Pearl Meyer

NACD ELEVATE BOARD PERFORMANCE

Reevaluating Short- and Long-Term Incentive Plans During A Crisis

A *Compensation Committee Series* Webinar
Presented by NACD and Pearl Meyer

May 14, 2020

Meet the Presenters

Robert Galford is the lead independent director of Forrester Research Inc., where he chairs the compensation and nominating committee. He is also on the board of directors of the Sakonnet Point Club and is an outside board advisor at Shepley Bulfinch, an architectural firm. Galford is a managing partner of the Center for Leading Organizations and a Leadership Fellow in Executive Education at Harvard University Graduate School of Design.

Terry Newth is a managing director in Pearl Meyer's Boston office. He consults on the design, development, and assessment of executive compensation programs that support each organization's business objectives, long term business strategy, and culture. His clients range from Fortune 500 organizations to pre-IPOs to private companies in a wide range of industries.

David Wrangham is a consultant in Pearl Meyer's Boston office. His executive compensation background includes both corporate and consulting experience and he received a BA from Middlebury College.

Housekeeping

- Submit a question and receive your answer directly from Pearl Meyer, 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.
- Tweet live during the event today with **@NACD** and **@PearlMeyer.**
- Presentation slides are available today at www.pearlmeyer.com/reevaluating-incentive-plans and within the webinar console.
- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/reevaluating-incentive-plans.

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DIRECTORSHIP CERTIFICATION

Today's Agenda

- Current environment
- Stages of COVID-19-related committee activities
- What to do with current short-term and long-term incentive plans
- Possible red flags
- Recap

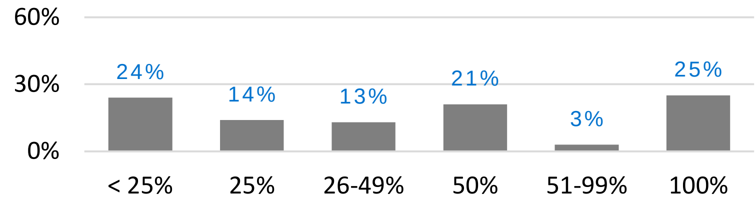
Current Environment

Independent Research* – S&P 500
As of April 14, 2020

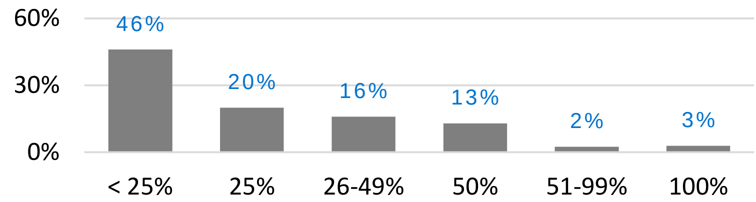
- **22%** **Suspended guidance**
- **13%** **Switched to virtual shareholder meeting**
- **9%** **Suspended share buybacks**
- **9%** **Reduced executive compensation (base salaries)**
- **6%** **Instituted work furloughs or hiring freezes**
- **3%** **Suspended dividends**
- **3%** **Added sick leave/other employee benefits**

Pearl Meyer Database – Disclosed Reductions
Database as of May 1, 2020

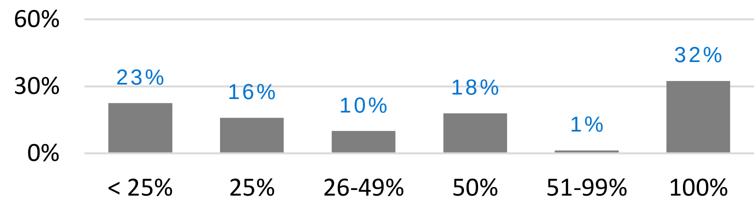
CEO Salary Reduction Percentage [1]



Other NEO Salary Reduction Percentage [1]



NED Cash Retainer Reduction Percentage [1]



[1] Source: 8-Ks filed between 2/20/2020 and 5/1/2020 as collected by Pearl Meyer (number of companies taking pay actions: 247 CEO cuts, 216 Other NEO cuts, 172 NED cuts); reflects percentage of companies disclosing a pay reduction. NED = non-employee director.

