

Compensation and Talent Governance Network

November 2022

CTGN

SUMMARY OF THEMES

Responding to economic uncertainty and new pay-versus-performance disclosure rules

Approaching the end of 2022, compensation committees face continued scrutiny of executive compensation levels and how pay connects to company performance, while also confronting an economic climate of inflation, market volatility, and impending threat of recession. On October 12, 2022, members of the Compensation and Talent Governance Network (CTGN) met virtually to discuss current trends in executive compensation—namely, the impact of the current economic environment and the implications of the SEC’s new pay-versus-performance disclosure rules.¹ *For a full list of meeting participants, please see the appendix on page 4.*

Compensation committees are reassessing incentive compensation in the face of economic uncertainty

The current economic climate is generating significant volatility and uncertainty, which complicates the task of setting appropriate goals for executives that effectively reward good performance while retaining valuable talent. *“The last 12 to 24 months have really been like none other. I’ve been doing this for 25 years and have not seen the kind of challenges we’re seeing, with the lingering pandemic, supply-chain disruption, and the continued uncertainty of the economic environment. All of that has played a role in compensation program designs,”* said Virginia Rhodes of Meridian Compensation Partners. One compensation chair said, *“The part that I think is most challenging is the uncertainty, which makes it difficult to set targets in a way that reflects how people are doing while not using the uncertainty as an excuse for having wild targets.”*

Members discussed several approaches they are using as they navigate the current economic climate:

- **Taking a holistic approach to incentive compensation.** Members emphasized the need to avoid overweighting plan components that may be influenced by short-term or external factors like interest rates, inflation, supply-chain disruptions, and currency fluctuations. One member said that while many companies had turned to performance stock units as the dominant vehicle for long-term incentive plans, committees are beginning to take a more holistic view. *“What I think is going to happen is slowly that pendulum will swing and committees will say, ‘What other vehicles do we need to start looking at?’ Do we need to be thinking about our long-term incentives as a portfolio, as opposed to one overly dominant set of long-term performance vehicles?”* Meridian’s Darren Moskovitz said, *“Step back and*

look at compensation holistically, and now's the time to do it. This concept of a portfolio approach to long-term incentives can be helpful; different vehicles preserve incentives in different markets."

- **Taking a longer view.** *"With all the uncertainty and volatility, I do recognize that it's not good to have a compensation plan with really wide swings,"* one member said. While some chairs are considering making one-time adjustments in the face of unusual circumstances, most committees are reluctant to do so unless the situation is truly exceptional. *"If executives feel like they were penalized when, say, the exchange rate was this and inflation was that or when interest rates were whatever, and then getting a rollback on the other side, I don't think it's fair."* It's more important, members said, to ensure that compensation is reasonable over the long term. *"Ultimately, you always want to look back and say, 'Over five years, have I paid out in a range where I think it was fair and appropriate?'"*
- **Making plans simple and understandable.** One compensation chair said, *"These plans have become just so complex that someone on our committee said recently, 'You shouldn't have to major in calculus to understand what your compensation is at the end of the year.'"* Members acknowledged that the complexity of compensation plans can obscure the connection between pay and performance. One member said, *"Having been an executive and seeing complex systems and realizing they had no impact on your motivation, I think our compensation system has to be transparent and simple and fair."* Mr. Moskovitz added, *"We need to make sure that whatever plans are in place are understood by participants so they can be motivating."* Another director agreed: *"People have to see that what they do is going to matter at the end of the day."*
- **Reconsidering stock options.** Stock options have fallen out of favor in recent years, but they may be gaining renewed attention from compensation committees. *"I've seen probably more discussions about putting stock options back on the table than we've had in years,"* one member said. While some do not regard options as performance-based compensation, members emphasized their usefulness as part of a broader long-term incentive plan. One member, whose company has never stopped using options, said that despite getting negative comments from proxy advisors, *"we feel that options are energizing for our organization and help executives connect the dots between the financial and strategic and ESG [environmental, social, and governance] goals that have been set for our plans along with shareholder returns—so every year we disregard the commentary."*

