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Five Compensation Committee Agenda Items for a Complex 2022

Boards and the C-suite are being called upon to do far more and to be accountable for far more than ever before. Directors today are expected to field issues that weren't traditionally their concern, both external (think social justice concerns or climate change) and internal (like broad-based talent retention). Management teams are likewise challenged with new work models, supply chains gone awry, inflation, and a host of other issues outside those of the normal business operating environment.

With that complex, fluctuating context in mind, Pearl Meyer offers its annual "Top Five" list for the board. This year, it takes the form of recommended conversations and actions that can provide beneficial guidance and structure for the management team and strengthen the board itself.

1. **Explore New Ideas in Executive Compensation Structures:** The core responsibility of designing compensation plans that attract, retain, and motivate the right CEO and his/her executive team requires new levels of creativity and flexibility—more customization to each organization's unique circumstances than ever before.
2. **Mitigate Risk and Create Resilience in Goal-Setting:** The effects of COVID over the last two years and recent concerns about rising inflation and supply chain deterioration have highlighted some possible areas for improvement when it comes to incentive plan goal-setting. How can compensation committees create plans that are more resilient to external unknowns, while still driving long-term performance?
3. **Evolve the ESG Conversation:** The exploration of the merits of environmental, social, and governance concerns has matured. The conversation now is about how best to move the needle on the ESG points that matter most to an organization. That may take place through incentive plans, or perhaps through other equally important actions.
4. **Bring Back Servant Leadership:** The nature of the workforce is in significant transition; it is increasingly contractual and everything is up for renegotiation. Organizations are seeing the need for leaders that can foster a sense of inclusion and flexibility in order to maintain a cohesive workforce that can grow the enterprise.
5. **Maximize Board Effectiveness:** Finally, the board itself must lead with the same traits it seeks to instill in the organization. How can an evolving board make the most of its diverse composition and skills?

Exploring New Ideas in Executive Compensation Structures

The typical executive compensation model for public companies has been relatively stagnant for the past decade, and it seems like everyone is following the herd. The question is whether the time is right for some companies to consider different and unique pay models that refute conventional wisdom and embrace differentiation as way to either achieve competitive advantage or improve the return on investment from executive compensation.

Achieving Competitive Advantage

In some industries, there is increased competition from private equity-owned businesses that have very different pay models than their publicly traded competitors. The typical private equity pay model has relatively low cash compensation and relatively high long-term equity-based compensation, the latter of which is often provided via a one-time equity grant exclusively in stock options. This simple and high risk/high reward pay structure serves to align executive and shareholder interests while minimizing the annual pay negotiation process (e.g., annual grant values, performance metrics, goal-setting, etc.).

Perhaps public companies could emulate some of these structural differences in their pay models. For example, some companies could be better off with up-front equity grants as opposed to annual equity grants. This tactic seems best aligned with "turnaround" situations, and may also be appropriate for businesses that are stagnant or in decline.

It's likely that some companies are more suited to using stock options than PSUs. The use of stock options only rewards for actual shareholder value creation and avoids the complexity of annually selecting metrics and setting multi-year performance goals; the latter of which can be very difficult for companies in industries that are regularly impacted by external factors or that have a significant merger and acquisition component to their business strategy.

Improving Return on Investment

We all generally agree that pay for performance is the best way to maximize the return on investment of executive compensation. Nonetheless, there are some common pay elements that may not live up to this standard. For example, merit salary increases. Base salary is a relatively small component of executive pay, it is not performance-based, it often has a cascading impact on other pay elements (bonus, equity grant values, severance, etc.), and the material differentiation of increases is elusive. Perhaps companies should not offer merit salary increases to executives and instead manage pay directly against market.

Another potential anomaly is executive severance. Often the poster-child for paying for poor performance, large severance packages that were agreed to when attracting the executive can often seem excessive when later exiting the executive. If the premise of severance is to bridge an employment gap, perhaps companies should limit severance to a multiple of salary and include mitigation. It may also be reasonable to have severance benefits decline over time once the initial risk and uncertainty of changing jobs has past and the executive has accumulated enough wealth to bridge their own employment gap.

