NACD

Empowering Directors. Transforming Boards.

Pearl Meyer

Regulatory Issues and Compensation Trends Going into 2025

A *Compensation Committee Series* Webinar

Presented by NACD and Pearl Meyer

November 12, 2024

© NACD 2024. All rights reserved.

Presenters

Frank Jaehnert
Former President and CEO Brady Corporation (ret.) Board Member of Nordson, Itron, National Material, NACD Chicago Chapter

Deborah Lifshey
Managing Director, Pearl Meyer

Dan Moynihan
Managing Director, Pearl Meyer

© NACD 2024. All rights reserved.

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/regulatory-issues-and-compensation-trends

- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/regulatory-issues-and-compensation-trends

© NACD 2024. All rights reserved.

NACD Credentialing Information

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 credit.**

NACD Directorship Certification®

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

© NACD 2024. All rights reserved.

Agenda

NACD

This year featured an abundance of regulatory issues and executive compensation headlines. In the news, the Tesla case examined director independence in setting pay and the Chemours case outlined the optics of potentially inappropriate actions with respect to incentive programs. In the regulatory arena, there was a judicial tug-of-war around the validity of a federal noncompete, as well as continuing regulatory gridlock on the oversight and regulation of proxy advisors, which may require that ISS and Glass Lewis make some changes. Further, proxy advisors are on the cusp of updating their voting policies for 2025.

We will review the details of these developments and what they mean for compensation committees going into a new proxy season. And as compensation committees prepare for 2025, we will also bring fresh data that offer a look at how companies plan to set 2024 payouts and compensation levels for the new year.

Learning Objectives:

- Identify the areas that may impact your compensation committee in 2025.
- Understand the details of new regulatory changes and the impact of precedents set in 2024.
- Take away timely data on anticipated changes to executive compensation levels.

© NACD 2024. All rights reserved.

Wrapping 2024 and Looking ahead 2025

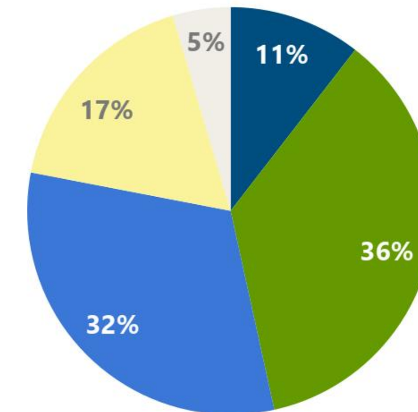
© NACD 2024. All rights reserved.

2024 Results and Impact on Pay

Almost half of companies are expecting 2024 business results to be moderately or significantly better than 2023

- Only 17% expecting a decline
- **Base pay** increases for 2025 expected to be lower than the prior year: 3.5% at median
- **STI:** 50% expect at or above target payouts
- **LTI:** 36% expect at or above target payouts, and a similar level (37%) are not sure about their expected payouts (10/1/2024)

Year-Over-Year Financial Performance Projections



Significantly better | Moderately better | About the same | Moderately worse | Don't know

© NACD 2024. All rights reserved.

