"The Top Compensation Consultants Speak"

Thursday, May 16, 2024

Course Materials

<u>"The Top Compensation Consultants Speak"</u>

Thursday, May 16, 2024

2 to 3 p.m. Eastern [archive and transcript to follow]

Our annual webcast focusing on what compensation committees should be learning about — and considering — today. Join these experts:

- **Blair Jones**, Managing Director, Semler Brossy
- **Ira Kay**, Managing Partner, Pay Governance
- **Jan Koors**, Senior Managing Director and Western Regional President, Pearl Meyer

Among other topics, this program will cover:

- Year 2 of Pay vs. Performance
- Incentive Plans — Setting Goals and Considering Adjustments
- Trends in Strategic and Operational Metrics
- Clawback Policies — What HR Teams and Compensation Committees Are Focusing on Now
- Human Capital Management — Recent Considerations and Disclosure Trends
- Director Compensation Today

<u>“The Top Compensation Consultants Speak”</u>

Course Outline/Notes

1. Year 2 of Pay vs. Performance

2. Incentive Plans — Setting Goals and Considering Adjustments

3. Trends in Strategic and Operational Metrics

4. Clawback Policies — What HR Teams and Compensation Committees Are Focusing on Now

5. Human Capital Management — Recent Considerations and Disclosure Trends

6. Director Compensation Today

<u>"The Top Compensation Consultants Speak"</u>

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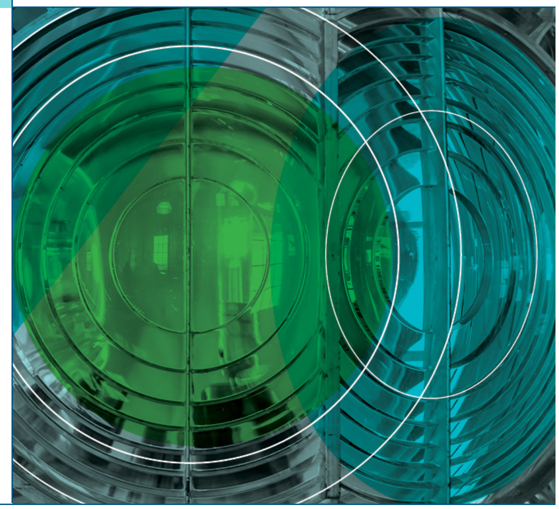

Enhancing Investor Confidence:

THE IAC'S PUSH FOR COMPREHENSIVE HCM DISCLOSURE

NOVEMBER 2023

Blair Jones

Michelle Garrett

Based on letters to the Securities and Exchange Commission (SEC), investors have been asking for more detailed human capital disclosures since at least 2017.

But it wasn't until August 2020 when the SEC made considerable changes to required disclosure of human capital matters under Item 101 of Regulation S-K. While this update expanded requirements to include human capital risks and resources, it fell short of investors' previous calls for clarity, specificity, and thoroughness. In fact, professors at the University of Waterloo[1] conducted a study in 2022 that found the SEC's newly introduced principles-based rule was unlikely to generate human capital disclosures sufficient to investors' needs. The same study showed that current rules did not yield the more specific, quantitatively-backed disclosures that investors had been seeking.

Investors also indicated to the Financial Accounting Standards Board (FASB) an interest in more detailed disclosure data on the cost of sales along with selling, general and administrative expenses that would enhance their comprehension of a company's cost framework and their ability to predict future cash flows. In July 2023 the FASB issued its own proposal requiring companies to reveal employee compensation costs included in the income statement.

[1] *The University of Waterloo used textual analysis to extract the linguistic features and numerical intensity of human capital disclosures for more than 3,600 public companies. The public companies were all filers of 10-Ks and reporting for the first time under the new regulation since enactment on November 9, 2020, through to early November 2021.*

In response to investor concerns, the SEC Investor Advisory Committee (IAC) (a specialized body comprised of experts across law, finance, and academia whose input helps inform the SEC's rulemaking and practices) drafted a separate proposal in September 2023 that aims to further improve human capital management (HCM) disclosures.

In this article, we will explore the IAC's recommendations, why they could be a big deal for investors, and questions boards can ask to prepare for these potential changes.

IAC's Recommendations for Strengthening HCM Disclosures

1 **Detailed Employee Breakdown:** The IAC argues that existing disclosures are inefficient and inconsistent, as they often omit international workers and frequently overlook contingent labor. The IAC proposes that the SEC requires companies to disclose the number of employees, categorized as full-time, part-time, or contingent workers.

RELEVANCE TO INVESTORS: This breakdown offers investors valuable context regarding workforce composition and changes. For instance, it helps in identifying unusual changes in the number of employees as potential indicators of financial inaccuracies or shifts in demand for a firm's products. In addition, the transition of a significant number of employees to part-time roles can signal a decline in operations, whereas the prevalence of independent contractors offers valuable insights into organizational model choices.

2 **Turnover Metrics:** The IAC emphasizes the financial importance of disclosing turnover metrics and the potential for numerical comparability across companies as a metric for human capital and workforce stability.

RELEVANCE TO INVESTORS: According to a study by Morgan Stanley Investment Management[2] and another by university academics[3], turnover is directly linked to financial performance, with higher retention rates associated with higher stock returns. The Morgan Stanley Investment Management study specifically found that companies with better retention saw 25% higher cumulative stock returns. Conversely, higher turnover can negatively impact profitability and incur substantial replacement costs.

3 **Comprehensive Workforce Cost Breakdown:** Human capital expenditures aren't broken out in the income statement. To help investors assess the efficiency of each dollar invested in human capital, the IAC suggests disclosing the total cost of the issuer's workforce, broken down into major compensation components—salary, equity, etc.

RELEVANCE TO INVESTORS: Labor costs often represent a significant operating expense, particularly for companies with many knowledge workers. However, labor costs are rarely disclosed. This lack of transparency makes comparisons across companies challenging. Disclosure of workforce costs would help investors understand these costs, assess the effectiveness of human capital investments, and evaluate organizational choices. This information could then help investors determine how a company's investment in its workforce could be integrated into its models.

[2] *Using monthly captured employer data from over 300 million employees between 2011 and 2022, Morgan Stanley Investment Management partnered with MSIM Data & Analytics and Morgan Stanley Artificial Intelligence Center of Excellence Teams to conduct systematic analysis of nearly 2,000 publicly traded companies that included identifying a correlation between retention and stock returns.*

[3] *Academics from Hong Kong Polytechnic University, the University of California, Irvine, and the University of Illinois at Chicago analyzed turnover and the return on assets quarter after quarter at over 3,600 firms between 2008 and 2018.*

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4 **Workforce Demographic Data:** The IAC contends that current disclosures are often generic, qualitative, and varied with respect to the level of detail. Instead, the IAC calls for companies to provide "decision-useful" workforce demographic data, including diversity at senior levels.

RELEVANCE TO INVESTORS: Data on diversity at every organizational level can assist in evaluating talent pipelines and gauging the effectiveness of diversity, equity, and inclusion (DE&I) efforts.

How Boards Can Get Ahead of Potential New HCM Disclosures

The IAC's recommendations represent a significant step forward in improving HCM disclosures, allowing investors to make more informed decisions. While we don't know if these specific requirements will be adopted into an SEC proposal and final rule, companies can begin thinking about how to collect and present the data sooner rather than later and start the discussion with their boards. Below are some questions boards can ask now.

1 **Do we have the right data?** Companies will need robust data collection systems to accurately gather and report the required HCM metrics. This may involve collaborating with HR, finance, and business unit leaders to ensure data accuracy and consistency.

2 **Does our organizational model tell a story that makes sense? Where might we need to fill in the blanks?** Are there weaknesses that our organizational model exposes? For example, a company that hires contractors as associates will look different than one that employs store associates full-time.

3 **Where are we experiencing the worst turnover and the best retention?** How does turnover compare to peers? What are the key factors in both turnover and retention? Does the turnover reflect any business vulnerability that will need to be discussed with investors?

4 **Where are the biggest sources of human capital costs and do they align with the business strategy and the parts of the organization the company should be investing most in?** With greater transparency into workforce costs, companies need to continuously evaluate the return on investment in human capital.

5 **Are our current DE&I efforts enough? Are we seeing good progress year-to-year?** Some companies may want to strengthen their efforts to improve diversity and inclusion, as this information will be increasingly scrutinized by investors. However, companies should consider the potential legal pushback that intensifying DE&I efforts could cause following the Supreme Court's decision to overturn affirmative action in college admissions. DE&I programs not tied to strategy or specific outcomes could become an easy target for legal challenges, so companies should consider seeking legal advice when navigating DE&I-related issues and opportunities.

6 **When we look at all the data in its entirety, will the market understand how our HCM practices align with our business strategy? How do we communicate this to investors?** Boards can engage in discussions on the strategic alignment of HCM practices with overall business objectives. Understanding how labor costs are viewed as investments in growth or operational maintenance is critical. Finally, companies should be prepared to address inquiries and provide context for their HCM data.

The need for greater HCM transparency is expected to rise, especially as intangible assets play an increasingly pivotal role in the valuation of public companies. While there may be some reluctance from boards to disclose more data, the benefits of fostering strategic discussions on these matters could outweigh concerns about the burden of additional disclosure. To start, boards can engage management to ensure the company proactively prepares for potential changes to meet regulatory requirements and enhance its strategic approach to HCM.

