EXECUTIVE COMPENSATION

Equity Incentive Pay Issues in a Down Market

By Bob Romanchek and Adam Hearn

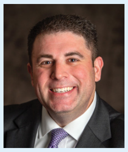
Uncertainty can have a strong negative impact on stock market performance. There are a number of catalysts that have greatly increased the level of uncertainty in recent months, including, but not limited to, the lingering impacts of the COVID-19 pandemic, supply chain disruptions, rising interest rates, and near-record levels of inflation over a very short period paired with a tapering of US government bond-buying. Serious global conflicts between major world powers add to this uncertainty. The stock market has reacted in kind, down materially since the start of 2022.

PROXY ADVISORY FIRMS START THEIR ANALYSES WITH QUANTITATIVE TESTS, ONE OF WHICH COMPARES CEO PAY TO THE MOVEMENT IN STOCK PRICE. IF STOCK PRICE DECREASES AND EXECUTIVE PAY INCREASES, THERE MAY BE A SUFFICIENTLY SERIOUS PAY MISALIGNMENT THAT RESULTS IN A "NO" VOTE RECOMMENDATION ON SAY ON PAY.

A down stock market translates to lower stock prices within executive pay programs. Stock-based long-term incentives are the largest pay component for top executives at most major public companies. These equity-based incentives attract and retain executive talent, create important links between executive pay and shareholder value creation, and can engender a focus on a company's important strategic goals. However, when the stock price decreases materially over a prolonged period, significant issues will arise in the following areas, requiring careful thought and planning:

- **Share pool usage.** All compensatory equity grants must come from a shareholder-approved pool. The number of shares that are available in this pool is fixed, regardless of changing stock price; a lower stock price means that companies are forced to use more shares to grant the targeted economic value from a share pool that itself is worth less overall. The obvious result is that the share pool will dry up much more quickly than otherwise expected, regardless of the long-term incentive vehicle that is used. In this case, companies may be forced to shift temporarily to cash-based vehicles or go back to shareholders sooner than expected to replenish the pool.
- **Choice of vehicles.** There are three general categories of long-term incentive vehicles. With lower share prices, restricted stock units are still effective in providing important retention incentives, but more shares will be required to maintain the specified grant value. Meanwhile, stock options may not encourage the desired focus on generating upside movement in stock price when the share price drops below the fixed exercise price for a material time period. Performance share units, with common relative total shareholder return goals, may yield illogical results, as companies may find themselves paying out incentives for "less-negative" share price performance compared to peers.
- **Executive and outside director stock ownership guidelines.** These policies typically require executives and outside directors to hold a targeted value of company stock, not a fixed number of shares. Thus, when stock price materially decreases, executives may find that they are no longer fulfilling their share ownership guidelines, even if they were previously in compliance at higher share prices.
- **Proxy advisory firm say-on-pay tests.** To formulate their recommendations on the annual say-on-pay vote, proxy advisory firms start their analyses with quantitative tests, one of which compares CEO pay to the movement in stock price. If stock price decreases and executive pay increases, there may be a sufficiently serious pay misalignment that results in a "no" vote recommendation on say on pay.

Boards should consider the impact of potentially sustained declines in share price when evaluating their companies' executive compensation programs and, in particular, their equity-based incentive plans. These impacts go beyond the issue of delivering lower pay value. D

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