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2024's Top Five Proactive Conversation Starters for Fall Compensation Committee Meetings

Introduction

Each year, we highlight several current issues that compensation and human capital committees are facing and outline some unique ways to address them. As we help clients start preparing for another very busy and uncertain fall, and reflect on the concerns of the last few years, it's clear there has been a recurring theme: expect the unexpected.

Today, despite unabating churn in market dynamics, regulations, and stakeholder expectations, boards are still expected to nimbly meet the current conditions while incorporating evolving responsibilities into their governance frameworks. In addition to maintaining focus on each organization's unique long-term business strategy, and anticipating that you may need to make quick decisions when circumstances arise, it's advisable to take a proactive stance wherever and whenever possible.

For the compensation committee this may include taking charge of the executive talent pipeline, modifying conventions of performance-based equity, selectively responding to shifting investor interests, planning for some departures that are sure to happen, or optimizing existing governance processes. Along these lines, we offer five questions that proactive directors can bring to their fall meetings and some corresponding suggested approaches.

- How can we use executive compensation to support leadership planning and internal succession?
- How can we design PSUs to be more effective in volatile markets?
- Is it time to remove ESG from our incentive program?
- Are we well-prepared for planned—and unplanned—exits of our named executive officers?
- Are we effectively evaluating our CEO?

1. How can we use executive compensation to support leadership planning and internal succession?

Setting executive compensation levels for a new CEO or other senior executive involves the consideration of multiple inputs, both external and internal. For example, market data informs the external worth of the position and what the market will bear in terms of the going rate for the role. But if the organization is considering promoting from within (and there are many reasons to do so), numerous internal factors, such as tenure, performance, current role criticality, and internal equity also come into play.

It's common practice for the market rate to play a large role in how compensation is leveled for an external hire. Yet despite the number of possible—and important—factors that can be used to level compensation for an internally promoted executive, getting it just right can be elusive. Far more nuance goes into the "calculations" than is required for a peer group analysis.

In practice, most companies set compensation below the market rate for an internally promoted executive. The common thinking is that since the individual is new to the role and thus has yet to demonstrate proficiency in the role, something less than market rate is appropriate. This leads to two questions. First, exactly how should compensation be structured at the time of the executive's promotion, and second, how do you know when the executive is fully functioning in the role such that paying the market rate (or higher) is warranted?

In terms of initial leveling of compensation for a newly promoted executive, we often recommend a discount to the market median to provide room for future adjustments based on demonstrated future competence and performance in the role. Further, reflecting that discount to market primarily in base salary positioning can allow the variable, performance-based elements (i.e., the annual and long-term incentives) to be set at or near market median since they will be earned based, in part, on the executive's future performance in the role. It is also important to consider internal equity among the executive team. Setting the annual incentive target as a percent of base salary, and long-term incentive value consistent with the executive's internal peers creates internal alignment and consistency.

Future adjustments to base salary and, as necessary, to annual and long-term incentives should then reflect how the executive is performing in the role with an eye toward bringing the individual to market norms over a two- to four-year period. To earn an appropriate return on the organization's investment in executive talent, particularly when they become a "market-priced" executive, it is important to be able to establish and communicate the skills, competencies, and performance expected of the executive. And then be able to develop and assess for those skills and competencies. In theory, this should be no different than the attributes that would be outlined upon executing an external search.

There are multiple advantages to "hiring" through an internal succession process as opposed to an external search. Internal candidates bring institutional knowledge of the company and its business strategy and culture, reducing the ramp-up time that comes with an external hire. Leadership continuity promotes organizational stability and communicates to next-level executives that there are senior-level career progression opportunities within the company, which helps with the retention of top talent. Of course, developing talent internally requires investment and resources. Competency assessment models can be used to evaluate potential leadership talent against desired attributes and identify areas for improvement. Responsibility roadmaps can identify opportunities for internal job rotation to allow for exposure to multiple areas of the business to further position the executive for senior leadership roles. In support, communication of career progression opportunities is important so that the next generation of leadership understands the potential opportunities and rewards to staying and growing within the company.

2. How can we design PSUs to be more effective in volatile markets?

Conventional wisdom suggests performance share units (PSUs) are an essential component of any shareholder-aligned executive compensation program structure. In fact, over 70% of the Russell 3000 use some percentage of PSUs in their program design. The reality that companies—as well as shareholders—need to face is that frequent periods of market volatility and unforeseen circumstances are becoming the norm. If PSUs continue to be a favored instrument because they provide a tighter pay-for-performance relationship, it is becoming increasingly important to adopt PSU program structures that are better insulated from market volatility than what has been typical. Neither a "set it and forget it" mentality, nor the use of discretion sufficiently address the programmatic failures PSUs face when market conditions dramatically change, therefore it is imperative that certain design modifications be considered, within the context of three still-critical core principles of PSU design that should be adhered to.