Given the tight timeline for implementing Pay vs. Performance disclosures for this past proxy season, we suggest companies be prepared for a potentially short turnaround time if the SEC proposes rules that are finalized and implemented. There should be additional guidance in 2024 as proposed rules are developed and comments come in. Therefore, boards are likely to have ample time for preparation, as the potential timeline for implementation will likely be in 2025. Even if these don't become the final rules, the strategic conversations prompted by this exercise will still be important. ■

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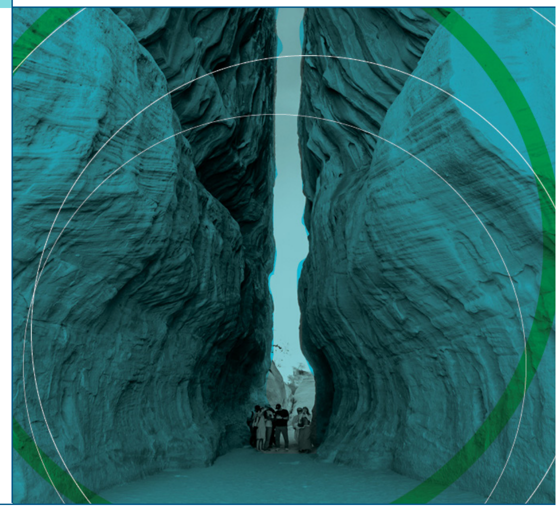
ESG & Human Capital Management



The State of ESG Goal-Setting:

EXPLORING THE GAP BETWEEN PREVALENCE AND PUBLIC DISCLOSURE

OCTOBER 2023

The following information is intended to provide market context on ESG goal-setting practices and our thinking on key drivers of these market trends. This may be a helpful resource for companies evaluating their own disclosure practices regarding ESG metrics in incentives.

John Borneman
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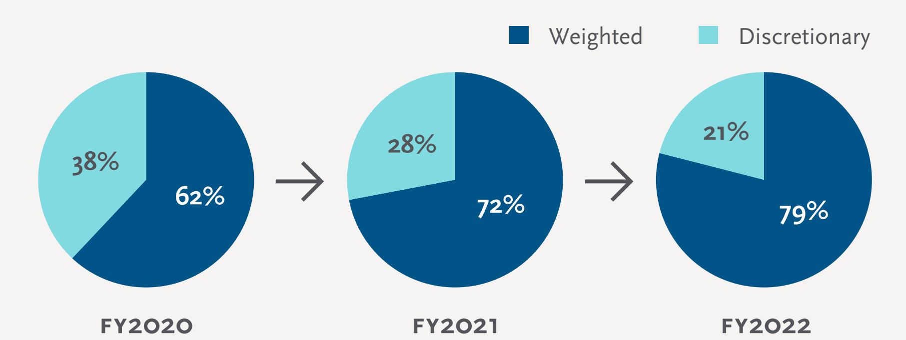
Jay Veale
Cecilia Miao
Anjani Trivedi
Jennifer Teefey

ESG metrics are increasingly prevalent in incentives, but disclosure has not kept pace.

In recent years, the prevalence of ESG metrics in executive compensation design has expanded. 72% of the S&P 500 companies include ESG metrics in their incentive plans, up from 70% last year and 57% the prior year. The implementation of ESG metrics has also shifted over time towards more formalized, weighted inclusion in plans such as discrete weighted goals and modifiers, away from discretionary measurement approaches.

Fig. 1. Year-over-Year Metric Structure



Weighted approaches includes discrete weighted, scorecard, and modifier structures
Data provided by ESGauge

Although the use of ESG incentive metrics is maturing, public disclosure regarding specific metric goals in incentives is still limited. Companies employ a range of disclosure strategies that vary based on the type of metric, its structure in programs, and whether the metric goal is measured quantitatively or qualitatively. Most companies do not disclose ESG-related goals in proxies. Among those that do, disclosure practices range from providing full details on the leverage of a specific ESG metric (i.e., threshold, target, and max performance goals) to limited disclosure of performance highlights against specific metrics achieved during the year.

According to our research, most companies with ESG metrics in their incentive plans (67%) do not disclose any detail on specific performance goals for their ESG metrics. Of these companies without detailed disclosure, 53% reveal key performance highlights achieved during the year in lieu of specific goals, while the other 47% do not provide any specific information on ESG-related goals or performance.

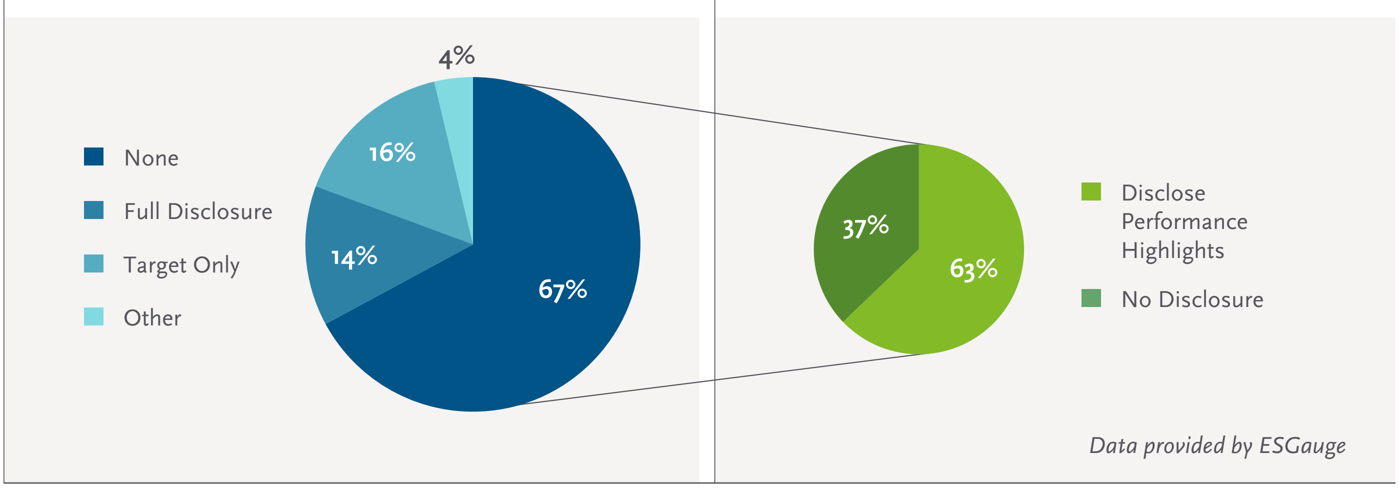
Of the 33% of companies that disclose specific ESG metric goals, practice is split between disclosing full details on the leverage of a specific ESG-related goal vs. disclosing some part of the leverage curve (e.g., target, threshold, max, or some subset of the three). Companies that disclose full details on the leverage of a specific ESG-related goal usually employ a quantitative goal. This disclosure may follow practice, as many companies do not assess ESG in a fully formulaic way and may allow for a degree of discretion in assessing performance around a 'target' goal.

Not surprisingly, details on ESG metrics and goals are most commonly disclosed at companies that have a discrete, weighted component of their incentive plan tied to ESG metrics. 77% of companies with this design for ESG disclose either full or partial details on the quantitative goals and performance. However, only 26% of companies have a discrete, weighted metric tied to ESG, so this remains minority practice.

Metrics included in scorecard, modifier, and discretionary structures in incentives are less likely to have associated goal disclosure than weighted individual metrics because these structures are more commonly measured with more judgement and discretion applied. Again, not surprisingly, the more qualitative the measurement framework the less detail that is provided. Companies that employ ESG metrics in a discretionary format only disclose any information about goals 6% of the time, while companies that employ ESG metrics in a scorecard or modifier format disclose information on goals 19% and 16%, respectively.

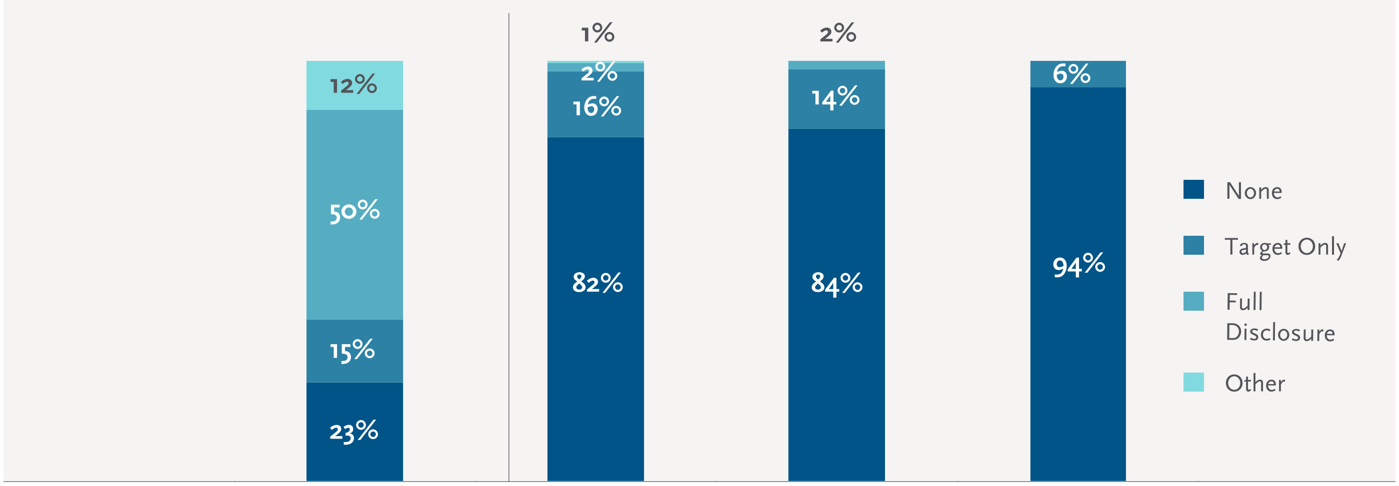
Fig. 2.
Goal Leverage Disclosure Prevalence in S&P500[1]

Performance Disclosure Amongst Companies with No Goal Disclosure



[1] *Source: The four categories of goal leverage disclosure are defined as the following: (i) Full Disclosure–discloses threshold, target and maximum goals; (ii) Target Only–discloses only target (neither threshold nor maximum goals); (iii) Other–discloses threshold, target and/or maximum goals alone or in combination, while not classified as Full Disclosure or Target Only; (iv) No Disclosure–does not disclose any threshold, target or maximum goals.*

Fig. 3. Goal Leverage Disclosure per Metric Structure by Company



	Discrete Weighted	Scorecard	Modifier	Discretionary
S&P500 Prevalence	**26%**	**40%**	**14%**	**21%**
Metric Structure Definition	ESG is incorporated in incentives through specific metrics, each of which has its own discrete weighting.	Metric grouping is weighted and assessed as part of a broader scorecard of ESG/ business priorities.	ESG metric(s) can adjust the overall plan payout by a specified amount.	ESG is included as a layer of discretionary considerations, often individual, that may impact payouts.

