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Executive Pay Issues

Materials

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Executive Pay Issues

Readings

Compensation Season 2022

Posted by Adam J. Shapiro, David E. Kahan, and Michael J. Schobel, Wachtell, Lipton, Rosen & Katz, on Sunday, January 9, 2022

Editor's note: Adam J. Shapiro, David E. Kahan, and Michael J. Schobel are partners at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell memorandum by Mr. Shapiro, Mr. Kahan, Mr. Schobel, Jeannemarie O'Brien, Andrea K. Wahlquist, and Erica E. Bonnett. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

U.S. companies continue to demonstrate resilience following another year in which the pandemic imposed itself on world events. Although 2021 did not deliver a full reopening, corporate activity thrived in spite of ongoing uncertainty around "return to work," building on momentum and lessons learned from 2020. As the impact of the pandemic subsides, company culture, talent retention and business objectives will shape the long-term workplace landscape. We identify below some of the key factors that may shape the 2022 compensation season.

Steady Rise of ESG. ESG-related goals are increasingly prevalent in annual incentive programs, with a meaningful year-over-year increase from 2020 to 2021. Over the next few years, we expect that use of these metrics will continue to increase and take on greater relevance. With so much attention on ESG objectives, it is vital for companies to carefully consider the goals that they establish and the manner in which they disclose those goals. Making well-intentioned commitments that go unfulfilled can backfire. And changing course or modifying goals midstream will receive heightened scrutiny from investors and the proxy advisory firms. A well-designed ESG goal should reward the achievement of a realistic, meaningful objective in a manner that is readily comprehensible by company constituents.

Proxy Advisors and Institutional Investors. Neither ISS nor Glass Lewis issued any significant compensation-related policy updates for the 2022 proxy season. Of course, while ISS and Glass Lewis recommendations have the most significant impact on outcomes, many institutional investors maintain their own voting guidelines on compensation matters. Understanding the guidelines of a company's largest institutional investors is essential. Blackrock is a bellwether for policy trends. Among other policy pronouncements, Blackrock's 2022 voting guidelines provide that "[d]uring a period in which executive compensation appears excessive relative to the performance of the company and compensation paid by peers, we may vote against the members of the compensation committee." Note that the Blackrock policy could result in an immediate vote against both a company's say-on-pay proposal and members of its compensation committee, rather than the more forgiving ISS escalation approach.

SEC Guidance on "Spring-Loaded" Compensation Awards. Late last year, the SEC issued accounting guidance on "spring-loaded" compensation awards, which the Commission defines as share-based compensation that is granted before the announcement of market-moving information. According to the Staff Accounting Bulletin, as companies measure compensation actually paid to executives, they must consider the impact that the material nonpublic information will have upon release. This interpretation would increase the accounting expense for award grants in scenarios in which a company's stock price rises after the award grant date as a result of the subsequent disclosure of material nonpublic information. While the Commission's guidance is well-intended, it runs the risk of penalizing companies for coincidental timing. We hope that the Commission will be judicious in limiting any enforcement activity to cases of abuse or clear negligence. In the meantime, companies should ensure adequate internal controls and policies to minimize the risk of a potential spring-loading issue.

Perk Disclosure. SEC inquiries and enforcement actions relating to inadequate perquisite disclosure continued in 2022. These actions assert violations of the proxy disclosure rules and do not require proof of intent. Settlements in this area include financial penalties, remedial action such as engaging outside advisers to review and revise policies and seeking repayment from the executives. It is important to maintain internal controls to track and properly report items that could be perquisites within the meaning of Item 402 of Reg S-K.

Dodd-Frank Act Regulations. Last October the SEC reopened the comment period for the compensation clawback policy rules first proposed in July 2015, suggesting that final rules may be forthcoming in early 2022. Now is a good time to take stock of existing clawback policies in order to ensure alignment with any new SEC requirements once the Commission promulgates final rules. We continue to await final regulations regarding disclosure of pay for performance.

Front-Loaded Equity Grants. Companies periodically grant equity awards that cover multiple grant cycles in lieu of issuing new awards each fiscal year. While Tesla's option grants to Elon Musk are the most prominent example of this type of award, front-loaded awards are more often structured as performance-based restricted stock units. Front-loaded grants highlight a number of considerations regarding equity award grant practices:

Review Equity Plan Limits. Always confirm that a grant complies with individual or aggregate share limits and does not otherwise run afoul of applicable plan terms.

Process Matters. Provide the compensation committee with the information it needs to consider and approve the grant on a fully informed basis, including a written summary of the material terms of the award, award cost, benchmark data and draft versions of applicable SEC disclosure. Additional care should be taken in potential conflict situations, *e.g.*, where the award recipient is also a significant stockholder.

Manage the Rollout. Anticipate the reaction of the proxy advisory firms and large institutional investors. ISS is likely to issue a negative say-on-pay recommendation, especially where the award results in a significant year-over-year increase in reported compensation.

Understand HSR Filing Requirements. The receipt of certain types of awards having a value above applicable thresholds will trigger an immediate filing obligation under the Hart- Scott-Rodino Antitrust Improvements Act of 1976. Failure to comply may result in significant fines.

While multi-year grants may present challenges, those challenges are not insurmountable, and such grants may be an effective way to retain key leaders over a longer time horizon.

Harvard Law School Forum on Corporate Governance

Executive Compensation Considerations for 2022 Annual Meetings

Posted by Brian Breheny and Joseph Yaffe, Skadden, Arps, Slate, Meagher & Flom LLP, on Thursday, January 20, 2022

Editor's note: Brian Breheny and Joseph Yaffe are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Mr. Breheny, Mr. Yaffe, Caroline Kim, Andrew Bond and Stephanie Birndorf.

Incorporate Lessons Learned From the 2021 Say-on-Pay Votes and Compensation Disclosures and Prepare for 2022 Pay Ratio Disclosures

Companies should consider their recent annual say-on-pay votes and general disclosure best practices when designing their compensation programs and communicating about their compensation programs to shareholders. This year, companies should understand key say-on-pay trends as they addressed the COVID-19 pandemic, including overall 2021 say-on-pay results, factors driving say-on-pay failure (*i.e.*, those say-on-pay votes that achieved less than 50% shareholder approval) and equity plan proposal results, as well as guidance from the proxy advisory firms firms Institutional Shareholder Services (ISS) and Glass Lewis.

Overall Results of 2021 Say-on-Pay Votes

Below is a summary of the results of the 2021 say-on-pay votes from Semler Brossy's annual survey[1] and trends over the last 10 years since the SEC adopted its say-on-pay rules. Overall, despite the uncertain climate during much of 2020, say-on-pay results at Russell 3000 companies surveyed in 2021 were generally the same or slightly below those in 2020, at least due in part related to COVID-19 related responses.

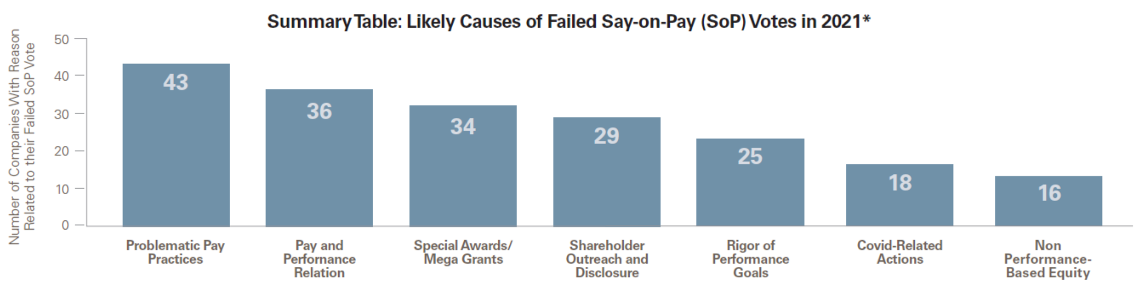
- Approximately 97.2% and 97.7% of Russell 3000 companies, in 2021 and 2020, respectively, received at least majority support on their say-on-pay vote, with approximately 93% receiving above 70% support in both years. This demonstrates slightly reduced say-on-pay support in 2021 compared with 2020.
- ISS' support for say-on-pay proposals in 2021 through September 2021 continues to be among the highest observed over the last 10 years with 89% of companies surveyed receiving an ISS "For" recommendation—the same result as in 2020.

[1] See Semler Brossy's report "2021 Say on Pay & Proxy Results" (September 30, 2021). See also Semler Brossy's report "2020 Say on Pay & Proxy Results" (September 24, 2020). Unless otherwise noted, Semler Brossy's report is the source of pay ratio, say-on-pay and equity plan proposal statistics in this post.

- Russell 3000 companies received an average vote result of 90.5% approval in 2021, which is slightly lower than the average vote result of 91% approval in 2020.
    - The average vote result exceeded 90% approval in 2021 across multiple industry sectors, including utilities, materials, industrials, consumer staples, energy, financials and consumer discretionary.
    - The communication services sector had the lowest level of average support of 84.6% compared with other industry sectors.
- Approximately 2.8% of say-on-pay votes for Russell 3000 companies failed in 2021 as of September 2021, which was slightly higher than the 2.3% failure rate for 2020 measured in September 2020.
- Approximately 11% of Russell 3000 companies and 12% of S&P 500 companies surveyed have failed to receive a majority support for say-on-pay at least once since 2011.
- 37% of S&P 500 companies and 30% of Russell 3000 companies surveyed have received less than 70% support at least once since 2011.

Factors Driving Say-on-Pay Failure

Overall, the most common causes of say-on-pay vote failure were problematic pay practices, pay and performance relation, special awards, shareholder outreach and disclosure, rigor of performance goals, COVID-related actions and nonperformance-based equity awards, as summarized in the chart below.[2]



*59 companies that failed on SoP were included in this survey. The same company may be counted towards multiple cases of failure.

Notably, special awards have increased from the fifth most frequently cited likely cause of say-on-pay vote failure in 2020 to the third in 2021, possibly due to increases in special awards made in connection with the COVID-19 pandemic, some of which were not reported as COVID-related actions. Otherwise,

the likely causes of say-on-pay failure remained largely consistent between 2020 and 2021, with problematic pay practices and pay and performance relation (i.e., a disconnect between pay and performance) as the continuing frontrunners.

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[2] See Semler Brossy's report "2021 Say on Pay & Proxy Results" (September 30, 2021).

ISS Guidance

When evaluating pay practices, proxy advisory firms tend to focus on whether a company's practices are contrary to a performance-based pay philosophy. In December of each year, ISS publishes FAQ to help shareholders and companies understand changes to ISS compensation-related methodologies. In December 2020, ISS published its most recent general United States Compensation Policies FAQ,[3] which included the following key updates:

- ISS' Multiple of Median (MOM) high concern threshold for S&P 500 companies is now three times the peer median rather than 3.33 times the peer median. This change was effective for meetings on or after February 1, 2021.
- MOM is one of ISS' quantitative pay-for-performance screens that expresses the prior year's CEO pay as a multiple of the median CEO pay of its comparison group for the most recently available annual period.
- ISS indicated that it would assess COVID-related pay decisions based on its "U.S. Compensation Policies and the COVID-19 Pandemic" FAQ published on October 15, 2020.[4] However, ISS may release updated guidance about its approach to COVID-related compensation developments in the coming weeks, especially given that companies could better predict the impact of COVID-19 on their businesses and compensation programs in 2021 compared with 2020. Highlights from ISS' COVID-19 Pandemic FAQ are as follows:
    - The common theme underlying executive compensation and incentive plan design during the pandemic is to permit discretion to address novel issues that generally arise only during periods of extreme market volatility while expecting companies to offer robust disclosure about their compensation decisions.
    - The following should be disclosed to help investors evaluate COVID-19 pandemic-related changes to an annual incentive program:
        - specific pandemic-related challenges that arose and how those challenges rendered the original program design obsolete or the original performance targets impossible to achieve, as well as how changes to compensation programs are not reflective of poor management performance;
        - the rationale for making mid-year changes to bonus program design as opposed to the grant one-time discretionary awards (or vice versa) and how such decision relates to investor interests;
        - performance-based conditions that apply to discretionary awards; and
        - how resulting payouts appropriately reflect individual and company annual performance and how they compare with payouts that would have been made under the original program design.
    - ISS generally does not support changes to long-term incentive programs that are driven by the pandemic; provided that movement to relative or qualitative metrics may be viewed as reasonable under certain circumstances. ISS continues to

[3] See ISS' FAQ "United States Compensation Policies" (December 21, 2020).
[4] See ISS' FAQ "U.S. Compensation Policies and the COVID-19 Pandemic" (October 15, 2020).

frown upon shifts to predominantly time-vesting equity or short-term measurement periods.

- For additional information about ISS' "U.S. Compensation Policies and the COVID-19 Pandemic" FAQ, see our December 14, 2020, client alert "Matters to Consider for
the 2021 Annual Meeting and Reporting Season."

ISS also made clear that companies will no longer receive credit for having stock ownership guidelines if such guidelines permit unearned performance awards or unexercised stock options (including vested unexercised options and "in the money" value of options) to count toward meeting stock ownership requirements. Unvested full value awards that require no exercise, such as time-based restricted stock and restricted stock units, may count toward stock ownership requirements without jeopardizing ISS credit.[5]

ISS' general United States Compensation Policies FAQ summarized which problematic practices are most likely to result in an adverse ISS vote recommendation. The problematic practices include the following and are expected to remain problematic in 2022:[6]

- repricing or replacing of underwater stock options or stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- extraordinary perquisites or tax gross-ups, likely including gross-ups related to personal use of corporate aircraft, executive life insurance, secular trusts, restricted stock vesting, home-loss buyouts or any lifetime perquisites;
- new or extended executive agreements that provide for
- termination or change in control severance payments exceeding three times the executive's base salary and bonus;
- change in control severance payments that do not require involuntary job loss or substantial diminution of duties;
- change in control payments with excise tax gross-ups, including modified gross-ups; (iv) multiyear guaranteed awards that are not at-risk due to rigorous performance conditions; (v) a "good reason" termination definition that presents windfall risks, such as definitions triggered by potential performance failures (*e.g.*, company bankruptcy or delisting); or (vi) a liberal change in control definition combined with any single-trigger change in control benefits; and
- any other egregious practice that presents a significant risk to investors.

Other issues contributing to low say-on-pay support include:

- inadequate disclosure around changes to performance metrics, such as disclosures that fail to explain changes and how they relate to performance;
- high-target incentives for companies that are underperforming relative to their peers;
- special bonuses and mega equity grants without sufficient rationale or risk-mitigating design features; and

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[5] See ISS' FAQ "United States Procedures & Policies (Non-Compensation)" (October 4, 2021).
[6] See ISS' FAQ "United States Compensation Policies" (December 21, 2020), FAQ Nos. 43 and 44.

- insufficient shareholder outreach and disclosure, including inadequate response to compensation-related concerns raised by shareholders.

ISS is expected to release a full set of updated compensation FAQ in December 2021, which will provide robust guidance for 2022.

Glass Lewis Guidance

Glass Lewis published its 2022 Policy Guidelines[7] for the United States, which included the following compensation updates that are expected to be in effect for the 2022 proxy season:

Environmental and Social Criteria and Executive Pay

Glass Lewis indicated that a company's particular circumstances should inform its decisions about whether and how to feature environmental and social (E&S) metrics in company compensation programs. Specifically, companies should consider factors such as their industry, size, risk profile, maturity, performance, financial condition and other relevant internal and external factors when determining whether and how to feature E&S metrics in their compensation programs.

Additionally, Glass Lewis expects companies to provide robust disclosure when they introduce E&S criteria into their executive incentive plans.

Such disclosure should include:

- how the E&S criteria align with the company's strategy;
- the rationale for selecting specific E&S metrics;
- a description of the target-setting process and corresponding payout opportunities;
- the basis on which E&S metrics will be assessed, particularly with respect to qualitative metrics; and
- targets for quantitative E&S metrics on an *ex ante* basis or why the board believes it is unable to make such a disclosure.