Challenging Norms

We've all heard the expression "if it's not broken, don't fix it." But just because something isn't broken doesn't mean it's functioning at its optimal level. The point here is to occasionally go beyond your comfort zone, even if only mentally, to challenge the status quo and either reaffirm your conviction with current practice or boldly select the path less chosen.

Mitigating Risk and Creating Resilience in Goal-Setting

In the days of yore, the profit and growth goals in an incentive plan were simply based on the company's operating plan and long-range forecast. In more recent years, with increased focus on pay for performance, many companies enhanced the goal-setting process to incorporate additional analytics and data, and have allowed more time for consideration, to ensure that thoughtful, shareholder-aligned goals were being set. Analytics might include peer and industry performance history and forecasts, as well as shareholder expectations modeling. And the compensation committee was given time to consider these inputs well in advance of the February committee meeting.

But even the most thoughtful and forward-looking companies have discovered, thanks to the events of the past few years, that good fundamentals cannot always produce bullet-proof performance goals and ranges. Things are vastly more complicated, executive performance expands far beyond profit and growth as ESG is emerging as a compensable factor, and the Great Resignation continues, raising the stakes for errors or misses in the incentive plans each year.

So how can companies balance the often competing objectives of achieving good pay-for-performance alignment, retaining and motivating people, and addressing a broader scorecard of performance? The answer, alas, involves more time and effort. The right combination of tactics will be different for each company, but here are some things to consider.

Good blocking and tackling means get the core profit and growth forecasts as “right” as possible. Make sure budget and planning perspectives are reinforced with a review of industry and peer performance analysis, shareholder expectations, and consideration of company-specific context. Also make sure the committee is engaged on goal-setting early and often.

Control for highly volatile inputs. Generally we want to hold management accountable for results they control and over which they have influence. Insulating short-term incentive plans from things like interest rate swings, price shocks from supply chain disruptions, exchange rates, etc. can create stronger alignment. Goals can be set conditionally, with formulaic adjustments occurring when key variables move outside of a planning collar. While adding complexity, controlling incentive metrics for these inputs can lead to less volatility in incentive plan outcomes. Be careful, however, that controlling for these inputs doesn’t incent bad decision-making or absolve management from managing the entire business during challenging times. Such adjustments may be limited to the short-term plan, with the long-term plan remaining “all in” on performance and external events.

Relative total shareholder return (rTSR) is an easy choice since it is the common bottom line for publicly traded companies. Other measures have traditionally been tougher to use due to different balance sheet legacies among peers, timeliness of information, and different operating context. But the increased uncertainty of planning makes now a good time to reconsider that balance of the pros and cons.

Go with wider performance ranges? While this may be obvious, the impact of the new uncertainty might be overlooked where a company has just mechanically applied plus or minus 10 percent or 20 percent ranges. It may be time for a recalibration reflecting actual historical and expected variances. Your operating income range may need to be plus or minus 30 percent or more.

Increase the use of time-based equity. Following every economic disruption we have seen the mix of long-term incentive vehicles tip back toward the use of time-based equity. After a couple of years, the trend reverses and performance-based equity prevalence increases. But this time, despite ISS objections, it may be worth keeping things simple if multi-year financial goals prove too difficult to set.

Finally, accept that discretion and judgement and qualitative performance evaluation is here to stay. Frankly, it's always been difficult to reduce executive performance evaluation to a formulaic assessment of profit, growth, and total shareholder return. But to do qualitative performance evaluation right, companies should adhere to a few key principles: be prepared, consistent, fair, modest, and act with integrity.

Evolving the ESG Conversation

The exploration of the merits of environmental, social, and governance concerns has matured. The conversation now is not whether these issues are vitally important, but about how best to move the needle on the ESG points that matter most to an organization. The pressure is on from investors to make greater progress in a shorter period of time, especially in the areas of diversity, equity and inclusion (DE&I) and climate change, and as a result, a general expectation has arisen that executive incentive plans should have ESG performance measures. That may be one effective way to achieve results, but perhaps other, equally important actions make more sense in some cases.