*Source: AGENDA Magazine "Pandemic Response by the Numbers" by Tony Chapelle

Degrees of Impact from COVID-19

- Although COVID-19 has had far reaching impact, the degrees of impact vary by sector and company

Severely Negatively Impacted (e.g., Retail)	Moderately Negatively Impacted (e.g., Consumer Staples)	Neutrally Impacted (e.g., Pre-commercial Biotech)	Positively Impacted (e.g., PPE makers)
▪ Significant layoffs ▪ Executive salary cuts ▪ Board pay cuts ▪ Government assistance	▪ Merit freezes ▪ Hiring freezes ▪ Targeted layoffs/furloughs ▪ Incentive goals outdated	▪ Supporting remote work force ▪ Evaluating non-critical investments ▪ "Wait-and-see"	▪ Active recruitment ▪ Special incentives ▪ Retention risk

Polling Question

- What bucket is your company in?
  - Severely negatively impacted
  - Moderately negatively impacted
  - Neutrally impacted
  - Positively impacted

Stages of COVID-19: Comp Committee

- We expect most companies will go through the following phases of action related to COVID-19

March – April

- Comp cost reduction
- Severance/furloughs
- Hiring freezes
- Communications
- Emergency planning

May – July

- **Incentives evaluation**
- Employee engagement
- Monitoring

July – ?

- Continued monitoring
- Leadership assessment
- Comp planning for 2021

Polling Question

- Has your company discussed how to treat outstanding incentive cycles in light of COVID-19?
- Examples: current 2020 bonus plan; performance stock unit grants from 2018/2019/2020

  – No and we don't plan to
  – No not yet
  – Yes but no action taken
  – Yes and we took action

Philosophical Guiding Principles

1. **Strive for shared experience between executives and other stakeholders**, including employees and stockholders; there will be an expectation of "sharing in the pain" in cases of:
   – Actions taken that negatively impact employees (e.g., layoffs/furloughs or pay cuts)
   – Negative stockholder experiences due to significant declines in market value and/or suspension of dividend payments
2. **Avoid over-reacting or reacting too soon**; in many cases, the best course is to take a "wait and see" approach but identify triggers that would cause the company to take action and what those actions may be
3. **Be prepared to use discretion at year-end**; in the event that goals set at the beginning of the year are no longer attainable, consider the basis for any appropriate recognition of management performance while being cognizant of shareholder and employee experience
4. **Balance proxy advisor views with the company's needs**; ISS and Glass Lewis are both more likely to support responsible actions with clear documented rationale; both advisors will be less supportive of modifications to multi-year incentive awards

Factors to Consider: Annual Incentives

Level of Impact to Company	• Severe/moderate/positive impact • Status of cost cutting efforts • Visibility into 2h 2020
Shareholder/ Proxy Advisory Views	• Stock price performance/dividend status • Performance /say-on-pay history • Recent policy guidance from ISS/Glass Lewis
Plan Designs	• Current funding level/likelihood of any funding • Nature of metrics (absolute vs. relative) • Use of individual performance component

Possible Actions for Short-Term Incentives

Alternative Action	Typical Scenario
No change	Incentives remain intact (i.e., there is a reasonable likelihood of a payout)
Proactively re-set performance goals from existing plan	Business has been materially disrupted, but there is visibility into 2H 2020
Set up new incentive plan for 2H 2020 based on strategic goals or other near term objectives	Business has been materially disrupted and there is little/ no visibility into 2H 2020
Apply retroactive discretion at the end of the year	Business has been materially disrupted and there is little/ no visibility into 2H 2020 **AND** little appetite for bonus plan modifications

Polling Question

- What do you expect your company will do with respect to their 2020 short-term cash incentive program?
  - Do nothing
  - Reset goals
  - Set up a new plan
  - Apply discretion at year end
  - Other

Those Considering Discretion…

- ✓ Review plan language to ensure discretion is allowed
- ✓ Determine if the discretion will apply uniformly across the organization
- ✓ Establish framework for applying "informed" discretion
  - – Can the company quantify some/all material impacts to incentive goals?
  - – What other goals and financial/operational/strategic inputs should be considered?
  - – How should the company report progress to the committee during the year?
  - – What does "good" look like?
- ✓ For public companies, document discussions and decisions to facilitate year-end disclosures and for accounting accrual purposes