Glass Lewis made clear that some behaviors should be regarded as baseline requirements for executive performance and therefore should not generally need to be incentivized. For example, Glass Lewis indicates that it would support shareholder challenges

to using metrics to reward executives for ethical behavior or compliance with policies and regulations.

Glass Lewis acknowledged that it generally supports company flexibility to determine whether to incorporate E&S metrics into their compensation programs, on both a general basis and with respect to short-term and long-term incentive compensation. In addition, Glass Lewis does not maintain a policy on the inclusion of such metrics.

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[7] See Glass Lewis' "2022 Policy Guidelines" (November 15, 2021).

Please see the section below titled “Consider Trends and Developments on Employee, Environmental, Social and Governance Metrics in Executive Compensation” for additional information on how environmental and social metrics are being featured in companies’ compensation plans.

Short-Term and Long-Term Incentive Awards and Front-Loaded Awards

Glass Lewis clarified the following in its 2022 Policy Guidelines:

- It may consider adjustment to GAAP financial results and the basis for such adjustments when it analyzes both short-term incentive awards and long-term incentive awards for their effectiveness at tying executive pay with performance. Clear disclosure of reconciliations between non-GAAP or bespoke metrics and GAAP figures in audited financial statements is expected.
- Threshold, target and maximum performance goals under short-term incentive plans should be disclosed, in addition to the corresponding payout levels.
- Glass Lewis may consider the total potential dilutive effect on shareholders of a front-loaded equity award in addition to considering the quantum of the award on an annualized basis.

Recommended Next Steps

Overall, companies continue to attract attention from proxy advisory firms, institutional investors, the news media, activist shareholders and other stakeholders with respect to their executive compensation programs, especially in light of recent global talent shortages and workers’ rights initiatives, the continued disproportionate impact of COVID-19 on low income workers and the Biden-Harris administration’s economic recovery plans. This year’s proxy season provides an opportunity for companies to clearly disclose the link between pay and performance and efforts to engage with shareholders about executive compensation. As always, these disclosures should explain the company’s rationale for selecting particular performance measures for performance-based pay and the mix of short-term and long-term incentives. Companies also should carefully disclose the rationale for any increases in executive compensation, emphasizing their link to specific individual and company performance.

In the year following a say-on-pay vote, proxy firms conduct a thorough review of companies whose say-on-pay approval votes fall below a certain threshold: 70% for ISS and 80% for Glass Lewis. ISS’ FAQ explain that this review involves investigating the breadth, frequency and disclosure of the compensation committee’s stakeholder engagement efforts, disclosure of specific feedback received from investors who voted against the proposal, actions taken to address the low level of support, other recent compensation actions, whether the issues raised were recurring, the company’s ownership structure and whether the proposal’s support level was less than 50%, which should elicit the most robust stakeholder engagement efforts and disclosures.

Looking ahead to 2022, companies that received say-on-pay results below the ISS and Glass Lewis thresholds should consider enhancing disclosures of their shareholder engagement efforts in 2022 and the specific actions they took to address potential shareholder concerns. Companies that fail to conduct sufficient shareholder engagement efforts and to make these disclosures may receive negative voting recommendations from proxy advisory firms on say-on-pay proposals and compensation committee member reelection.

Recommended actions for such companies include:

- Assess results of the most recent say-on-pay vote. As part of this analysis, identify which shareholders were likely the dissenting shareholders and why.
- Engage key company stakeholders by soliciting and documenting their perspectives on the company's compensation practices. Analyze stakeholder feedback, determine recommended next steps and discuss findings with relevant internal stakeholders, such as the compensation committee and the board of directors.
- Review ISS and Glass Lewis company-specific reports and guidance to determine the reason for their vote recommendations in 2021. Carefully consider how shareholders and proxy advisory firms will react to planned compensation decisions for the remainder of the current fiscal year and recalibrate as necessary. For example, consider compensation for new hires, leadership transitions and any special one-time grants or other arrangements.
- Determine and document which changes will be made to the company's compensation policies in response to shareholder feedback.
- Disclose specific shareholder engagement efforts and results in the 2022 proxy statement. Such disclosures should include information about the shareholders engaged, such as the number of them, their level of ownership in the company and how the company engaged them. They also should reflect actions taken in response to shareholder concerns, such as a company's decision to offer more robust disclosures or to adjust certain compensation practices.

Companies that have not changed their compensation plans or programs in response to major shareholder concerns should consider disclosing (i) a brief description of those concerns, (ii) a statement that the concerns were reviewed and considered, and (iii) an explanation of why changes were not made.

Say-on-Golden-Parachute Proposal Results

Say-on-golden-parachute votes historically have received lower support than annual say-on-pay votes, and this trend was even stronger in 2020. Average support for golden parachute proposals dropped from 79% in average support in 2019 to 76% in average support from January 1, 2020, through December 31, 2020.[8] ISS' negative vote recommendations were up in 2020 at 34%, from 28% in 2019. Companies should beware of including single-trigger benefits (*i.e.*, automatic vesting upon a change in control) in their parachute proposals, given that stakeholders cite single-trigger vesting as a primary source of concern, with tax gross-ups and performance awards vesting at maximum as significant secondary concerns. In addition, companies historically have also cited excessive cash payouts as a significant secondary concern.

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[8] See Willis Towers Watson's "U.S. Executive Pay Votes—2020 Proxy Season Review" (March 2021).

Equity Plan Proposal Results

Equity plans continue to be widely approved, with 1% of equity plan proposals at Russell 3000 companies receiving less than a majority vote in 2021 through September 2021.[9] Average support for 2021 equity plan proposals as of September 2021 was 89%, which was lower than the 89.4% average support observed in September 2020.[10]

Most companies garner strong equity plan proposal support from shareholders, regardless of the say-on-pay results. As of September 2021, Russell 3000 companies with less than 70% say-on-pay approval that presented an equity plan proposal still received 85% support for the equity plan proposal.[11]

The threshold number of points to receive a favorable equity plan proposal recommendation from ISS is expected to remain at 57 points for the S&P 500 model, 55 points for the Russell 3000 model and 53 points for all other Equity Plan Scorecard models.[12]

ISS also provided guidance for companies that are intending to terminate an existing equity plan (including canceling any remaining shares reserved for awards thereunder) upon shareholder approval of a new equity plan. Under such circumstances, companies may make certain disclosures to dissuade ISS from including the shares available for issuance under the existing equity plan in ISS' Shareholder Value Transfer (SVT) analysis.[13] Such disclosures would typically be made in the company's annual report on Form 10-K filed prior to the proxy statement that requests shareholder approval of the new equity plan and include the following:

- the total number of shares remaining available for future awards under the existing equity plan, including any impact from fungible counting provisions, that will no longer be available upon approval of the new equity plan;
- the total number of full value awards and appreciation awards outstanding, disclosed separately and including the weighted average exercise price and remaining term of appreciation awards (and for performance-based awards, the number of shares with respect to the earned and unearned portions); and
- a commitment as of the date of the securities filing that no further shares will be granted as awards under the existing equity plan unless the new equity plan is not approved by shareholders.

Other Proxy Advisory Firm Takeaways

ISS' updated methodology for evaluating whether nonemployee director (NED) pay is excessive has taken effect and is expected to continue to apply in 2022. Under such policy, ISS may issue adverse vote recommendations for board members responsible for approving/setting NED pay. Such recommendations could occur where ISS determines there is a recurring pattern (two or

[9] See Semler Brossy's report "2021 Say on Pay & Proxy Results" (September 30, 2021); see also Semler Brossy's report "2020 Say on Pay & Proxy Results" (September 24, 2020).
[10] See Semler Brossy's report "2021 Say on Pay & Proxy Results" (September 30, 2021).
[11] See *Id*.
[12] See ISS's FAQ "United States Equity Compensation Plans" (December 21, 2020); ISS' FAQ "U.S. Compensation Policies and the COVID-19 Pandemic" (October 15, 2020).
[13] See ISS's FAQ "United States Equity Compensation Plans" (December 21, 2020), FAQ No. 11.

more consecutive years) of excessive director pay without disclosure of a compelling rationale for those prior years or other mitigating factors.

Each year, companies should consider whether to make any updates to the compensation benchmarking peers included in ISS' database. ISS uses these company-selected peers when it determines the peer group it will use for evaluating a company's compensation programs. This year, ISS accepted these updates through December 3, 2021.[14]

Prepare for 2022 Pay Ratio Disclosures

The year 2022 marks the fifth year that SEC rules require companies to disclose their pay ratio, which compares the annual total compensation of the median company employee to the annual total compensation of the CEO.[15] This section helps companies prepare for the fifth year of mandatory pay ratio disclosures by considering the following:

- Can the same median employee be used this year, and, if not, what new considerations should be taken into account when identifying the median employee?
- What else do companies need to know for 2022?

Determining Whether To Use the Same Median Employee. Under Regulation S-K Item 402(u), companies only need to perform median employee calculations once every three years, unless they had a change in the employee population or compensation arrangements that could significantly affect the pay ratio. This requires companies to assess annually whether their workforce composition or compensation arrangements have materially changed.

When selecting a median employee for pay ratio disclosures about compensation in fiscal 2021, companies should consider the following:

- If the company has been using the same median employee for three years, they will need to perform median employee calculations for fiscal 2021.
- Other companies that were originally planning to feature the same median employee as last year should not do so if their employee populations or employee compensation arrangements significantly changed in the past year, including, without limitation, in response to the COVID-19 pandemic.

When selecting a median employee for pay ratio disclosures regarding fiscal 2021, companies should carefully consider how to incorporate furloughed employees, if applicable. For information on how to incorporate furloughed employees into pay ratio calculations, see our December 14, 2020, client alert "Matters to Consider for the 2021 Annual Meeting and Reporting Season."

Additionally, companies should consider how headcount changes may impact their ability to exclude certain non-U.S. employees from their pay ratio calculation under the commonly relied upon *de minimis* exception in Item 402(u)(4)(ii). Therefore, companies should evaluate whether

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[14] See ISS' article "Company Peer Group Feedback" (2021).

[15] Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirement. Transition periods are also available for newly public companies.

non-U.S. employees in the aggregate and by jurisdiction newly constitute or no longer constitute more than 5% of the company's total employees.

- The *de minimis* exception generally allows a company to exclude non-U.S. employees when identifying their median employee, if excluded non-U.S. employees constitute 5% or less of their workforce.
    - If a company's non-U.S. employees account for 5% or less of their total employees, the company may either exclude all non-U.S. employees or include all non-U.S.
    - Alternatively, if over 5% of a company's total employees are non-U.S. employees, the company may exclude up to 5% of its total employees who are non-U.S. employees; provided that the company exclude all non-U.S. employees in a particular jurisdiction if it excludes any employees in that jurisdiction, and employees excluded under Item 402(u)'s data privacy exception count toward this limit.
    - Non-U.S. jurisdictions with employees that exceed 5% of a company's total employees may not be excluded from the pay ratio calculation under the *de minimis* exception, although they may be permitted to be excluded under the data privacy exception.

Even if a company uses the same median employee in its proxy statement filed in 2022 as in 2021, it must disclose that it is using the same median employee and briefly describe the basis for its reasonable belief that no change occurred that would significantly affect the pay ratio.

To determine whether a material change occurred, companies should generally continue to evaluate the following:

- How has workforce composition evolved over the past year?
    - Review hiring, retention and promotion rates.
    - Consider the applicability of exceptions under the pay ratio rules:
        - Determine whether to incorporate employees from recent acquisitions or business combinations into the consistently applied compensation measure (CACM). For example, for the fiscal year in which a business combination or acquisition becomes effective, a company may exclude individuals that become its employees as the result of the business combination or acquisition, as long as the company discloses the approximate number of employees it is omitting and identifies the acquired business that is being excluded.
        - Determine whether the *de minimis* exception applies within the context of the company's 2021 workforce composition. As described above, under this exception, non-U.S. employees may be disregarded if the excluded employees account for less than 5% of the company's total employees or if a country's data privacy laws make a company's reasonable efforts insufficient to comply with Item 402(u).
    - Analyze how the workforce used for the CACM is distributed across the pay scale and how the distribution has changed since last year.
- How have compensation policies changed in the past year compared to the workforce composition? For example, an across-the-board bonus that benefits all employees may

not materially change the pay ratio, while new special commission pay limited to a company's sales team would do so.

Have the median employee's circumstances changed since last year? Consider changes to the employee's title and job responsibilities alongside any changes to the structure and amount of the employee's compensation, factoring in the company's broader workforce composition. Additionally, if the median employee was terminated, companies must identify a new median employee.

Although the SEC provides companies with substantial flexibility in calculating their pay ratios, to satisfy the SEC staff and engage with investors, employees and other stakeholders, companies should continue to diligently document and disclose their pay ratio methodology, analyses and rationale.

Consider Trends and Developments on Employee, Environmental, Social and Governance Metrics in Executive Compensation

EESG Metrics and Incentive Compensation Programs. Employee, environmental, social and governance (EESG) issues,[16] continue to be a high priority item for board and management teams as shareholders, customers and employees increasingly recognize EESG issues can materially impact company value. From an executive compensation perspective, EESG goals are most frequently reinforced through incentive compensation programs and clawback policies, with 57% of S&P 500 companies disclosing the use of some form of EESG metrics tied to incentive compensation.[17]

In recognition of growing expectations that companies confront EESG issues, companies are increasingly tying executive incentive compensation performance metrics to EESG factors, with the most common implementation of EESG metrics in annual incentive plans versus long-term incentive plans.

Quantitative research suggests that large public companies are spearheading implementation of EESG metrics in incentive plans with an emphasis on employee and social metrics:

- One study found that of the S&P 500 companies that incorporate EESG measures in their executive compensation programs, 28% use D&I metrics. Customer satisfaction was second at 27% and safety third at 24%.[18]
- The use of different EESG metrics is driven largely by business models and strategy, as expected, such as employee safety metrics in the energy and materials industry sectors. However, implementation of D&I metrics in incentives was prevalent across all industries, with implementation by 25% or more of the companies within seven of the 11 survey industries.[19]

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[16] These topics are often referred to as ESG issues, but in recognition of the importance of employee-specific concerns regarding worker health and safety, pay equity and diversity in the workplace, this annual client alert adds an "E" for employee to such term. Otherwise, employee issues typically are grouped together with social issues, under the "S" in ESG.

[17] See Semler Brossy's "ESG + Incentives 2021 Report (Part 1)" (June 14, 2021) (according to public disclosures filed between March 2020 and March 2021).

[18] See *Id.*

[19] See Semler Brossy's "ESG + Incentives 2021 Report (Part 2)" (August 2, 2021).

- Another study found that 35% of surveyed companies (consisting of public, privately held and not-for-profit organizations) had already incorporated D&I metrics into their annual executive incentive plans and 9% had incorporated them into long-term incentive plans.[20]
- D&I prevalence in incentives is expected to continue to grow, and D&I metric prevalence increased by 19% year-over-year in S&P 500 proxy statements filed between January and March of 2021 versus 2020.[21]
- More companies are implementing EESG metrics in annual incentive plans (as opposed to long-term incentive programs), which may ultimately reach a larger population of employees. However, only a small fraction of the bonus is typically tied to achievement of EESG metrics, such as between 5% and 10% of the annual bonus.[22]
- One study found that of the S&P 500 companies that incorporate EESG metrics in incentive plans, it is most commonly incorporated as a scorecard (36%) or part of individual components (28%), with weighted metrics (20%) and modifiers (16%) being less common.[23]
- Based on a 2021 study that included publicly traded, private for-profit and nonprofit organizations, 13% of all respondents and 19% of public company respondents (21% for those with revenues of $10 billion or more), reported that they intend to add one or more formal EESG metric in 2022.[24]

The practice of linking executive compensation to achievement of EESG metrics continues to attract attention as companies grapple with implementing both qualitative and quantitative metrics. A few examples are as follows:

- McDonald's Corporation[25] announced earlier this year that it added new metrics to its executive short-term incentive plans, which focus on human capital management to reinforce the company's values and to hold executives accountable for advances in diversity, equity and inclusion. 15% of bonus achievement will be generally based on human capital metrics.
- Chipotle Mexican Grill, Inc.[26] is implementing EESG goals into its annual incentive program by tying executive compensation to EESG goals, which are categorized by Food & Animals, People and the Environment. For 2021, 10% of the overall annual incentive for executives will be based on achieving the new EESG factor.
- Medtronic PLC[27] announced that beginning in fiscal year 2022, its management incentive plan will include, in addition to key financial metrics, a qualitative scorecard to measure key non-financial metrics such as quality, strategic priorities, culture and inclusion, diversity, and equity. Performance against the non-financial metrics will be qualitatively evaluated by the compensation committee.