We expect that in response to broader stakeholder views, many companies will integrate ESG metrics into their incentive plans even though they are not core to the business strategy. No doubt those metrics may be important in other ways and for other reasons, but fundamentally sound incentive plans should only reflect those metrics that are part of or directly and materially supporting the business strategy. Nevertheless, our conversations with boards over the last couple of years indicate we will begin to see a substantial increase in the number of companies that have an ESG measure in their short-term incentive plans. While they are currently very rare in long-term plans, we may also see an increasing number of companies include ESG there as well. And this may turn out to be a more thoughtfully planned approach, given the complexity and long-range nature of most ESG issues.

We also know that including one or more ESG metrics in incentive plans is often viewed as an effective way to signal how important these issues are to the organization. There is no disputing the signaling power, but that should not be the goal. In order to make significant progress beyond noting an issue's basic importance, the board must establish a baseline, explore what is possible over what timeframe, and ensure that the executives charged with making this progress have clear line of sight to a successful outcome.

This is the next logical step in the compensation committee's discussions about ESG: integrating the desire to make progress against ESG factors with the very specific conversation about goals and metrics. Talking about ESG within the context of annual and long-term goal-setting is the best way to ensure you don't end up with competing priorities, ineffective incentive plans, or unintended consequences.

As an example, let's look at a short-term incentive plan, where ESG metrics are currently most common. Many companies use a mix of financial and non-financial metrics in their annual plans (e.g., 80% weight on financial performance and 20% weight on non-financial performance). Replacing a non-financial metric with an ESG metric is relatively easy for companies that already include non-financial metrics in their annual incentive plan. But incorporating an ESG metric is far more difficult for companies with annual incentive plans that only measure financial performance. These companies must consider the degree to which ESG or other non-financial priorities should "dilute" financial priorities. This is where it gets difficult very quickly, although many times these companies may already be considering ESG in their compensation deliberations *outside* the annual plan. For example it may influence salary decisions or long-term incentive grant values, but companies may not be adequately explaining this process to shareholders. This could be a missed opportunity to help connect the dots and explain what is being done in service to ESG and why, as well as what is not being done and why.

Ultimately, investors expect progress. Making it clear how the organization is pursuing its ESG goals and how it will be held accountable is a must. Whether this plays out within incentive plans or through otherwise stated company objectives that have baselines, goals, and timeframes outside of compensation—such as in standards-based corporate social responsibility reports—is the right determination for the moment.

Bringing Back Servant Leadership

While ESG is a front-and-center conversation—and not likely to abate at any point soon—it is influencing more than just business operations and outcomes. We are also seeing a different kind of leadership conversation in this ESG era: real, down-to-earth conversations between leaders and their people, with genuine expressions of concern for safety, health, and well-being. Leadership teams are shedding their former selves in pursuit of a greater purpose, often known as "servant leadership," with a desire to serve and be of service to others. These highly effective leaders are engaging in ways that restore a sense of personal safety, provide employees with greater control and work/life balance, and cultivate a work environment that feels more individually significant and important.

This goes beyond simply creating a pleasant work climate. Not only does this type of leadership help combat some of the increasingly urgent engagement and retention issues many companies are facing, it frankly helps drive better outcomes. Company leaders and their boards often see that helping individuals find greater belonging and inclusion, flexibility, mental health, and physical wellbeing can lead to their full potential being realized. This leadership from a place of compassion naturally leads to improvements in collective organizational performance.

We know that moving from highly analytical, data-driven, and/or "command and control" leadership into a "softer" arena is a major culture shift for many organizations, but definitions can help. What, exactly, does a servant culture look like? It is not an individual style of leading; it is the art of teaming to liberate people to do what is required of them in the most effective and humane way possible. It begins with a heavy dose of empathy, putting others' needs above one's own, and requires a show of humility. And it seeks to actively build trusting relationships and foster active listening.