Data provided by ESGauge

Why is there a lack of goal-setting disclosure?

Shareholders and other constituents might want more detail around ESG goals in incentive plans. However, companies might limit goal-setting disclosure for three main reasons:

1. **Manage Social & Legal Risk:** Detailed public disclosure of ESG goals carries significant social and/ or legal risk. For instance, underperformance on publicly disclosed diversity, equity, and inclusion (DE&I) goals may lead to external and/or cultural backlash. Sensitive to external signaling, many companies are "greenhushing" and erring on the side of caution when it comes to what information they disclose. The recent Supreme Court decision on Affirmative Action in higher education has further sparked concerns about disclosing ESG goals given the increased litigation risk associated with DE&I politicization. Companies value flexibility as they manage social/legal risks while focusing on advancing their ESG agenda and meeting shareholder and customer expectations.

2. **Limited Performance Measurement Capabilities:** Due to increasing external shareholder pressures over the last few years, many companies quickly adopted ESG into their incentive plans before they had the measurement and tracking capabilities to assess performance quantitatively or set explicit improvement objectives. Some companies are still in the process of defining success (i.e., what is "good" performance), and learning how to evaluate performance most effectively with limited ESG market data. It is difficult to develop performance

measurement systems for qualitative objectives and discretionary evaluation; consequently, the absence of a good measurement system will make it hard to define tangible goals.

3. **Desire to Maintain Flexibility:** Many companies are still in the process of determining which ESG goals are most important to their overall business and may not be prepared to publicly commit to key performance goals. Given the dynamic nature of ESG issues, companies can benefit from maintaining flexibility in which metrics they choose to focus on each year. In addition, even with clear goals and commitments, companies may hesitate to define success by just one or two metrics. Many companies, for example, are genuinely more concerned about creating a culture of inclusion that supports a diverse workforce, rather than just measuring diversity directly, and such assessments do not always lend themselves to explicit, quantitative goals.

In addition to the above factors, the SEC's disclosure requirements allow limited disclosure in some contexts. For instance, qualitative goals don't require disclosure unless the metrics are material to the company's compensation policies and decisions, and companies may limit disclosure of internally managed metrics that may cause the company "competitive harm."

We are hearing reports that shareholders are questioning the commitment to ESG due to limited disclosure. There is a suspicion that ESG metrics in incentives are meant as a form of 'greenwashing' and/or are just another qualitative goal that may be used to drive pay without a clear performance link. This growing demand for more detail may push companies toward more explicit measures, goals, and disclosure over time.

However, given the factors outlined above, we anticipate that the pace of change toward more detailed and explicit goals and objectives may continue to be muted, especially considering concerns over the politicization of ESG in the U.S. In our experience, a lack of goal-setting disclosure does not necessarily indicate a lack of rigor in a company's ESG metric goals. Rather, companies have often set meaningful goals internally that are intended to drive performance against specific ESG objectives. Companies will be challenged with the need to continue telling their story on ESG compellingly, even if they are not moving toward more explicit objectives in their incentive plans.

As always, linking ESG objectives and achievements back to the fundamental business rationale (why we are doing this in the first place) is always the strongest starting point for expressing and maintaining a company's commitment to ESG, regardless of how this is implemented in incentives. ■

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With Ambiguity Comes Opportunity:

AFFIRMING DIVERSITY, EQUITY, AND INCLUSION STRATEGY AND MEASUREMENT

AUGUST 2023

Blair Jones

Austin Vanbastelaer

Michelle Garrett

The recent Supreme Court decision in *Students For Fair Admissions, Inc. v. President and Fellows of Harvard College* to overturn affirmative action in college admissions has sparked concerns about potential challenges to companies prioritizing diversity, equity, and inclusion (DE&I). According to Semler Brossy, 55% of the companies in the S&P 500 have DE&I metrics in their executive incentives, prompting executives, board members, and legal experts to question how *Students for Fair Admissions*, and increased politicization of DE&I initiatives at large, might impact their companies.

While we don't anticipate immediate clarity on these questions, we see this as an opportunity for companies to reflect on their DE&I policies, practices, and metrics to ensure they align with business and communication strategies.

What Is the Business Case for DE&I Initiatives?

Companies that have advanced their DE&I efforts in the talent management and executive compensation spheres inherently believe that these policies and practices maximize long-term business performance, often referred to as "sustainability." This conviction is supported by numerous studies, including several by McKinsey & Company. Though many "unknowns" remain on where the DE&I conversation will move in the political and judicial systems, companies can proactively use the current moment to clarify the purpose of their DE&I initiatives and their ties to strategic business objectives and sustainability. This is particularly true of companies with DE&I-related metrics in their compensation programs.

As a starting point, companies could take a fresh look at the motivation for their DE&I-related initiatives to ensure that: (i) they clearly tie to an overarching business objective such as sustainability and (ii) the initiatives are communicated within these objectives. The "on the ground" business case for DE&I can take several forms, for example:

- The broadest possible talent pipeline allows companies to find the highest caliber of talent which adds the most value to their services or products (almost all industries could fit into this grouping).
- A company's workforce needs to broadly reflect its customer base to understand its end-users and how they will engage with its product (relevant industries may be consumer products companies, healthcare providers, automotive manufacturers, etc.).
- A company's ability to serve its clients is enhanced if it can meet them "where they are" and for who they are (relevant industries may be software services, banking, pharma, etc.).
- A company's high-performing employee hire and retention rates will increase if its culture is inclusive and representative of all communities and geographies in which it operates.

What Is the Appropriate Framework for Measuring DE&I Success?

Currently, there is a risk that Students for Fair Admissions opens the door for analogous cases against companies under Title VII (which protects employees and job applicants from employment discrimination based on race, color, religion, sex, and national origin). Also at stake, regardless of legal arguments, is reputational harm that could come from increased interest in DE&I-related initiatives and issues. The possibility of these cases, and the very immediate risks that the politicization of DE&I initiatives pose, create an opportunity for boards and management teams to step back and consider the efficacy of their measurement approaches and alignment of DE&I metric selection with their newly-clarified DE&I strategy.

The metrics below could work well to incentivize collaborative and dynamic talent environments through different channels. These metrics may also be appealing to companies that will be introducing DE&I-related metrics into their incentive programs for the first time or for companies that want to take a cautious approach to measurement in light of the uncertain legal and social environment surrounding DE&I:

- Metrics Incentivizing the Building of a Diverse Talent Pipeline: percentage of hiring slates with diverse candidates, economic diversity of schools/areas from which it hires, "return" on investment into local underserved areas (e.g., through job training, etc.), geographic background of candidates, social mobility of workforce, etc.
- Metrics Incentivizing an Inclusive Culture: employee engagement (generally), "inclusiveness" score within engagement surveys, percentage of employees who believe rewards align with job performance, etc.

We suggest maintaining a constant pulse on the framework for measuring success against DE&I objectives, particularly as companies periodically revisit the purpose and grounding of these strategies. To supplement these pulse checks, companies should ensure they have comprehensive annual pay equity and hiring equity audits that identify and remedy structural biases in the recruiting and total rewards systems. As a part of this process, company leadership can commission a third-party audit on employee performance ratings relative to employee demographics to understand better whether biases exist. And, as always, internal and external legal counsel will be crucial to navigating DE&I-related issues and opportunities.

How Can Companies Optimize Communication of DE&I Initiatives?

The uncertainty surrounding the current DE&I environment, and the perceived stress it may place on a company's ability to nurture many of its core cultural values, create the need for clear and consistent communication of its DE&I strategy. Absent consistent communications, and clarifications where appropriate, employees may question whether companies will abandon initiatives that promote and support a safe, thoughtful, and high-performing work culture absent clarification. Investors and other stakeholders will want to know the rationale behind any pivots in DE&I strategy and how these pivots best support the business's long-term health. So how does a company effectively communicate its strategy across these stakeholders?

We suggest as a general principle that companies ground their DE&I-related efforts in the "business case" in both external and internal communications to make the importance of these efforts resonate with all stakeholders. At the end of the day, a company's strategy and its prosperity are inextricably linked. This remains true when discussing DE&I-related strategies. As a result, we suggest that companies remain transparent in their affirmation of their DE&I strategies and the related implementation of these strategies. Anchoring to one or more of the illustrative business cases above can help create consistent language for addressing various stakeholders when discussing the direction a company is taking. This approach can also provide investors with greater insight into the importance of the company's talent investments and approach to human capital management at large.

For internal communications, crystallizing the "how DE&I impacts us" part of a company's story is critical. This messaging can help personalize the topic and directly illustrate how the team's efforts will contribute to the enterprise's success. We also suggest that companies highlight the desire among employees for fair, equitable, and diverse workplaces, which are typically captured in employee engagement surveys and other forums (e.g., exit interviews, the talent acquisition process, etc.). Companies can also highlight that efforts to increase employee engagement and hire the best candidates from the broadest possible talent pool create meritocratic opportunities for all to win together (rather than creating a "zero-sum" system with winners and losers). This internal forum might also provide periodic opportunities for more fulsome discussions about the company's cultural values and how DE&I-related strategies uphold those principles.

We suggest as a general principle that companies ground their DE&I-related efforts in the "business case" in both external and internal communications to make the importance of these efforts resonate with all stakeholders. At the end of the day, a company's strategy and its prosperity are inextricably linked.

Public companies can also consider with outside legal counsel whether talent-related risks, including those involving DE&I issues, ascend to levels warranting reporting in the risks section of the annual 10-K, which is another opportunity to engage with investors on the topic.