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[20] See Pearl Meyer's "Tracking and Reporting on Diversity, Equity, and Inclusion—Executive Summary" (October 2021).

[21] See Semler Brossy's "ESG + Incentives 2021 Report (Part 1)" (June 14, 2021) (according to public disclosures filed between March 2020 and March 2021).

[22] See Semler Brossy's "How To Translate ESG Imperatives into Executive Compensation" (September 22, 2021).

[23] See Semler Brossy's "ESG + Incentives 2021 Report (Part 3)" (September 13, 2021).

[24] See Pearl Meyer's "Looking Ahead to Executive Pay Practices in 2022—Executive Summary" (November 2021).

[25] See McDonald's Corporation's "Definitive Proxy Statement on Schedule 14A" (April 8, 2021).

[26] See Chipotle Mexican Grill, Inc.'s "Definitive Proxy Statement on Schedule 14A" (April 5, 2021).

[27] See Medtronic PLC's "Definitive Proxy Statement on Schedule 14A" (August 27, 2021).

- The Proctor & Gamble, Co.[28] announced following an August 2021 meeting of its compensation and leadership development committee that an EESG factor will be applied to the 2021-22 annual incentive program for senior executives, which links pay to long-term equality and inclusion and environmental sustainability The EESG factor will serve as a modifier of the company performance factor by consisting of a multiplier between 80% and 120% depending on such EESG performance.
- Seagate Technology Holdings PLC[29] also announced following a July 2021 meeting of its compensation committee that it intends to implement EESG modifiers with respect to PSUs, which will impact PSU achievement level based on the company's performance against both a social (gender diversity) goal and an environmental (greenhouse gas reduction) goal.

Although companies are increasingly considering how to feature EESG metrics in incentive plans, one study found that less than 3% of approximately 3,000 companies disclosed that fulfilling diversity goals was linked to a portion of their chief executives' pay, and few companies provided details on their diversity goals or the share of compensation that is contingent on them.[30] A recent survey of general counsel and senior legal officers in large and mid-sized companies sheds some light on the disparity, finding that although on average general counsel support EESG-related activities, there is significant concern for the legal and regulatory risk of disclosing these activities.[31] In fact, the survey found that companies currently disclose only a portion of the information they track relating to EESG initiatives.[32]

Proxy Season 2022: Early Trends in Executive Compensation

Posted by Amit Batish, Equilar, Inc., on Tuesday, March 29, 2022

Editor's note: Amit Batish is Director of Content at Equilar, Inc. This post is based on an Equilar memorandum by Mr. Batish and Courtney Yu. Related research from the Program on Corporate Governance includes The Perils and Questionable Promise of ESG-Based Compensation by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); and Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

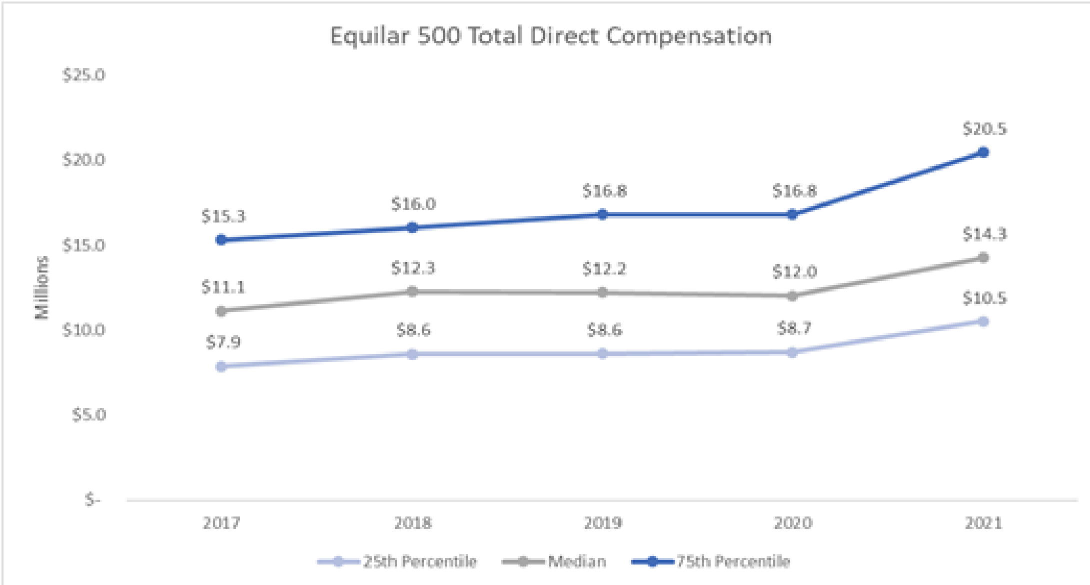
The 2022 proxy season is now in full swing. Over the next two months, thousands of U.S. public companies will file proxy statements highlighting trends pertaining to their governance practices, including those related to executive compensation. In this post, Equilar examines a sample of early DEF14A proxy filings from Equilar 500 companies—the 500 largest U.S. public companies by revenue—as of March 18, 2022, to offer a preview of how executive compensation was structured in 2021, as well as key trends to watch through the remainder of proxy season.

CEO Pay Appears to Bounce Back Strongly From Pandemic "Woes"

Following the onset of the COVID-19 pandemic, several companies adjusted their executive pay packages to ease the burden of the pandemic on employees. For example, many CEOs saw salary cuts, adjustments to bonus payouts, changes in long-term incentive plans (LTIPs) and more. Ultimately, many companies restored those adjustments, but median CEO pay declined from $12.2 million in 2019 to $12 million in 2020 (Figure 1).

Two years after the start of the pandemic, the early data shows that CEO pay is back on the rise. In 2021, median total direct compensation for companies included in the analysis increased to $14.3 million. This change from $12 million in 2020 would represent a near 20% increase, should the trend persist. Over the last two years, many companies elected to award their CEOs for staying on board and guiding their organizations through turbulent times, likely contributing to the increase in pay.

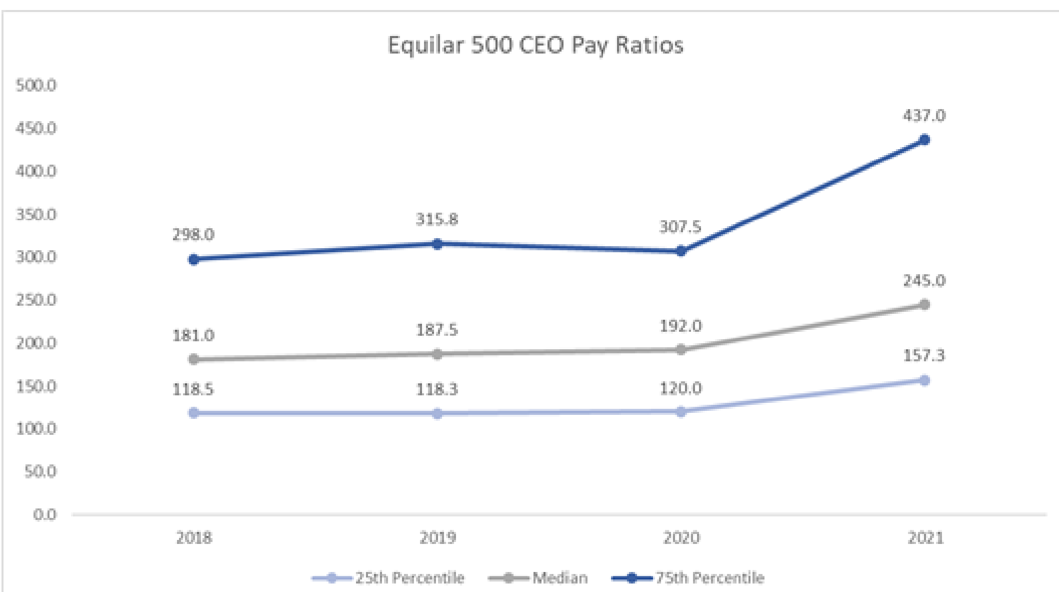
Figure 1: CEO Total Direct Compensation (Equilar 500)



The CEO Pay Ratio Rises, While Median Employee Pay Declines

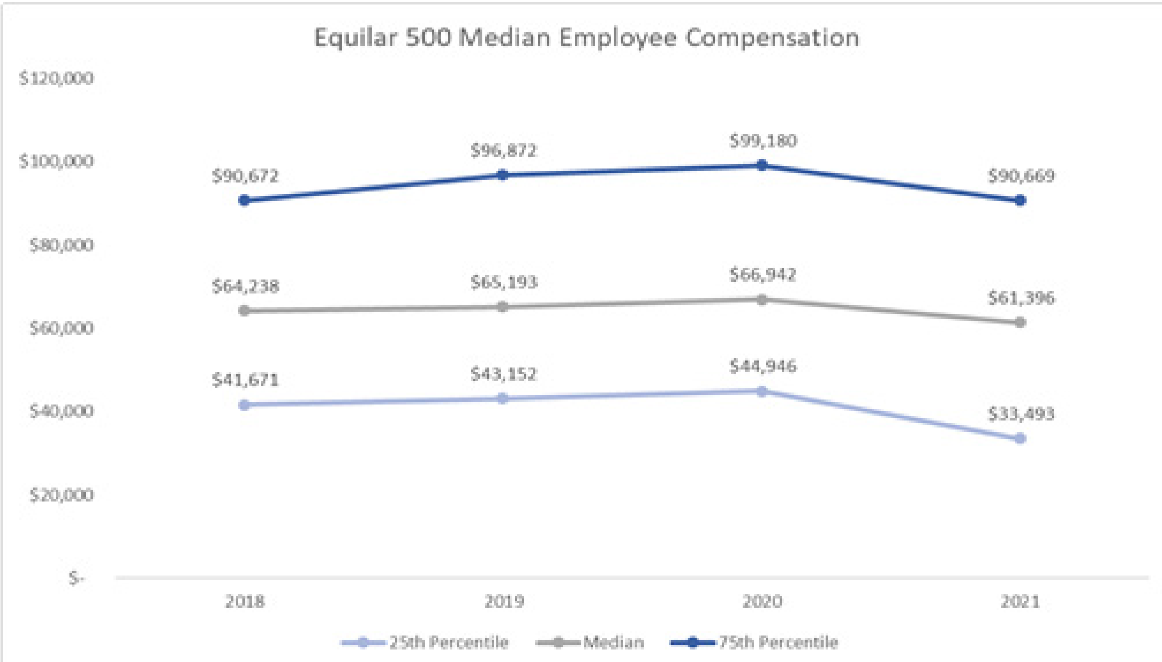
With CEO compensation increasing, the CEO Pay Ratio—the ratio of CEO-to-typical-worker compensation—is following suit. According to the analysis, the median CEO Pay Ratio so far in 2021 is 245:1, representing a 27.6% increase from 192:1 in 2020 and a 35.4% increase from 181:1 in 2018 (Figure 2). The median CEO Pay Ratio increased in each year of the study period, and if the current trend for 2021 holds, then it would be the largest year-over-year increase since the ratio became a required SEC disclosure during the 2018 proxy season.

Figure 2: CEO Pay Ratios (Equilar 500)



The spike in the CEO Pay Ratio for 2021 is being driven by both increased CEO pay as well as a decline in compensation for the median employee. Median employee compensation for companies that have reported thus far for 2021 is $61,396, an 8.3% decrease from 2020. Prior to 2021, compensation for the median employee increased every year since 2018.

Figure 3: Median Employee Compensation (Equilar 500)



It's worth noting that the lower value in median employee pay is a function of the types of companies that have filed their proxies thus far. A large portion of consumer companies, which are more likely to have seasonal or part-time employees, have filed earlier than other sectors, resulting in a lower median employee compensation value for 2021. Another trend that may be driving this value down further is that the sectors that typically make up the bottom half of median employee pay—healthcare, industrials, consumer defensive and consumer cyclical—currently represent 60% of the early filings.

Regardless of the composition of companies featured in the early trends, many critics still argue that booming CEO pay packages following a year of shutdowns and financial struggles for so many Americans is unjust and reflects poorly on an organization, particularly as median employee pay remains low. While the CEO Pay Ratio has yet to garner the impact that many key stakeholders initially thought it would have prior to its implementation, a change may be on the horizon. Lawmakers in Washington D.C. last year introduced legislation targeted at excessive CEO pay packages. Coined the "Tax Excessive CEO Pay Act," the legislation would penalize companies that pay CEOs or other executives 50 times more than median employee pay.

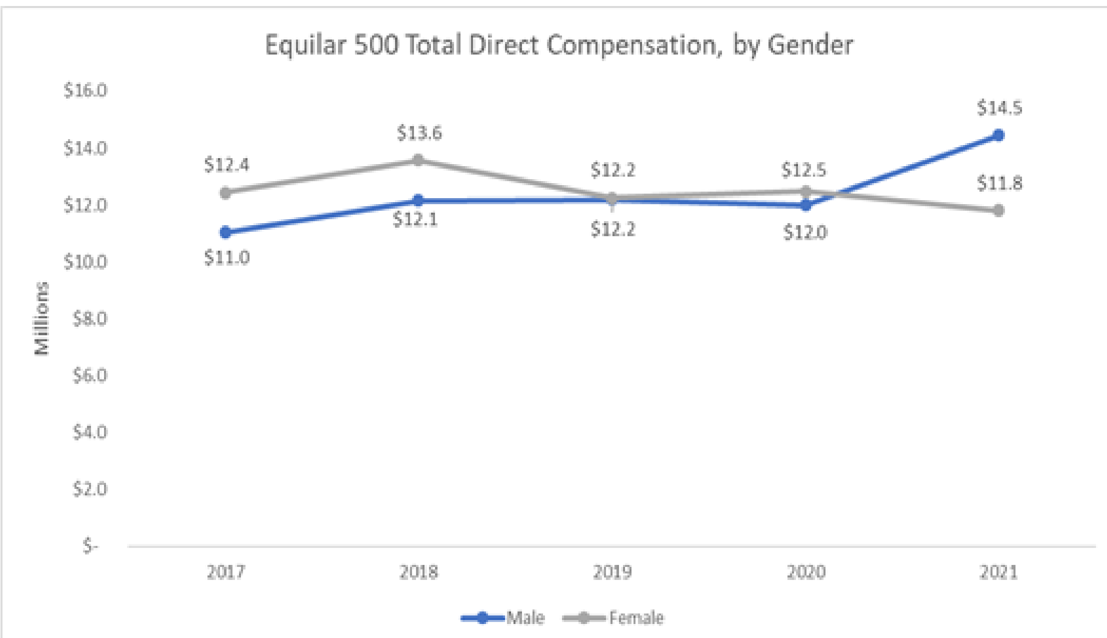
While the bill faces an uphill battle through Congress, there is no question stakeholders will pay closer attention to the CEO Pay Ratio, particularly if the early trends continue. If the pandemic taught us one thing, it's that a company's greatest asset is its people. Ensuring employees are treated adequately will be critical in the years ahead, and oftentimes this will come in the form of competitive compensation.

A Gender Pay Gap Looms

Over the last few years, men have largely dominated representation in the CEO role. Despite the low representation, women in CEO positions at the largest U.S. companies have out-earned their male counterparts during the same period. During the first four years of the study, CEO pay for women outpaced compensation for men, with the one exception being 2019 when pay was the same for both men and women at $12.2 million.