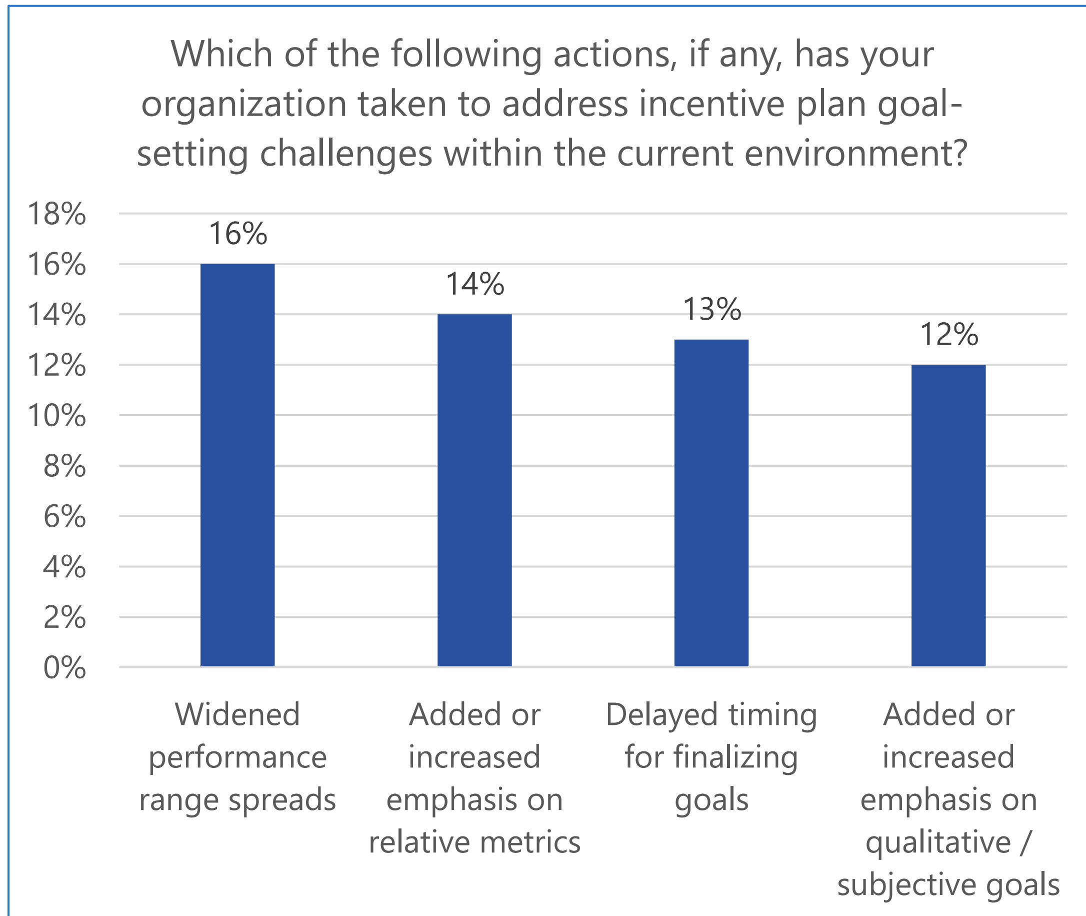
Polling Question #1

Q1: Do you think short term incentive payouts for 2024 results at your business will be:

1. Below threshold
2. At or slightly above threshold
3. At or slightly above target
4. At, near, or above max
5. Not sure yet

© NACD 2024. All rights reserved.

