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WORKSPAN

Eye on the Future of Executive Compensation Programs

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Thinking longer-term is difficult when the world turns upside down. Executive pay is no exception. Our focus narrows to the items in front of us and getting past current obstacles. Eventually we focus on getting "back on track" when the existential risk passes or we get used to it, and the new "normal" gets shaped by these prior experiences.

Like past crises, the Covid pandemic and national turmoil related to racism and gender inequality will introduce new thinking about pay and performance and permanent shifts in "how executive pay works". Today's executive compensation landscape has been shaped by past significant events and will be further molded by this year's events.

Enduring evolution and change beyond this year are likely in four areas.

EVENT	> LED TO	> AND THIS LASTING EXEC PAY IMPACT
Enron/ WorldCom	Sarbanes-Oxley 409A	• Reduced discretion • Significant reduction in deferred compensation programs • Focus on governance risk
Dotcom Crash	Stock Option Expensing/FAS 123	• Rise of PSUs for executives • Rise of RSUs for broad-based awards • Decline of stock options
Financial Crisis	Dodd-Frank	• Homogenization of pay program expectations and prominence of proxy advisors • Independence of board advisors • Say on Pay • Relative TSR and 3-year performance measures • Compensation risk reviews • Clawbacks • Shareholder outreach

1. Increase in strategic and non-financial goals, including ESG and Human Capital Management

PROGNOSIS: *Large prevalence uptick in 2021 programs; further increases in later years*

This trend was evolving, but the pace has picked up dramatically. Corporate responsibility for employee wellbeing, social justice, environmental protection, and stakeholder responsibility is a major platform for key institutional shareholders. We expect new models and measurement approaches to emerge in the 2021 proxy season. Trends typically filter down from largest companies, but we suspect a higher-than-normal adoption rate and innovative approaches in both large and mid-sized companies.

2. Increased discretion in pay decisions and normalization of expectations

PROGNOSIS: *Major element in 2020 that will lessen but endure in later years. Increased and more fulsome disclosure will be immediate. Expectations about structure of discretion and expected disclosure will normalize over time.*

A disconnect exists between issuers and shareholders/proxy advisors over the use of discretion. Issuers generally think that discretion is the "D-word" to shareholders and proxy advisors. However, these same shareholders generally agree that discretion should be exercised but want more of the "why" in the proxy instead of "what" and "how". Institutional shareholders have set the expectation this year that discretion is completely appropriate, with a request for more direct and clear disclosure. The SEC has implored issuers to provide as much insight as possible into all shareholder communications[1]. Will this be the year when the SEC's quixotic quest for "plain English" disclosure finally gets a win? We hope so.

3. Fundamental re-thinking, with shareholder input, of the risk/reward equation in long-term compensation

PROGNOSIS: *Discussions begin in 2021 for 2022 changes. A slower moving trend, perhaps until the next crisis.*

This is too big a topic to expect major changes in a short window. Performance shares have an under-appreciated mismatch between true range of outcomes and recipient expectations. When outcomes are above or around target, this trade-off feels acceptable, but 2020 demonstrates the inherent riskiness of an equity program that is PSU-dominant. We suspect that equity mix will evolve gradually towards more balance, with a greater appreciation for PSU risk.

4. Reshaping of incentive curves to introduce tolerance in goal setting

PROGNOSIS: *Will vary with perceived uncertainty and recent experience. 2020 events will create more gradual curves in 2021 programs and permanent changes over time.*

The incentive formula may be the most critical factor after measure selection to build programs that are appropriately sensitive to performance and feel fair to participants and shareholders. Traditional incentive programs are linear, i.e., the amount earned changes at a fixed slope with performance. The line often is steeper above target, and programs with additional changes in slope are uncommon. We may see more use of more gradual performance curves, multiple changes in slope around "expected" performance, increased prevalence of discretionary modifiers to financial results, and/or adjustment factors and "collars" that change the shape of the incentive curve based on macroeconomic variables.

Boards and management must think about long-term implications of 2020 on their strategy, forecasting ability, and the incentives they want to provide. Managing and guiding corporations through periods of tremendous social, political, and geopolitical risk requires near-term action in conjunction with long-term planning for a "new normal".

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[1] *https://www.sec.gov/news/public-statement/statement-clayton-hinman*