From a first look at early proxy filings, this trend has flipped. Median pay for women CEOs in the Equilar 500 was $11.8 million in 2021, more than 18% lower than the median $14.5 million awarded to men. Since 2018, this represents a 13.2% decrease in pay for women, while pay for men increased by nearly 20% during the same time period.

Figure 4: Total Direct CEO Compensation by Gender (Equilar 500)



Similar trends were observed in an early look analysis in 2021, but among the companies that have reported in 2022, 7% have CEOs who are women, slightly higher than the average of women-led companies during the study period. As conversations around gender equity continue to grow louder, this will certainly be a looming trend to keep a close eye on as proxy season progresses.

The state of CEO compensation continues to draw interest from several stakeholders, to no surprise. The trends uncovered in this analysis could paint a picture of overall trends not only in 2021, but also what to expect in 2022 and beyond. Ultimately, time will tell how CEO pay evolves, and investors and other stakeholders will watch closely how the 2022 proxy season unfolds.

The COVID-19 Pandemic's Fleeting and Lasting Impact on Executive Compensation

Posted by Mike Kesner, Linda Pappas, and Joshua Bright, Pay Governance LLC, on Thursday, March 31, 2022

Editor's note: Mike Kesner is partner and Linda Pappas and Joshua Bright are principals at Pay Governance LLC. This post is based on a Pay Governance memorandum by Mr. Kesner, Ms. Pappas, Mr. Bright, and Ira Kay. Related research from the Program on Corporate Governance includes The Perils and Questionable Promise of ESG-Based Compensation by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here) and Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

The 2021 proxy season was dominated by COVID-19. Close to half of Standard & Poor (S&P) 500 companies took some type of COVID-19-related action in 2020, including base salary reductions, modifications to incentive plan targets, and the grant of special awards.

Despite the significant upheaval in compensation, financial results, and stock price performance during 2020, shareholders supported 97.3% of Say on Pay votes among Russell 3000 companies through November 30, 2021, with strong average support of 92.2%. Sixty-two companies—or 2.7%—failed Say on Pay, including some large, "name-brand" companies. The reasons for these high-profile failures can be primarily attributed to several factors including the use of positive discretion in determining annual incentive payouts, modifications to in-flight long-term incentive (LTI) awards, grants of "out-sized" stock awards without a compelling rationale, and a disconnect between pay and performance.

Part of the strong showing in shareholder support can be attributed to Institutional Shareholder Services (ISS) recommending a vote for Say on Pay at 88.5% of Russell 3000 companies, which was only down 0.5% compared to the 2020 proxy season. While ISS approved most companies' Say on Pay proposals, those companies that received an *against* recommendation from ISS were more likely to fail Say on Pay (24%) compared to prior years (for example, 18.4% in 2020, 18.8% in 2019, and 17.1% in 2018). Thus, ISS influence increased in 2021 and an against recommendation was far more likely to result in a failed Say on Pay vote compared to prior years.

The 2021 compensation year has also been filled with continued uncertainty due to COVID-19, supply chain issues, workforce shortages, and—most recently—inflation fears and the Russia-Ukraine conflict, so what should we expect to see (or not see) during the 2022 proxy year compared to 2021?

The 2022 Proxy Season

Given strong shareholder support in the 2021 proxy season, it is unlikely companies will have significantly revamped their 2021 compensation programs. **In some cases, compensation**

practices that were adopted in 2020 to address COVID-19-related uncertainty will have carried over to the 2021 compensation year, including:

Wider performance curves. Many companies widened their performance curves to minimize the chance of a zero or maximum payout given the uncertainty in setting performance targets. This uncertainty persisted at the beginning of 2021, and a widening of the performance curve allowed companies to retain the basic structure of existing plans but with far less pay/performance leverage.

Semi-annual short-term incentive performance periods. Companies in industries facing the greatest level of uncertainty continued or adopted a "1st half/2nd half short-term incentive plan whereby 6-month goals are set at the beginning and the middle of the performance year to allow for a "resetting" of targets at mid-year based on more current financial outlook.

Inclusion of qualitative metrics. After unprecedented levels of discretionary adjustments applied in 2020, some companies added or increased the weighting of qualitative metrics to allow the Compensation Committee to exercise discretion within predefined guardrails (e.g., +/- 20%).

Above target annual incentive plan payouts. Given the limited visibility at the beginning of 2021 amid the continued impact of COVID-19 (e.g., supply chain pressures, "The Great Resignation," etc.) and 2020 annual incentive plan payouts, the majority of which were below target or zero, many companies may have established relatively conservative financial targets for their 2021 annual incentive plans. Early indications are that above target (or maximum) annual incentive payouts are being reported by companies that were more resilient than forecasted and capitalized on better-than-expected market opportunities in 2021.

As of the writing of this post, actual annual incentive payouts for 2021 at Russell 3000 companies are tracking between target and maximum (average of nearly 150% of target).[1] Eighty percent of the companies in the sample are paying annual incentives above target (average of 160% of target). Based on year-over-year comparisons for a subset of companies paying 2021 annual incentives above target, 2020 annual incentives were paid out at an average of about 90% of target.

[1] **Source:** ESGAUGE Reflects Russell 3000 companies that filed proxy statements between 11/1/21-3/15/22 and reported target non-equity incentive values.

Preliminary Results of Russell 3000 Fiscal Year 2021 Annual Incentive Payouts[2]

	Total Sample	At or Below Target Payouts	Above Target Payouts
Sample Size	n=319	n=63	n=256
% of Sample	100%	20%	80%
Average Payout (% of Target)	**148% of target**	**67% of target**	**160% of target**

Inclusion of relative total shareholder return (TSR) as a metric in performance share(PSU) plans. Many companies struggled to set annual financial targets, let alone multi-year goals for PSUs. To address this uncertainty, more companies may have added relative TSR to their PSU scorecards, thereby eliminating the need to establish absolute goals at the beginning of the performance cycle.

Replace multi-year goals with multiple annual goals in PSU plans. Another approach companies carried over or adopted is the use of annual goals within PSU programs, with performance measured each year and earned shares distributed on, for a 3-year plan, the third anniversary of the grant. This approach allows companies to maintain a performance-oriented plan while minimizing the risk with 20-20 hindsight of setting overly aggressive or conservative performance targets.

We do not expect to see, in the 2021 compensation year, some of the compensation practices that were originally adopted during the pandemic. These include:

Base salary reductions. All but the most severely-harmed companies by COVID-19 restored 2020 base salary reductions prior to the end of 2020. Thus, only a handful of companies have maintained reduced base salaries in the 2021 compensation year.

Exercise of upward discretion. Given the more conservative approach in setting performance goals as noted above and the most recent trend on 2021 annual incentive payouts, there will be far less need for compensation committees to exercise discretion to increase annual incentive payouts. It is possible some compensation committees will exercise negative discretion if the formulaic result does not fit with the overall health/performance of the company.

Modifications to in-flight LTI awards. Given the 2021 proxy season investor and proxy advisor backlash delivered to companies that modified in-flight LTI awards in the 2021 proxy season, it is unlikely many companies made similar changes during the 2021 compensation year.

The payout outcomes of LTI award cycles ending in 2021 are likely to be across the full spectrum—zero to maximum. Among companies that set multi-year goals pre-pandemic, payouts

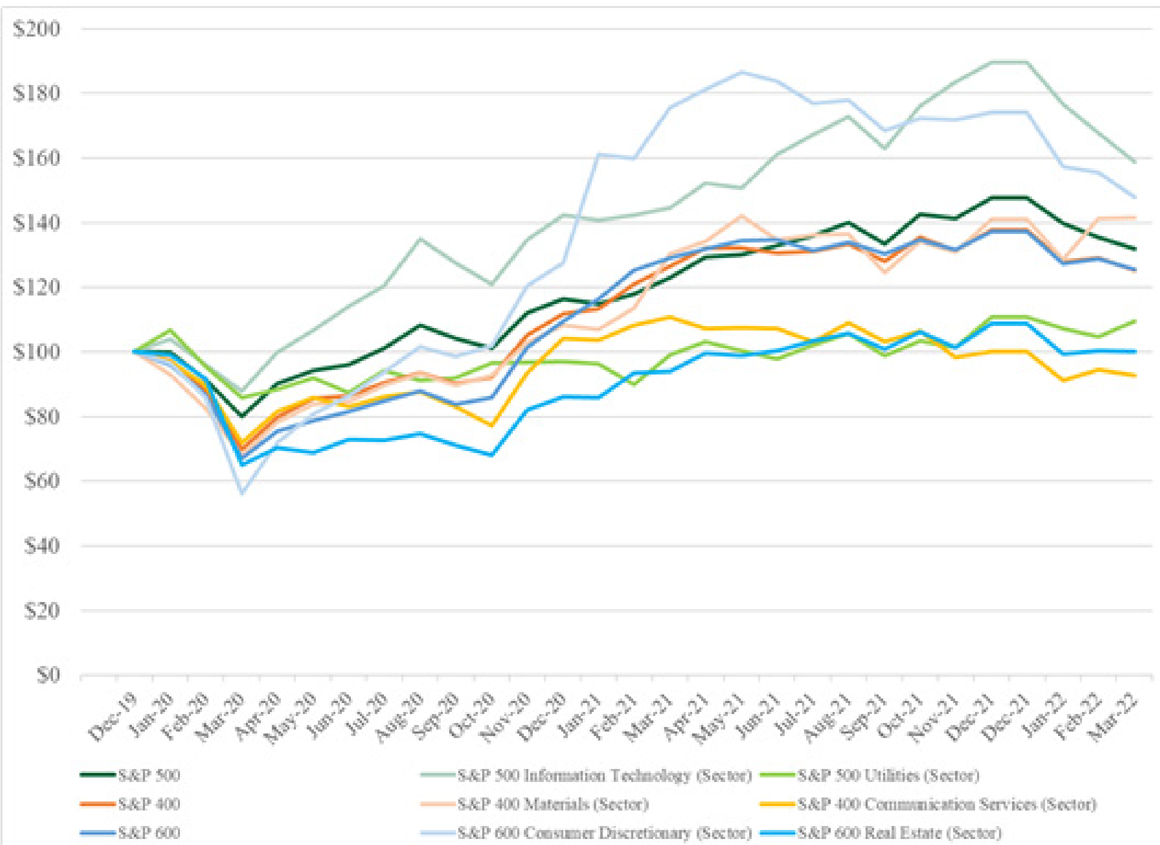
[2] *Id.*

are likely to be at or below target. Performance plans tied to relative TSR or based on 1-year performance metrics are generally above target or at maximum.

Stock Price Performance

Stock price performance will continue to play a role in compensation decisions, with higher performing companies having significantly more flexibility when making compensation decisions than lower performing companies. After the “COVID dip” in stock prices in March of 2020, which impacted all major market indices and sectors, the rebound was almost as swift. However, the rate of recovery has varied by sector, which led to a broad spectrum of compensation actions. In summary, while the playbook for managing incentive plan actions due to the COVID dip was relatively consistent, the playbook for managing the recovery was more nuanced during 2021depending on the strength of the company’s performance—a trend that we expect to continue during 2022.

The chart below shows the performance of a hypothetical $100 investment from December 31, 2019 through March 15, 2022 for the S&P 500, S&P 400, and S&P 600 as well as the highest and lowest performance sectors (during this measurement period) within each of these indices:



Looking Ahead to 2022 Proxy Season Outcomes

Two areas of potential concern could arise if shareholders and the proxy advisory firms consider the 2021 annual incentive goals lacked rigor or if companies significantly increased 2021 equity awards (either delivered through annual awards or through special, one-time arrangements) without a detailed explanation. Companies are likely to have addressed these concerns by providing fulsome disclosure of the degree of goal rigor, rationale for increased LTI awards, and the linkage to shareholder value creation in their 2022 proxies.

Given the compensation changes made in 2021 to adapt to an uncertain economic environment and likely avoidance of the “foot-faults” that occurred in the 2020 compensation year, it is highly likely shareholder support for Say on Pay in 2022 will be as good as, if not better than, 2021. While this could make for a far less exciting proxy season, it should be a welcome relief and allow companies more time to focus on what could be a challenging business environment.

Post-Pandemic? What to Look For in the 2022 Proxy Season

Posted by Blair Jones, Sarah Hartman, and Austin Vanbastelaer, Semler Brossy LLC, on Thursday, March 31, 2022

Editor's note: Blair Jones is Managing Director, Sarah Hartman is Senior Associate Consultant, and Austin Vanbastelaer is Senior Consultant at Semler Brossy Consulting Group, LLC. This post is based on their Semler Brossy memorandum.

The wrenching Covid-19 pandemic is far from over, but investors will see something of a return to business as usual in the 2022 proxy season. Last year, most companies refrained from split performance years, discretionary awards, liquidity-focused metrics, and other pandemic-induced responses of 2020. This proxy season will revert toward the pre-pandemic focus on financial metrics and conventional pay-for-performance structures.

Rather than a complete reversion, however, investors should expect a "new normal." We're seeing some likely permanent pandemic-influenced changes, as talent market considerations and ongoing uncertainty prod boards to challenge traditional practices. We expect flexible reward structures, more room for structured discretion, and greater consideration of non-financial metrics—the latter from governance conversations related to environmental, social, and human capital concerns. We urge advisors and investors to keep an open mind about these changes.

Compensation Challenges from the Market for Talent

The pandemic directly and indirectly affected the market for executive talent in all companies, not just high-growth businesses. Covid-19 accelerated a number of corporate trends, especially in e-commerce and other digitization. It also unleashed a new wave of entrepreneurship, with startups both competing for talent and disrupting established businesses.

The result has been a strong market for tech and growth-oriented executives, with boards raising the urgency for transformation. Directors are also eager to recruit and retain people in all areas as they see windows of strategic opportunity, though pay boosts here are more likely in 2022 and future years. Overall, investors will see more companies leaning in to pay increases than in the past, in order to stay competitive in the talent market. Those developments are generally separate from pay issues at "tailwind" companies with higher revenue and profits due to the pandemic.

We also expect continued "de-risking" of performance-based stock awards. In 2020, many boards went from a 60/40 split of performance- and restricted-stock units to 50/50, and we expect that ratio to stay as companies approach compensation cautiously. In making compensation more flexible and resilient, Boards are also moderating award curves. Executives are taking less of a hit if business falls, but they also need to stretch farther for maximum awards. Investors will also see more discretion on pay than was the 2019 norm.

While still a sidelight, some boards have gone in the opposite direction, influenced by “moonshot” mega-grants at venture capital-backed firms. Most of these packages are at fast-growing startups offering one-off multi-year (seven-plus) incentives with extreme targets and extreme awards. However fascinating, these developments are still in the early phase, and different rules apply here. We expect investors to assess each package on its own merits, considering the pay and performance relationship—assessing the risk, and also the returns to shareholders if targets are hit.

Together, these trends have reignited debates on the magnitude of executive pay, dating from before 2019. We are seeing Boards grant awards that set new standards for what top-performing leaders can command. All of these awards will need to be assessed in the context of shareholder value created, other stakeholder experiences, future performance requirements, and ongoing grant expectations. Controversies also continue as to whether larger equity awards should include restricted stock units and options: these are generally not awarded based on specific performance achievements, even though they still align with shareholder interests.

Covid Overhang

Some 2021 Covid-related actions boards took to address retention and motivation in the face of reduced incentive opportunities in 2020 will be reported for the first time. In some cases, companies provided additional equity awards, or used greater discretion, so executives still saw compelling opportunities for gain.

Other boards may have adjusted long-term incentives in ways that first appear only in the 2021 proxies. They did so to maintain executive motivation in difficult times, but the move ran counter to investor guidance on preserving LTI plans despite short-term events. Because of accounting rules, those adjustments will look like new grants and will inflate levels in the Summary Compensation Tables.

Investors will see those responses now. A closer look at the proxy will give investors the context for assessing whether the structure appropriately links pay and performance.