Actions Taken to Address Incentive Plan Goal-Setting Challenges

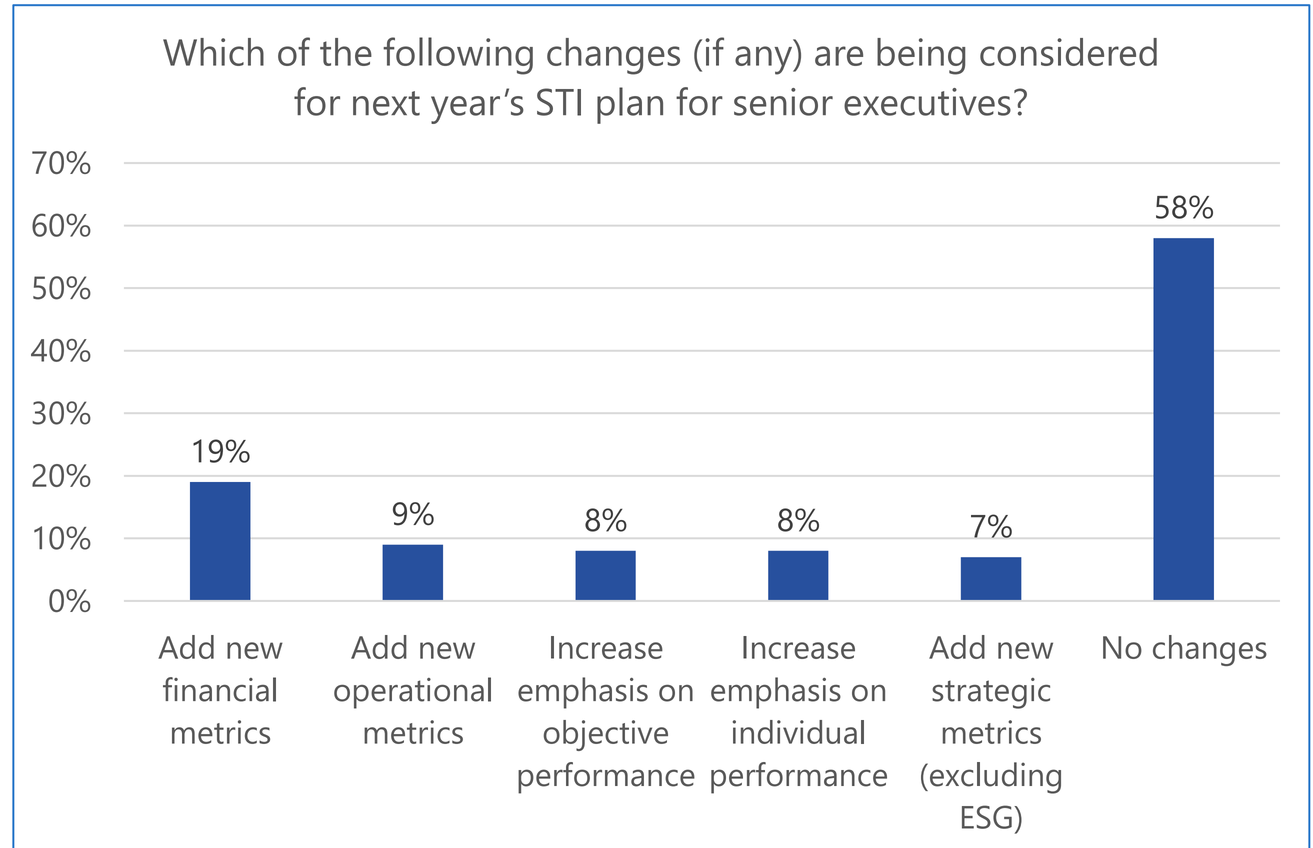


- Nearly 40% took one or more actions to address incentive plan goal-setting challenges within the current environment
- Widening performance range spreads and more emphasis on relative metrics were most popular changes
  - By industry, the consumer sector had the highest prevalence (67%) for taking one or more actions while the business/other services had the lowest prevalence (36%)
- Almost 60% of all respondents feel the stretch performance in plans is adequate, but **22% increased the performance required to achieve maximum payouts**

© NACD 2024. All rights reserved.

STI Plan Design Changes for 2025

