# 2021 CHALLENGES FOR EXECUTIVE COMPENSATION IN A COVID-19 PANDEMIC WORLD

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# OBJECTIVES

- Review incentive plan pay actions taken by “early-filer” companies in response to COVID-19 and feedback from shareholders and proxy advisors
- Review ISS guidance on COVID-19 pay actions
- Discuss expected 2021 incentive plan design trends
- Address proxy and 10-K questions unique or new for 2021 filings
- Provide overview on the latest ESG trends in incentive plans
- Examine new Human Capital disclosure requirement and examples to date

# QUESTIONS?

***All attendees can submit questions via the chat feature on the virtual meeting interface.***

# COVID-19 ACTIONS AT S&P 1500 COMPANIES

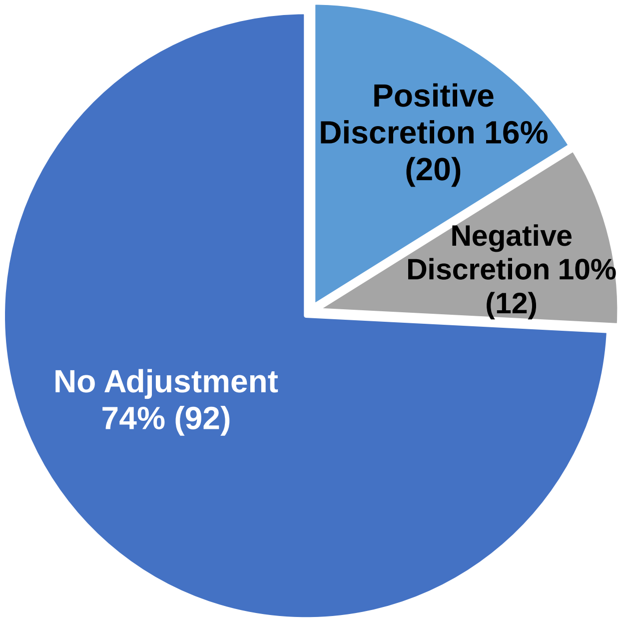
- The sample represents a total of 124 companies with fiscal years ending 4/24/2020 to 8/31/2020
- Data covers actions impacting plans in place for fiscal 2020, and forward-looking actions for fiscal 2021 and beyond
- The focus is on performance-based annual and long-term incentive (LTI) plans and is generally limited to Named Executive Officers (NEOs), as described in the disclosures
- Following is a summary indicating that actions of one type or another are prevalent

| | **Fiscal 2020** | **Fiscal 2021+** |
|---|---|---|
| No Actions Disclosed | 89 (72%) | 81(65%) |
| Annual Incentive Action Only | 22 (18%) | 8 (6%) |
| LTI Action Only | 3 (2%) | 15 (12%) |
| Both Annual and LTI Action | 10 (8%) | 20 (16%) |

# ANNUAL INCENTIVES

- The majority (74%) of early filers paid out bonuses pursuant to the original formulas, including fifteen companies that paid no bonuses
- 20 companies (16%) applied positive discretion to low/no bonus payouts under the original plan
- Payouts were increased from 16% of target to 74% of target (+58%) on average
- Twelve companies (10%) applied negative discretion or canceled the bonus plan
- Nineteen companies (15%) paid no bonuses to NEOs.
- Fifteen of these were based on the original bonus formula, while three canceled the bonus plan, and one applied negative discretion to reduce the funded amount to 0
- Two companies provided additional long-term incentives in the following year rather than applying positive discretion to current year AIP payouts

**S&P 1500 "Early Filer" Annual Incentive Plan Actions**



# LONG TERM INCENTIVES, SPECIAL AWARDS AND 2021 GOAL-SETTING

| | |
|---|---|
| **Long-Term Incentive Plan Payouts** | • Twelve companies (13%) applied positive discretion to increase LTI payouts<br>– Among these companies, LTI payouts increased from 52% to 106% of target on average (a 54 percentage-point increase)<br>• One company applied negative discretion to decrease LTI payout |
| **Special Awards** | • Thirteen companies (10%) disclosed special LTI awards to one or more NEOs to provide retention and/or offset the impact of COVID on incentive payouts and the value of outstanding LTI awards<br>– Includes the two companies mentioned on prior page, whose special awards were directly related to lower bonuses for the most recent fiscal year |
| **Goal-Setting for FY 21** | • Multiple companies revised their goal-setting approach for incentives due to continued COVID uncertainty, including:<br>– Delaying AIP and LTI goal-setting<br>– Granting RSUs in lieu of the FY 21 AIP<br>– Planning to use only second-half financial results for the FY 21 AIP<br>– Using a staged approach to goal-setting (e.g., 1-year goal for FY 21 followed by 2-year goal for FY 22-23) |

