Compensation Committee Leadership Network

SUMMARY of THEMES

Leading practices in executive compensation

Amid fierce competition for talent, compensation committees are assessing whether their pay philosophies are effective in rewarding and retaining skilled leaders. The current wave of volatility is causing boards to consider what circumstances warrant the use of discretion and what tools—adjustments, clawbacks, and one-time grants—are appropriate in particular cases.

On November 22, 2021, CCLN members met to discuss how their committees are addressing a wide range of compensation-related issues.[1] *For a full list of meeting participants, please see the appendix on page 4.*

The conversation centered on the following topics:

- **Committees value a discussion about discretion, whether or not they ultimately use it.** Compensation chairs said that in general it is useful for their committees to retain some form of discretion over the final incentive payments to senior executives. In most cases, committees exercise the discretion to modify quantitative performance pay only in extraordinary circumstances. Sometimes the decision is based on a qualitative assessment at year end; in other cases, committees look at whether one or more of a predetermined set of events occurred over the course of the year. Most agreed that the process of assessing whether to exercise discretion is worthwhile, even if ultimately it is rarely used.

  A member described a benefit of following a defined process to consider whether or not to use discretion each year: *"We actually have a box in our proxy that discloses our framework for discretion. We don't use it very often—only when there is a significant change in the environment—but we have found that providing that color around our program forces the committee to have a conversation about discretion, so when investors see it applied, it doesn't appear to be ad hoc."* Another member discussed using two filters to start the committee's discussion: *"First, we look at the calculated pool. We always ask, does this calculation feel right to us? We don't want to be systematically adjusting up or down. The second lens is by the individual—and we do try to capture some leadership attributes that are simply not easy to have calculated metrics on. From time to time, we use discretion to send a message to a leader that really stood out or one we may be concerned about [because of] their behavior."* One member stressed the importance of remembering that the annual plan is just one portion of compensation: *"Sometimes there is volatility for two months, and then six months later there is a huge upside surprise. I think it's a good discipline to remind management that there is also a long-term incentive plan, in addition to the annual. We let the numbers fall where they will, and history tells us they tend to even out over time."*

- **Unpredictable external factors are weighing on committees as they assess adjustments for 2021 and goals for 2022.** Inevitably, each year brings with it a series of events that the compensation committee did not contemplate when it established management's goals and targets. Compensation chairs discussed some of the factors that they expect to review when considering whether to use discretion this year. Several members plan to take a closer look at the effects of the recent and dramatic rise in the rate of inflation. Likewise, the current supply chain crisis—and how to take the disruption into account when assessing results—is causing tension between some boards and management teams. A member shared how one committee is handling the issue: *"We are looking at our curves and will try to minimize the market risk by putting more protection on the downside, but probably less opportunity on the upside, as a counterbalance. It's causing us to think hard about how to align the compensation approach with the business strategy."* Another compensation chair shared a similar approach at a company for which the price of commodities has an outsized influence on performance in certain businesses: *"This year we are looking to reduce volatility and apply discretion for some stability around payouts. We consider the commodity price and performance in relation to that price, and [we] try to limit huge payouts on an upside year and minimize zero-payouts in down years."*

  Looking forward to 2022, committee chairs discussed the difficulty they face setting goals, given the prospect of interest rate hikes. One director said, *"We have asked management to earn through the declining-interest-rate environment, and they have done a great job. Now we are heading into a rise that may be a little steeper than the declining environment, but we didn't use discretion on the way down, so I don't think we change that on the way up, even if the slope of the curve is a little different."*

- **Recent regulatory activity has caused committees to reevaluate their clawback policies.** The SEC recently reopened the comment period on the compensation clawback rules it proposed in 2015. These proposed rules will ultimately require companies to adopt policies that require executives to return certain compensation the event of a financial restatement. Notwithstanding these rules, many CCLN members said that their boards have already updated their clawback policies to allow for recovery based on employee misconduct. Meridian Compensation Partners' Annette Leckie said, *"Committees are making sure that they have the tools they need to take the actions necessary in a high-profile or public event. And that often includes being able to claw back for misconduct or violation of company policy. Having the lever of a well-crafted clawback policy to pull is important. A policy that is focused only on cases that involve a restatement limits the board's options."* Several members said that difficult events at other companies have caused their boards to reassess their overall approach to severance, forfeiture, and clawbacks. One member shared, *"We recently decided to make some modifications and expanded our policy to include violations of our code of conduct. It was a helpful and timely exercise to work through."*

- **One-time grants are an effective tool but are coming under increased scrutiny.** In certain cases, often when a board is trying to recruit or retain key talent, compensation committees will go outside of the ordinary incentive process and issue a one-time equity grant. Some of these grants, especially ones with high dollar values, have come under scrutiny from both investors and the public. Meridian Compensation Partners' Virginia Rhodes said it is important to distinguish sign-on grants designed to make someone whole from payments designed to retain current executives: *"The make-whole grants are viewed as a cost of doing business in this highly competitive talent market."* She encouraged caution around so-called make-up awards: *"We are seeing some grants designed to retain employees who received significantly less than originally anticipated either in bonus payouts and/or performance share vesting – in part due to the impact of COVID-19 on financial and operational results. These are a cautionary tale because we have seen proxy advisers react negatively to those types of awards, particularly when shareholders have not experienced the same recovery."* Ultimately, as with most one-time events, it is incumbent upon the board to justify its decision through robust disclosure.

Appendix: Meeting participants

- Homaira Akbari, Temenos
- Tracy Atkinson, Raytheon Technologies
- Gaurdie Banister, Tyson
- Jevin Eagle, Carter's Inc
- Tony Earley, Ford Motor
- Helene Gayle, The Coca-Cola Company
- Lisa Gersh, Hasbro
- Marianne Harris, Sun Life Financial
- Kathy Hill, Moody's
- Worthing Jackman, Quanta Services
- Annette Leckie, Meridian
- Aylwin Lewis, Marriott International
- Leo Mackay, Cognizant
- Karen Maidment, TD Bank Group
- Cheryl Miller, Tyson
- Virginia Rhodes, Meridian
- Laurie Siegel, Lumen
- Amanda Sourry, PVH
- Matt Winter, The Hartford

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[1] *Summary of Themes* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Guests, however, have given permission for their remarks to be attributed. Comments by guests and network members are shown in italics.