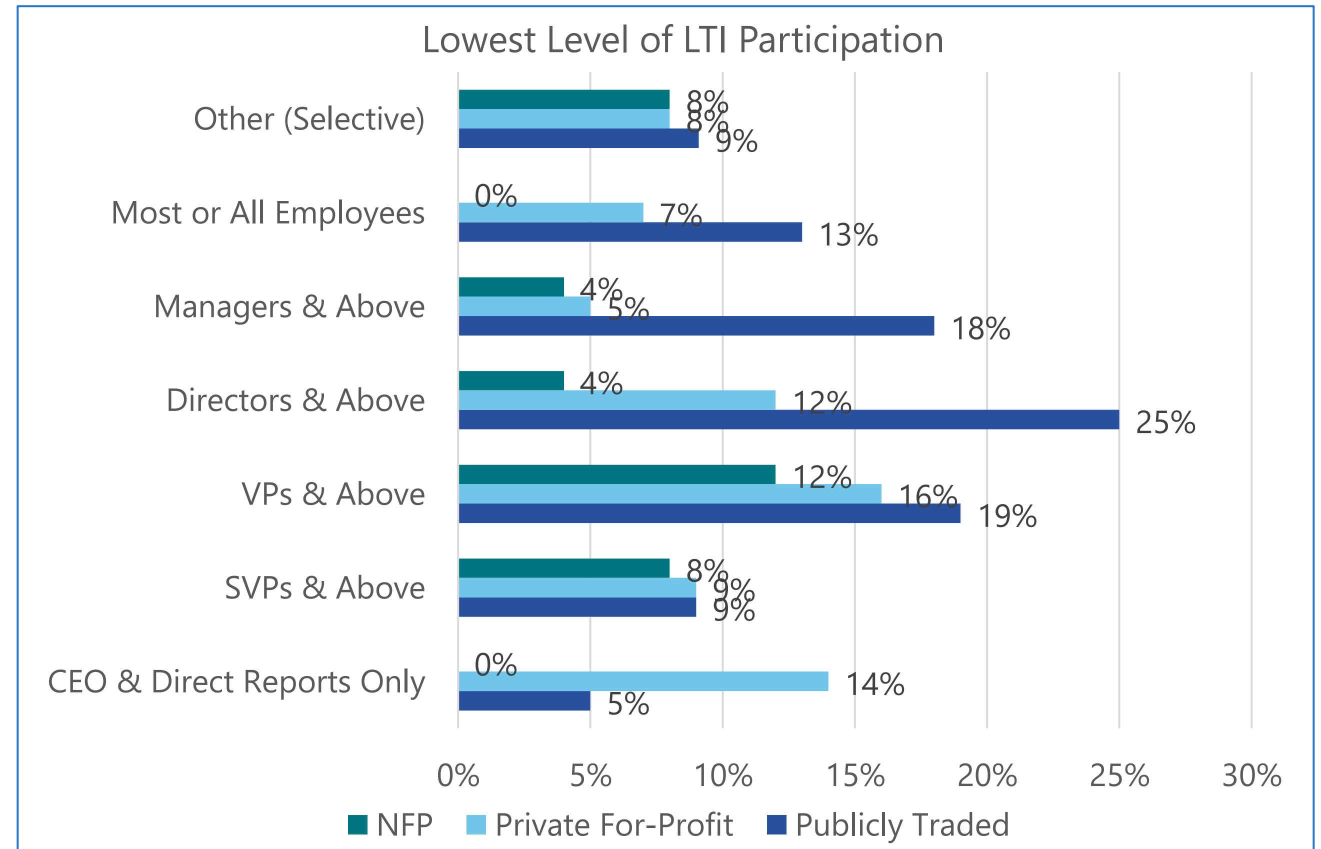
- Slightly more than 40% of all respondents are considering making changes to senior executive STI designs for 2025
- Anticipated changes typically include adding new performance metrics with higher prevalence for private respondents vs. publicly traded companies
    - Only 4% of respondents plan to add new ESG metrics, with none removing them and virtually none changing their weightings
    - By sector, respondents in the real estate/construction sector were most likely to add new financial or operations metrics (44% and 19% prevalence, respectively)
    - Financials/insurance sector were least likely to make any changes (69% did not make or plan to make any design changes)