# 2020 PAY ACTIONS BY INDUSTRY

**A breakdown of 2020 annual and long-term incentive pay actions by industry is provided in the table below**

| Industries | Company Count | Annual Incentive Pay Actions | | | | | Long-Term Incentive Pay Actions | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Positive Discretion | Negative Discretion | Disc. Bonus Plan | Extra Equity | No Actions | Positive Discretion | Negative Discretion | No Actions |
| Communication Services | 6 | 1 | 1 | 0 | 0 | 4 | 2 | 0 | 4 |
| Consumer Discretionary | 16 | 5 | 1 | 0 | 0 | 10 | 2 | 1 | 13 |
| Consumer Staples | 22 | 3 | 1 | 2 | 1 | 15 | 2 | 0 | 20 |
| Financials | 2 | 0 | 0 | 0 | 0 | 2 | 0 | 0 | 2 |
| Health Care | 14 | 3 | 0 | 2 | 1 | 8 | 1 | 0 | 13 |
| Industrials | 24 | 4 | 4 | 1 | 0 | 15 | 3 | 0 | 21 |
| Information Technology | 34 | 3 | 5 | 2 | 0 | 24 | 2 | 0 | 32 |
| Materials | 6 | 1 | 0 | 0 | 0 | 5 | 0 | 0 | 6 |
| **All Industries** | **124** | **20** | **12** | **7** | **2** | **83** | **12** | **1** | **111** |

# 2021 EXPECTED DESIGN TRENDS

**We expect fiscal 2021 incentive plan design changes intended to improve the durability of incentive programs in light of market uncertainty, such as:**

- Wider threshold-to-maximum goal ranges
- Increased prevalence of non-financial components measuring strategic and/or individual performance in annual plans
- In particular, ESG goals, which have been a priority for institutional investors
- Two six-month performance periods instead of one annual performance period in annual plans
- Increased prevalence of relative performance metrics
- Increased weighting of LTI in restricted stock (while maintaining at least 50% in performance shares)
- Measuring annually against three-year goals for performance shares and averaging/banking the result so a single year does not make or break the entire period
- Some companies are also contemplating larger annual grants in the next cycle to make up for lost retention value from outstanding awards and avoid the negative optics of a special or one-off award

# ISS POLICY UPDATES – COVID-19 PAY ACTIONS

**ISS policy updates related to executive compensation primarily focus on how ISS Research intends to qualitatively evaluate COVID-related pay actions when determining Say-on-Pay vote recommendations**

| COVID-19 Pay Action | ISS Policy Updates |
|---|---|
| **Temporary Salary Reductions** | • Will be given “mitigating weight” to the extent they decrease total pay<br>• ***More meaningful if incentive payout opportunity (typically a percentage of salary) is based on reduced salary*** |
| **Adjustments to Annual Incentive Plans** | • Evaluated case-by-case<br>• May be deemed reasonable if justifications and rationale are compelling and clearly disclosed. Disclosure should include:<br>– Specific challenges resulting from the pandemic that rendered original program obsolete or original performance targets impossible to achieve, and how changes are not reflective of poor management performance<br>– Why company chose one approach versus another (e.g., year-end discretion rather than mid-year program changes) and how that approach was in shareholders’ best interests<br>– Performance considerations and underlying criteria for any discretionary awards. ***Generic descriptions (i.e., “strong leadership during challenging times”) will be deemed insufficient***<br>– How payouts reflect executive and company performance and how they compare to what would have been paid under original plan. ***Above-target payouts under changed programs will be closely scrutinized***<br>– Changes to 2021 annual incentive plan design that may mitigate other concerns |