ESG and Human Capital

The pandemic also heightened inequalities of income and wealth, exacerbated by inflation. Activists calling for greater attention to social and environmental issues see the pandemic as a turning point. With most companies’ businesses coming back strong, they are pushing for substantial change, and have won the support of some institutional investors.

The 2022 proxy season should therefore feature greater attention to non-financial incentives in executive compensation, particularly metrics on DE&I and reducing carbon emissions. All of these efforts foster constructive conversations about the purpose of corporations and whether they primarily serve investors or all stakeholders. It’s still important that boards balance these goals with other strategic priorities. But we’ve been amazed at how quickly ESG topics generally have become a priority in compensation committees.

More prosaically, boards are giving greater attention now to human capital issues. The pandemic-induced “Great Resignation” is forcing companies to improve their employee value proposition. Recruitment and retention are priorities now across the organization, not just in the C-suite. Investors can expect some experimentation in pay packages to help make companies more of a talent magnet.

These topics may generate the most discussion at shareholder meetings, as investors evaluate the responses and weigh in on the role they see executive compensation playing in successful human capital management.

Say-on-Pay Voting

We also expect lower approvals on non-binding “say-on-pay” resolutions, continuing a trend from 2021. Semler Brossy found last year’s average vote results to be among the lowest ever, with an average favorable vote of 88.3% for the S&P 500 and 90.4% for the Russell 3000. Rather than revert to 2019 levels, the 2022 votes are likely to be at least as low as 2021. We expect the outright failure rate (favorable votes below 50%) to again hover around 3%.

Some of the “no” votes and abstentions come from the issues discussed above, with larger companies held to a higher standard. But even before the pandemic, investors were becoming sophisticated about compensation practices, and now they have high expectations on design features and outcomes. Also contributing to lower approval rates was the decision of many asset managers, separate from the pandemic, to drop centralized voting—which freed up shares for individual fund-holder votes.

A new trend this year was investors’ concern with boards’ responsiveness to low say-on-pay approvals. When a company’s approval falls below 70%, and especially when the vote actually fails, investors expect substantial outreach from directors—with explanations of what they heard and what they are doing about it, including redesigning compensation packages. Proxy advisors have faulted several boards for their inadequate response, and have asked for limits on one-time actions going forward. Investors are thus elevating responsiveness to such concerns in their list of expectations.

Rethinking Stability and Efficiency

Covid-19 may be shifting from a crisis to an ongoing hazard. But the tumult it unleashed isn’t likely to go away soon, especially with the geopolitical and macroeconomic volatility. Just as supply chains were starting to improve, the Russian invasion of Ukraine showed that our interconnected world is less robust than we thought—and future pandemics are now a worry. It’s still hard for companies to plan. Covid significantly tested traditional compensation practices, and boards are now likely to continue challenging the accepted wisdom. That’s especially likely in emphasizing resilience over efficiency.

* * *

A full return to 2019-style normal is unlikely. At least for 2022, the pandemic will continue to cast a long shadow. We encourage investors to be open to some divergence from 2019’s expectations, especially in greater board discretion. Yet, investors must still insist on transparency for that discretion, and boards would do well to clearly disclose their rationale for changes. As always, executive compensation should link to strategies that drive long-term overall performance.

ESG Continues to Find its Way into Incentive Compensation Plans

Posted by Matthew Behrens and Annie Anderson, Shearman & Sterling LLP, on Thursday, December 2, 2021

Editor's note: Matthew Behrens and Annie Anderson are associates at Shearman & Sterling LLP. This post is part of the 19th Annual Corporate Governance Survey publication prepared by Shearman & Sterling LLP, by Mr. Behrens, Ms. Anderson, Richard Alsop, Doreen Lilienfeld, Gillian Moldowan, and Lona Nallengara. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here).

Although COVID-19 and its impact on business operations brought its own challenges to issuers' incentive compensation programs, a review of 2020 proxies showed no slowdown in the incorporation of ESG metrics into plan design. Traditional incentive compensation metrics, namely quantitative shareholder return and financial and operational metrics, still dominate but, increasingly, qualitative "social" factors, such as diversity and pay equity, are playing a meaningful role in executives' take-home incentive pay. In the Top 100 Companies, 15 have announced in their 2020 CD&As that incentive compensation for 2021 will include new ESG metrics. The move toward ESG metrics is both a response to stakeholder pressures and a growing recognition that these factors are important to long-term shareholder value.

This post discusses the forces leading companies to adopt ESG metrics, analyzes how those companies are incorporating ESG metrics into their incentive compensation programs and discusses the challenges of establishing meaningful metrics.

The Forces of Change

A number of forces have led to the increased use of ESG metrics in incentive compensation plans. These include:

1. Institutional Investor Focus on Sustainability

In January of 2020, Larry Fink, Chairman and CEO of BlackRock, noted in his letter to CEOs that failure to focus on the needs of a broad range of stakeholders will ultimately damage long-term profitability. In his 2021 letter, Mr. Fink reiterated this position and called for a single global standard with respect to sustainability disclosures. Survey data shows that asset managers agree that a focus on ESG brings financial benefits. According to the 2020 RBC Global Asset

Management (RBC GAM) Responsible Investing Survey, 75% of institutional investors in Canada, Asia, the United States and the United Kingdom apply ESG principles to investment decisions, with a 26% increase in Asia. In addition, 43% of the respondents said they believe ESG-integrated portfolios are likely to perform best, which is a 14% increase from 2019. Notably, the United States lags behind its peers, as only 28% of U.S. institutional investors polled held this view.

2. Shifting Views of the Role of the Corporation

In August of 2019, more than 180 CEOs signed onto a Business Roundtable statement that, for the first time, expanded the view that corporations exist principally to serve their shareholders to say that corporations should commit to serving the interests of all stakeholders, including shareholders, customers, employees, suppliers and communities. The Business Roundtable's position undoubtably reflects increasing public, investor and employee pressure on companies to focus not only on advancing profits, but to also contribute to solving societal problems such as income inequality and environmental sustainability. The incorporation of ESG into incentive compensation plans is a key measure that observers will use to track whether the signatories' companies are honoring this new philosophy.

3. Regulatory Activities

In March of 2021, the SEC requested public input on climate change disclosure and tasked the staff with evaluating SEC disclosure rules related to climate change. The SEC received more than 550 unique comment letters in response, and three out of every four letters was in support of mandatory climate disclosure rules. SEC Chair Gary Gensler subsequently announced that the staff is developing a mandatory climate risk disclosure rule for the SEC's consideration by the end of the year, emphasizing that investors are looking for "consistent, comparable, and decision-useful" disclosures in this regard. In addition, the removal of the "performance-based compensation" exemption from Section 162(m) of the tax code provides companies with greater latitude to use qualitative performance metrics and to implement a bonus "modifier," which enables the company to increase the payable bonus as a result of a subjective determination, such as a commitment to the company's ESG principles.

The Challenge of Metrics

Boards looking to incorporate ESG metrics into incentive compensation plans are faced with the dual challenge of choosing appropriate metrics and appropriately measuring success. Although there is a movement toward establishing a global set of standards for reporting ESG metrics—as is the case with financial reporting—there is an ongoing debate as to whether a global set of ESG standards is, in fact, beneficial. For example, in April of 2021, SEC Commissioner Hester Peirce argued that a "global reliance on a centrally determined set of metrics could undermine the very people-centered objectives of the ESG movement by displacing the insights of the people making and consuming products and services."[1] Further, for any individual issuer, the chosen set of

[1] *See* Hester Peirce, "Rethinking Global ESG Metrics," *Views—the Eurofi Magazine*, page 208 (April 2021). (Also available at https://www.sec.gov/news/public-statement/rethinking-global-esg-metrics).

global standards required to be reported on may not align with the long-term business strategy of the issuer and, therefore, may not be appropriate as an incentive compensation metric.

As issuers continue to grapple with how best to incorporate ESG metrics in their incentive compensation programs, most provide for a qualitative review and include the metrics as part of an overall review of individual performance. Regardless of how the ESG metrics are utilized, they should come coupled with transparent disclosure to investors as to how and why the metrics were chosen, weighted and evaluated.

ESG METRICS IN THE INCENTIVE COMPENSATION PLANS OF THE TOP 100 COMPANIES

Of the Top 100 Companies:

41

surveyed companies incorporate ESG metrics into their executive compensation program

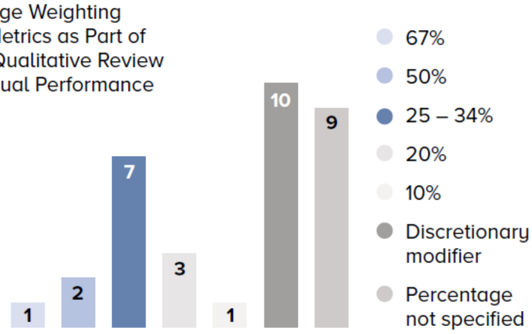
36 of these companies include them in their annual plan

5 in both their annual plan and their long-term plan and

5 as part of their annual determination of total target compensation

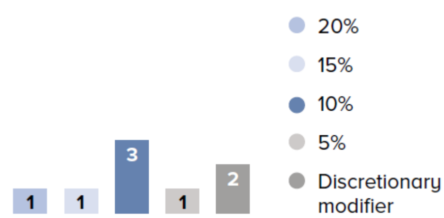
33 **of the Top 100 Companies incorporate ESG metrics into a holistic qualitative review of individual performance**

Percentage Weighting of ESG Metrics as Part of Holistic Qualitative Review of Individual Performance



8 **of the Top 100 Companies include ESG as an individual metric (one company includes ESG as an element of a holistic qualitative review and also as an individual metric)**

Weighting of Individual ESG Metric



ESG means different things to different companies. This is how companies that used ESG metrics defined ESG:

27

specifically reference a focus on diversity

17

state that a focus on safety is a metric, up from five companies last year that stated that increasing the health and safety of their employees was a metric, and one of these companies specifically states that COVID-19 safety is a metric

1

includes fixing disparities in the healthcare of underrepresented groups as a metric

7

have ESG metrics that apply only to certain named executive officers or that are tailored for each named executive officer

Action Items for Incorporating ESG Metrics

The following is a list of action items for companies looking to incorporate ESG metrics into their incentive compensation programs:

1. Engage with Shareholders

As part of a company's regular calendar on shareholder engagement, the company should discuss with key shareholders the inclusion of ESG metrics into its incentive compensation programs. Companies should seek to emphasize that these metrics are not divorced from the interests of shareholders but are, in fact, value drivers.

2. Identify the Appropriate Metrics

Consider a task force comprising different stakeholders within the organization that can appropriately determine ESG metrics that reflect the company's strategy and key risks and promote value creation.

3. Ensure a Line of Sight between Executive Actions and Performance

Incentive compensation metrics are without value if employees do not have the ability within their job function to impact the desired outcome. For example, while improved safety may be an important goal for an organization, it is likely the controller has little ability to effect change in this regard and his or her attention should be directed toward other goals of the company.

4. Set Goals

With a lack of historical context by which to measure ESG progress, consider providing the compensation committee with discretion to determine how executives have performed with respect to the company's ESG goals. Although companies may decide to measure success against targets set by third parties, such as SASB, these external targets may not be appropriate for every individual company. Also, determine whether goals should be annual or long-term. As shown in the Survey data, most ESG metrics are tied to annual incentive plans, reflecting the long-held belief that long-term goals should relate to financial and shareholder return metrics.

5. Review Your Executive Officer Scorecards

As discussed, unlike financial metrics, ESG performance cannot be boiled down to numbers on a spreadsheet and requires a subjective analysis. Therefore, when evaluating the overall performance of the company's executive officers, the board should include relevant ESG metrics on its scorecards.

The DOL's Rules on ESG Investing for ERISA Plans—The Pendulum Swings Again

In December 2020, the Department of Labor (DOL) published a final rule with respect to ESG investing in the ERISA context. Purporting to reflect the DOL's long-standing position that ERISA fiduciaries may not sacrifice investment returns in order to promote social, environmental or other policy goals, the rule provided that ESG factors may be considered only to the extent they present material economic risks or opportunities. The rule was not without controversy, as evidenced by the over 8,000 comment letters sent to the DOL following the initial release of the proposed rule.

Reflecting the long-standing back and forth between Republican and Democrat administrations as to the role of ESG considerations in ERISA investing, the Biden administration announced it would not enforce the rule and, on October 13, 2021, the DOL promulgated a new proposed rule. The proposed rule addresses concerns that the previous rule put fiduciaries at risk if they considered ESG factors in their financial evaluation of plan investments. Therefore, the proposed rule eliminates the requirement that fiduciaries only consider "pecuniary factors" in making investment decisions and allows fiduciaries to consider any factor that is material to the risk-return analysis. Therefore, the proposal would allow fiduciaries to consider ESG factors, including climate change-related factors.

The Evolving Role of ESG Metrics in Executive Compensation Plans

Posted by Maria Castañón Moats, Leah Malone, and Christopher Hamilton, PricewaterhouseCoopers LLP, on Saturday, March 19, 2022

Editor's note: Maria Castañón Moats is Leader of the Governance Insights Center, Leah Malone is Director of the Governance Insights Center, and Christopher Hamilton is Principal in Workforce Transformation at PricewaterhouseCoopers LLP. This post is based on their PwC memorandum. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here), and The Perils and Questionable Promise of ESG-Based Compensation by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here).

The broad area of environmental, social, and governance (ESG) issues is undeniably making its way onto corporate boardroom agendas today. Many large institutional shareholders are asking companies to focus more, do more, and disclose more about ESG efforts. In fact, ESG is now the topic most often covered during shareholder engagements that include company directors.

As boards work to integrate ESG concerns into discussions of company strategy, many are also considering how to create the right incentives for achievement of ESG-related goals. Incentive plans have long been driven primarily by objective financial goals. That often means quantitative goals related to things like revenue, cash flow, units sold, EBITDA, earnings

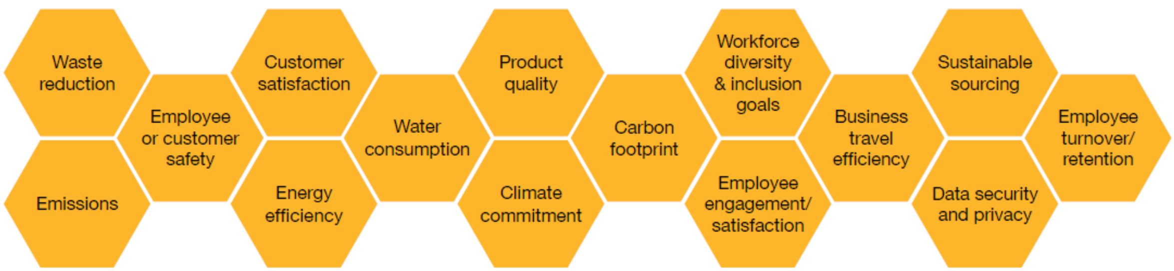
per share, or total shareholder return. But at many companies, a shift is underway as non-financial goals become more common. As of March 2021, more than half of companies in the S&P 500 (57%) used at least one ESG metric in their plans.

Many investors support—or are even urging—these changes. The *2021 Global Benchmark Policy Survey* published by Institutional Shareholder Services (ISS) found that 86% of investors (and 73% of non-investors) think non-financial ESG metrics are an appropriate measure to incentivize executives. **But investors are also clear—if ESG metrics are to be used, it needs to be done**

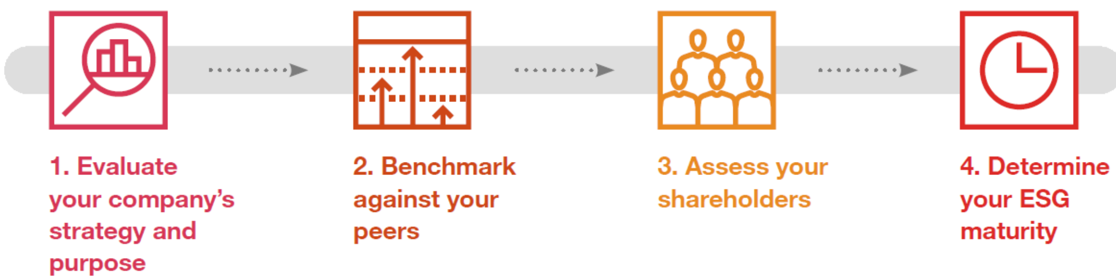
right. Metrics should be carefully chosen and should align with a company's strategy and business model.