1. **Support sustainable value creation.** Adopt metrics that have a demonstrated correlation to shareholder value creation and/or long-term strategic business priorities.
2. **Focus on the long-term.** Measure performance or calibrate the final vesting date over a period that is sufficiently longer than the time period covered by the company's cash bonus program.
3. **Assess the risk of the leverage curve.** On the heels of the Chemours case and current investigation of ADM's accounting practices, it is essential that boards evaluate the PSU leverage curve and determine if it encourages excessive risk-taking.

With these tenets in mind, there are a few PSU design features that can be deployed to thoughtfully mitigate the noise of market volatility.

Use a combination of relative and absolute performance metrics.

The majority of PSU programs identify one or two metrics to measure over a designated timeframe. Although an increasing number of companies are adopting both a relative and an absolute performance metric, the majority of companies continue to only adopt one or the other. The benefit of incorporating both types of metrics in a PSU program is that company-specific achievements can be isolated from broader market fluctuations by allowing for the metrics to act as a "hedge" against one another.

If an unanticipated macro event impacts the ability to achieve pre-determined goals, then the true pay-for-performance test of the management team is how they execute versus their comparators by the time the performance period ends. Conversely, if relative performance metrics are solely used, a company's specific circumstance (i.e., the degree of difficulty required to achieve the goal) is often lost. Specifically, companies should consider the interplay between the use of relative metrics (e.g., TSR, margin, or growth rate) as modifiers to core corporate metrics versus the relative metric being a stand-alone weighted metric. While a stand-alone weighted relative metric may serve to shield a company from a financial forecast that was negatively impacted by unforeseen macro events, a modifier reduces the impact of the relative metric and places more emphasis on what is directly within management's line of sight. Ultimately, we recommend a company undergo an analysis of how macro conditions have impacted the organization historically in order to inform what degree of emphasis should be placed on absolute metrics versus relative.

Consider a balanced scorecard approach.

PSUs based solely on financial and/or market metrics are sacrosanct across most industries. However, incorporating a combination of financial, operational/strategic, and market metrics creates a broader performance assessment framework and can mitigate the impact of market volatility or macro conditions on any single metric category. A scorecard is particularly useful in situations where the stock price reacts more to external market factors than it does to company performance. Additionally, using multiple metric categories facilitates the development of a scorecard that is uniquely customized to the company's current and future state. The caution here is ensuring that the operational/strategic measures are objective and measurable.

Give thought to a formulaic mechanism that adjusts performance goals.

Although committees always retain the discretion to adjust payouts and/or performance goals, most rarely do so given the message it sends to the management team and shareholders. However, as part of the PSU design, a formulaic "adjuster" could be adopted that modifies targets up or down when pre-determined macroeconomic conditions (e.g., commodity price fluctuation, consumer price index, exchange rates, etc.) or critical budget inputs fall outside of a certain range.

Adopting a formulaic adjuster serves multiple purposes: It takes some pressure off multi-year goal-setting, creates dynamic targets that can respond to changing macro conditions, and allows for a mechanism whereby committee discretion can be applied sparingly. Similar to PSU performance metrics and goals, the adjuster framework should be reviewed annually when new awards are contemplated and recalibrated to account for any changing market conditions.

Modify the approach to leverage curves.

Typical leverage curves tend not to have payouts below 80 or 90% of target, and target payout is only achieved when performance is at 100% of goal. Given the significant drop in payout level if threshold performance is not achieved, the typical PSU leverage curve is highly susceptible to exogenous market and economic conditions. By extending the leverage curve and allowing for payouts to be earned at 25-35% of target (or lower, if appropriate), the PSU program can be de-risked and better able to weather macro volatility. In addition to extending the downside protection of the leverage curve, companies can also consider establishing a "target zone" where performance within the zone yields 100% payout thereby reducing the pressure to hit a specific number.

3. Is it time to remove ESG from our incentive program?

Over the past few years, there has been a rise in the use of non-financial metrics in executive-level incentive plans. The two most notable drivers of this change have been the COVID-19 pandemic and a surge in ESG-related initiatives.

Adding non-financial metrics during COVID turned out to be a legitimate way to de-risk incentive plan payouts during a period of heightened uncertainty, as well as to recognize the significant efforts required to keep some businesses afloat, even if not profitable. It also created a “home” within the incentive framework to incorporate metrics and goals related to a company’s ESG initiatives, which saw heighted focus during that same time period.

