A 2020 Vision for the Compensation Committee

Compensation Committee Series Webinar
Presented by Pearl Meyer

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Meet the Presenters

Richard Schapiro has 35 years of investment banking experience as a trusted advisor in the health care and financial services sectors, principally at Salomon Brothers and Bank of America Merrill Lynch (retired 2014). He currently serves as an independent director on the boards of Molina Healthcare and Transamerica, chairing the compensation committee and serving as a member of the audit committee for both organizations. In addition, he serves on the finance committee of Molina Healthcare. Schapiro is an NACD Board Leadership Fellow and has received the CERT Certificate in Cybersecurity Oversight. Schapiro was named to the NACD Directorship 100 in 2018.

Pete Lupo is a senior managing director and head of the Atlantic Region at Pearl Meyer. Pete has worked extensively with compensation committees and management covering a variety of needs including the development of total compensation programs covering the senior leadership team, aligning pay to performance, designing annual and long-term incentive plans, developing board of director pay programs, advising on change-in-control, executive benefits, perquisites, and governance-related matters.

Scott Evenson is a vice president in Pearl Meyer's Boston office and a member of the firm's Banking Industry Team. He has extensive experience advising financial institutions of all sizes on executive and non-employee director compensation, and regulatory and governance matters.

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- The replay will be available early next week at www.NACDonline.org and www.pearlmeyer.com/top-five-2020.

Today's Agenda – Looking Ahead at Top Questions for 2020

- In what situations is EVA the best measure?
- When is the right time to move from disclosure to inclusion of ESG metrics in an incentive plan?
- What exactly should directors be doing in response to the compensation committee's expanding charter and responsibility?
- Can we or should we use adjusted performance metrics and if so, how?
- How do we balance the pressure to be transparent with the risks of sharing too much information?
- Key Takeaways

1. EVA and ISS

- In 2020, ISS will be using EVA metrics rather than GAAP metrics in their Financial Performance Assessment (FPA)
  – Moreover, the actual metrics used are EVA derivatives – even further removed from standard GAAP profit and growth measures than normal EVA.
  – The FPA remains a secondary performance screen (with relative TSR as the primary), affecting a relatively small number of companies.
- The move raises a few key questions for compensation committees:
  A. How exactly is ISS using EVA?
  B. How is our company going to fare vis a vis these EVA metrics?
  C. Should our company have EVA in the executive compensation program?

1. EVA and ISS (cont.)

A. How exactly is ISS using EVA?

- Four EVA-based metrics (scaled) XXX, YYY, ZZZ, and AAA
- Underlying EVA reflects a slate of XX adjustments to GAAP data

B. How will our company fare?

- Modeling will be difficult because of the adjustments
- Companies could seek to reverse engineer and model ISS calculations

C. Should we use EVA?

- Decision should place ZERO weight on ISS' move to EVA
- All the traditional pros and cons of EVA remain relevant
- EVA is not necessary. However, the performance dimensions of EVA—*profit, growth, capital efficiency*—ought to be represented, and properly balanced, in your incentive framework (reflecting your company's specific economic context).

2. ESG and Incentives

What is ESG?

	NEW	NEW	OLD
	Environmental	**Social**	**Governance**
ISS Categories	• Environmental risks and opportunities • Carbon and climate • Natural resources • Waste and toxicity • Sustainability • 12 subcategories total	• Human rights • Labor, health & safety • Stakeholders & society • Product safety, quality, brand • Customer satisfaction • 25 subcategories total	• Board structure • Compensation • Shareholder rights • Audit & risk oversight

- **For now:** it's about transparency and disclosure, not necessarily incentive design.
- **In the future:** should ESG be included in incentive plans?
- All companies are unique. Some of them may deliver the same product or service as a competitor, but their culture and how they go about their business are usually very different.
- Just as companies are unique, so are their incentive plans. They may all have STI and LTI plans, but the way they implement, communicate, and most importantly think about their plans are different. Therefore, how each company addresses ESG performance measures will be specific to each company.

2. ESG and Incentives (cont.)

A Potential Approach to ESG and Compensation: Annual Review Process

- Step 1 - Initial review
  - Context – why is this important
  - What ESG issues are important enough to be measured?
  - Should any issues be included in the incentive plans?
- Step 2 - Establish baselines for those ESG issues to be measured
  - Is it currently possible to measure or do systems need to be introduced to measure?
  - Identify historical performance (industry standards or competitive data)
  - Establish baselines for future comparisons
- Step 3 – Establish annual objectives
  - Review prior year performance
  - Establish goals (annual or multi year)
- Step 4 – Communication
  - Internal communication plan - what is the target, how can it be achieved, why it is important
  - Integration with sustainability report (if any)
  - Communicate in the CD&A how ESG issues are considered in compensation decision-making
- Step 5 – Measure results
  - After year end, measure results (consider periodic updates during year)
  - Consider results in pay decisions
  - Go back to step 3

3. Comp Committee's Expanding Role: Succession Planning and Talent Development

"Far from trying to second guess or micro-manage the senior management team, boards understand that these human capital issues present real, strategic business challenges, risks, and opportunities to their companies."

Roles and Responsibilities

- From emergency succession planning only to short and long-term succession planning.
- From CEO succession to monitoring the overall health of the leadership and talent pipeline – do we have the right people, in the right roles, at the right time to support our strategic plan? Look at roles 2-3 levels removed from CEO.
- From succession planning to succession management and talent development – actively managing the talent pipelines.
- From talent risk management to employee engagement – can we motivate and retain our high performers?