The current legal uncertainty and politicization surrounding DE&I present a good opportunity for companies to revisit their DE&I efforts to ensure alignment with their business strategy and employee value proposition. Many of today's DE&I strategies and practices were implemented just before or in the early days of the Covid-19 pandemic. But many things have since changed since then: the legal context surrounding DE&I has evolved with the increasing likelihood of legal challenge and the related reputational impact, regardless of the outcome, as have companies' talent-related challenges (e.g., deciding on "return to office" or "hybrid working" rather than "work from home" policies), and investor preferences. Companies cannot resolve the legal uncertainty and political challenges surrounding DE&I in their employment practices and incentive plans. However, they can use these uncertainties as a catalyst for a constructive discussion around the efficacy of their existing programs and initiatives and whether any changes are warranted as matters unfold. ■

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Viewpoint on Executive Compensation

UTILIZING COMPENSATION ACTUALLY PAID TO EVALUATE PAY AND PERFORMANCE

IRA KAY, MIKE KESNER, LINDA PAPPAS, AND ED SIM

Does the SEC's new Pay Versus Performance (PVP) disclosure provide an effective means to evaluate the alignment of pay and performance?

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) required that companies disclose the relationship of PVP and granted the SEC wide discretion in promulgating the required disclosure. At the time, Congress acknowledged that the current disclosure rules, which included the Compensation, Discussion, and Analysis (CD&A) and Summary Compensation Table (SCT), did not provide shareholders with a sufficient understanding of the relationship of compensation and performance. While the CD&A and SCT provided better visibility to the rationale for — and components of — compensation, they did not illustrate the relationship between the pay decisions made in the reporting year with the subsequent performance of the organization.

The introduction of the PVP disclosure provides a more multidimensional view of pay relative to performance as it incorporates the impact of stock price and performance on equity awards in measuring compensation. At this point in the 2023 proxy season, thousands of companies have filed their proxy statements and spent countless hours preparing the new PVP disclosure, and many are now asking the question, *"Does the SEC's new PVP disclosure provide an effective means to evaluate the alignment of pay and performance?"*

Based on Pay Governance's analysis of 188 S&P 500 company PVP disclosures, *the answer is Yes.*

Various organizations and articles have utilized the newly required PVP disclosures in different ways, but many

Key Takeaways

Based on our analysis, there are several key takeaways that shareholders and companies may find of interest, including:

- CAP is more fit for purpose than SCT compensation disclosure for evaluating pay for performance.
- A relative rank analysis against a company's peer group or industry-specific index provides the most useful evaluation of the relationship between CAP and company performance.
- The number of situations where a company's compensation percentile rank significantly exceeds its TSR percentile rank drops dramatically when actual performance is considered when calculating compensation.
- Significant differentials in relative TSR and CAP rank may help identify competitive deficits/surpluses in total pay opportunities, competitive discrepancies with incentive design features, potential issues with performance metric rigor or alignment with shareholder value, etc.

concluded that compensation actually paid (CAP) and total shareholder return (TSR) are aligned.

While this was nearly a foregone conclusion given the large emphasis on stock-based compensation for executives, it should reassure shareholders that their strong support for Say on Pay over the last 13 years was well founded. In that sense, one could argue that the PVP disclosures were successful, and we certainly agree that CAP is much better than Summary Compensation Table Total Compensation (SCT compensation) when evaluating the alignment of pay and performance. What remains to be seen is whether and how Compensation Committees, shareholders, and proxy advisory firms incorporate the PVP disclosures when evaluating pay and performance.

Establishing the Approach: Using PVP and Company Performance to Determine Level of Pay and Performance Alignment

Prior to the introduction of the PVP disclosure requirement, SCT compensation has been the primary measure of compensation used by many investors, academics, the media, and, importantly, proxy advisory firms to evaluate the alignment of pay and performance, in part because the data was most readily available. However, SCT compensation is based on the Grant Date Fair Value of equity awards which means equity awards are not adjusted for changes in stock price and/or actual performance. This is in contrast with an outcomes-based valuation of equity awards, such as CAP, which reflects the change in value of equity awards until the vest date. *As a result, SCT compensation is not ideal for evaluating the relationship of pay and performance, as it provides a view into the accounting value of equity awards but not the actual performance-adjusted value of those awards, which is critically important when measuring pay for performance.*

Based on our analysis, CAP is better for alignment evaluation purposes than SCT compensation to facilitate a meaningful evaluation of the alignment of pay with performance if a comparison of the relative amount of a company's CAP is compared to its relative performance against an appropriate peer set.

While CAP amounts may be distorted (e.g., by the inclusion of equity awards granted prior to the performance period, use of the Black-Scholes value of stock options rather than the in-the-money value of such awards, and exclusion of cash long-term incentive plans until the year the award is earned, among others), they reflect the actual or best estimate of the value of equity at the time of disclosure versus the accounting value of equity at the time of grant. Further, the use of relative percentile comparisons against a peer index or peer group can remove some of the noise in these data.

To demonstrate how to analyze pay and performance using the PVP disclosures, the following approach was utilized:

- Compared a company's percentile ranking of cumulative CAP and cumulative TSR against companies in their 2-digit GICS® Sector.
- Included only companies with revenue between the 25th and 75th percentiles to eliminate the potential effect of exceptionally large or small companies in the analysis.
- Used cumulative figures over a 3- and eventually 5-year period to minimize the impact of outliers, transitions, and other CAP anomalies.

Assessing the relative positioning of CAP and performance using percentile rankings against a relevant peer or industry group demonstrates if a particular company's pay and performance alignment is commensurate, better, or worse than peers. This type of relative analysis is consistent with how Pay Governance typically evaluates Realizable Pay and performance alignment for our clients. For additional valid methodologies for evaluating and confirming the alignment of pay and performance, see our Viewpoints, Demonstrating Pay and Performance Alignment: A Comparison of Compensation Actually Paid and Realizable Pay and What Shareholders Can Learn from the SEC's New Pay Versus Performance Disclosure, which compare, respectively, changes in CAP to changes in TSR and key differences between CAP and Realizable Pay.

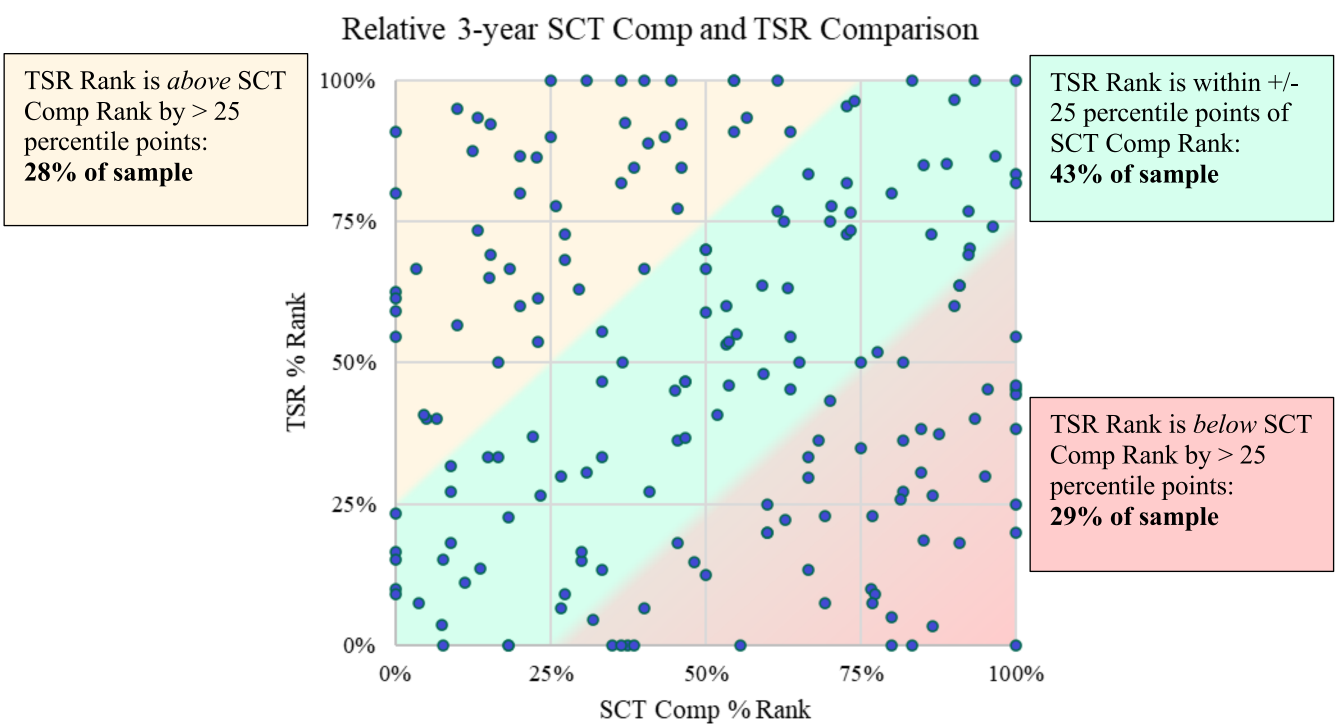
Analysis

SCT Compensation

Figure 1 below is based on 188 S&P 500 companies and plots each one based on their difference in percentile ranking of 3-year cumulative TSR and 3-year cumulative SCT compensation. The three-shaded areas represent companies where relative TSR performance and SCT compensation percentile ranking are within 25 percentile points (green zone), TSR percentile ranking exceeds SCT compensation ranking by > 25 percentile points (yellow zone), and TSR percentile ranking is below SCT compensation ranking by > 25 percentile points (red zone).

- As shown, only 43% of the companies have a TSR rank that is within +/- 25 percentile points of the SCT compensation rank (green zone), which suggests a minority of companies have aligned pay and performance.
- The remaining 57% of the companies fall in the yellow or red zones, where the TSR rank either exceeds or is lower than the SCT compensation rank by > 25 percentile points, signaling a possible disconnect between pay and performance.
- The correlation between TSR rank and SCT compensation rank is low (0.08). *This is a strong indication that using SCT compensation for evaluating pay for performance has limited utility.*

Figure 1: Relative 3-year Cumulative SCT compensation versus 3-year Cumulative TSR (N=188 S&P 500 Companies)[1]



When the same analysis is performed using CAP rather than SCT compensation, the alignment of pay and performance improves dramatically as observed in prior Viewpoints and as shown in Figure 2 below.

