Pearl Meyer

NACD ELEVATE BOARD PERFORMANCE

The Only Constant is Change: What New Compensation Issues Will Emerge in 2019?

Compensation Committee Series Webinar
Presented by Pearl Meyer

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Meet the Presenters

Martin Coyne is a director of Ocugen. Coyne is the chair and founder of the CEO Learning Network and he is the chair of the National Association of Corporate Directors' New Jersey Chapter. He previously served on multiple boards including RainDance Technologies, Akamai, Welch Allyn, Bioclinica, Avecia, and OpenPages. His roles included board chair, lead director, and chair of compensation, audit, and governance committees. Coyne has held a variety of senior management positions, including executive vice president of Eastman Kodak Co. and executive of its Photography Group. His book, How to Manage Your Board While Your Board Manages You (2009), helps directors, CEOs, and other C-suite executives improve governance and the relationship between management and their board.

Deborah Lifshey is a managing director in Pearl Meyer's New York office, 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 with more than 15 years' experience providing executive and board compensation consulting services to public and privately-held clients. She specializes in executive compensation strategy and philosophy development, and compensation market benchmarking, proxy analysis, and incentive plan design.

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- Presentation slides are available today at www.pearlmeyer.com/top-five-2019 and within the webinar console.
- The replay will be available early next week at www.NACDonline.org and www.pearlmeyer.com/top-five-2019.

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Today's Agenda

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- Regulatory Review
- 1: The Changing Role of the Compensation Committee
- 2: Director Compensation
- 3: Revisiting and Refining TSR
- 4: Non-Financial Metrics
- 5: Expecting—and Preparing for—the Unexpected
- Key Takeaways

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Regulatory Review

ISS 2019 Executive Compensation Policies

2019 Pay-For-Performance (PFP) Test

- No change to PFP test in 2019
- Continue with GAAP/ accounting measures to supplement TSR, but will also note EVA measures

Adverse Vote Recommendations on NED Pay

- Will not be issued until 2020
- ISS will revise outlier test so that it has more transparency and will provide details in late December 2018

Equity Plan Scorecard

- Passing score will not change from last year, although weightings may be adjusted from last year
- Additional override factor will include excessive dilution for S&P500 (>20%) and Russell 3000 (>25%)
- CIC vesting factor will be updated to provide points on quality of disclosure of CIC vesting (vs. actual vesting treatment)

Glass Lewis (GL) 2019 Executive Compensation Policies

Clarifies its positions (mostly negative) on new excise tax gross-ups, contractual payments (sign-on awards, severance, etc.), front-loaded awards, "bare-minimum" clawback provisions, performance-based equity for directors, and use of discretion in incentive plans

GL will consider outsized peer groups and compensation targets well above peers

GL provides a somewhat more robust discussion of A-F scores in PFP Model

May recommend against committee members if a regular filer becomes a Smaller Reporting Company (or "SRC") under new disclosure rules, and exercises ability to scale back its disclosure

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Regulatory Review (cont'd)

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Tax Reform	
	• Companies should be careful to preserve grandfathered arrangements (pre-11/2/17) • While compensation design changes and shift to more discretion were anticipated as a result of tax reform and changes to Section 162(m), not much action here in 2018

CEO Pay Ratio Disclosure Round Two: Things to Consider

- Were there any material changes, including your workforce, pay programs, median employee's circumstances? Did you have an acquisition in Year 1?
- Should you change your methodology or did any constituency or the media have a reaction to the disclosure?
- Did you have a material swing in CEO pay or resulting ratio?
- Do you want to compare yourselves to general averages or the now-known peer ratios?
- Be consistent in your Year 2 analysis.
- Remember what you need to do even if you do nothing.

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Poll Question #1

Q1: On a scale of 1 to 5 (with 1 being "not at all effective" and 5 being "extremely effective"), how effective do you think an EVA metric would be as part of a company's incentive program?

1

2

3

4

5

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Poll Question #2

Q2: On a scale of 1 to 5 (with 1 being "not at all likely" and 5 being "extremely likely"), how likely are you to use EVA as a metric in your incentive plans if ISS adds EVA to its financial performance assessment?