# ISS POLICY UPDATES – COVID-19 PAY ACTIONS

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| COVID-19 Pay Action | ISS Policy Updates |
| --- | --- |
| **Modifications to in-cycle long-term incentives** | • Will generally be viewed negatively, especially for companies scoring poorly on quantitative pay-for-performance tests<br>• For award cycles beginning in 2020, modest changes may be deemed reasonable if awards continue to be performance-based and rationale is clearly disclosed<br>– For example, changing from absolute to relative or qualitative metrics may be reasonable<br>– ***Shifting to predominantly time-vesting or short-term measurement periods would be viewed negatively*** |
| **Retention/ One-Time Awards** | • May be appropriate in limited circumstances with transparent disclosure of rationale<br>– ***Boilerplate language ("retention concerns") will not be considered sufficient***<br>– Vesting conditions should be long-term, strongly performance-based, and clearly linked to the underlying concerns the awards aim to address<br>– To avoid windfall scenarios, awards should include limitations on termination-related vesting<br>• ***Companies that indicate one-time awards were granted in consideration of (a) forfeited incentives, (b) fairness considerations, (c) lowered realizable pay, etc. will also need to explain how such awards do not merely insulate executives from lower pay*** |

# WHAT TO EXPECT FOR 2021 PROXY FILINGS

- 2021 Compensation Discussion & Analysis (CD&A) likely to be much different than in prior years
  - Expect significant changes to executive summaries to address how the pandemic has impacted both the business and the results under annual and long-term incentive plans
  - Remember every company situation is different; it’s important to provide context for the investor
  - Emphasize how the compensation committee made decisions if changes were made to incentive plans either during or shortly after the fiscal year in light of the pandemic
  - Provide more detail regarding incentive programs
  - Explain in detail any discretion that was used to increase incentive compensation or pay bonuses; prepare disclosure in light of all key stakeholder interests
  - Consider disclosing 2021 incentive plans if the business is still being adversely impacted by the pandemic, particularly if those plans will be materially different than last year

# WHAT TO EXPECT FOR 2021 PROXY FILINGS

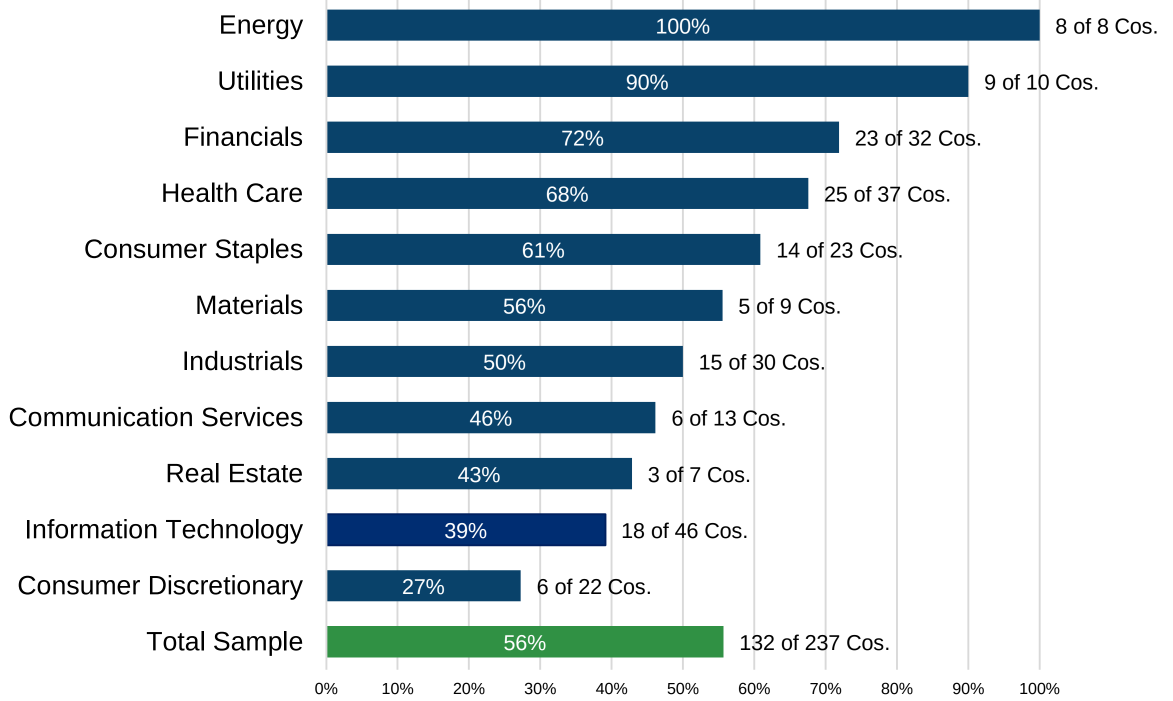
- Expect changes to the Summary Compensation Table (SCT) and other quantitative disclosures for COVID related changes in compensation
  - Cash incentives: non-equity incentive compensation, bonus or both in SCT (C&DI 119.02)
  - Adjustments to existing equity awards:  (C&DIs 119.21 and 120.07)
  - Earned amounts that are not cancelled (C&DI 119.25) vs. deferred (Instruction 4, Item 402(c))
  - Retention bonuses (C&DI 119.17)
  - Payments made in stock instead of cash (C&DI 119.03)
  - New COVID related benefits and perk status (C&DI 219.05)
- Median employee may need to change due change in circumstances from pandemic
  - Has there been a change to employee population or compensation that is significant?
    - Consider treatment of furloughed employees (C&DI 128C.04)
  - Is the median employee still with the company?
- Need to reconcile non-GAAP figures used for CD&A pay for performance discussion