In Part 1 of this post we describe the roadmap to readiness for companies that are not yet using ESG metrics in their plans. In Part 2, we consider the "how" of implementing those metrics into a company's plans. Finally, in Part 3 we discuss the risks and pitfalls companies could encounter.

Examples of non-financial ESG metrics



Part 1: ESG metrics: the roadmap to readiness



1. Evaluate your company's strategy and purpose.

How does the board define the company's strategy and purpose? How are ESG issues incorporated into that strategy and purpose—or are they not? For some companies, there is a clear business case for certain ESG metrics. It may already be reflected in the business plan or even be core to the company's purpose. For others, ESG issues may (at least at this moment) not seem core to their mission.

The incorporation of new goals into compensation programs should always be motivated by a clear and compelling reason. Some companies bring in ESG metrics because they are looking to reflect, or change, the culture at a company. Others are looking to manage business risks or pursue opportunities related to ESG.

Targets and metrics in executive compensation plans are premium real estate—and space for new metrics is limited. Compensation committees are wise to avoid overburdening those plans with too many different goals. This keeps the organization's main priorities front and center, and makes expectations clear. Some boards also prefer to include only easily quantifiable measures in incentive plans, which makes using ESG metrics (which can be more difficult to measure) challenging.

2. Benchmark against your peers.

While a majority of S&P 500 companies are now making use of ESG metrics, that trend doesn't hold true for smaller companies. Fewer than 10% of companies within the Russell 3000 (excluding those companies that make up the S&P 500) are using ESG metrics in their executive compensation plans. So even though the practice has gotten tremendous attention, it is not as widespread as it may seem. For now, it is largely concentrated among large-cap companies and among companies within certain industries.

No board wants to be last when it comes to implementing new governance practices. But many don't want their company to be the first one within their peer group either. Specific benchmarking will show what comparative peer companies are doing.

Use of ESG metrics correlates to company size

Percentage of companies that use ESG metrics in their executive compensation plans:

Source: Aon, "As More Firms Add ESG Metrics to Executive Pay, Best Practices are Emerging," August 2021.

3. Assess your shareholders.

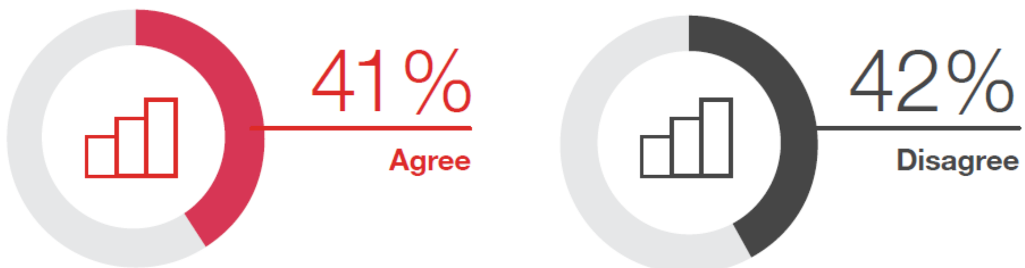
Shareholder views on the role of ESG in executive compensation are critical to understand. But investors are not a monolith, and they don't want the same things. Even among large institutional investors, companies will find that views and perspectives on the proper role for ESG metrics will vary widely. Some investors have signaled their general support for the inclusion of ESG metrics. Others are more skeptical.

Among those that support using ESG metrics, they often disagree on what types are most appropriate and under what circumstances they should be used. PwC's *Global investor survey* shows that shareholders are almost evenly split on the question of balancing ESG metrics against long-term shareholder value. Forty-one percent think those metrics have value even if they conflict with long-term returns. About the same percentage disagree.

Engaging with the company's top shareholders on the question of ESG metrics in executive compensation plans, or becoming familiar with their public policy statements on the topic, will be an important step in setting the path forward. These facts won't necessarily determine the board and the compensation committee's decision on the topic. But they will be helpful data points along the way.

ESG metrics vs. long-term shareholder value

Investors are split that ESG performance measures should be included even if the targets conflict with long-term shareholder value



Source: PwC, *Global investor survey*, December 2021.

4. Determine your ESG maturity

Whether the compensation committee is ready to incorporate ESG metrics into the executive compensation plans will also depend on the company's ESG maturity. Companies generally fall into three categories: laggards, middle of the pack, and front runners.

Many companies that are front runners may already be using ESG metrics in some fashion in their compensation programs. If they are not, they are likely preparing to do so now. For companies lower on the maturity curve, it may make sense to continue to refine the company's ESG strategy before adding related elements to the compensation plans. In part, this is because ESG targets are often set with respect to 5-10 year periods—much longer than traditional incentive plan periods. While front runners may have set interim measurement periods that can align with the 1- or 3-year performance periods compensation plans often use, many other companies will not be ready to do so.

And remember: adding ESG metrics to plans is not the only way for the board to encourage certain behaviors from executives. Achievement of goals that fall into the ESG categories can also play a key role in promotion and hiring decisions. Some companies have even recognized efforts with spot bonuses or other firm-wide recognition outside of the incentive plans.

The ESG maturity curve

The bottom line: Don't add new elements to an executive compensation program just to follow the trend, or because you think shareholders want it. Without the proper connection to strategy and overall compensation decisions, neither the board, the executive team nor the shareholders will be pleased with the result.

Part 2: Thinking through implementation

Once the decision is made to add ESG metrics to executive compensation plans, the work is far from done. From which metrics, to which plans, to the structure of the targets— companies and boards are using a wide variety of approaches. Each approach has different benefits and risks, and sends a different signal to executives, and to investors.

Key considerations for choosing ESG metrics:

- Importance to investors and other stakeholders
- Correlation to the company's purpose
- Ability to measure and track progress

1. Which metrics and weighting?

Executive compensation plan goals and targets are one of the board's most essential tools for motivating Any new goal added to a compensation plan needs to be purposeful and clear. But newly-added ESG metrics can also bring additional complications. Given the current spotlight on this trend, the metrics chosen will send a message to the company's stakeholders about the board and the company's commitment to ESG concerns.

Some companies are using a dozen or more different types of ESG metrics in their compensation plans. Which metrics are right for the company's executive team will depend on a number of factors.

Currently, the most common types of metrics relate to human capital management and social issues. Among the S&P 500 companies that use ESG metrics, 41% use some kind of human capital-related metric, with diversity and inclusion (D&I) metrics being most common. Only 14% are using one or more environmental-based metric.

Similarly, our research has shown that public company directors are most likely to support metrics that would fall under the "social" pillar. These include customer satisfaction, safety, and quality—goals which are not necessarily new to compensation plans. D&I goals, however, were uncommon a few years ago but are taking hold quickly. The public focus on social concerns has led employees, customers, suppliers, and the media to question what companies themselves are doing to promote equity internally. The number of S&P 500 companies disclosing metrics related to D&I in their plans grew 19% from 2020 to 2021.

Director support for non-financial metrics outstrips their use in practice

Support from directors for certain non-financial metrics compared to the percentage of companies using them

Metric	% of directors who think the metric should be included in executive compensation plans*	% of S&P 500 companies that utilize the metric in their plans^
Customer satisfaction	68%	27%
Safety	55%	24%
Quality	53%	11%
D&I	52%	28%
Environmental goals	39%	14%

Sources: *PwC, *2021 Annual Corporate Directors Survey*, October 2021; ^Semler Brossy, *ESG+Incentives 2021 Report: Preliminary Findings*, June 2021.

While the scope of metrics that fall under the broad ESG umbrella is wide, many boards choose to start with just one. For some, it may be the one that is most developed or the easiest to measure, even if not necessarily the one that is most important to the company. This might be a response to some of the most vocal shareholders, who emphasize the need for ESG targets to be objectively measurable, similar to other financial or operational targets. More than half (52%) of investors say that ESG metrics should be included in plans if they are specific and measurable. Only 34% agreed that even non-measurable targets have a place in those plans.

The value of third-party perspectives

Lawyers, compensation consultants and others will have a valuable role to play as companies navigate changes to their compensation plans. These advisors can share experiences and perspectives from other organizations, as well as help mediate metric and goal discussions between management and the board.

2. To whom should the goals apply?

Some boards start by creating goals that apply only to the Others choose to hold the entire executive team accountable, and still others create broad-based goals that apply to employees much further down in the organization. The right answer for a company might depend upon:

- How closely is the ESG goal tied to company strategy?
- What is the scope of responsibility for the metric within the organization?

A goal like customer satisfaction may be so intrinsically connected to company strategy, and so central to employees' roles, that the goal should be more broadly applicable. On the other hand, goals that may require key strategic decisions, like carbon emissions reductions, may be more appropriately limited to the CEO and other members of senior leadership. Some boards and compensation committees also choose to start with a narrower field as they begin to implement a new goal, and widen the scope once they become more comfortable with the target.

3. How do the metrics operate?

Executive compensation plans are complex and Different types of plans present different options for building metrics. The current plans in place at a company may limit the options available now, but as the topic evolves, boards and compensation committees may start to consider slightly different plan structures depending on their goals and perspectives.

Types of ESG metrics

Scorecard	• Metrics do not have specific individual weighting, but are part of a broad mix of ESG or non-financial business metrics • Gives the compensation committee flexibility to judge achievement subjectively • Currently the most common structure, used by 36% of S&P 500 companies with ESG metrics
Individual components	• ESG metrics are not used on their own but as part of a discretionary individual assessment (e.g., as part of a "leadership" category) • Second most common structure, used by 28% of S&P 500 companies with ESG metrics • Allows for individuals to have different goals and relative weighting
Weighted components	• Metrics are broken out with specific weightings and goals within a composite performance target • Requires ESG metrics that are clearly measurable
Underpin or global modifier	• ESG metrics are used to adjust the entire payout up or down. Some companies use a negative modifier only; achievement does not increase the payout, but a missed target results in a negative adjustment even if the financial performance target is achieved.
Stand-alone plan	• Allows the company to design an additional plan in a way most compatible with the types of goals it would like to achieve • Because the existing incentive plans remain in place, there is a risk that the new plan is hard to explain or viewed as duplicative by investors

4. What time horizon is appropriate?

ESG metrics are most commonly used in annual bonus plans, rather than long-term incentive plans. Shorter-term annual plans tend to have more flexibility, allowing for strategic and/or individual performance goals. But many ESG goals do not fit naturally into a one-year time horizon. Long-term incentive plans may align better with the long-term changes companies are pursuing as part of their ESG strategy. But even then, the common three-year measurement periods may not be long enough to capture five to 10-year ESG goals. And using ESG metrics in those plans presents complications too. Long-term plans that are stock-based (as many are) have less flexibility from an accounting standpoint. If goals are not purely objective and require the compensation committee to exercise judgment, the accounting treatment may be less advantageous for the company.

Investors say they are fairly open to either structure. More than four out of five investors (81%) agree that both short-term and long-term incentives may be the right place for ESG incentives, depending on circumstances.

5. How will this affect disclosure?

Currently, sustainability disclosures are predominantly voluntary, meaning that companies take a variety of approaches to ESG reporting. Many companies publish a stand-alone report, or create a separate section of the website. Some elements might be incorporated into the company's financial reports, but until new SEC regulations on the topic are issued, most are not.

But this changes when ESG metrics are added to executive compensation plans. A company is required to describe the executive compensation plans and goals, as well as the rationale for those choices. Then, of course, performance against those metrics will need to be described. That means that if specific ESG metrics are established with accompanying targets, the company needs to prepare for disclosure about achievement and perhaps be prepared to discuss why targets were missed.

Part 3: What can go wrong?

For boards and compensation committees thinking about adding new metrics to compensation plans, it's important to consider the risks associated with those changes.

Incentivizing the wrong behaviors	Setting targets and establishing metrics sets expectations for executives. But with brand new types of metrics, it's possible to discover that you've incentivized the wrong behavior. An executive team might be able to meet emissions goals with a big spend on a carbon sink, for example, or meet D&I goals with a short-term hiring blitz at the end of the year. These methods may sacrifice long-term shareholder value for the sake of hitting short-term targets.
Setting the wrong targets	New metrics can create complications just by being new. Partway into the performance period, the compensation committee may realize that the targets were too far off to be reasonable, leading the committee to want to make adjustments. Those adjustments can be hard to explain and can damage the company's credibility with shareholders.
Sending the wrong signal to the executive team, or to investors	In particular with goals relating to ESG, the new metrics will send a message. Does that message express the company's values?
Creating just another entitlement	If the metrics or targets relate to areas that shareholders or employees assumed were non-negotiable, the compensation committee risks creating an almost guaranteed bonus. Shareholders are wary of incentive pay for something executives should be doing in any case.
Losing the goal in translation	For global companies—how do the goals translate to other countries? Or are different goals set? The company can risk sending the wrong message if team members across the globe are subject to different expectations on ESG issues.
Difficult-to-measure performance	Many ESG goals are qualitative, rather than quantitative. Success is often highly subjective, and some boards are wary of even setting specific goals because they don't want to have to report missing targets on sensitive issues.
Finding comfort in the numbers	Which groups internally will be responsible for collecting the relevant data, and assessing

	performance? Who oversees this process? Does the company have external assurance? How confident is the compensation committee in its ability to assess performance? This is especially challenging for areas where the company is not accustomed to gathering reporting.
Exercising discretion	Since many ESG-related metrics are subjective, they can also allow for greater discretion in determining performance. But the compensation committee may also have situations where it wishes to exercise discretion because targets were unrealistic, or were set too low. How will the executive team and shareholders react to that?
Balancing ESG performance against financial performance	When determining the structure of the plan, consider how shareholders will react if ESG targets are met, but financial targets are missed.

Conclusion

As an increasing number of companies incorporate ESG metrics into their compensation plans, best practices continue to emerge. Compensation committees and boards face the challenges of creating clear, appropriate targets that align with and reinforce an evolving ESG strategy. Managing the company's stakeholders is critical, as is balancing the expectations of various shareholders with those of leadership. For those that have made recent changes to their executive compensation plans to account for ESG metrics: continue to monitor developments and expect an evolution in how those goals are being defined and utilized. For those who haven't added ESG metrics yet: consider when the company will be ready, and start to lay the groundwork with the executive team.

The Perils and Questionable Promise of ESG-Based Compensation

Posted by Lucian Bebchuk and Roberto Tallarita (Harvard Law School), on Wednesday, March 9, 2022

Editor's note: Lucian Bebchuk is the James Barr Ames Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School; and Roberto Tallarita is a Lecturer on Law and Associate Director of the Program on Corporate Governance at Harvard Law School. This post is based on their recent paper.

Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); Stakeholder Capitalism in the Time of COVID, by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Will Corporations Deliver Value to All Stakeholders?, by Lucian A. Bebchuk and Roberto Tallarita.

With the rising support for stakeholder capitalism and at the urging of its advocates, companies have been increasingly using ESG metrics for CEO compensation. In a recently released study, The Perils and Questionable Promise of ESG-Based Compensation, we provide a conceptual and empirical analysis of this practice, and we expose its fundamental flaws and limitations. The use of ESG-based compensation, we show, has questionable promise and poses significant perils.

Based partly on an empirical analysis of the use of ESG compensation metrics in S&P 100 companies, we identify two structural problems. First, ESG metrics commonly attempt to tie CEO pay to limited dimensions of the welfare of a limited subset of stakeholders. Therefore, even if these pay arrangements were to provide a meaningful incentive to improve the given dimensions, the economics of multitasking indicates that the use of these metrics could well ultimately hurt, not serve, aggregate stakeholder welfare.

