Issues Facing Compensation Committees in 2024

MIKE KESNER, STEVE PAKELA, AND LANE RINGLEE

Introduction

The current economic environment and geopolitical unrest have created substantial uncertainty as companies prepare annual budgets and long-term forecasts for 2024 and beyond. At the same time, the U.S. Securities and Exchange Commission (SEC)'s unprecedented release of new regulations and guidance has many companies scrambling to adopt new policies and comply with new disclosure requirements, and the onslaught of new rules does not appear to be abating anytime soon. Further, the number of proxy proposals this past year reached an all-time high as the SEC changed its rules, making it more difficult for companies to exclude such proposals.

Over the last several months, our Firm's partners and consulting staff have attended hundreds of corporate Boards of Directors' compensation committee meetings and engaged with company C-Suite executives on a regular basis in our role as executive compensation advisors. From these meetings, we have learned a great deal about the key issues and dominant themes that are on the minds of board members and have prepared a summary of these items along with some commentary.

The goal of this Viewpoint is to highlight the emerging issues and developments in executive compensation as Board committees and management teams prepare for 2024.

Emerging Issues and Developments

The following list of emerging issues and developments is organized into three sections: Goal Setting and Performance Measurement, Long-Term Incentive (LTI) Design, and Corporate Governance. We consider each of these issues to be noteworthy discussion topics that will surface within committee discussions depending upon each company's individual situation.

Goal Setting and Performance Measurement

1. **Rethinking Incentive Plan Performance Ranges** — Given the significant economic and geopolitical uncertainties facing companies as we approach 2024, it is likely that compensation committees will reevaluate the performance range around target performance levels to determine if minimum and maximum performance levels need to be lowered and increased, respectively. The use of a wider performance range provides several possible advantages, as it reduces the likelihood of a zero payout if actual performance falls short of expectations and minimizes the likelihood of a maximum or near-maximum payout if the company set overly conservative targets and/or an uptick in the

PARTNERS

Aubrey Bout
Josh Bright
Chris Brindisi
John D. England
R. David Fitt
Patrick Haggerty
Jeffrey W. Joyce
Ira T. Kay
Michael Kesner
Donald S. Kokoskie
Brian Lane
Jack Marsteller
Richard Meischeid
Sandra Pace
Steve Pakela
Jaime Pludo
Matt Quarles
Lane T. Ringlee
Brian Scheiring
John R. Sinkular
Christine O. Skizas
Bentham W. Stradley
Tara Tays
Olivia Wakefield
Jon Weinstein

economy boosts company performance more than originally anticipated. Also, compensation committees should be aware that setting lower performance targets compared to the prior year's actual results could attract unwanted attention and criticism unless the company provides a clear rationale for the lower performance targets. The challenge facing compensation committees anticipating a downturn in performance is the need to strike the right balance between rigorous yet achievable performance goals with shareholder sensitivity over potentially paying higher incentives for lower actual performance.

2. **Use of Discretion** — The exercise of discretion to increase formulaic payouts during COVID-19 resulted in a fierce backlash by investors and the proxy advisory firms, many of whom recently codified strict policies regarding discretion. To summarize, these policies do not support the exercise of discretion to increase LTI plan payouts under any circumstances and require a strong rationale to exercise upward discretion when adjusting annual incentive plan payouts, with a further proviso that the adjusted incentive payout not exceed target.

   Unfortunately, the COVID-19 fallout has also tainted the responsible use of discretion in annual incentive plans that carve out 20% to 30% of the target incentive for strategic or non-financial performance goals. While many compensation committees may feel pressured to abandon any form of discretion, the use of judgement to assess performance is often required. This is especially true when evaluating milestone type goals — such as progress towards commercialization of a new product — or improvement in diversity initiatives such as improved recruiting practices or building a pipeline of diverse candidates. The key to successful use of discretion is compelling disclosure of the factors that led to the performance evaluation and payout decision.

3. **Non-Generally Accepted Accounting Principles (GAAP) Incentive Plan Metrics** — A significant number of companies disclose non-GAAP financial results when reporting earnings, as the adjusted results often provide a clearer picture of the company's performance deemed within management's control. Many of these companies also use non-GAAP results when determining incentive plan performance and payouts, often to exclude items that may not be related to the underlying business or ongoing operation of the company. These exclusions could include the impact upon operations of conflicts in Ukraine and the Middle East. Such exclusions have led to increased scrutiny by investors and the proxy advisory firms. Institutional Shareholder Services (ISS)' recent policy survey, for example, asked respondents if companies should be required to include in the proxy a detailed reconciliation of GAAP financial results to the disclosed non-GAAP incentive plan performance used to calculate incentive plan payouts. In addition, the SEC provided guidance in December 2022 in the form of Compliance & Disclosure Interpretations outlining when non-GAAP reconciliations may be misleading.