1

2

3

4

5

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1. The Changing Role of the Compensation Committee

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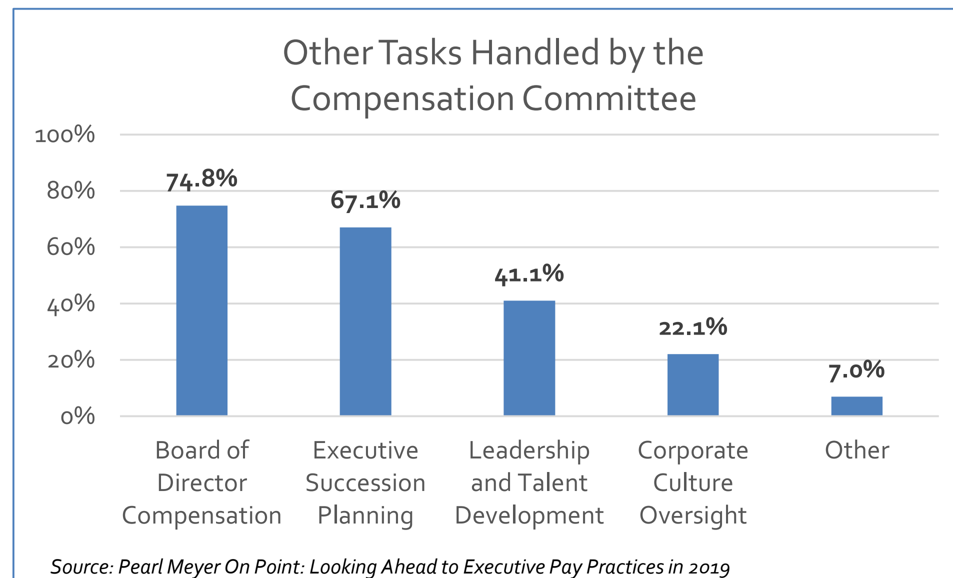
- Increasingly, compensation committees are spending time on non-compensation "human capital" issues
  - Our review of 1400 public companies for the NACD director compensation study found that around 20% have changed their committee name
  - Our recent executive pay survey revealed 41% of "compensation" committees are expanding their purview



Source: Pearl Meyer On Point: Looking Ahead to Executive Pay Practices in 2019

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1. The Changing Role of the Compensation Committee (cont'd)

- Broad-based pay issues are getting board attention
  - CEO Pay Ratio disclosure and comparisons
  - Gender (and other diversity-based) pay gaps
- Rising unemployment creating a new "war" for talent
  - New focus on retention and talent development
  - Succession planning
- Reputational risk of culture-based issues
  - #metoo
  - Wells Fargo
  - Volkswagen
- So now what?
  - Charter
  - Proxy disclosure
  - Impact on director compensation

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2. Director Compensation

- Market Practices
- ISS & Glass Lewis
- Board Diversity (e.g., gender, age, skills, experience, etc.)
- Board Refreshment
- Board Education
- Additional Responsibilities

- Greater flexibility to select between cash and equity
- At-election grants
- Education-related accounts

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2. Director Compensation (cont'd)

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Possible Design Considerations	
Greater flexibility to select between cash and equity—supports candidates with diverse financial circumstances	In-person vs. telephonic meetings and fees
At-election/initial equity grants	Per diems or education-related accounts—supports first-time directors
Right equity vehicles in place (e.g., tax timing)?	Desire for some level of individualization in director compensation program?
Defer or not to defer equity	Provide directors additional pay for non-traditional compensation tasks? Additional pay for additional responsibilities (e.g., mentoring)

- Be mindful of more scrutiny on director compensation—ISS will spotlight reasonableness of director pay; impacting votes starting in 2020
- Better disclosure of rationale for all director payments

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3. Revisiting and Refining TSR

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- Despite concerns about its effectiveness, rTSR plans remain popular
  - Over 50% of S&P 500; over 80% prevalence within more homogenous sectors like energy, utilities, and real estate
- Not hard to understand why, particularly in highly cyclical industries
  - Easily defensible—aligns pay outcomes with shareholder experience
  - Simpler goal-setting than for absolute financial performance metrics
  - Peer selection and performance tracking is easier than for other relative financial measures
- Earning "full credit" for your rTSR while maintaining incentive value of the awards is becoming more challenging
  - Questions about rigor of performance goals that pay at target for median performance
  - Increasing pressure to adopt negative absolute TSR caps
- How should boards be thinking about the rTSR plan entering 2019?

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Poll Question #3

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Q: If you have a relative TSR plan, have you had external pressure/feedback to modify it?