Second, the push for ESG metrics overlooks and exacerbates the agency problem of executive pay, which have received closed attention from both scholars and policymakers. In particular, we warn that the use of ESG metrics threatens to reverse the progress achieved in the past few decades in making executive pay more transparent, more sensitive to actual performance, and more open to outside oversight and scrutiny.

To ensure that they are designed to provide effective incentives rather than serve the interests of executives, pay arrangements need to be subject to effective scrutiny by outsiders. However, our empirical analysis shows that in almost all cases in which S&P 100 companies use ESG metrics, it is difficult if not impossible for outside observers to assess whether this use provides valuable incentives or rather merely lines CEOs' pockets through performance-insensitive pay. Encouraging and expanding the use of ESG-based compensation, we explain, gives self-interested executives a powerful tool to increase their payoffs without creating any significant incentives to deliver value to either stakeholders or shareholders.

The current use of ESG metrics, we conclude, likely serves the interests of executives, not of stakeholders. Expansion of ESG metrics should not be supported even by those who care deeply about stakeholder welfare.

Below is a more detailed account of our analysis:

A heated debate is taking place on how to create a more inclusive capitalism that serves not only shareholders but also "stakeholders," including employees, consumers, suppliers, communities, and the environment. According to the increasingly influential view of stakeholder governance ("stakeholderism"), corporate leaders should be encouraged and relied upon to use their discretion to take into account the interests of all stakeholders.

In response to skepticism as to whether corporate leaders have adequate incentives to create value for stakeholders, some supporters of stakeholderism have posited that corporate leaders can be incentivized to improve stakeholder welfare by tying their compensation to ESG goals. Based on this view, compensation consultants have been busy developing ways to incorporate ESG metrics into executive compensation, many companies have been using such metrics in their pay arrangements, and stakeholderism supporters have been urging an expansion of this practice.

This trend raises two important questions for corporate governance and the debate on stakeholderism. The first is whether the current practices of ESG-based compensation produce meaningful incentives to increase stakeholder welfare. The second is whether the current limits of ESG-based compensation can be improved and to what extent.

In order to address these questions, we analyze the use of ESG compensation metrics in large corporations. We chose to focus on the 97 U.S. companies included in the S&P 100 index, as they represent more than half of the entire U.S. stock market and arguably have a significant impact on stakeholders and society at large. We found that slightly more than half (52.6%) of S&P 100 companies included some ESG metrics in their 2020 CEO compensation packages. These metrics focus chiefly on employee composition and employee treatment, as well as customers and the environment, but also, to a much smaller extent, communities and suppliers.

ESG metrics are mostly used as performance goals for the determination of annual cash bonuses. However, most companies do not disclose the weight of ESG goals for overall CEO pay, and those that do disclose it (27.4% of the companies with ESG metrics) assign to ESG factors a very modest weight (between less than 1% to 12.5%, with most companies assigning a weight between 1.5% and 3%).

Interestingly, despite the rampant stakeholderist rhetoric, many companies that signed the Business Roundtable Statement on the Purpose of the Corporation, and therein pledged to deliver value to all stakeholders, do not use ESG metrics in their CEO compensation arrangements. In fact, of the 62 sample companies that signed the statement, 42% do not use any stakeholder-oriented incentives for their CEOs. This finding seems consistent with the view, expressed by us in previous work (see The Illusory Promise of Stakeholder Governance and Will

Corporations Deliver Value to All Stakeholders?), that the Business Roundtable statement should be considered a public relations move rather than an actual redefinition of corporate purpose.

Our empirical analysis highlights two structural limits of ESG-based compensation practices. The first limit lies in their use of a limited number of welfare dimensions of a limited number of stakeholders. Despite the promise of a new paradigm that delivers value to “all stakeholders,” and the potential breadth of companies’ stakeholders and the multiple ways their interests are affected by corporate decisions, companies in reality choose a small subset of stakeholder groups and interests on which to focus.

The narrowness of ESG metrics reveals the limits of ESG-based compensation and also raises a well-known problem in the economics of multitasking. By incentivizing CEOs to improve the performance of narrow quantifiable metrics, companies create distorted incentives not to focus on other significant, but hard-to-quantify, dimensions.

The second structural limit of ESG-based compensation concerns the fundamental agency problem involved in executive compensation. CEOs exert substantial influence on their boards of directors and can therefore extract significant value from their companies through excessive compensation packages. In order to mitigate this agency problem, compensation arrangements should be tied to performance and companies should disclose enough information to allow an outside observer to review and assess the meaningfulness of the performance.

Yet almost no company in our sample uses ESG metrics that meet this standard. Most companies mention the use of ESG goals but do not disclose the relevant targets and actual outcomes, or they leave significant discretion to their boards. Among the very few companies that disclose clear and objective goals as well as actual outcomes, almost none provides sufficient contextual information allowing outsiders to review and assess the pay arrangements.

Our analysis has significant implications for ESG-based compensation practices and the broader debate on stakeholderism. Our analysis shows that the ESG compensation trend should not be expected to produce meaningful incentives for the creation of value for stakeholders and that it poses the danger of creating vague, opaque, and easy-to-manipulate compensation components, which can be exploited by self-interested CEOs to inflate their payoffs, with little or no accountability for actual performance.

The demand for ESG-based compensation is, explicitly or implicitly, based on the recognition that corporate executives do not have, on their own, sufficiently strong incentives to give weight to the welfare of stakeholders. We agree with this recognition; in fact, we believe that it is the fundamental weakness at the core of stakeholderism. When framed in this way, the campaign to promote and expand the use of ESG compensation metrics can be interpreted as a good-faith attempt to address this very important problem.

However, our conceptual and empirical analysis shows that the current use of ESG metrics is crucially flawed. Furthermore, it shows that such use is afflicted by certain structural problems that are difficult to address and that both significantly limit potential benefits and introduce considerable perils. Thus, we warn that the expansion in the use of ESG metrics, which stakeholderists support and that corporate leaders have incentives to embrace, would likely be counterproductive. It would likely deliver little value to stakeholders and would operate to increase executive payoffs without improving their incentives.

Our new study is available here.

E&S Metrics and Executive Compensation

Posted by Eric Shostal and Krishna Shah, Glass, Lewis & Co., on Wednesday, March 23, 2022

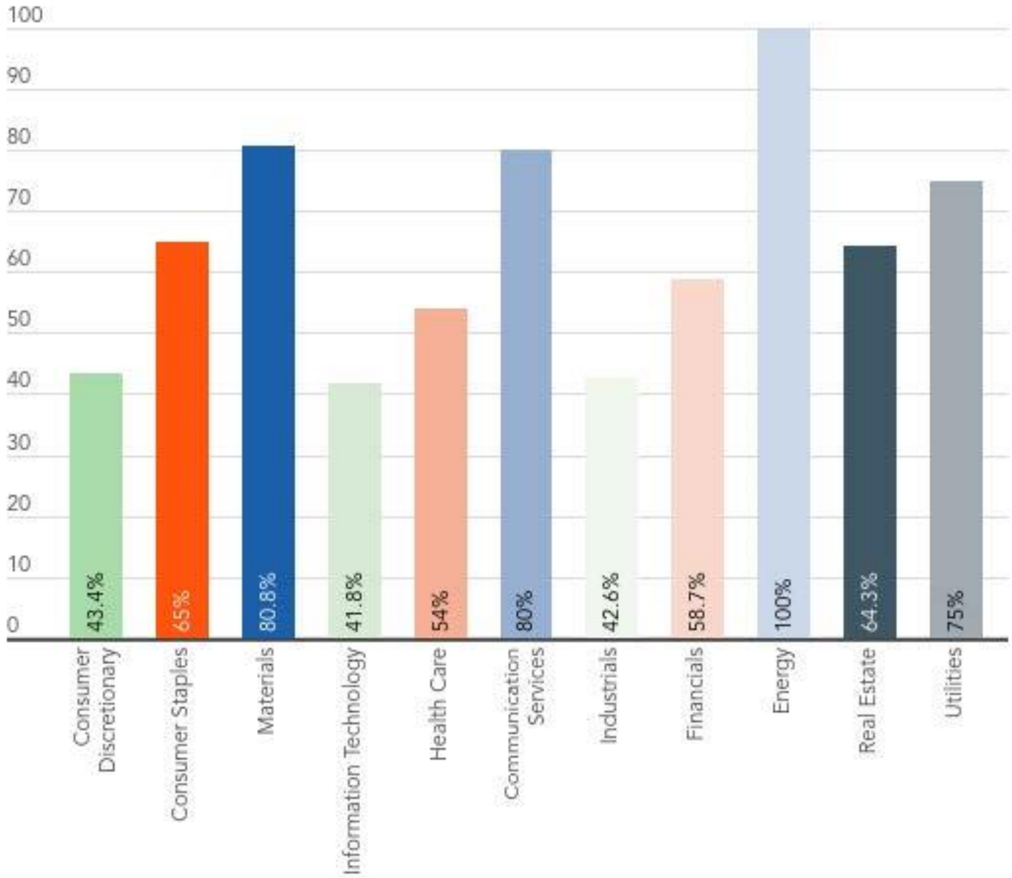
Editor's note: Eric Shostal is Senior Vice President of Research and Engagement, and Krishna Shah is Manager of Executive Compensation at Glass, Lewis & Co. This post is based on their Glass Lewis memorandum. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here), and The Perils and Questionable Promise of ESG-Based Compensation by Lucian Bebchuk and Roberto Tallarita (discussed on the Forum here).

Introduction

Stemming from increasing shareholder stewardship on matters of risk, investors have expanded the scope of their evaluation of companies from pure financials to include topics like human capital management, diversity, safety—the list goes on. And for good reason: research has shown a link between good environmental and social (E&S) practices and strong financial performance.

To promote that link, boards are increasingly basing a portion of executive incentives on non-financial metrics that measure E&S performance. Of the $6.96 billion paid to S&P 500 CEOs in 2021, at minimum nearly $600 million (8.6%) was based on E&S performance, including approximately $515 million tied to short-term incentives (STIs) and approximately $83 million tied to long-term incentives (LTIs). Since E&S performance is often measured along with other unweighted considerations the true number could be much higher, and it is increasing.

In recent years, the percentage of U.S. companies that included some type of E&S consideration within their executive incentives has risen steadily from 16% in 2019, to 21% in 2020, and 25% in 2021. The year-on-year increases are even more stark at the top: approximately half of all S&P 500 companies included some form of E&S consideration under an incentive plan in 2021, compared to 39% in 2020.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Consumer Discretionary
Consumer Staples
Materials
Information Technology
Health Care
Communication Services
Industrials
Financials
Energy
Real Estate
Utilities

E&S Categories

E&S metrics can take many forms, and often differ greatly from company to company and industry to industry. Glass Lewis distinguishes between the following categories of E&S metric:

Safety	Metrics that consider employee safety, such as: TRIR (total recordable incident rate), DART (Days away/restricted or Transfer Rate), OSHA metrics and deaths-per-year.
Environment	Metrics that consider the company's environmental impact, such as: environmental accident reports, oil spills and emission reductions.
Human Capital Management	Metrics that consider the company's efforts to support their human capital, aka, their own employees, such as attracting, developing and retaining high quality employees and succession planning.
Diversity	Metrics that consider improving and/or addressing diversity in the workplace, such as: increasing gender and racial diversity in management, promoting and fostering a diverse workplace, developing and implementing programs to improve diversity.
Community	Metrics that consider the company efforts to interact with their local communities, such as contributing to charitable works or fundraising.
General ESG/CSR	Metrics that broadly account for Company sustainability efforts from a holistic perspective, including Company efforts to maintain or develop corporate governance practices, such as market best practices, or social responsibilities such as fair labor practices abroad, human rights, and anti-discrimination.

Of these categories, diversity, safety and human capital management are most commonly included as metrics. This is not wholly surprising. Safety has historically been the most popular E&S metric category due to the nature of these metrics being more quantifiable and lending themselves more easily to tracking, as well as the topic's relevance to mining, oil and gas, and utility company operations.

Meanwhile, issues related to diversity and the treatment of employees, as well as other stakeholders, have become increasingly important considerations for companies and their investors. Moreover, diversity considerations largely go hand in hand with human capital management as the two categories are closely linked. While Glass Lewis treats these as separate categories, we have found that companies measuring diversity are more likely to also focus on areas of human capital management, such as succession planning and developing internal talent. Of the 149 companies that considered diversity, 95 also considered separate human capital management metrics. These categories were particularly common within sectors where safety considerations are less relevant, such as communications, consumer staples, financial, health care and information technology; many of the companies in these sectors also face significant direct exposure to consumers and the public at large, enhancing reputational risk. That said, we note that diversity and human capital management metrics were also quite common within the industrials sector, and are becoming more widespread across the market.

Typical STIP Metrics: Marathon Petroleum

Marathon Petroleum's sustainability metrics under its STIP lay out some of the most typical safety and environmental metrics used for these companies by evaluating performance against pre-determined targets related to greenhouse gas intensity, its safety performance index, process safety events rate, and designated environmental incidents (Form DEF 14A, filed March 15, 2021). These metrics make up a total of 20% of the company's short-term incentive payouts, and are tied to $480,000 of the CEO's target bonus. These are relatively standard safety and environmental metrics for companies in the energy, materials, industrials, or utilities sectors, incentivizing lowering of greenhouse gas intensity, improving safety accountability, and decreasing both process safety events and designated environmental incidents.

Types of E&S Metrics

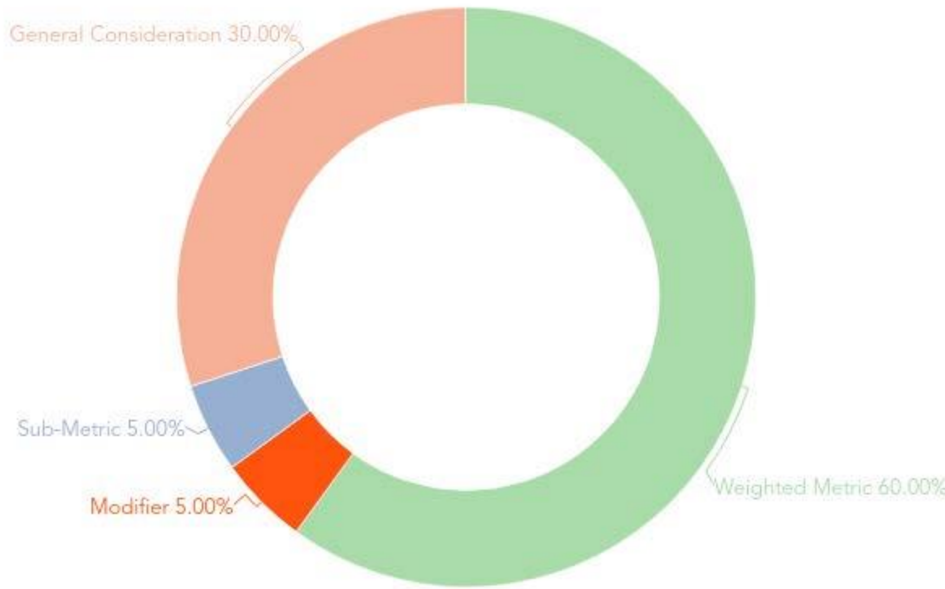
Just as there are different categories of E&S performance being measured, there are a variety of different ways of measuring that performance:

- **Weighted metric**: Carries a specific weight, meaning performance is directly tied to a proportion of payouts for the award.
    - Ex: TRIR accounts for 5% of the STIP, 5% target bonus payouts based on TRIR performance.
- **Modifier**: Adjusts final payouts upward or downward within specified range based on level of achievement.
    - Ex: Increasing diverse representation in management positions by 5% is the goal, achievement/missing the goal can adjust final bonus payouts upward/downward by 10%.
- **Sub-metric:** A specified goal under a weighted overarching metric.
    - Ex: Diversity goal makes up a portion of the 40% weighted strategic objectives metric.
- **General consideration:** The company discloses that it considers an E&S metric under a subjective metric or when determining final payouts.
    - Ex: Company subjective considers diversity and inclusion initiatives when evaluating individual performance.