Committees must quickly navigate the SEC's pay-versus-performance disclosure rules

The SEC announced its finalized pay-versus-performance rules on August 25, 2022, creating significant new disclosure requirements for management teams and compensation committees.² CTGN members discussed several considerations raised by the new rules:

- **Connecting actual pay to performance.** The intent behind the SEC’s new disclosure rules is simple, Ms. Rhodes said: *“They want companies to disclose actual pay and how actual pay aligns to performance.”* While the intent is simple, delivering on that is quite complicated. The rules require firms to disclose compensation actually paid, and *“that’s a very difficult and very complicated exercise,”* she said. *“The equity valuations will be cumbersome and costly for companies to calculate, and—given the varying time periods, the “marking to market” of the awards, and the impact of COVID on financials and stock price over the last few years—it is going to be difficult to provide the narrative that they’re asking for and to really send the message that you want to your investors.”*
- **No relief on aggressive timing.** The new rules have caught many off guard, and firms are scrambling to assemble the necessary information. Despite requests from several leading law firms and compensation consultants, it is very unlikely that the SEC will delay implementation. *“Unfortunately, we are full steam ahead,”* Ms. Rhodes said. As a result, any company whose fiscal year ends after December 16, 2022, will have to include the new disclosures in next year’s proxy filing. This will create real challenges for issuers, because *“we’re not going to see all the numbers until the end of the year, and then you’ve got to quickly figure out how to tell the story,”* one member said.
- **Minimal impact on plan design.** While the new disclosure requirements may invite greater scrutiny, members agreed that the new rules would not significantly affect the way they construct compensation plans. Ms. Rhodes supported that sentiment, saying, *“Our hope is that this disclosure requirement doesn’t cause you to react in a way that would make you rethink how you comprise a peer group or how you design your incentive plans. Because, ultimately, this question should be based on asking, What is the driver of the business and how do you want to motivate your executives?”*

Although the current climate of uncertainty and volatility poses challenges, it is also creating an opportunity to rethink compensation. Mr. Moskovitz said, *“We’re probably on the cusp of one of those large macroeconomic events that is going to change the way that we think about executive compensation.”* One member agreed: *“It has turned out to be a very good period of time to be thinking all of this through because everything’s shifting so much. We really wanted to reflect and address volatility and what we’re anticipating the next two or three years to look like.”* Ms. Rhodes said, *“I think each one of these cycles presents an opportunity for us to take a fresh look, whether that’s simplifying your plan design or thinking about other vehicles to reward your leadership team. There’s always the opportunity to do that, and there’s no better time than in a crisis.”*

Appendix: Meeting attendance

- Stephanie Coyles, Sun Life Financial
- Jevin Eagle, Carter's
- Helene Gayle, Coca-Cola Company
- Lisa Gersh, Hasbro
- Mirian Graddick-Weir, Booking Holdings
- Jim Johnson, Ameren
- Karen Maidment, TD Bank Group
- Cheryl Miller, Tyson Foods
- Darren Moskovitz, Meridian Compensation Partners
- Meg Porfido, Kaiser Permanente
- Virginia Rhodes, Meridian Compensation Partners
- Barb Samardzich, Adient
- Laurie Siegel, Lumen Technologies, FactSet Research Systems
- Amanda Sourry, PVH
- Jerry Storch, Bristol-Myers Squibb

Tapestry Networks

- Eric Baldwin
- Marsha Ershaghi Hames
- Laura Koski
- Andre Senecal

Endnotes

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 are not attributed to individuals or corporations. Quotations in italics are drawn from conversations with network members and guests in connection with the meeting.

² For a discussion of the new rules, see Meridian Compensation Partners, *SEC Adopts Final Rule on Pay-Versus-Performance Disclosure*, Meridian Client Update (Meridian Compensation Partners, September 6, 2022).