# ESG TRENDS

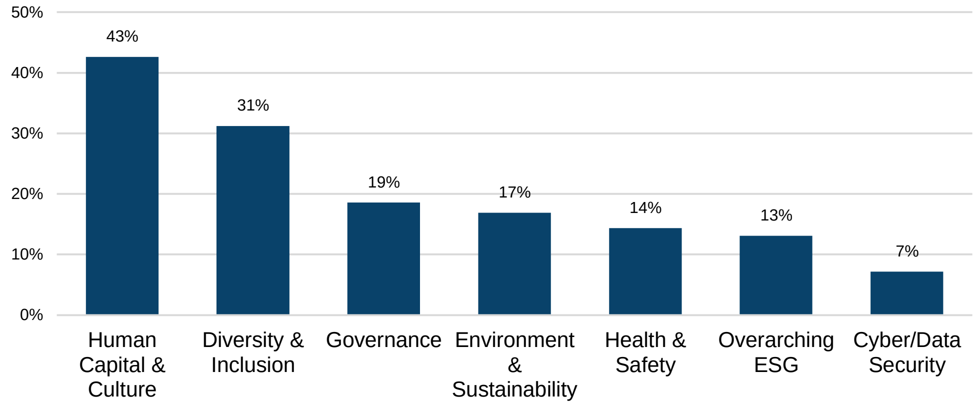
A 2020 FW Cook study of 237 of the largest U.S. companies found that 56% included an environmental, social, or governance (ESG) metric within their annual or long-term incentive plan design

- ESG metric usage has been trending upwards as shareholders place greater pressure on companies to address societal issues
- The most common ESG metrics in compensation plans include those related to human capital and culture, diversity and inclusion, and governance

## Prevalence of ESG Measures in Incentive Plans by GICS Sector




## Prevalence of ESG Measures by Category




| ESG Category | Examples of Goals |
|---|---|
| **Human Capital & Culture** | Automation goals, culture survey results, employee engagement survey results, health of workforce score, high performance retention rates |
| **Diversity & Inclusion** | Improvement in female and minority representation rates in employee population and at management levels, inclusion survey results |
| **Governance** | Stakeholder engagement targets, compliance achievements, continuity plan completion |
| **Environmental & Sustainability** | Annual progress towards long-term emissions goals, reduce carbon intensity, reduce greenhouse gas emissions |
| **Health & Safety** | Lost time injury rate (LITR), safety audit goals, reduce workplace incidents, total recordable incident rates (TRIR) |
| **Overarching ESG** | Implement overall ESG strategy, recognition for ESG initiatives, ESG scores from external ratings agencies |
| **Cyber/Data Security** | Fraud prevention, data governance, mean time to identify risk, mean time to resolve |