   Given the heightened scrutiny and desire for greater understanding of outcomes, more compensation committees are likely to review or implement guiding principles for such adjustments at the beginning of the performance period and are likely to evaluate the impact the adjustments have on incentive payouts in the context of shareholder outcomes during the performance period. Companies may also consider enhancing the disclosure of non-GAAP adjustments in the Compensation Discussion and Analysis (CD&A) by providing a compelling rationale for the adjustments and their impact on incentive payouts or by adding a reconciliation of GAAP to non-GAAP results as an addendum to the proxy rather than simply referring to the earnings release. While many companies establish threshold values to minimize the number of adjustments, the most tenuous situations typically arise in the treatment of material items— those that when included in the incentive plan calculation result in a low or zero incentive payout but when excluded result in a significant or above-target payout. These events are situational in nature and need to be evaluated on a case-by-case basis.

4. **Addressing Foreign Exchange Fluctuations** — Global companies generally manage foreign currency fluctuations by purchasing goods and borrowing in local currencies or by hedging some of the exchange risk. However, significant foreign currency fluctuations, including the recent strengthening of the dollar, are generally outside of management's direct influence and control and have led several companies to establish performance targets on a constant currency basis or allow adjustments to GAAP financial results for all or a portion of such fluctuations. Some companies have been reluctant to adjust targets or results for foreign currency fluctuations, which may alienate some shareholders with higher incentive payouts, and have instead accepted the volatility these fluctuations may have on incentive plan payouts. Some companies "split the difference" by using a currency corridor, wherein fluctuations within 5% to 10% of budget or plus or minus 10% of the target payout are not adjusted and any fluctuations outside the corridor are adjusted.

5. **Pay Versus Performance (PVP) Disclosure** — The SEC's PVP rules required significant effort to prepare the necessary disclosure. Given the recency and complexity of the disclosure, compensation committees, investors, proxy advisors, and even the media have struggled to determine if the data is useful. Interestingly, in many cases, the new PVP compensation actually paid data shows strong alignment to changes in total shareholder return (TSR) and therefore can be used in combination with "realizable" compensation to explain the alignment of CEO compensation and company performance, the main tenant of a company's compensation philosophy. Whether companies use PVP or a separate realizable pay analysis, we believe compensation committees find such analyses useful to gain insight into how the company's executive pay aligns with performance.

6. **Environmental, Social, and Governance (ESG) Goals** — While about 75% of Standard and Poor's (S&P) 500 companies use ESG metrics to some extent in incentive programs, the practices have varied (i.e., scorecard of metrics/goals, standalone metric/goal, or included in individual goals or discretionary evaluation). This suggests that companies have adopted practices that align with the evolution of their approaches to measuring and managing ESG. As Vanguard Investment Stewardship recently communicated, a common framework that can be applied to all companies does not exist, but expectations for selecting, implementing, and disclosing a company's approach are the same as they are for financial incentive metrics or goals.[1] Additionally, there is skepticism that the addition of ESG metrics is leading to inflated incentive payouts. However, initial research by Pay Governance (see Viewpoint "ESG Incentives: Intended to Improve Corporate and Societal, Environmental, and Social Outcomes" May 2022) indicated that such criticism is not empirically supported.

LTI Design

7. **LTI Programs will Continue to be Dominated by Performance Shares** — Performance shares represent most of the value granted in LTI programs (performance plans for S&P 500 CEOs are now at 54% of total LTI value) while the use of stock options continues to decline (prevalence is down from 70% to 56% in the last 6 years). We believe the trend towards a higher proportion of performance-based LTI awards for CEOs will continue over the next few years as both a means for motivating and rewarding their performance and to ensure their compensation is heavily performance based.

8. **Reconsidering the Use of a 3-Year Performance Period** — Compensation committees and management teams can struggle to establish reliable 3-year performance targets as preferred by shareholders and the proxy advisory firms. COVID-19 forced many companies to adopt other approaches to goal setting given the substantial uncertainty it created, and the current economic and geopolitical turmoil has not made it any easier. To address the difficulty of establishing multi-year goals, several companies have adopted the use of three 1-year goals within the 3-year performance period.

Some of these companies also added a 3-year relative TSR modifier to incorporate a longer-term aspect to the amounts earned.

The use of three 1-year goals allows companies to establish more reliable performance goals that are set and measured over a shorter (and presumably more predictable) timeframe. Goals can be set at the beginning of each year permitting one-third of the award to be earned and banked until the completion of the three-year performance cycle. While such plans may be criticized for using annual performance goals to determine LTI payouts, the inclusion of a relative TSR modifier alleviates the concern to some degree. Companies often provide an explanation for selecting this design choice in the CD&A in addition to a description of the mechanics of the plan to reduce criticism.