© NACD 2024. All rights reserved.

LTI Prevalence and Participation Levels

- Most public companies are providing equity or LTI at the director level and above
- In privately held businesses, it is typically VP and above, while many only provide to the CEO and direct reports
- Non-profits are still slow to adopt, but we have seen increases each year in the development of LTI plans at mission-based organizations

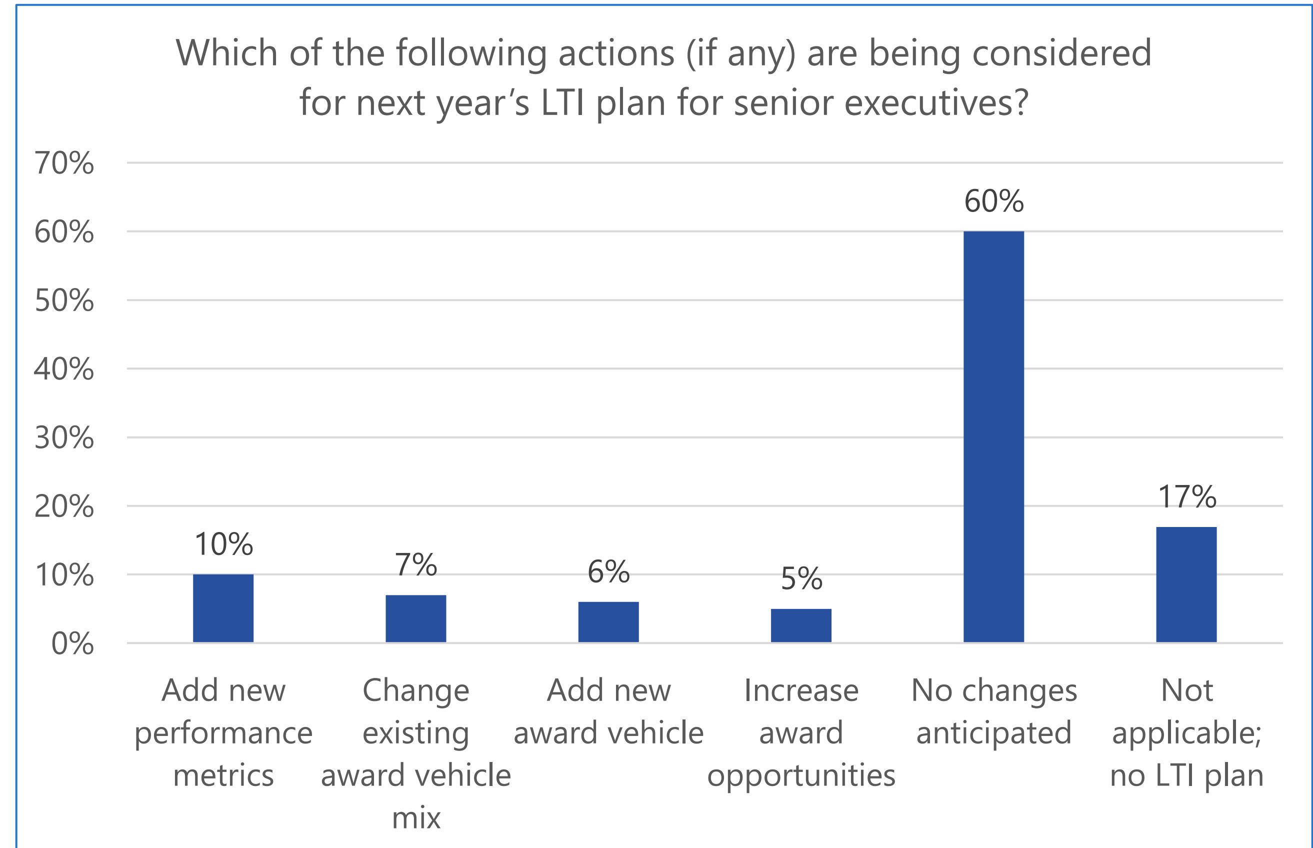


Note: In the chart above, "Other" refers to other non-specified categories (e.g., senior managers and above, or some other combination of roles)

© NACD 2024. All rights reserved.

LTI Plan Design Changes for 2025

- < 20% of all respondents currently anticipate making one or more LTI plan design changes for 2025, with the most common actions shown in the chart:
  - Adding new performance metrics is highest for the industrials/materials/transportation sector (16% of respondents) while the business/other services sector is most likely to increase LTI award opportunities (13% of respondents)
- Less than 5% of respondents currently anticipate making any change in LTI grant practices for 2025 or have any pre-established annual cap for aggregate grants



© NACD 2024. All rights reserved.

Polling Question #2

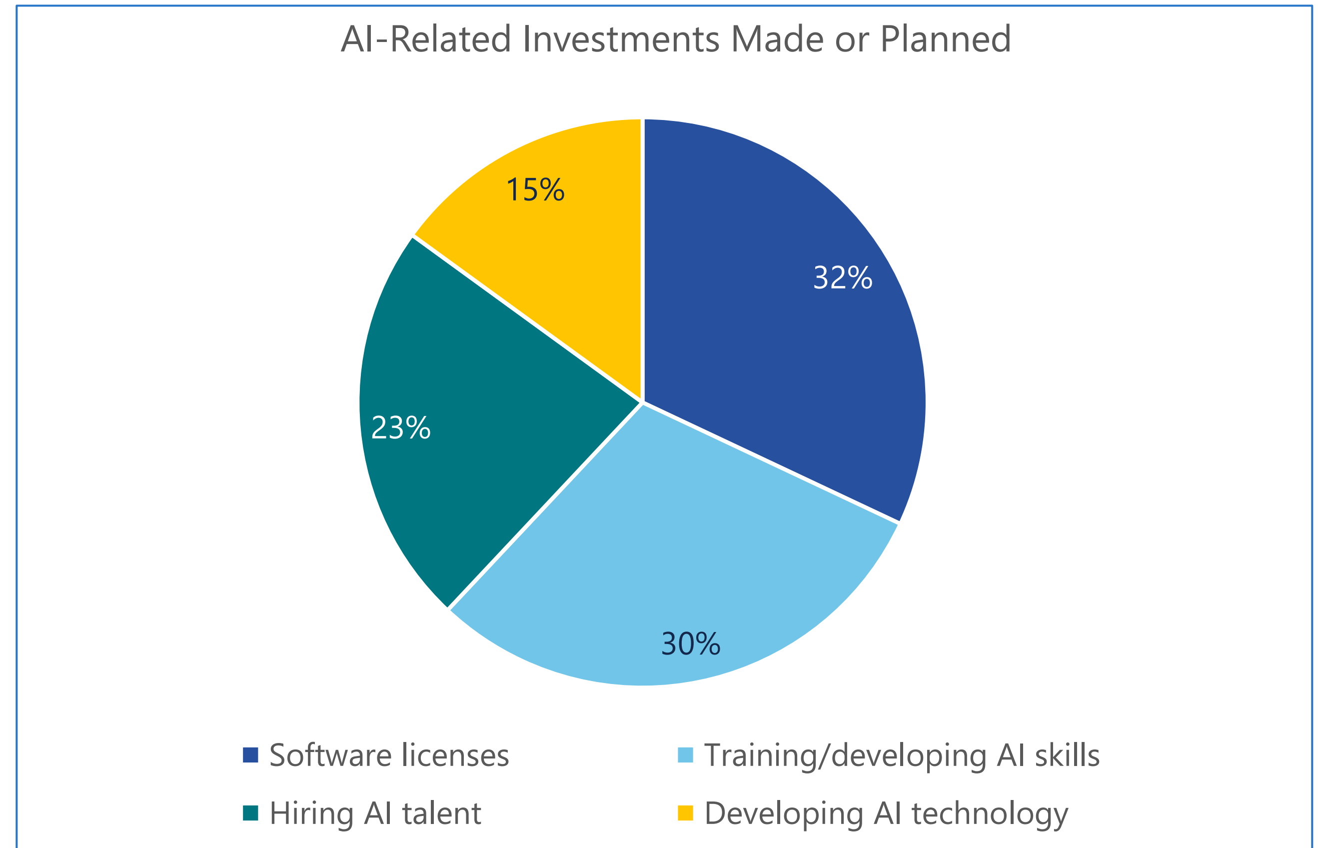
Q2: Is your board talking about AI and how it might impact executive compensation?