Scorecard Metrics

- Succession plans for key roles: emergency successors, # of ready now, ready soon, ready 2+ years
- Turnover rates – high performing talent and overall voluntary turnover
- Leadership bench strength – # of high performers/high mobility (potential) for key roles 2-3 levels below CEO by function and organizational unit
- Leadership development – # of ready soon and ready 2+ who move into next readiness category within 12 months
- Engagement scores – overall trends by function and organizational unit

3. Comp Committee's Expanding Role (cont.): Gender Pay Gap; Diversity & Inclusion

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Roles and Responsibilities

- From assessing financial risk to promoting positive brand identity
- From diversity compliance to creating a positive employment brand for competitive advantage: the "employer of choice"
- From risk and liability to strategic lever for increasing shareholder return
- From diversity and inclusion metrics to strategic diversified talent pipeline

Scorecard Metrics

- Gender and other diversity categories: talent pipeline metrics:
  - *Into the pipeline:* recruitment and selection
  - *Through the pipeline:* promotions, designated high potentials identified in the leadership succession plan, development opportunities and compensation
  - *Leaving the pipeline/exits:* voluntary turnover, turnover of high performers and identified successors

4. Adjusted Metrics

- Although it has its critics, it is prevalent practice to use "adjusted" financial performance metrics in incentive programs.
- The benefits of using "adjusted" metrics include:
  - Aligned with how companies communicate results to investors;
  - Better reflects core operating performance; and
  - Allows for more accurate year-over-year comparisons without one-time distortions.
- Profit-based metrics are typically most often adjusted for the following:
  - M&A-related expenses
  - Restructuring
  - One-time gains or losses
  - Legal fees/settlements
  - Foreign currency translation

4. Adjusted Metrics (cont'd)

- Given criticism that adjustments to financial metrics lack consistency across companies, what factors should compensation committees consider in allowing for adjustments?
- Pearl Meyer suggests the following "rules of the road":
  - **Materiality:** Consider a threshold dollar amount over which adjustments would be considered
  - **Consistency:** Review against historical adjustment decisions
  - **Accountability:** Was the item/event outside of management's control and not part of core operating performance?
  - **Disclosure:** Is the proposed adjustment also reported externally to investors? If not, does approving this adjustment create additional proxy disclosure burden?
- We also recommend that committees adopt a regular cadence of reviewing potential adjustments on a quarterly basis to avoid any unanticipated year-end surprises.

5. Strategic Transparency

Strategic transparency is prioritizing and tailoring messages to stakeholders to ensure all-around support for your compensation programs.

- We operate in a demanding environment with a market that has an insatiable appetite for information
  - Compensation is no longer considered off limits—it is part of today's global conversation.
- The issues that connect to compensation are broad, diverse, and sensitive.
  - Business, succession, and leadership strategy; pay-for performance; sustainability; pay equity; responsiveness to shareholders; governance; etc.
- Not all stakeholders are created equal.
  - Expectations about information vary across audience segments.
  - Some issues and/or messages are more important for some than for others.
  - Some audience segments carry more risk and require more focused attention, but may not need excessive details about your programs.
- The board and senior management should have a shared view on the company's strategic transparency goals.
  - Stakeholders; level of detail; frequency of messages; methods of delivery; etc.

5. A Strategic Transparency Roadmap

Mapping out your stakeholders and the issues your organization should be addressing is the best first step.

Example Issues	Example Stakeholders				
	Investors	*Proxy Advisors*	*Executives*	*Broad-Based Employees*	*The Public/Media*
	Pay-for-Performance	Pay-for-Performance	Competitive Pay	Competitive Pay	Pay-for-Performance
	Shareholder Engagement	Shareholder Engagement	Succession Planning	Succession Planning	Succession Planning
	Succession Planning	Succession Planning	Career Growth Opportunities	Career Growth Opportunities	Sustainability
	Compensation Governance	Compensation Governance	Sustainability	Sustainability	Pay Equity
	Sustainability	Sustainability	Pay Equity	Pay Equity	
	Pay Equity	Pay Equity			

Compliance issues may not always be the top focus of content, but it should always underpin of all of your communication materials.

- Define overall messages for each issue
  - Find the overlaps
  - Weigh the risks of sharing information with some versus others
  - Tailor messages for each stakeholder group based on priority and risk
- Plot optimal timing
  - Regular milestones (quarterly, annually)
  - Special (circumstantial) touchpoints
- Develop materials
  - Public disclosures
  - Investor calls/presentations
  - Leadership/employee meetings

Key Takeaways

EVA is not necessary.

However, the performance dimensions of EVA —*profit, growth, capital efficiency* — ought to be represented, and properly balanced, in your incentive framework (reflecting your company's specific economic context).

For now, ESG is about transparency and disclosure.

But if/as it is implemented in an incentive plan, it will be highly specific to each company.

The compensation committee's responsibilities are broader.

Includes succession planning, talent development, the gender pay gap, and diversity & inclusion.

Adjusted metrics require stated "rules of the road."

Materiality, consistency, accountability, and disclosure

The appetite for information is insatiable.

Not all stakeholders are equal; develop a shared view of the level of transparency required and a roadmap for execution.

Questions

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