with environmental, societal, technological, and economic changes that impact a company's strategic direction
  - Asking the right questions and requesting data to provide insights into current ESG, DE&I metrics, measurement and goals and connections back to the business and society
  - Pivoting in how they govern to address a company's biggest needs as it leads and manages change and deals with organization challenges (e.g., global pandemics, reputational risk etc.)
  - Looking more deeply at organizational culture, level of organizational health, and how culture will need to evolve to drive future growth
  - Understanding and adding valued insight into strategic planning and achievement of goals
  - Working on effectively leveraging the board's diversity and ensuring the organization is benefiting in turn
  - More deeply evaluating board performance; ensuring the board is supporting management effectively during these difficult times and providing effective leadership and governance

5. Maximizing Board Effectiveness

- There is added importance and a broadened role specific to the compensation committee
- Beyond the focus on compensation, more progressive compensation committees are doing the following:
  - Broadening their charters to include a robust focus on CEO and senior leader succession and development, with an eye to developing leaders who can build winning and resilient cultures
  - Focus on broader people capabilities and degree of alignment with strategic needs of the current and future organization
  - Asking for DE&I reviews: what does DE&I mean for the organization, review of goals and metrics, and asking the right questions to spur action
  - Understanding and reviewing culture survey data and spurring rich discussion on culture needed for the future to ensure continued success and organization health and how this needs to be driven by effective leadership

Key Takeaways

- Organizations should consider creating dynamic pay programs that can flex to accommodate market conditions that either evolve or drastically change.
- The key to workforce engagement is fostering greater inclusivity and responsibility to an expanding stakeholder population.
- Purview of the board is moving more and more away from simply being a fiduciary to being an active partner in expanding the company's commitment to its people and stakeholders.
- This all begins with an honest assessment of where we are today versus where we need to go.

Q&A

Don’t Miss Our Next Webinar

Join NACD and Pearl Meyer for our 2022 Compensation Series webinars.

Archives of earlier webinars in this series are available at www.nacdonline.org/webinars or www.pearlmeyer.com/knowledge-share

NACD Credentialing Information

Interested in NACD director credentials?

Certification.NACDonline.org
Credentialing@NACDonline.org

NACDonline.org/Fellowship
Credentialing@NACDonline.org

Thank You