1. Yes, making decisions
2. Yes, considering options
3. No
4. Maybe in the future

© NACD 2024. All rights reserved.

Impact of Artificial Intelligence (AI) on Company Performance and Executive Compensation

- Approximately 30% of respondents are already making or planning to make significant AI investments; when made, these typically include acquiring software licenses and hiring or developing AI talent/skills as shown in the chart to the right (some respondents make multiple types of investments)
  - To date, 43% of respondents have discussed the financial impact of these AI investments
- Less than 2% of respondents have already discussed the possibility of incorporating AI-related goals into executive compensation plans while approximately 10% expect to begin addressing this subject during upcoming meetings
  - Opinions are evenly split between including AI goals within STI plans vs. both STI and LTI plans and whether to measure at the corporate vs. individual level



© NACD 2024. All rights reserved.

Regulatory Updates

© NACD 2024. All rights reserved.

FTC Update: Federal Non-Competes

- On April 23, 2024, the Federal Trade Commission (FTC) adopted a national ban on non-compete clauses and enforcement of any previously existing non-compete agreements with limited exceptions

- The proposed rule would have barred employers from entering into or enforcing non-competes with workers and also required companies to nullify existing non-competes (with limited exception for existing "Senior Executive" arrangements (i.e., workers in a policy-making role at the parent level who earn more than $151,164) and sale of business non-competes

- The effective date was scheduled for September 4, 2024, but has already been litigated in several federal courts
  - A Texas federal court banned the FTC on a nationwide level, and a Florida court banned the rule as to an individual plaintiff
  - A Pennsylvania court affirmed the legitimacy of the rule
  - The FTC has filed appeals in the 5th and 11th circuit challenging the ban, with possible appeals to the Supreme Court in 2025

- At this juncture, the federal rule is on hold, but many state laws have similar bans

- The proposed rule resulted in many companies, regardless of state, inventorying existing non-competes and re-evaluating methods to protect their assets, such as stronger non-solicits, garden leaves, intellectual property and NDAs, longer vesting periods and deferrals, etc.

© NACD 2024. All rights reserved.

The Tesla Executive Compensation Ruling and Shareholder Vote

- The Delaware Court invalidated Elon Musk's $55B stock option grant package in February of 2024 citing:
  - ✓Improper and inaccurate disclosure (plan authorship, performance expectations, board independence)
  - ✓Conflicts of interest and lack of process (imperial CEO, beholden board, general counsel's role, not arms-length)
  - ✓Unreasonableness and lack of justification in context
  - ✓No complexity in unwinding the grant since it had not yet been exercised
- The case provides critical lessons for compensation committee governance:
  - ✓Ensure strong governance protocols over process and decision-making
  - ✓Ensure board independence, especially in compensation committees, in both form and substance
  - ✓Shareholder approval may not matter in cases of controlled ownership structures
  - ✓Establish reasonableness and rationale in decision-making
  - ✓Ensure accurate disclosure
- Shareholders were asked to reinstate compensation and reincorporate in TX at the June meeting:
  - ✓Tesla hired proxy solicitors for an undisclosed amount to secure votes
  - ✓Proposal to ratify the 2018 option grant (by then valued at $45B) was passed at 76.22% of the voting power of the shares present in person or represented by proxy at the Annual Meeting and entitled to vote on the proposal. Excluding Elon and Kimbal Musk's shares, the proposal still passed at 71.82%
  - ✓SOP proposal passed by 79% of the shares present in person or represented by proxy and entitled to vote on the matter
  - ✓Proposal to reincorporate in Texas passed by approximately 63% of outstanding shares entitled to vote on the proposal

© NACD 2024. All rights reserved.