- *The percentage of companies in the green zone increases from 43% to 66%. This model significantly reduces the number of "false negatives" by 43 companies, as SCT compensation is not aligned to stock price changes, but CAP is clearly aligned.*
- Correlation between TSR rank and CAP rank is high (0.54).

Figure 2: Relative 3-year Cumulative CAP versus 3-year Cumulative TSR (N = 188 S&P 500 Companies)[1]

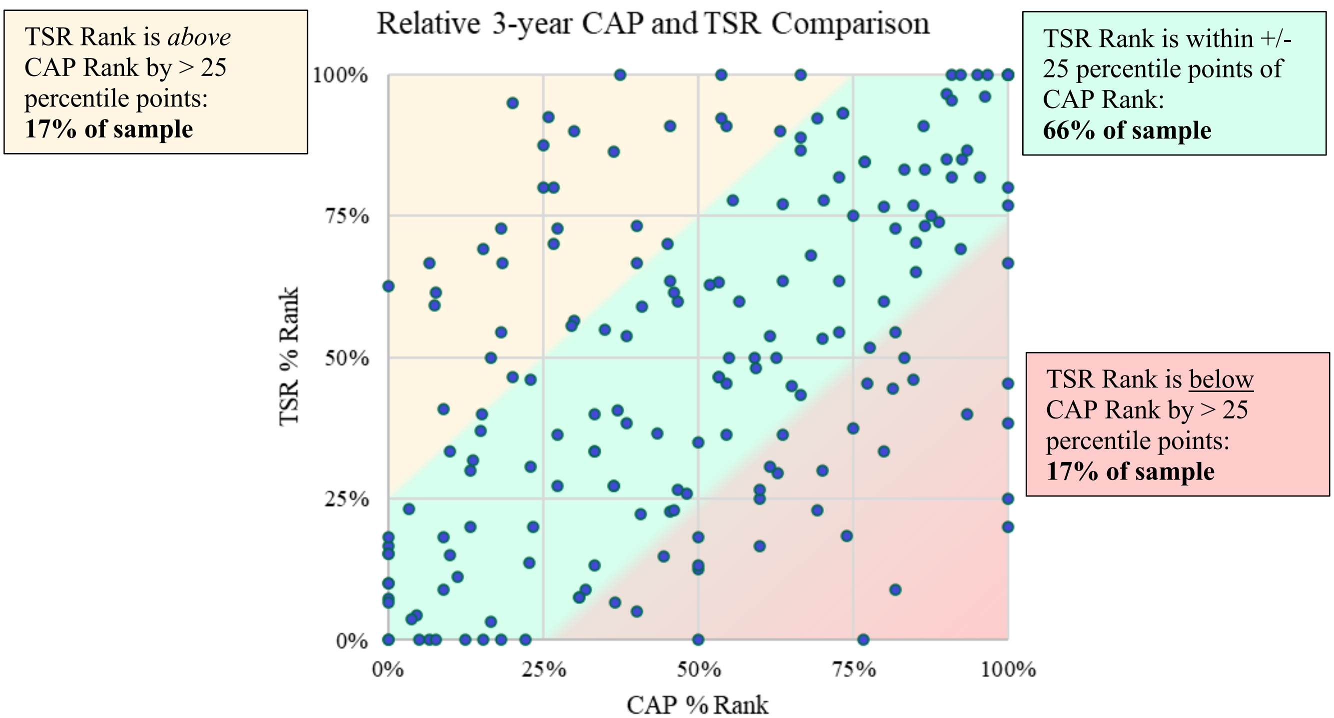


Figure 3 below focuses on the change in pay for performance alignment for the 28 companies in the Industrials sector using SCT compensation and CAP.

- The chart on the left (3a) shows the comparison of SCT compensation and TSR; the distribution is random, and correlation is low as observed in **Figure 1**.
- The chart in the middle (3b) shows how compensation percentile changes when using CAP instead of SCT compensation; arrows show the directional shift in SCT compensation rank to CAP rank.
    - The circled observation at the top of the middle chart highlights an Industrials Sector company in the sample with the highest relative TSR and SCT compensation at the 44th percentile, suggesting a misalignment of pay and performance. When CAP is used, the percentile ranking of TSR and CAP are both at the 100th percentile (highest performer provided the highest compensation), thus squarely in the green zone.
    - The circled observation at the bottom of the middle chart highlights an Industrials Sector company in the sample with the lowest relative TSR and SCT compensation at the 56th percentile (red zone). When CAP is used, the percentile ranking for CAP is reduced to the 22nd percentile, which is far more aligned with the company's TSR rank and is squarely in the green zone.
- The chart on the right (3c) shows the strong alignment of CAP and TSR among the Industrials Sector companies.
    - Overall, when using CAP instead of SCT compensation, 7 of the 28 observations (25%) move from outside the green zone (+/- 25 percentile points) to inside the green zone, while only 1 moves from inside the green zone to outside.
    - The total percentage of Industrials Sector companies in the green zone is 68% compared to 46% if using SCT.
    - 5 of the 28 observations (18%) do not change, meaning compensation percentile rank using SCT compensation and CAP are the same.

Figure 3: Illustrative Industry Sector Analysis of Relative 3-year Cumulative SCT compensation/CAP versus 3-year Cumulative TSR (N = 28 S&P 500 Companies in the Industrials Sector)[1]

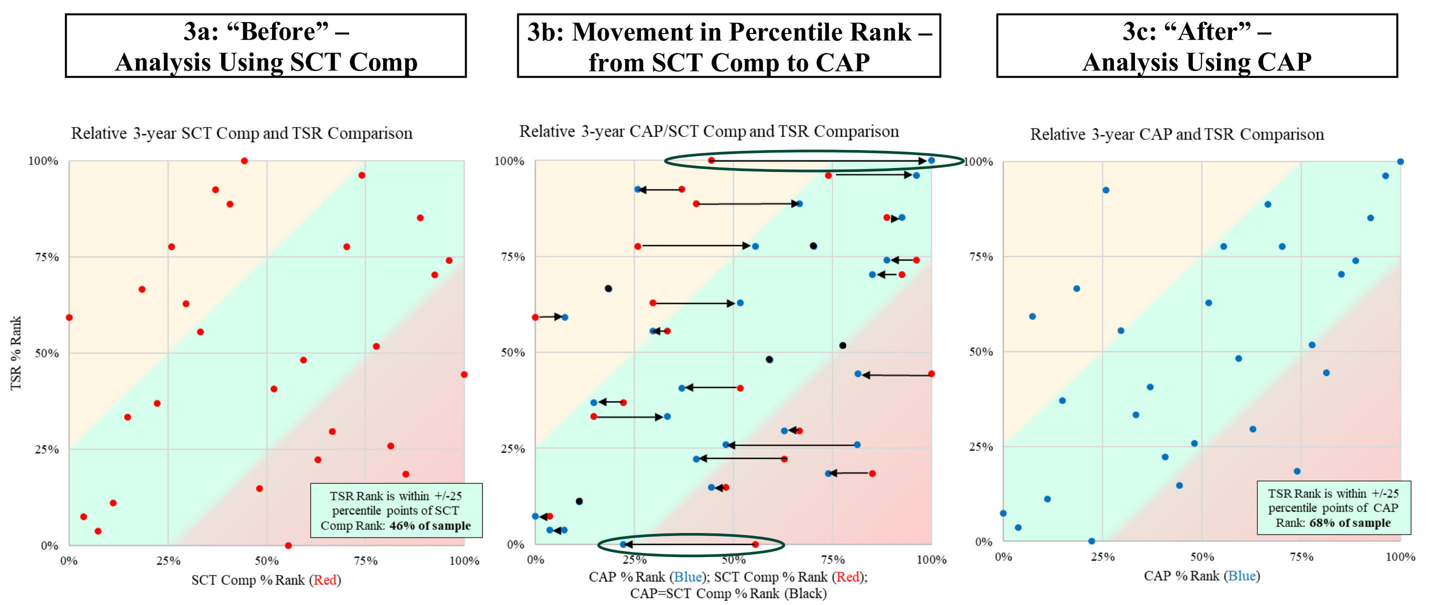


Table 1 below shows the distribution of compensation and TSR rank by Sector within the three zones of alignment: yellow zone where TSR rank exceeds compensation rank by > 25 percentile points, green zone where TSR rank is within +/- 25 percentile points of compensation rank, and red zone where TSR is below compensation rank by > 25 percentile points.

The percentage of companies identified in the red zone, where TSR is less than compensation rank by > 25 percentile points, decreases for all Sectors except Communication Services, which is likely due to the small sample size of seven companies.

A key takeaway of Table 1 for investors and others is the number of situations where a company's compensation percentile rank significantly exceeds its TSR percentile rank (red zone) drops dramatically when actual performance is considered in calculating compensation.