Now, with the COVID impact mostly in the rear-view mirror and investor sentiment toward ESG-related initiatives becoming more polarized—seemingly by the week—the question is whether companies should retain non-financial metrics in their executive-level incentive plans.

The primary case for non-financial metrics is that they are important leading indicators of performance that serve to counterbalance the lagging indicators of financial results. However, the case against notes that some non-financial metrics may not have a strong, direct link to subsequent financial results, and that performance goal rigor can be difficult to assess. It’s frequently cited that the relatively low weight often placed on non-financial metrics can introduce subjectivity into a process that is otherwise predominantly objective. For example, critics may say a 5-20% weight on one to five non-financial objectives over-complicates the incentive structure, makes goal-setting more challenging, and can distort the pay-for-performance relationship in any given year. These are valid critiques.

As with most compensation program design elements, the decision to include or exclude non-financial metrics—and how heavily to weight them—should be driven by the company’s business context and strategy. Companies executing a material turnaround or unprecedented business expansion may benefit from incenting and rewarding non-financial goals such as supply chain improvements, store remodels, and successfully entering new markets. The thought is such short-term, non-financial goals can lead to long-term financial success. In another example, companies pursing a cultural transformation may benefit from assessing and rewarding improvements in employee and customer engagement, employee retention, and career development and succession planning. And where environmental stewardship is a priority and/or a market differentiator, critical path objectives and goals may be appropriate.

However, in this context, the use of non-financial metrics might be occasional and temporary. In other words, on an “as-needed” basis to address a specific situation or set of key objectives. All companies will have important non-financial objectives, but not all companies will have a set of circumstances necessitating that these objectives be incorporated directly into the incentive programs. And for those that do, the circumstances are unlikely to be permanent.

For many companies, the overall measurement and monitoring system will include non-financial goals and objectives, but the executive-level incentive programs will be 100% based on financial results. This maintains the simplicity and integrity of the incentive structure, while acknowledging the importance of non-financial objectives in driving both near-term and long-term financial results. No matter the route taken, as long as the decision-making is based on the company’s strategy, and not entered into as a matter of trend or external pressure, then the approach is correct. Communicating the overall strategy, rather than broadly characterizing the set of measures, is the right way to go and will help avoid unnecessary controversy.

4. Are we well-prepared for planned—and unplanned—exits of our named executive officers?

Committees spend a great deal of time ensuring that the executive compensation program delivers a competitive pay opportunity, which facilitates effective recruitment and motivation of the executive team. They typically spend less time on how the program works when there is the separation of an executive under various circumstances. Twenty years ago, tally sheets came into vogue as a way for compensation committees to monitor, manage, and prepare for external communications about exit pay for CEOs. But over time, it seems that this analysis has fallen by the wayside.

However, proxy advisors have put the spotlight back on exit pay, and not just for CEOs, but for all proxy-named executive officers (NEOs). Both ISS and Glass Lewis have refined and sharpened their positions, with increased negative consequences for poor practices. In fact, in the most recent annual review of "Against" say-on-pay vote recommendations by ISS, poor exit pay practices are second in frequency only to poor pay-for-performance alignment. Clearly, it's time to put exit pay back on committees' radar.

Essentially, there are two practices that companies should seek to avoid. First, avoid ex-post separation arrangements, where a departing executive receives materially richer treatment than they are contractually entitled to. For example, a company may determine that it is time for an executive to move on but finds that formal severance arrangements are either too thin, or non-existent. To ensure a smooth transition, the committee approves liberal treatment of unvested equity despite a plan provision that calls for forfeiture. If the value of the ex-post provisions is rich enough, and the company is receiving nothing of value from the executive in exchange, the proxy advisors are increasingly likely to issue an "Against" vote recommendation.

The second practice to avoid is paying severance for a "voluntary" termination. Proxy advisors are acutely opposed to severance pay associated with an apparent retirement, or a "mutual agreement" to separate. For example, a company may determine that it is time to upgrade their CFO, but the outgoing CFO is long-tenured and well-liked by the CEO and the board. Further, the CFO is concerned about the stigma of an involuntary termination, but nevertheless, expects "a package" to leave. The company pays severance but discloses the separation as a mutual agreement as opposed to a termination. As far as the proxy advisors are concerned, the days of gratuitous cordiality are over. Such a disclosure is very likely to garner an "Against" vote recommendation.

To eliminate, or at least reduce, the need to resort to such practices, companies should do a few things well in advance of any separation.

Review and update the formal treatment of cash incentive and equity grants upon all classes of separation.