The Secondary Clawback Policy

Now that companies have implemented the Dodd-Frank clawback triggered by restatement, companies are considering a second clawback policy pertaining to misconduct and/or erroneous incentive payments that did not result in restatement

- **Covered Executives:** May include not only Section 16 officers, but also select non-officers
- **Clawback Trigger:** May be triggered by misconduct, misconduct coupled with restatement and/or other codes of conduct violations
    - Note: Glass Lewis expects companies to maintain clawbacks triggered by misconduct
- **Compensation Covered:** Not limited to "performance-based compensation;" may also include time-based and other forms of compensation
- **Period Covered:** Not limited to three years preceding restatement and may even extend to years that follow the misconduct
- **Amount Covered:** May cover entire value of award, not just excess compared to what would have been earned absent misconduct
- **Mandatory vs. Discretionary:** Most supplemental policies allow committee full discretion to determine how and whether to enforce

© NACD 2024. All rights reserved.

Proxy Advisors: ISS Policy Survey Key Takeaways

- **Time-Based Equity as a Potential Positive Mitigating Factor**
  - Reconsideration of time-based equity: ISS asked if it should continue current approach (where predominance of time-based equity is a negative factor) or revise the approach such that time-based equity with extended vesting periods (i.e., longer than four years) is a positive mitigating factor
    - Investors preferred continuing with approach, but companies wanted a change
  - Vesting Period of time-based equity: ISS inquires as to what length of extended vesting period for time-based awards is enough to view awards as a positive mitigating factor
    - Most responded at least five years would be appropriate
  - Post-vesting hold on time-based equity: ISS inquires whether a post-vest hold should be required to view time-based awards as a positive mitigating factor in the context of a PFP misalignment
    - Investors preferred; companies did not
- **Use of Discretionary Short-Term Incentive Plans**
  - Assessing Discretionary STI Plans: ISS inquires as to whether such programs are problematic
    - Most investors responded problematic, with some companies believing they are not problematic in certain scenarios
- **Asset Manager Incentives Based on Profits**
  - ISS inquired if share of profits as a compensation mechanism should receive special consideration
    - Most investors responded that they should not, with some investors opining a different approach would be preferable

© NACD 2024. All rights reserved.

Proxy Advisors: Glass Lewis Policy Survey Key Takeaways

- **Disclosure around make-whole grants:** GL implies that stronger disclosure warranted for make-up grant rationale
- **Reconsideration of time-based equity:** GL (like ISS) seems to be revisiting whether time-based awards with longer vesting periods (at least five years) can be as appropriate and effective as performance-based awards.
- **Impact of workplace safety/fatalities on executive bonuses:** GL inquires as to what impact a fatality in the workplace should have on annual bonus payouts; alternative answers range from no penalty to significant penalties (beyond the typical adjustment range of 5-15%)
- **Impact of equity incentive plans/awards with passing but low support:** GL inquires whether it would be appropriate for shareholders to escalate their concern by voting against the next say-on-pay ("SOP"), voting against the payout in year of payout, voting against SOP the year following payout if award was concerning, or voting against the compensation committee members who implemented the plan
- **Impact of excessive perquisites on voting:** GL notes that values of perks have been on the rise and asks how perks should be considered in voting
- **Impact of median employee pay disclosure:** GL inquires whether participants view this number as important (regardless of regulatory requirements)
- **Impact of executive pay gap:** GL inquires as to whether participants believe that the executive pay gap is problematic, and if so, which factors participants think influence the gap (voting structures, investor influence, regulators, incentive award structures, competition/retention concerns, cultural perceptions)
- **Impact of pay vs. performance:** GL indicates it may be used in its grading models going forward

© NACD 2024. All rights reserved.

Controls on ISS and GL

- **A recent court case in the 5th Circuit has resurrected the possibility that companies may have access to proxy advisor reports at the same time as institutional investors, and that proxy advisors must inform those institutional investors of company rebuttals**

- **Brief Historical Recap**
  - Prior to 2019, proxy investors were largely unregulated until a Trump-appointed SEC commission issued Final Rules in 2020 requiring that (1) reports be produced to companies at no cost simultaneous with institutional investors, (2) institutional investors be informed as to company rebuttals to reports, and (3) proxy advisors provide enhanced disclosure that they had no conflict of interest in providing recommendations
  - This led ISS to sue the SEC and then-SEC Chair Jay Clayton
  - In 2020, under a Biden-appointed commission, those rules were called into question; by 2022, the previously approved 2020 Final Rules were partially rescinded
  - On June 26, 2024, the 5th Circuit Court of Appeals ruled that the SEC acted arbitrarily and capriciously in rescinding the 2020 Final Rules
  - At this juncture, the SEC will either appeal the ruling or reinstate the 2020 Final Rules which would require provision of reports to companies simultaneous to institutional investors

- **Impact of Court Case**
  - It is unclear if the SEC will appeal or revert to the 2020 Final Rules, although it is widely believed they may concede the issue, particularly following repeal of the Chevron doctrine
  - If the 2020 Final Rules are reinstated, clients will be able to review reports on an expedited timeline with improved ability to react to any criticism of compensation programs, and ample time to provide rebuttals that will be heard by investors on an accelerated timeline
  - Whether clients will receive timely, no-cost reports in the 2025 proxy season may also depend on the new administration’s policies and/or changes to SEC Commissioners

© NACD 2024. All rights reserved.

