What are Compensation Committees Discussing in 2021?

By: Jessica Page

While 2020 proved that business forecasts do not always go according to plan, we believe it is a safe assumption that making good governance a priority in 2021 will not only be welcome by investors, but it may be an important consideration in securing favorable Say on Pay outcomes and support for director elections in 2022. Everyone has been on some variation of the “Covid Coaster” in the last 12 months. Management teams were tasked with managing employee well-being, significant change in working environment, a teetering economic situation, and uncertainty about when the economy will become more stable. Discussions about the “new normal”, school opening plans and where to get a PCR test replaced discussions about where to have lunch and last night’s baseball game. Much of the last 12 months has been spent reacting to changes and adjusting plans based on new information. However, there appears to be some light at the end of the tunnel and companies are finally(!) able to look forward.

Now that most 2020 bonus plans have been settled and 2021 goals have been established, we are shifting our focus to what Compensation Committees may be discussing in 2021.

Director Orientation or “Reset”: *With a chaotic 2020, what plans are in place going forward?*

Many directors spent 2020 discussing what changes needed to be made in order to keep businesses open and moving during the pandemic. As vaccines are more widely distributed and the “Covid Ride” slows down, it may be helpful for Committees to regroup and perform a holistic review of the 2021 executive compensation program, with specific focus on what temporary changes that have been made to the compensation program in response to COVID (e.g., wider performance ranges) versus changes that have been made that may be more enduring or permanent (e.g., introduction of ESG metrics). This can usually be done in summary form on a slide or two to give the Committee an opportunity to review everything in one place, at the same time.

Metrics, Including ESG: ***How can non-financial goals be included in the company’s incentive plan?***

This is not a new topic for Committees to be considering - social unrest in 2020 brought these goals, particularly diversity and inclusion, front and center with many Committees. Activist investors have made a push for inclusion of these goals in 2021. However, companies are still identifying the best way to measure these goals and how to tie them to investor experience. The discussion this year may not just be about whether these goals should be incorporated into the incentive program, but whether they are better used as short-or long-term goals. Although a minority practice, some companies have “dipped their toe in the water” by establishing an ESG modifier to the current incentive plan. Many companies will be reviewing public disclosures this year to see how other companies are incorporating these goals into their programs.

Goal-Setting: *Are threshold and maximum goals aligned with the probability of occurrence?*

Historically many companies have used a symmetrical payout curve to determine threshold and maximum performance levels. For example, 90% of the performance target would result in a threshold payout and 110% achievement of the performance target would result in maximum payout. However, this program does not take into account the probability of achieving these levels, and for many companies the uncertainty related to the pandemic made many companies rethink static and symmetrical performance ranges. For many companies, especially in 2021 with uncertainty still a concern, it is unlikely that achieving 90% of the performance goal is equally as likely as achieving 110% of the goal. Narrowing in on the likelihood of performance outcomes above and below target will produce a more effective incentive program with outcomes better aligned with actual performance.

Time Horizon of Long-Term Incentive Plans: ***Should vesting of time- and performance-based awards be extended beyond 3 years?***

As prevalence of stock options has reduced in prevalence from 61% to 36% in the last 10 years, executive awards that extend beyond the three year program of restricted stock awards (time or performance vested) has diminished. Some shareholder groups have been pushing for performance periods that extend beyond three years. However, the already difficult challenge of establishing a three year goal has become harder in the last 12 months. Committees may be faced with balancing the ability to set multi-year performance goals with the shareholder push for a longer time horizon on these awards. As a result, some Committees may consider extended additional vesting following a typical 3-year performance period or even reintroducing stock options to increase retention and to align executives with longer-term strategic goals of the company.

Retention: *How can we retain executives as marketplace opens up?*

Committees should review current programs to ensure sufficient retention is in place for key talent. While some companies are considering retention awards, there are other ways to enhance retention without making a special award which is often received poorly by shareholders. Some examples include:

1.) Bring target pay to market or slightly above to convey value to executive, particularly LTI values which have the most retentive value.

2.) Confirm severance program is competitive with market such that an involuntary termination will provide reasonable form of financial security for the executive.

3.) Review unvested holdings that executive currently has and determine if there is a significant vesting event at which point the executive may be more “at-risk.” This is especially true for companies who have multiple cycles of “blown-up” performance plans.

4.) Review retirement programs and deferred compensation arrangements that may be at-risk upon termination or subject to substantial tax consequences.

While these issues may relate to some aspects of committee discussions we expect to see in 2021, not all of these will necessarily result in plan changes. Considering peer trends is also an important aspect of informed Committee decision making, however, market information is just one of many perspectives that are pertinent to making these important decisions.