Here are 10 actions that can help your management team and board work toward a meaningful servant culture:

1. **Deeply Listen:** Practice the discipline of hearing, acknowledging, validating, and being open to others' views as a way to build trust.
2. **Be Empathetic:** Stand in someone else's shoes, take in their unique circumstances, and put their needs above your own.
3. **Foster Belonging and Inclusion:** Help people feel a sense of shared identity, while recognizing their individuality.
4. **Provide Healing:** Care about the well-being of others and take steps to help them overcome challenges.
5. **Show Humility:** Be self-aware, know your limitations, admit mistakes, learn, and be

open to change.
6. **Communicate with Inspiration:** Engage in authentic communication that reaches people at a personal level.
7. **Be Visionary:** Focus on the bigger picture, giving others hope for the future.
8. **Build Community:** Help people participate in something bigger than themselves, in the organization and the community.
9. **Take Accountability:** Take personal responsibility for yourself, for others, and the organization at large.
10. **Commit to the Growth of Others:** Help each person in the organization grow—personally and professionally.

The beauty of servant leadership is that as it takes root, it creates lift and builds momentum, allowing more to achieve their full potential.

Maximizing Board Effectiveness

The lessons of the past two years suggest that having a top-notch board is more important than ever. We see many boards developing stronger partnerships with the CEO, while retaining their independence and oversight responsibilities. Most high performing CEOs are proactively seeking this kind of relationship with their boards, as they realize the benefit of the additional experience and perspective the board can provide during these challenging times.

Looking ahead, it is likely that companies will continue to face layers of crises—social, economic, environmental, and geopolitical. The most resilient companies will have CEOs and boards who have forged a partnership to weather the storms and pull their companies through, perhaps even better than before. There are five areas we see as key to such collaboration:

1. **Being Proactive:** Stepping up as a partner to the CEO and management team as they navigate very difficult and ambiguous waters
2. **Encouraging Agility and the Ability to Pivot:** Helping prioritize a company's most urgent challenges
3. **Checking in Personally:** Ensuring the CEO and management team are personally doing okay, along with providing advice and counsel as they adjust their leadership styles to meet the current needs of the organization
4. **Building Talent for the Future:** Developing a diverse bench of leadership-ready talent and emphasizing the need to cultivate leaders for the long haul
5. **Spotlighting DE&I and ESG:** Asking the right questions and requesting data to provide insights into current goals, metrics, and measurement

As boards have been asked to step up and lead in new and different ways, the day-to-day work of directors has evolved and broadened beyond the traditional focus on profitable growth. For example, the most effective boards today are also meeting an urgent concern by focusing on the alignment of the workforce and its needs with the strategic needs of the current and future organization. While the full board has more to do, there is certainly added importance and a broadened role specific to the compensation committee. Many are broadening their charters to include a robust focus on CEO and senior leader succession and development, with an eye toward developing leaders who can build winning and resilient cultures. And of course, the most proactive boards are looking inward with an eye to improving their own leadership capabilities. Three important shifts are happening amongst boards that are evolving to better meet the needs of their organizations:

1. **Recognizing the Importance of Culture:** Looking more deeply at organizational culture, the level of organizational health, and how the culture will need to evolve to drive future growth
2. **Role Modeling Diversity and Inclusion:** Working to build board diversity and inclusion that translates into added value to the organization
3. **Engaging in Deeper, More Meaningful Board Assessment:** Below-the-surface evaluation of the board's performance and a frank outlining of its current and future talent and experience needs

In Conclusion

It seems true more now than ever: the only differentiating trait of an organization in the long run is its people and the quality of its leadership. Eventually, all of the fundamental issues—and opportunities—associated with people and leadership will come through the compensation committee. We have seen some shining examples, particularly over the last couple of challenging years, where together boards and management teams are bringing together a respect for the power of corporate culture and a desire to more actively foster leadership with a strategic and well aligned compensation philosophy. Not coincidentally, these same companies are reaping the benefits in financial performance.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.