Ensure that the exit pay is appropriate to real-world situations for your executive team. This goes for voluntary terminations, involuntary terminations (both for-cause and not-for-cause), death, disability, and retirements. Pay particularly close attention to the involuntary not-for-cause case, including the formal severance pay component. Model the provisions to understand how each member of the executive team would be treated to ensure all seems fair, so that exceptions can become extremely rare.

Carefully consider and plan the disclosure of named executive separations.

For any NEO departure, the proxy advisors will carefully scrutinize the narrative disclosure as well as the specific pay provisions. Stick to the plans and get comfortable with clearly disclosing terminations as such when severance pay and provisions are utilized.

Use retention agreements to set ex-ante special arrangements.

It may seem odd to suggest "retention," since the proxy advisors also don't like special retention awards. But there are occasions when a company can anticipate a key executive separation in the next few years and wants to ensure service through a particular date. For example, a company might give retirement treatment to that executive's equity even though they won't be retirement-eligible, provided they serve through that date. It is far better to bake that special treatment into new equity grants and disclose those terms ex-ante than to deliver them as a "golden handshake," and modify existing grants.

If exceptions must be made, consider if some continued service through a transition period can legitimately be incorporated into the separation agreement, such as a consulting arrangement or service in a special executive role. Such an arrangement will garner further scrutiny by ISS and Glass Lewis but they will provide at least some cover for exceptional treatments.

5. Are we effectively evaluating our CEO?

The annual CEO evaluation process is an often-overlooked golden opportunity. While it is often treated as another "must do" for the board and CEO, it may not be leveraged to its full benefit. When executed with intention, this process is a great chance to not only provide the CEO with an evaluation of performance against clear goals set by the board for a given year, but also to provide valuable developmental feedback—something many CEOs say they want and value—above the evaluation process itself.

It's important to note that evaluation and development are two different things, and in most respects should remain separate conversations. But the truth is that one often bleeds into the other, after all it is natural that as we think about how to improve performance, we also look to ways to develop to better hit those targets.

What does such a CEO evaluation process look like in practice? Here are tips for ensuring you are truly maximizing the CEO succession process, from both performance evaluation and development perspectives.

Outline the full CEO evaluation process up front amongst the CEO and board.

Note the steps that will take place, approximate timing, participants, and expected outputs, such as written reports and/or follow-up discussions. Consider documenting the process as a component of the board's overall governance.

Clarify what will be evaluated and how.

Identify the clear goals and metrics tied to achieving the business strategy that the board and CEO have agreed upon as key areas of focus for the year. (These may also be reflected in the annual incentive plan.) In addition, outline the core leadership attributes tied to the achievement of those strategic goals and ensure the CEO understands at the outset that *how* they achieve results will also be evaluated.

Measure both business and leadership performance areas.

Business measures will likely be straightforward, consisting of clear financial goals and other key performance indicators. Leadership measures may be less quantitative, but can be captured in survey and interview feedback from direct reports and the board, and may be most effectively captured by a third party with expertise in executive evaluation and development.

Provide a comprehensive CEO evaluation report.

The resulting detailed report should also include an easy-to-digest executive summary and a scorecard that is initially delivered to the compensation committee and then to the full board. The scorecard will be a simple and clear display summarizing all CEO evaluation findings.

Schedule a discussion.

The chair of the board, or the chair of the nominating/governance or compensation committee should share the evaluation findings with the CEO. Ideally, this can be followed by a developmental feedback session with a third-party coach who can discuss the scorecard and the 360-degree assessment report with the CEO in detail. Ensure the CEO fully understands the feedback and owns their associated development plan. This lays the foundation for future performance improvement.

Share a summary with the full board.

Often as a follow-up, CEO's have appreciated sharing a high level summary of their evaluation findings, as well as discussing their focused future development plan with the board. This creates space for the CEO to have a healthy and direct discussion with the board with an emphasis on their forward development as a CEO.

The results of this type of CEO evaluation process will give directors a better grounding in the true performance of the CEO and will provide clear direction for stronger alignment with the company's strategic priorities and further personal growth. The benefits will build over time and consistency in the process should strengthen executive performance, as well as communication between the board and CEO.

In Conclusion

One thing is certain: 2025 will bring more change. In our experience, working with thousands of public and private companies, two board attributes that help weather heavy storms are a proactive stance and a core philosophy of making strategic decisions based on the individual facts and circumstances of each organization. Whether it's actively exploring these five scenarios, or others that might arise, the good news is that compensation and human capital committees have numerous opportunities and tools available to help steer their companies and management teams to successful outcomes.

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.