# NEW HUMAN CAPITAL DISCLOSURE REQUIREMENTS

- Annual reports filed by companies after November 8, 2020 are subject to new disclosure requirements regarding human capital resources
- New rules state that “where material to an understanding of the registrant’s business,” any human capital resources (including total number of employees), and any “human capital measures or objectives” that it uses in managing the business should be disclosed
  - Disclosure requirements are “principles-based” meaning they should be customized to each company’s unique circumstances
- While there are numerous metrics and objectives that an HR department focuses on (commentators have listed more than 30), the question is which measures are so significant that an investor might conclude that the measure is material to an understanding of the business
  - Stating a company intends to comply with all U.S. discrimination laws is likely immaterial; investors assume this
  - A statement that the company believes low employee turnover is critical and the HR department strives for a turnover rate of X% or less might be material, depending on the particular company
  - If an HR head is told that her/his job performance should be focused on a few specific metrics, they might warrant examination as possible material measures
- As companies file annual reports after November 8, patterns of disclosure may emerge, as was the case when companies began making proxy statement disclosures with respect to compensation risk assessments
- Such disclosure may also be influenced by shareholders, many of which have urged companies to disclose additional information about human capital management

# NEW HUMAN CAPITAL DISCLOSURE REQUIREMENTS

**A preliminary review of the first 50 filings for companies with market caps in excess of $1 billion indicated:**

- Significant differences in the lengths of the new disclosures with some companies expanding on past practice and others either repeating past disclosures or cross-referencing other documents, such as the proxy statement or Corporate Responsibility Statement
  - It appears that some companies may be concluding that, if their recruiting, training, compensation, etc. are what one would normally expect from a business of its size and character, then no additional disclosures are required because such additional disclosures are not material to understanding the business
- Topics considered "material" differ by company, with the most common topics reflecting expanded headcount, diversity and inclusion, and employee training and development. Other less common topics include employee compensation/benefits, company culture, values, and ethics, safety, employee engagement, tenure/promotion/ turnover and recruiting
- The most prevalent expanded disclosure was with respect to expanding headcount data beyond total employees, covering business segments/geography, gender and/or ethnicity
- Robust diversity and inclusion disclosures specifically addressed how diversity and inclusion were incorporated into various aspects of the company (for example, training, recruitment, goal setting, etc.) and incorporated statistical data
- Expanded employee compensation/benefits, development and training disclosures went beyond stating generic descriptions and instead described specific compensation/benefit designs and development/training programs
- Disclosures regarding company culture or ethics emphasized their importance and how these values are reinforced within the workforce

# NEW HUMAN CAPITAL DISCLOSURE REQUIREMENTS

**A preliminary review of the first 50 filings for companies with market caps in excess of $1 billion indicated:**

- Under the topic of safety, some disclosures addressed safety more generally, others specifically in the context of the COVID-19 pandemic, while several companies covered both topics
- Expansive employee engagement disclosures gave specific examples of how employees are engaged via surveys and/or other channels
- The most robust tenure, promotion and/or turnover disclosures stated that these metrics are tracked and provided statistical data
- Expanded recruiting disclosures addressed the importance of recruiting and the channels through which the company recruits
  - In some disclosures, recruiting was discussed in a specific context (for example, within a discussion of diversity and inclusion)

# SUMMARY

- Proxy filings by “early-filer” S&P 1500 companies indicate that the majority paid bonuses in accordance with the original formulas and a small minority of companies applied positive discretion to increase LTI payouts
  - No decline of Say-on-Pay support was observed for the companies that took COVID-19 related pay actions; against vote recommendations from proxy advisors were rare and based on multiple factors
- COVID-19 adjustments for “in-flight” PSU awards, where the relevant metrics and/or goal levels have been negatively impacted by the pandemic, continues to be a challenging issue for some companies
- Initial guidance from the proxy advisory firms acknowledges changes to incentive plans are likely among the hardest hit companies and advocates for contemporaneous and transparent disclosure of rationale for changes and Board decisions
- Most major institutional investors have not issued specific guidance on executive pay in the context of COVID-19 and will presumably use their existing principles and judgment to evaluate companies on a case-by-case basis
- Despite historic investor concerns about short-term measurement in long-term plans, prevalence may increase in 2021 as a means to ensure robust goal setting
- ESG considerations are a core part of stakeholder capitalism and there is increasing pressure to address broader ESG issues
- There are significant differences in the lengths of the new Human Capital disclosures with some companies expanding on past practice and others either repeating past disclosures or cross-referencing other documents
- The Human Capital topics considered “material” differ by company, with the most common topics reflecting expanded headcount, diversity and inclusion, and employee training and development

# THANK YOU FOR ATTENDING

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