Table 1: Industry Sector Analysis of Relative TSR and CAP/SCT compensation Alignment

		3-year Cumulative SCT/CAP Comp and TSR against relevant Sector only (cut-off for companies with P25-P75 revenue)						
		Difference in % Rank: TSR-SCT **Comp**			Difference in % Rank: TSR-**CAP**			
Sector	**N**	+25 or more Percentile Points	**Between +/- 25 Percentile Points**	-25 or more Percentile Points	+25 or more Percentile Points	**Between +/- 25 Percentile Points**	-25 or more Percentile Points	Reduction of Companies flagged in the red zone (percentage points)
All Sectors	187	28%	43%	29%	17%	66%	17%	12%
Materials	12	25%	**42%**	33%	17%	**75%**	8%	25%
Health Care	23	30%	**39%**	30%	13%	**78%**	9%	22%
Information Technology	14	36%	**29%**	36%	14%	**71%**	14%	21%
Utilities	14	36%	**36%**	29%	14%	**71%**	14%	14%
Consumer Discretionary	21	29%	**38%**	33%	14%	**67%**	19%	14%
Real Estate	16	31%	**38%**	31%	19%	**63%**	19%	13%
Consumer Staples	9	33%	**22%**	44%	33%	**33%**	33%	11%
Industrials	28	25%	**46%**	29%	14%	**68%**	18%	11%
Financials	31	23%	**55%**	23%	19%	**65%**	16%	6%
Energy	12	25%	**50%**	25%	17%	**58%**	25%	0%
Communication Services	7	14%	**71%**	14%	29%	**43%**	29%	-14%

Conclusion, Implications and Considerations

A relative analysis of cumulative CAP and TSR against a company's peer group or industry sector can provide a more meaningful evaluation of pay and performance than comparing SCT compensation and TSR (or other industry specific performance measures).

For companies in the yellow zone, where TSR rank exceeds CAP rank by > 25 percentile points, it may signal:

- Pay opportunities/targets are low relative to peers
- Performance targets are more difficult than peers
- Incentive plans are less leveraged than peers
- TSR is performing better than incentive plan metrics

Companies in the yellow zone may want to further investigate the apparent pay for performance disconnect to ensure the company is not at a competitive disadvantage in retaining executive talent.

For companies in the red zone, where CAP exceeds TSR rank by > 25 percentile points, there may be several explanations, including:

- Pay opportunities/targets may be high relative to peers
- Pay mix may place less emphasis on equity incentives relative to peers
- Performance targets may be less rigorous than peers
- Incentive plans may be more leveraged than peers
- Actual performance against incentive plan metrics/incentive goals is not translating to share price performance

Companies in the red zone may also want to further investigate the apparent disconnect to ensure the company's pay levels and incentive plan design are appropriately rewarding their executive talent.

General questions about this Viewpoint can be directed to Ira Kay (ira.kay@paygovernance.com), Mike Kesner (mike.kesner@paygovernance.com), Linda Pappas (linda.pappas@paygovernance.com), or Ed Sim (edward.sim@paygovernance.com).

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[1] This study includes data provided to us by ESGAUGE of 389 S&P 500 companies that filed PVP disclosures as of May 31, 2023. The sample was divided into 11 industry sectors, which were further refined by removing companies with revenues in the bottom and top quartiles within each sector. Results of the full sample were consistent with the data utilized by the presented figures and tables.

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TRENDS IN S&P 500 BOARD OF DIRECTOR COMPENSATION

CLEMENT MA, LINDA PAPPAS, CHRISTINE SKIZAS, AND OLIVIA WAKEFIELD

Executive Summary

- Over the last three years, median S&P 500 pay level increases for non-employee directors of the board ("directors") have been minimal compared to prior years, with total cash compensation (TCC or cash retainers plus meeting fees) remaining flat, annual equity retainers up by +3%, and total direct compensation (TDC or sum of cash plus equity) up by +1%.
- When observed over the longer term, S&P 500 director TDC has increased +2% on an annualized basis since 2015.
- Structural director pay trends observed since 2015 include the decrease of meeting fee prevalence: used by 18% of the S&P 500 in 2015 compared to 9% as reported in proxy filings to date.
- Premiums for both Non-Executive Board Chair roles and Lead Director roles have also increased in prevalence and quantum since 2015, potentially indicating an increased emphasis of these roles on corporate governance matters.
- Of S&P 500 companies, 70% have established director pay limits with a median value of $750,000.

Introduction

Board of Director remit has expanded over recent years as outlined below. This has resulted in greater accountability and oversight for emerging areas of investor attention in addition to the corporate governance and fiduciary responsibilities to shareholders, community stakeholders, employees, and other key constituents, including:

- ESG issues
- Diversity, equity, belonging, and inclusion with requirements to analyze and report gender pay parity and pay transparency in select geographies
- Human capital, succession planning, and talent management
- Cyber security, digital, and privacy issues relating to artificial intelligence and machine learning

While the responsibilities of the Board continue to evolve and expand, director compensation increases have remained generally modest with a +1% annualized increase since 2020. Pay Governance reviewed non-employee director compensation levels for S&P 500 companies over the last three years using information within the most recent proxy disclosures.[1] Our observations generally reflect compensation for fiscal years 2020, 2021, and 2022. In addition, we compared 2022 director pay information to findings from 2015 from our previously published Viewpoint titled "Board of

Directors Compensation: Past, Present and Future" in an effort to identify long-term trends in both director pay levels and design.[2]

Key Findings & Trends

Over the last three years, median S&P 500 director pay levels have increased at a modest pace. Total cash compensation (TCC)—or the sum of Board and Committee member retainers and Board and Committee meeting fees—was flat, while annual equity retainers increased by +3% each year. Total direct compensation (TDC)—or the sum of total cash and equity retainers—increased by +1% on an annualized basis. When analyzing year-to-year trends, we observed a dip of -2% in median TDC in 2020 (as disclosed in proxy statements filed in 2021), followed by a rebound of +5% in 2021 median TDC and then a modest increase of +1% in 2022 median TDC. This likely reflects the impact of temporary COVID-related pay reductions many Boards elected to take during 2020.

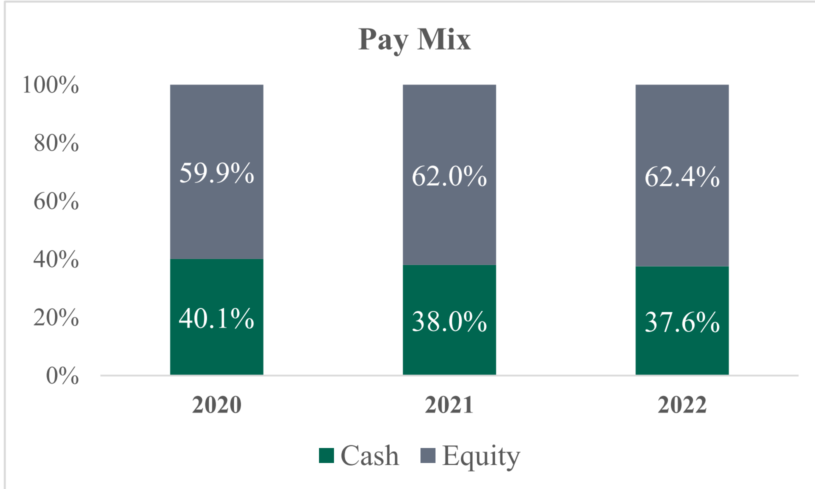
	% Change in Median		
Time Period	**TCC**	**Equity**	**TDC**
1-Year Growth:			
2019-2020	-3%	3%	-2%
2020-2021	1%	3%	5%
2021-2022	2%	3%	1%
3-Year Annualized Growth:			
2019-2022	**0%**	**3%**	**1%**

When we take a longer look back at historical director compensation levels, the trend is consistent with our more recent observations. Since 2015, median TDC increased by +2% on an annualized basis. The median value of premium fees for leadership roles, namely Lead Independent Director and Non-Executive Board Chair incremental fees, have increased at a quicker pace than total pay for a "typical" director (i.e., a director who is not in a board or committee leadership role). Lead Director incremental fees increased by +7% on an annualized basis, while Non-Executive Board Chair incremental fees increased by +5% on an annualized basis.

	Prevalence			Median Value When Element is Used			
Compensation Element	**2015**	**2022**	**% pt. Change**	**2015**	**2022**	**Cumulative % Change**	***Annualized % Change***
Annual Board Cash Retainer	97%	98%	**1%**	$88,000	$100,000	**14%**	***2%***
Board Meeting Fees (per meeting)	18%	9%	**-9%**	$1,900	$2,000	**5%**	***1%***
Annual Equity Retainer	98%	98%	**0%**	$150,000	$185,000	**23%**	***3%***
Audit Chair Retainer	96%	95%	**-1%**	$20,000	$25,000	**25%**	***3%***
Compensation Chair Retainer	94%	95%	**1%**	$20,000	$20,000	**0%**	***0%***
Nominating/Governance Chair Retainer	90%	92%	**2%**	$15,000	$15,000	**0%**	***0%***
Audit Member Retainer	42%	47%	**5%**	$10,000	$15,000	**50%**	***6%***
Compensation Member Retainer	29%	35%	**6%**	$10,000	$10,000	**0%**	***0%***
Nominating/Governance Member Retainer	27%	34%	**7%**	$7,500	$10,000	**33%**	***4%***
Lead Director Retainer "Premium"	80%	90%	**9%**	$25,000	$40,000	**60%**	***7%***
Non-Executive Board Chair Retainer "Premium"	74%	98%	**24%**	$130,000	$177,500	**37%**	***5%***
Total Direct Compensation for "Typical" Director	100%	100%	**0%**	$260,000	$300,000	**15%**	***2%***
Cash / Equity Mix				41% Cash / 59% Equity	38% Cash / 62% Equity		

Note: TDC for a "Typical Director" reflects the sum of Board cash retainers, Committee member retainers, Board and Committee meeting fees, and annual equity retainers. Incremental fees for Board and Committee leadership roles are excluded (e.g., Committee Chair Retainers, Lead Director Retainers, Non-Executive Board Chair Retainers).

Board Service Pay Mix



The portion of total compensation delivered in cash versus equity, or overall pay mix, has been relatively stable at approximately 40% cash and 60% equity. Over the last two years, we have seen the proportion delivered in equity inch slightly higher (to 62% equity), as meaningful increases in director compensation are more commonly provided through equity than through cash-based compensation.

Cash Fees for Board Service

The median value of annual cash retainers for board service has remained constant at $100,000 over the last three years. We continue to observe fewer S&P 500 companies providing meeting fees, with the most recent prevalence at 9% (compared to 12% prevalence in 2020 and 18% prevalence in 2015). However, we note that the decline in the use of meeting fees is somewhat offset by the increase in committee member retainers. Among companies that provide a fee for each board meeting attended, the median value of $2,000 per meeting has remained constant over the last three years.