9. **Revisiting the Inclusion of Relative TSR as a Long-Term Performance Metric** — Recent surveys show that the inclusion of relative TSR is a majority practice among large cap companies, although such use may have topped out at the 60% to 70% prevalence range. Some companies not already employing relative TSR may reconsider its use given the impact economic uncertainty can have on the ability to establish reliable LTI plan targets. Perhaps a similar number of companies may determine that the lack of a suitable performance peer group or management's inability to directly influence results makes inclusion of relative TSR a non-starter. Companies evaluating relative TSR as a performance measure should consider that once adopted, it can be difficult to eliminate or reduce its weighting in the future without a strong rationale, as doing so could send an unintended signal to investors that management has lost some of its confidence in future stock price performance. While many companies prefer the use of internal financial metrics in their LTI plans in order to maximize line of sight, other companies use a relative TSR modifier to serve as a "governor" to internal goal setting. This ensures that payouts based on internal goals are adjusted up or down to align with the results experienced by shareholders more loosely.

10. **"Mega" Grants** — While the use of "moonshot" or "mega grants" continues to be a minority practice, we have seen an uptick in their prevalence, particularly in certain industries. The quantum of some awards and/or the lack of performance goals have faced sharp criticism from investors and the proxy advisory firms. Committees exploring the use of such awards should carefully consider their design and potential shareholder reaction, as some awards have received significant shareholder support while others have not. Beyond the quantum and design, the committee should also consider how the company will disclose its underlying rationale and justification for the award.

Corporate Governance

11. **Activist Investors Use of Executive Compensation to Support a Broader Agenda** — CEO pay is an easy target for many activist investors as a lever to pursue their broader agenda whether that includes a desire for Board seats, changes in top management, or the pursuit of strategic change. The involvement of an activist investor exacerbates the risk of "high pay and low performance" situations. Good corporate governance, solid relationships with institutional investors developed through outreach efforts, and careful decisions about CEO compensation will be needed to withstand the potential pressure imposed by activist investors.

12. **Organized Labor** — Recent strikes by labor unions and a tight labor market have created significant risk of organizing efforts and/or union demands for higher wages. One of the tools currently being used by organized labor in its negotiations or organizing efforts is to focus on the wage gap between the company's management and its workers. Compensation committees may want to better understand if the company is at risk and how the company is compensating and addressing front-line employees'

concerns. In addition, companies should consider having a communication plan ready that details and reconciles changes in executive compensation compared to the workforce over the past 3 to 5 years.

13. **Clawbacks** — The SEC and stock exchange's mandatory clawback policy requirement forced companies to adopt compliant policies by December 1, 2023, which cover incentive compensation received by executive officers after October 2, 2023. Given the relatively short compliance period allowed by the SEC, many companies may not have fully assessed if changes were also needed to existing clawback policies that typically covered a broader group of participants, allowed the recovery of both time-based and performance-based equity, and included a wider range of clawback triggers (for example, material code of conduct violation, reputational harm, cybersecurity breach, etc.) or if a broader clawback policy should be adopted. Additionally, while recoupment of cash-based incentives is relatively straightforward, the impact of a clawback policy on share-based compensation is complex. Compensation committees may want to better understand how the new mandatory policy interacts with the broader policy or consider whether to adopt a broad policy over time. In addition, companies are required to disclose their SEC mandated clawback policy as an exhibit to the 10-K or 20-F, and it is likely some "best practices" may be identified from this disclosure.

14. **Insider Trading Policies** — The SEC revamped the requirements for Rule 10b5-1 trading plans. Some companies have suspended existing provisions within their insider trading policies that mandated executive officers use 10b5-1 plans for all sale transactions to allow time to further study the new requirements and determine if the use of such plans would be overly burdensome. This also provided companies with time to ensure that proper internal controls were in place to comply with the SEC's quarterly reporting requirements for the establishment, modification, or termination of such plans. Compensation committees may want to better understand market trends on the required or voluntary use of such plans as well as whether the insider trading policy needs to be updated. The SEC's requirement that companies disclose their insider trading policies and procedures as an Exhibit to the 10-K or 20-F will aid compensation committees in better understanding market practice.

Closing Remarks

Significant economic and political uncertainty is emerging with possible downside economic risks in 2024 and beyond. Compensation committees will need to devote greater attention in the coming months to ensure their companies' executive compensation programs continue to attract, retain, and motivate talent while maintaining alignment with shareholder expectations in a challenging environment. We expect many of the topics described above, and perhaps even more challenging issues, to surface over the coming months. Because shareholders have significant visibility into compensation committee decision making — including incentive plan performance metrics, goal rigor, pay level benchmarking, pay versus performance, and alignment of compensation with business strategy, among others — our firm advocates healthy dialogue about executive pay issues, at the compensation committee and board level and with shareholders as companies strive to maximize shareholder value and link executive pay to performance.

Questions about this Viewpoint can be directed to Mike Kesner (mike.kesner@paygovernance.com), Steve Pakela (steve.pakela@paygovernance.com), or Lane Ringlee (lane.ringlee@paygovernance.com).

---

1 ESG Metrics in Compensation Plans. Vanguard. September 2023. https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/perspectives-and-commentary/esg_metrics_in_compensation_plans.pdf