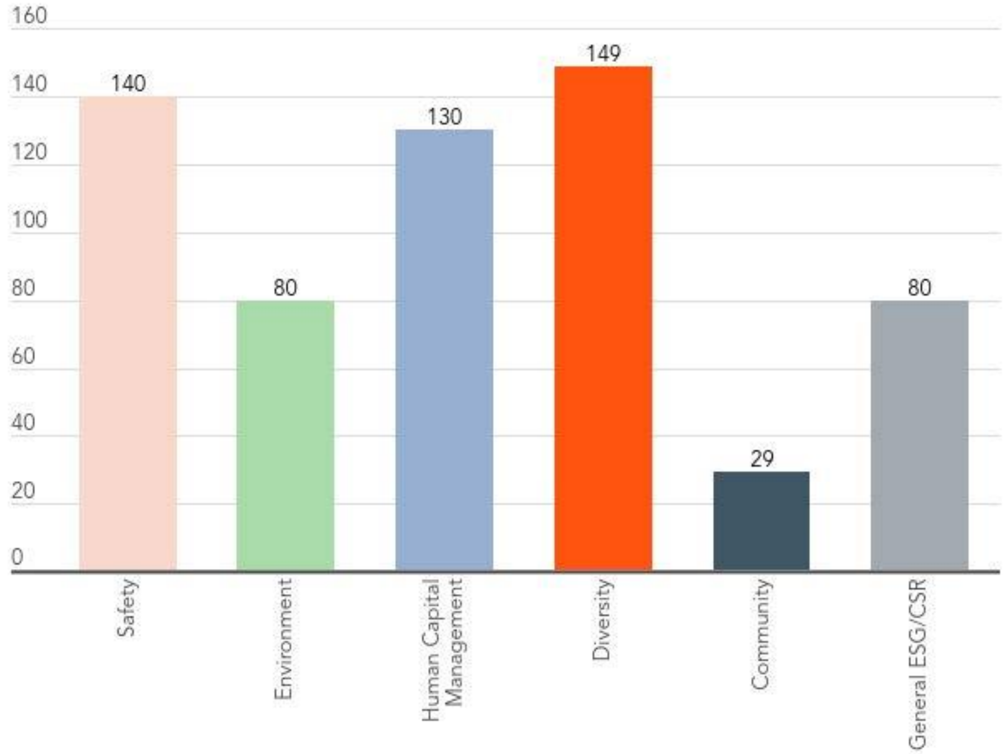
The way E&S metrics impact payouts differs greatly amongst these different types of metrics. Some can be subjective, such as a general consideration under an individual performance goal; some can be more objective and clearly defined, such as a weighted metric that specifically allocated 5% of a bonus payout to improving diverse representation in management roles by a specified amount; some serve as a red line, such as caps on overall payouts if there is a worker fatality.

STI vs LTI, Subjective vs Objective

When used, E&S metrics are more likely to be tied to a portion of an executive's STI payout, rather than long-term incentive LTI payout. Indeed, while nearly half of the S&P 500 (244 companies) included an E&S consideration in their STI plan, only 20 companies used them within their performance-based LTIs.



Given that many areas of E&S performance are difficult to measure objectively, the skew towards STIs likely reflects the general tendency to avoid using subjectively determined metrics or goals, such as individual performance or strategic objectives, in LTI plans. As discussed in the examples below, the small number of companies that choose to include E&S metrics in their long-term incentives already have a more codified, less discretionary approach to capturing this performance.



Examples of LTIP Metrics: American Electric Power & Prudential Financial

Performance shares granted by American Electric Power in 2020 included a non-emitting generation capacity growth metric with a 10% weight (Form DEF 14A filed March 10, 2021). Non-emitting generation capacity includes nuclear, hydro, wind, solar, energy efficiency, demand response and storage capacity owned or contracted by the company as a percentage of total owned and contracted generation capacity. In this case, American Electric Power clearly states what this metric is incentivizing, the encouragement of management to seek and develop opportunities to increase generating capacity that does not emit CO2, thus reducing greenhouse gas emissions. The company discloses the starting percentage for the metric and discloses the goals set for the three-year performance period. The clear linkage of the metric to E&S issues and the disclosure of goals, including the baseline and discussion of why it is material to the company's operations, reflects a relatively good level of disclosure for E&S metrics.

Prudential Financial introduced an employee diversity modifier for its 2018 performance cycle and followed up with another in 2021 (Form DEF 14A, filed March 25, 2021). The 2021 modifiers adjusted final payouts up or down by 10% depending on the increase of diverse representation among leaders in its top ~600 U.S, positions by 10%, the increase in the representation of people of color in U.S. positions one level below Vice President by 8%, and whether it was able to close the gap in employee engagement scores of black employees relative to other employees. For the first two goals, there is sub-goal that dictates that part of the goal is increasing the representation of black/LatinX employees by at least 25%.

Disclosure Coming Into Focus?

Clearly defined goals make it easy for shareholders to determine how the targets align with a company's long-term goals and ambitions—but for many categories of E&S performance, they are still relatively rare. The majority of companies remain vague in disclosing how they measure performance related to E&S considerations, particularly when it is not a safety metric.

One representative example comes from FedEx, which includes the following as consideration under its STIP individual performance modifier: "Implement and document good faith efforts designed to ensure inclusion of females and minorities in the pool of qualified applicants for open positions and promotional opportunities, and otherwise promote FedEx's commitment to diversity, equity, tolerance and inclusion in the workplace," (Form DEF 14A, filed August 16, 2021). This type of disclosure, while indicating that E&S is explicitly considered, does not clearly articulate measurable goals. Rather, it suggests more of a subjective assessment.

That approach is common—for now. In recent years, Glass Lewis has observed a movement toward providing clearer disclosure of E&S metrics by stating what specific considerations and goals were reviewed. Rather than simply saying diversity is a consideration under an individual performance factor, companies are beginning to provide more specific information—for example, by detailing that one of the CEO's goals was growing a diverse talent pool for succession planning, or stating the specific amount that is based on that area of performance. Moreover, as illustrated above, we are observing more examples of companies integrating more measurable, objective E&S measures.

The trend reflects the evolving shareholder expectations on both the board's role in overseeing E&S factors and on executive compensation that are being communicated to public companies through investor engagements. The inclusion and disclosure of E&S metrics within the pay program is a common approach towards meeting those expectations.

Of course, that's not the end of the discussion. Executive compensation is frequently at the top of the agenda in both engagement and proxy voting, and shareholders want to know the thought process when setting any type of incentive goals, whether or not they include E&S metrics. That interest is heightened when the metrics in question are innovative, subjective, or simply lack a clear benchmark, as is often the case with many categories of E&S performance.

As E&S metrics have become more common, and both companies and investors have more effective examples to point to, there appears to be a natural coalescing. Going forward, disclosure of specific goals, whether they are weighted, modifiers, or subjective considerations, appears to be where the market is heading.

SEC Re-Opens Comment Period for Pay vs. Performance Proposed Rules

Posted by Daniel Laddin and Louisa Heywood, Compensation Advisory Partners, on Friday, February 18, 2022

Editor's note: Daniel Laddin is a founding partner and Louisa Heywood is an analyst at Compensation Advisory Partners. This post is based on their CAP memorandum. Related research from the Program on Corporate Governance includes the book Pay without Performance: The Unfulfilled Promise of Executive Compensation, by Lucian Bebchuk and Jesse Fried; and Executive Compensation as an Agency Problem by Lucian Bebchuk and Jesse Fried.

Five years after the initial rules proposal and comment period, the SEC has re-opened the comment period and proposed new requirements to enhance the pay versus performance disclosure. CAP submitted comments to the SEC on the 2015 Proposed Rules, and this statement can be found here.

Background

To address Section 953(a) of the 2010 Dodd-Frank Act, the Securities and Exchange Commission (SEC) published Proposed Rules in 2015 to address the Act's stipulation that companies disclose information to show the relationship between actual compensation paid to executives and a company's financial performance. Disclosure rules currently in place for the Compensation Discussion and Analysis section require companies to describe material information related to executive compensation programs and how pay is determined; however, this information is generally prospective. The proposed rules expand disclosure of how compensation actually paid to executives is determined.

Originally, the 2015 proposed rules to enhance pay versus performance disclosure recommended a supplemental table to show actual compensation paid to the principal executive officer (PEO), average actual compensation paid to the other named executive officers (NEOs) and total shareholder return over the five-year period for the company and its peer group (Exhibit 1). Actual compensation reported in the supplemental table would differ from the summary compensation table (SCT) reported value in that it would reflect the value of equity awards at vest rather than grant and exclude changes in actuarial present value of benefits under defined benefit and pension plans not attributable to the most recent year of service.

Since the rules were first proposed in 2015, performance-based long-term incentive plans have grown in prevalence relative to stock option incentives in the market. Financial performance metrics in performance-based long-term incentive plans are increasing in quantity and variety. The COVID-19 pandemic further impacted metrics used for determining company performance and executive pay. Total shareholder return (TSR) is now rarely the sole metric for evaluating company performance and it no longer captures the full picture of company financial performance. The updated rules published in January 2022 consider these changes in the executive compensation landscape.

Updated Proposed Rules under Section 953(a)

In its update published January 27, 2022, the SEC revised its 2015 proposal to request comment on (1) requiring disclosure of three new financial performance measures in addition to TSR in the supplemental table with clear description of the relationship between the measures and (2) requiring companies to provide a list of the five most important performance measures used to determine compensation actually paid to the executive, potentially in a tabular format (Exhibits 2a and 2b).

The new rules contemplate adding measures of pre-tax net income, net income and a third financial performance measure selected by the company to the table, to be shown in addition to TSR. In response to sentiment that TSR does not capture the full financial picture of a company, and the reality that other metrics are consistently used in long-term performance share programs, the SEC proposes pre-tax net income and net income because they are standard metrics of profitability, are familiar to investors and are GAAP metrics already calculated for prepared financial statements. The company-selected measure is intended to be a financial performance metric that the company finds represents the most important performance metric not already shown in the table for the evaluating the link between compensation actually paid and company performance over the period represented. To complement the data reported in the table, companies will have to substantiate the relationship between pay and performance through a clear description.

In addition to the new financial performance measures reported in the table, the 2022 updated rules propose requiring companies to separately disclose the five (at max) most important company performance metrics that inform actual compensation decisions during the period. The SEC hypothesizes that disclosure of these metrics would provide investors with visibility into which performance measures most strongly impact actual compensation paid and to assess whether compensation programs appropriately incent executives. This component also functions to reduce the risk of misrepresenting or providing an incomplete picture of pay versus performance alignment.

The SEC is soliciting comment on these revised recommendations, with particular focus on the additional financial performance metrics and the tabular disclosure of the five most important performance measures in determining actual compensation.

We support the objective of enhanced transparency and many companies have incorporated the principles in the SEC rules through the disclosure of “realizable/realized pay,” robust discussion of pay for performance philosophy and practices, and detailed disclosure of the rationale for compensation structures and decisions. While the use of GAAP metrics may drive some level of comparability, often companies deviate from GAAP definitions for incentives and the rationale for deviating will be even more critical if/when these rules go into effect.

Spring-Loaded Equity Awards are Back on the SEC's Agenda

Posted by Maj Vaseghi, Lori Goodman, and Pamela Marcogliese, Freshfields Bruckhaus Deringer LLP, on Wednesday, December 29, 2021

Editor's note: Maj Vaseghi, Lori Goodman, and Pamela Marcogliese are partners at Freshfields Bruckhaus Deringer LLP. This post is based on a Freshfields memorandum by Ms. Vaseghi, Ms. Goodman, Ms. Marcogliese, Elizabeth K. Bieber, and Andrew Herman. Related research from the Program on Corporate Governance includes Stealth Compensation Via Retirement Benefits by Lucian Bebchuk and Jesse M. Fried.

On November 29, 2021 the United States Securities and Exchange Commission (the "SEC") issued new guidance under Staff Accounting Bulletin No. 120 (the "Bulletin") on estimating the fair value of share-based compensation under Accounting Standards Codification ("ASC") Topic 718, Compensation—Stock Compensation ("Topic 718") that leaves some key questions unanswered and that we expect will significantly curtail, if not eliminate, the granting of so-called "spring-loaded" equity awards. The new guidance comes on the heels of reports on "spring-loaded" stock options granted to senior executives prior to the announcement of significant positive news. The Bulletin notes that "[t]he staff has observed numerous instances where companies have granted share-based compensation while in possession of positive material non-public information, including share-based payment transactions that are commonly referred to as being "spring-loaded."'

The Bulletin relates to estimating the accounting fair value of equity grants that are made in contemplation of, or shortly before, a planned release of positive material non-public information, such as an earnings release in which the company discloses it significantly outperformed guidance and analyst expectations or a transaction, where the information is expected to result in a material increase in share price (i.e., "spring-loaded" equity awards). Under the SEC's guidance, when determining the fair value of any "spring-loaded" equity awards for accounting purposes under ASC Topic 718, companies will be required to consider the expected increase to the current share price and the expected volatility in share price following the disclosure of such information.

The Bulletin notes that companies that have traditionally valued stock-based awards based on the share price on the date of the grant, without taking into account any prospective share price increases expected in the near-future following the grant, should take into account these expected price increases when valuing "spring-loaded" equity awards. Companies should also disclose how they identified if an increase in the "observable market price" was taken into account and the quantum of such adjustment in its publicly filed financial statements. The SEC expects that companies will disclose information on "spring-loaded" awards independently from their disclosure of other share-based awards .

The Bulletin provides as an example a public company that entered into a material contract with a customer after market close. Subsequent to entering into the contract but before the market opens the next trading day, the company grants stock options to its executives. The company expects the share price to increase significantly once the announcement of the contract is made the next day. In this case the SEC expects the company to consider *"whether such awards are consistent with its policies and procedures, including the terms of the compensation plan approved by shareholders, other governance policies, and legal requirements"* and *"reminds companies of the importance of strong corporate governance and controls in granting share options, as well as the requirements to maintain effective internal control over financial reporting and disclosure controls and procedures."* [Emphasis added] The SEC continues, that in this case, using the closing share price on the date of grant, without an adjustment to reflect the impact of the new material contract with a customer, *"would not be a reasonable and supportable estimate and, without an adjustment the valuation of the award would not meet the fair value measurement objective of FASB ASC Topic 718."* [Emphasis added]

What Are the Implications of the SEC's Guidance?

While historically "spring-loaded" stock options awards have been the primary focus of scrutiny and have, under Delaware law, implicated directors' fiduciary duties, the SEC's guidance broadly applies to any share-based payments and would include other award types such as restricted stock and restricted stock units. While the Bulletin provides that non-routine grants merit particular scrutiny, we note that the Bulletin suggests that the guidance will similarly apply to grants made in a company's normal grant cycle that are close in time to a market price moving announcement.

The guidance leaves a number of unanswered questions, including:

- The methodology companies should use to determine the appropriate valuation of "spring-loaded" awards and what would be considered a reasonable adjustment to the valuation; and
- If the new guidance will apply to awards that have already been granted, including, for example, during the current quarter of the effective date of the Bulletin, or will only apply to awards granted following the effective date of the Bulletin.

Given the difficulty and other implications in applying the SEC's guidance, we expect that it will result in significantly curtailing, if not eliminating, "spring-loaded" awards. The implications of the Bulletin will go beyond accounting treatment, especially with respect to stock option grants. A company that increases the accounting fair value of a stock option grant based on future expected movement in the stock price, will need to think hard about also increasing the option exercise price of that award as the underlying stockholder approved equity plan that the awards are issued under generally require that stock option exercise prices be at least equal to the fair market value of stock on the date of grant.

In light of this SEC renewed focus in this area and guidance, companies will need to reassess their equity award grant practices so that grants are not made shortly before planned releases of positive material non-public information.