	Median Value		Prevalence	
Year	Retainer	Meeting Fee	Retainer	Meeting Fee
2020	$100,000	$2,000	98%	12%
2021	$100,000	$2,000	98%	11%
2022	$100,000	$2,000	98%	9%

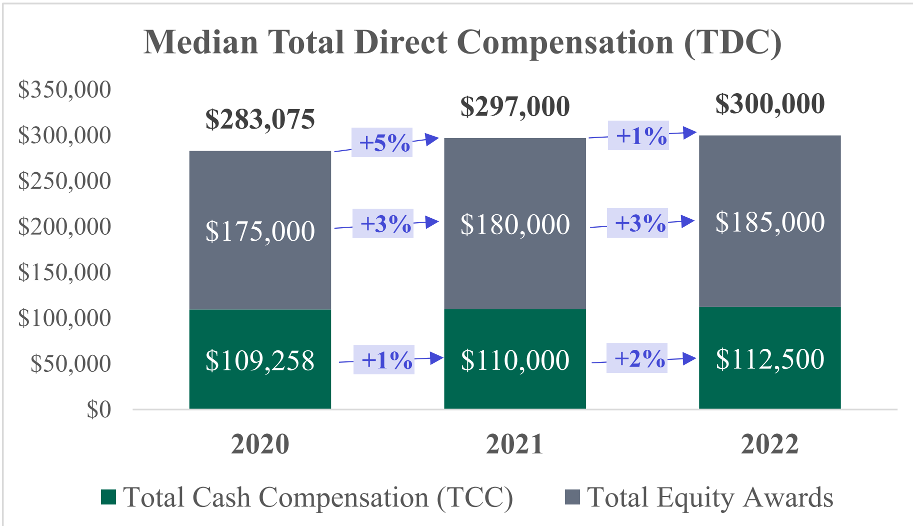
Equity-Based Awards

The median value of total equity awards has steadily increased over the last three years, with the most recent median value equal to $185,000. Although full value shares (e.g., restricted shares/stock units, deferred shares/stock units, common stock) remain nearly universal in prevalence (provided by 96% of S&P 500 companies), the use of stock options has increased slightly since 2020 (provided by 9% of S&P 500 companies in both 2021 and 2022).

	Median Value			Prevalence		
Year	Full Value Shares	Stock Options	All Equity	Full Value Shares	Stock Options	All Equity
2020	$170,000	$100,000	$175,000	96%	3%	96%
2021	$175,000	$92,500	$180,000	96%	9%	98%
2022	$180,000	$100,000	$185,000	96%	9%	98%

TDC for a "Typical" Director

The median sum of all cash-based and equity-based fees to a director who is not in a board or committee leadership role (a "typical" director) was $300,000 for 2022 and reflects a modest increase of +1% compared to 2021 median TDC. This followed a higher increase of +5% between 2020 and 2021. Many companies froze or deferred increases to director compensation levels during the pandemic but resumed increases for 2021 as observed in 2022 proxy filings.



Note: Independently arrayed, will not sum to total

Fees for Committee Service

Additional retainers provided to committee members and chairs have remained stable over the last three years. The only increase observed at the median was for Audit Committee Chairs, where the median value increased from $20,000 to $25,000 in 2022. This reflects a differentiation from Compensation Committee Chair retainers where the median value remained at $20,000. The Chair of the Nominating and Governance Committee continues to have a median retainer of $15,000. When additional fees are provided for committee service, members of Audit Committees typically receive a higher retainer (median value of $15,000) than members of other committees (median value of $10,000).

	Median Value					
	Committee Member Retainer			Committee Chair Retainer		
Year	Audit	Comp	Nom/Gov	Audit	Comp	Nom/Gov
2020	$15,000	$10,000	$10,000	$20,000	$20,000	$15,000
2021	$15,000	$10,000	$10,000	$20,000	$20,000	$15,000
2022	$15,000	$10,000	$10,000	$25,000	$20,000	$15,000
Prevalence:						
2022	*47%*	*35%*	*34%*	*95%*	*95%*	*92%*

Fees for Board Leadership Roles

In the last three years, we observed a steady increase in premium pay for Non-Executive Board Chairs and a modest increase in premium pay for Lead Independent Directors. The median value of incremental fees for Non-Executive Board Chairs was $177,500 in 2022 and represents 161% of the total pay that is provided to a "typical" director. The median value of incremental fees for Lead Independent Directors was $40,000 in 2022 and represents 113% of the total pay that is provided to a "typical" director.

	Premium Pay for Board Leadership Roles			
	Board Chair		Lead Director	
Year	Median Value	% Premium Over "Typical" Director	Median Value	% Premium Over "Typical" Director
2020	$150,000	154%	$35,000	112%
2021	$160,000	151%	$40,000	113%
2022	$177,500	161%	$40,000	113%

Director Stock Ownership Guidelines

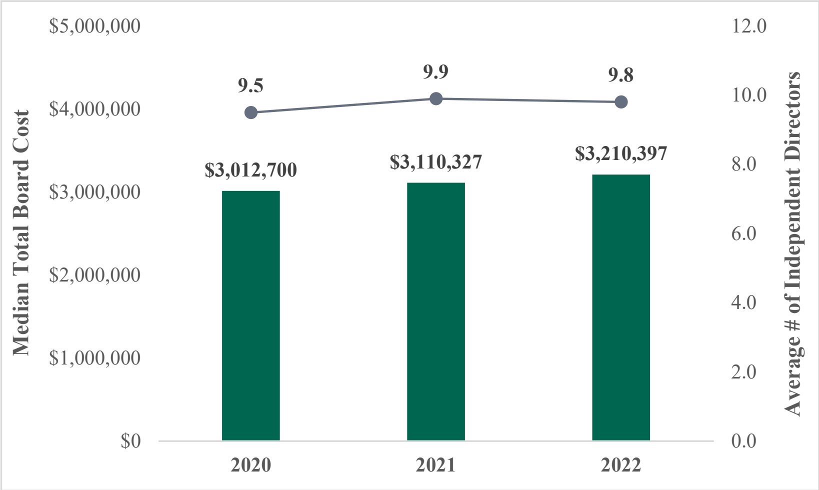
There has been very little change in S&P 500 stock ownership requirements for directors over the last three years. Prevalence is nearly universal, with guidelines in place at 95% of the S&P 500 companies. The most common stock ownership guideline is 5X the annual board cash retainer with a time requirement of five years.

Director Pay Limits

Approximately 70% of S&P 500 companies have established annual limits on non-employee director compensation, which reflects significant growth in prevalence over the last 10 years. An increase in the number of lawsuits brought against companies asserting that directors were breaching their fiduciary duties and awarding themselves "excessive" compensation, especially in the form of equity compensation, led many companies to establish "meaningful" director pay limits over the past decade. These limits are typically found within new or amended stock plans that are specifically applicable to non-employee directors and are typically substantially lower than the individual limits under stock plans related to all employees. Practice is split between defining annual limits as equity-based awards only or defining limits as a total of all cash and equity-based compensation. Both definitions have a median value of $750,000. A limited number of S&P 500 companies define cash-only annual non-employee director pay limits with a median value of $500,000.

Total Board Cost

The size of S&P 500 boards has remained relatively stable over the last three years, with an average of about 10 independent directors serving on the board. The median total board cost, or the aggregate of all cash and equity-based fees plus "all other compensation" actually paid to all non-employee directors as reported in the proxy statement's "Director Compensation Table," increased to about $3.2 million in 2022. This represents an increase of about +3% over the 2021 total board cost and, over the last three years, reflects an annualized increase of +2%.



Conclusion

In recent years, the core profile of an S&P 500 director pay program has remained generally consistent. Although the remit of a director may be expanding, increases in median "typical director" TDC of +1% are modest. The delivery of total pay to directors split as 40% cash and 60% equity has also remained generally constant. Where more movement has been observed is in the continued trend away from meeting fees and increased differentiation in total pay for board leadership roles.

Perhaps it is not surprising that director compensation has increased so modestly. While the role of a director today balances shareholder value creation with increasingly complex stakeholder priorities against a digital backdrop that provides a platform for both greater transparency and potential communication pitfalls, the fundamental purpose of a director is to be an independent, experienced operator who can partner with and, in some cases, coach leadership teams to execute on long-term business strategy while sustaining near-term business performance. For this reason, directors should be compensated fairly for their experience and time dedicated to their Board role without being perceived as being excessively compensated for the role; hence the wider use of Director Pay Limits over the past decade.

General questions about this Viewpoint can be directed to Clement Ma (clement.ma@paygovernance.com), Linda Pappas (linda.pappas@paygovernance.com), Christine Skizas (christine.skizas@paygovernance.com), or Olivia Wakefield (olivia.wakefeld@paygovernance.com).

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[1] Board of Director compensation data collected from Main Data Group for constituents of the S&P 500 Index.

[2] Board of Directors Compensation: Past, Present and Future. Pay Governance. March 2, 2017. https://www.paygovernance.com/viewpoints/board-of-directors-compensation-past-present-and-future.

CLIENT ALERT | FEB 2024

The Tesla Executive Compensation Ruling: What Directors Need to Know

This week the Delaware Court of Chancery struck down the largest public company compensation grant in history: Elon Musk's $55 billion pay package at Tesla. The ruling comes more than a year after a five-day trial in 2022, with tone set in the first sentence of the court's 200-page ruling asking, "Was the richest man in the world overpaid?"

The ruling, if not appealed, will significantly diminish Musk's wealth, likely bringing him down to the third-richest person in the world. It could also put the fate of his other companies in question. Beyond the newsworthiness of the decision, board directors—and particularly those on public company compensation committees—should pay careful attention as the court took a fairly atypical position by second-guessing director decision-making and ordering a complete rescission of a payout.

We outline below our review of the key facts and elements from this opinion. While the size of the grant and facts of the case are highly idiosyncratic, there are important takeaways for governance generally and specifical for public board members.