Factors to Consider: LTI

Level of Impact to Company

- Severe/moderate/positive impact
- Visibility/outlook
- New business strategy / model

Shareholder/ Proxy Advisory Views

- Stock price performance/dividend status
- Performance/say-on-pay history
- Recent policy guidance from ISS/Glass Lewis

Plan Designs

- Current funding level/likelihood of any funding
- Nature of metrics (absolute vs. relative)
- Award "runway" (i.e., 2018 grant vs. 2020)

Long-Term Performance Plan Alternatives

Possible Actions	Typical Scenario
No change	Relative goals or multi-year targets with reasonable "runway" to make up for COVID-19-related decline
Proactively reset performance goals from existing plan	Some visibility to set new goals for outstanding cycles coupled with desire to create new incentive effect
Truncate/extend performance period	For awards with little runway (i.e., ending in 2020), companies may decide to alter the performance period; this approach should be used with great care and associated reduction in award opportunity
Apply retroactive discretion at the end of the cycle	Business has been materially disrupted and there is little/ no visibility into future performance
Upsize future grants	No desire to modify existing grants, but acknowledgement that something needs to be done

Polling Question

- What do you expect your company will do with respect to current outstanding performance-based LTI grants?
  - Do nothing
  - Reset goals
  - Truncate or extend performance period
  - Apply discretion
  - Make up in new grants/awards
  - Other

Those Considering Modifications to Awards…

- **Accounting:** changes to awards will likely trigger remeasurement of fair value and associated non-cash expense
- **Disclosure:** the incremental fair value of any remeasured awards for named executives will need to be disclosed in the next proxy statement
- **Shareholder views:** rationale for modification will need to make logical sense as shareholders generally take a principal-based view of long-term incentives
- **Proxy advisory views:** recent guidance suggests that modifications to long-term incentive awards will generally be criticized so rationale and good disclosure will be key

Our List of Key Red Flags

- Incentive plan payouts > target if discretion applied
- Modifying plans with relative goals
- Appearance of make-up grants without tie to future performance
- Repricing for executives/directors
- Modifications to awards without sufficient disclosure of rationale

…not an exhaustive list

Key Takeaways

- Each company has unique factors that impact the decision-making process around incentives
- Making changes to incentive plans to reflect COVID-19 can be reasonable and appropriate if they reflect a fair and balanced approach
- Careful consideration should be taken regarding the factors that impact your company
- Effective communications to employees and stakeholders will be critical to acceptance

Supplemental Reading

- https://www.pearlmeyer.com/coronavirus
- https://www.pearlmeyer.com/blog/preserving-the-motivational-effect-in-2020-annual-incentive-programs
- https://www.pearlmeyer.com/blog/dont-panic
- https://www.pearlmeyer.com/knowledge-share/client-alert/proxy-advisor-guidance-on-covid-19-pandemic-minimal-relief-provided
- https://nacdonline.org/insights/resource_center.cfm?itemnumber=67403
- https://nacdonline.org/insights/publications.cfm?ItemNumber=67418

Questions

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Thank You

Appendix: Proxy Advisor Guidelines

ISS Policy Guidance

Topic	Guidance
Short-Term Incentives	▪ Any changes to metrics/measures should be contemporaneously disclosed (i.e., at the time decisions are made, not in the following year's proxy)
Long-Term Incentives	▪ Case-by-case review but generally not supportive of changes to outstanding multi-year awards; If changes are made, they will be reviewed for appropriate director discretion and adequate disclosure
Option Repricing	▪ No relief; will be assessed under current standards which recommend against repricing that occurs within one year of a precipitous drop in stock price. Other key provisions that would generally trigger an ISS Against recommendation include: exchange is not subject to shareholder approval, exchange is not value-for-value, no vesting re-start, and inclusion of executives and board directors

Glass Lewis Policy Guidance

Topic	Guidance
Compensation	▪ Preemptory warning that executive compensation should not be protected at the expense of employees and shareholders – 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	▪ 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