1. None

2. Yes, pressure to adopt a negative absolute TSR cap

3. Yes, pressure to increase performance standards

4. Yes, pressure to adopt a negative absolute TSR cap **AND** to increase performance standards

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3. Revisiting and Refining TSR (cont'd)

What is the role of rTSR in our mix?

- Will additional modifications serve to dilute the incentive value of these awards?
- Are there other components of our pay mix that already enforce absolute performance?

Do we already have an absolute modifier built into our rTSR plan?

- Realized value of awards denominated and settled in shares varies with both the payout multiple and the underlying FMV of the shares when they vest

Are there reasonable alternatives to a simple TSR cap?

- Consider an absolute TSR collar or matrix to employ an absolute modifier that works in more than one direction

Has the payout schedule been properly calibrated?

- Any modification has implications for expected (and reported) value of awards

Are we overthinking this?

- Beware unhelpful complexity…and don't forget about the original absolute TSR award: stock options!

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4. Non-Financial Metrics

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"To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.*

- Larry Fink 2018 Letter to CEOs

Increased Attention on Non-Financial Drivers	• Investors are increasingly asking companies to expand performance criteria beyond traditional financial yardsticks and increase the focus on (and investment in) non-financial drivers of long-term value creation.
48% Tie Bonus to Non-Financial Goals	• In our most recent annual executive pay practices survey, 48% of respondents indicated their company ties a portion of the annual bonus plan for senior executives to non-financial goals.
Implementing Non-Financial Metrics	• Implementing non-financial metrics as part of the executive incentive portfolio has its challenges, but if done correctly, the resulting balance of both lead (non-financial) and lag (financial) metrics will provide a more holistic framework to motivate and reward performance.

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Poll Question #4

Q4: Currently, how much weight do you place on non-financial metrics in your compensation program (note: not referring to individual performance, but more strategic, balanced scorecard, ESG, quality-type metrics)?

- 0%
- 1% to 10%
- 11% to 25%
- 26% to 49%
- 50% or more

4. Non-Financial Metrics (cont'd)

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Which non-financial metrics should be considered and for what program?

- Should reflect key value drivers; for example effective capital deployment, advancement of new products/markets, customer satisfaction
- ESG metrics getting attention, but they can be measured and reinforced outside of incentive program

Should non-financial metrics be a separately-weighted component?

- Many companies use as a modifier (e.g., +/-20%) to financial metrics; however in practice modifiers are rarely negative
- A separately-weighted component increases visibility and goal-setting discipline

What are potential pitfalls in implementing non-financial metrics?

- Minimize need for subjective measurement; goals should be quantifiable or at least allow for objective evaluation
- Avoid too many metrics, which can lead to lack of understanding and dilution of importance; limit to two to three key metrics

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5. Expecting—and Preparing for—the Unexpected

- Good plan design, and good executive compensation governance, includes planning for the unexpected
- Even in normal times, events may occur which warrant consideration of adjustment to incentives
  - Acquisitions and divestitures
  - Unusual swings in commodity prices, exchange rates, interest rates
  - Settlement of lawsuits or regulatory actions
  - Asset write-downs
  - Share repurchases
  - Changes in accounting rules
  - Windfall gains or losses
- More recently, the list of events to consider has broadened!
  - Trade wars; tariffs
  - Major environmental events; impact of global climate change
  - Tax law changes

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5. Expecting—and Preparing for—the Unexpected (cont'd)

Plan Ahead	• Discuss potential treatment at the start of incentive cycles
For a Given Event, Consider the Following Questions:	1. Is the event unusual/extraordinary? Is it the new normal? 2. What has been done in the past? 3. How might decision-making be influenced if adjustments are/are not made? 4. What is the magnitude of the event on incentives? 5. What will be perceived as "fair" to employees/executives? To shareholders? 6. What precedent is being set?
Raise the Event in Compensation Committees Early and Often	• Don't wait until the end of the year when an event is known or developing mid-year • Decisions do not have to be made right away, but committees should be aware of the potential impact of events as early as possible

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Key Takeaways

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- 2019 will be a year for some flexibility, creativity, and forward thinking
  - No major regulatory changes
  - Dealing with softer (not formulaic) issues
- State of flux and turbulent times
  - Tariffs, trade wars, environmental issues…you don't know what will pop up
  - Good plan design, and good executive compensation governance, includes planning for the unexpected
- Try to avoid doing the same old
  - The demise of 162(m)
  - Today's social and cultural norms
  - Take a step back and make sure your executive and director pay programs are still accomplishing what you want them to do

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Questions

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Director Compensation in 2019

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