Polling Question #3

Q3: Which regulatory/governance issues give you the most concern as a director?

1. Understanding the Tesla issue relative to independence and decision making
2. FTC rulings and challenges with non-competes
3. Performance goals and the risk of accounting manipulation (Chemours)
4. Other

© NACD 2024. All rights reserved.

Top 5 for 2025

© NACD 2024. All rights reserved.

Top 5 Committee Considerations for 2025

- How can we design PSUs to be more effective in volatile markets?
- Is it time to remove ESG from our incentive program?
- Can we use executive compensation to support leadership planning and internal succession?
- Are we well-prepared for planned—and unplanned—exits of our named executive officers?
- Are we effectively evaluating our CEO?

© NACD 2024. All rights reserved.

#1: Can PSU's be more effective?

- Use a combination of relative and absolute performance metrics
- Consider a balanced scorecard approach
- Give thought to a formulaic mechanism that adjusts performance goals
- Modify the approach to leverage curves

© NACD 2024. All rights reserved.

#2: Does ESG have a place in executive compensation?

- Corporate ESG initiatives have come under attack by some state politicians and investor groups
  - Change terminology to sustainability rather than ESG
- Political and investor pushback may impact the prevalence of incentive plan ESG metrics
  - Companies should ensure metrics implemented are critical to the business and not solely because of social pressures
- According to latest Pearl Meyer survey, only 4% of respondents plan to add new ESG metrics in the LTI plans, with none removing them and virtually none changing their weightings

© NACD 2024. All rights reserved.

#3: Exec Comp to Support Leadership Development

- Review succession practices and rethink how pay impacts internal vs. external hires
  - Review the use of incentives for retention and attraction of key talent
- Is the philosophy the same?
  - Often companies will underpay the internal hire vs. the external hire
  - Future adjustments to base salary and, as necessary, to annual and long-term incentives should then reflect how the executive is performing in the role with an eye toward bringing the individual to market norms over a two- to four-year period
- The role of the committee continues to evolve with new responsibilities each year

© NACD 2024. All rights reserved.

#4: CEO Succession

- Boards are bracing for a slew of executive retirements in 2025; “baby boomers” will hit “peak 65” in 2024/2025
- The cost of management transitions can be significant for unprepared companies
  - Research published in Harvard Business Review indicates at a macro level that the cost of “badly managed CEO and C-suite transitions in the S&P 1500 is close to $1 trillion a year”
- The dramatic demographic shift underscores the critical importance of succession planning and the CC plays a vital role in this

#5: CEO Evaluation

- The annual CEO evaluation process is an often-overlooked golden opportunity
- While it is often treated as another “must do” for the board and CEO, it may not be leveraged to its full benefit
- Focus on a process
  - Outline the full CEO evaluation process up front amongst the CEO and board
  - Clarify what will be evaluated and how
  - Measure both business and leadership performance areas
  - Provide a comprehensive CEO evaluation report
  - Schedule a discussion
  - Share a summary with the full board

© NACD 2024. All rights reserved.

Polling Question #4

Q4: Which of the following do you have oversight for in your compensation committee?

1. Executive pay
2. Executive pay and succession planning
3. Executive pay, succession planning, and leadership development
4. Executive pay, succession planning, leadership development, and DEI/culture
5. Other

© NACD 2024. All rights reserved.

Closing Thoughts

- The role of the committee continues to evolve
- Regulatory pressures continue to mount, and make the role of director more challenging than ever
- Pay quantums and pay design can drive performance
- Choosing metrics and evaluating their effectiveness can be challenging
  - ESG & AI
- Leadership development and succession planning will become far more critical than in the past

© NACD 2024. All rights reserved.

NACD

Empowering Directors. Transforming Boards.

Pearl Meyer

Q&A

Please submit your questions in the Q&A box below.

© NACD 2024. All rights reserved.

Enjoy this Webinar?

Stay tuned for 2025 *Compensation Committee Series* webinar dates and check out the archives of earlier webinars in this series at www.nacdonline.org/webinars or www.pearlmeyer.com/insights-and-research

© NACD 2024. All rights reserved.