Background

In this derivative case, a plaintiff-stockholder claimed that Tesla's directors breached their fiduciary duties by awarding Musk a performance-based equity plan in 2018 that offered Musk the opportunity to secure 12 total tranches of options, each representing 1% of Tesla's total outstanding shares as of 2018.

According to the plan, in order for a tranche to vest, Tesla's market cap had to increase in $50 billion increments, and Tesla was required to achieve either an adjusted EBITDA target or a revenue target in four consecutive fiscal quarters—goals which Musk had characterized as "all upside." With a $55 billion maximum value and a $2.6 billion grant-date fair-value, this was the largest potential compensation opportunity ever observed in public markets by a landslide. (For context, it was approximately 250 times larger than plans for median peer companies and 33 times larger than the plan's closest comparison, which was in fact Musk's prior compensation plan.)

The plan was presented to stockholders and approved by 73%, excluding shares held by Musk and his brother. The targets were met although Musk did not exercise any of the options as they vested.

The Outcome and Rationale

In the first step of its analysis, the court determined that the plan would not be reviewed under the business judgment rule, which would have given far more deference to the board's decision-making process on Musk's compensation. Rather, because Delaware law recognizes that there are unique risks inherent in a company's transactions with its controlling stockholder, the court reviewed this case under the less deferential entire fairness standard. This standard shifted the burden to Musk to prove the compensation plan was fair—a burden which he failed to meet.

Rationale for the court's ultimate decision to rescind the award was based on the following concepts:

Director Conflicts: Conflicts of interest tainted the board's consideration of the pay plan. All of the directors (except one) including most members of the compensation committee, had economic and/or personal ties that compromised independence, despite the fact that they may have been viewed as "independent" by regulatory standards. The court specifically pointed out the 15-year personal and professional relationships between the chair of the compensation committee and Musk, calling it "too weighty" in light of the director's role in connection with the challenged grant. Many of the directors had longstanding friendships with Musk, attending family weddings and vacations with him. Aside from personal relationships, many of the directors amassed great wealth as a result of their ties to Musk, Tesla, and/or his other business ventures.

Lack of Process: The court found that there was a complete lapse in governance in considering and approving the grant. In combination with the personal and economic conflicts noted above, the court concluded that the board acted with a "controlled mindset" rather than acting on behalf of the company and its stockholders. As a "superstar CEO," Musk was far too influential in the process leading up to the grant. Specifically, Musk was the first to engineer the pay package and he controlled the timing of when the committee and board would discuss his package, sometimes accelerating a review of the pay package and sometimes cancelling a meeting without substantive notice. Testimony revealed that the directors viewed pay package assessment as a cooperative, collaborative process rather than a negotiation or at the very least controlling the process themselves. At one point Musk even stated that he was "negotiating against himself" as he proposed differed versions of the package.

Lack of Reasonableness and Rationale: Clearly the outsized package was the headline in this case, but the court seemed to find final affront in the complete lack of rationale or justification for the award. The court found no evidence that the historically unprecedented compensation plan was necessary to motivate Musk to stay with the company or for the company to achieve transformative growth. The package was not motivated by retention concerns and did not even require Musk to spend most of his time on behalf of Tesla (as opposed to his other ventures). As Musk already owned 21.9% of the company prior to the grant, the court noted that he already had enough of a stake in the company to motivate him to achieve the same market cap milestones and transformative growth. The court questioned why none of the directors discussed his pre-existing ownership stake before putting additional equity on the table. Furthermore, the court highlighted lack of any substantive benchmarking analysis, and rejected claims that the package should have been compared to private-equity deals as this is very much a public company.

Inaccurate Disclosure: Tesla put the Musk compensation plan to stockholder approval at a special meeting, and it was approved by 73% (excluding Musk and his brother). Under

Delaware law, this would typically shift the burden of proof on the question of entire fairness to the plaintiffs. However, the court found that the proxy statement on which the stockholders relied inaccurately characterized the directors as independent. It also found the description of the process leading up to approval of the package failed to describe the true nature of Musk's involvement in the process. Moreover, the court took issue with the proxy's description of the mechanics of the plan. It represented that many of the key milestones described as very difficult were in fact expected based on Tesla's confidential projections shared with banks and rating agencies. As a result, the court did not allow the burden of proof to shift to the plaintiffs despite the stockholder vote.

No Complexity in Unwinding: While it was not a legal basis for the decision, the court noted that since the options were unexercised (and would have been subject to a five-year hold even if exercised), and there were no stakeholders in the plan other than Musk, voiding the entire plan was not overly complex.

What Do Directors Need to Know?

There are a large number of take-aways for boards and specifically their compensation committees. While any plan remotely resembling the Musk/Tesla plan is highly unlikely for any other company, there may be circumstances when a plan is outside market norms, quite possibly for a good reason. Boards should be able to definitively check off these guiding points:

- **Ensure a Clean Process:** Executives should not have a heavy hand in the compensation plan design process. While there may be discussions between the board and the executive with input from the executive, the committee should drive the process and decisions following significant analysis of the plan and its impact. It is the committee or board's responsibility to control discussions and meetings, and approve modifications, timing, and ultimately plan adoption.
- **Demonstrate Reasonableness and Rationale:** Boards should be prepared to demonstrate the consideration the executive gives back in the plan design discussions, recognizing that "upside" to stockholders is not enough. There should be ample evidence that any package put forth is needed in order to sustain the executive's employment or attention. If the executive already has a considerable ownership stake, boards should ask whether additional shares are needed to motivate the executive.
- **Be Certain of Independence:** Board members, but especially compensation committee members, should be independent both in form and substance. This court focused on interpersonal and business relationships outside of Tesla.
- **Disclosures Must Not Be Misleading or Contradictory:** Make sure the words used to describe targets accurately reflect reality. They should align with disclosures made to other parties such as banks and rating agencies.
- **Recognize the Limits of Stockholder Approval:** Even if stockholders approve a compensation plan, a positive vote may not matter if the disclosure on which the stockholders relied is deemed to be inaccurate.

In closing, a key lesson is that size matters but its impact may be mitigated by proper governance. This was obviously an extreme case with compensation so outsized that it is hard to imagine an analogous situation. Nevertheless, the case offers guidance on proper governance channels that could possibly have led to a different outcome.

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CLIENT ALERT | JAN 2024

Updates on Proxy Advisor Voting Policies for 2024

Deb Lifshey

MANAGING DIRECTOR

Institutional Shareholder Services (ISS) and Glass Lewis (GL) have recently released updates to their voting policies for the 2024 proxy season. The following provides a high level summary of the most significant compensation-related policy updates for the United States. As compared to prior years, the US updates were relatively light and included more clarifications rather than major policy shifts.

Institutional Shareholder Services

The new policies for ISS[1] apply to shareholder meetings on or after February 1, 2024. ISS had only one new US policy, which was related to shareholder proposals concerning both executive severance agreements and golden parachutes. The update codifies the case-by-case approach ISS uses when analyzing such shareholder proposals, including consideration of the following factors:

- The company's severance or change-in-control agreements in place, and the presence of problematic features (such as excessive severance entitlements, single triggers, excise tax gross-ups, etc.);
- Any existing limits on cash severance payouts or policies which require shareholder ratification of severance payments exceeding a certain level;
- Any recent severance-related controversies; and
- Whether the proposal is overly prescriptive, such as requiring shareholder approval of severance that does not exceed market norms.

In addition to this update, ISS issued changes in some of its supplementary compensation-related guidance, as follows:

US Compensation Policies: Frequently Asked Questions

Changing Vote Recommendation: ISS will consider company actions taken in response to pay-related concerns in the ISS research paper only if they are disclosed in a public filing. However, ISS is unlikely to change the vote recommendation if the additional filing is made fewer than five business days before the meeting date. Additionally, vote recommendations would only be changed where a company has specifically remedied the concerns (i.e., disclosed specific plan design changes, rather than simply broad commitment to increase focus on performance-based pay) in the report or modifies existing awards to strengthen the performance linkage.

Impact of Adjustments (including non-GAAP metrics): If adjustments materially increase incentive payouts, companies should provide clear disclosure in the proxy explaining the nature of the adjustment, its impact (dollar or percentage) on payouts, and the board's rationale. Disclosure in the proxy of line-item reconciliation to GAAP results, when possible, is considered a best practice. ISS views the absence of these disclosures negatively, particularly for companies that exhibit a quantitative pay-for-performance misalignment.

Single-Trigger Change in Control (CIC) vs. CIC Incentives: ISS has clarified that while CIC severance without a qualifying termination remains a problematic pay practice, bona fide incentive awards payable upon a CIC transaction would not be viewed as problematic so long as they are not excessive and are accompanied by sufficient disclosure about rationale for the incentive.

US Equity Compensation Plans: Frequently Asked Questions

ISS provided certain clarifying adjustments to their Equity Plan Scorecard Model which addresses factors according to five different company models (S&P 500, Russell 3000, Non-Russell 3000, and two categories of Special Cases) and three different pillars (Plan Cost, Plan Features and Grant Practices). Among these adjustments, weighting of the Plan Cost factor decreased for both the S&P 500 and Russell 3000 models. Weighting of the Grant Practices pillar for the S&P 500, Russell 3000, and Non-Russell 3000 models decreased, while the weighting of the Plan Features pillar for the same models increased. There are no factor score adjustments for the Special Cases – Non-Russell 3000 model. There were no factor definition changes nor threshold passing score changes for any model. ISS also provided 2024 updates to their Value-Adjusted Burn Rate Benchmarks. Further thresholds and details are contained within the FAQ.

Glass Lewis

The new policies for GL will apply for shareholder meetings on or after January 1, 2024. The following highlights compensation-related updates and select board-related clarifications.

Clawback Trigger Expanded

In addition to meeting Dodd-Frank Act (DFA) requirements, clawback policies should provide companies with the ability to recoup both time-based and performance-based incentive payments when there is evidence of problematic decisions or actions (e.g., material misconduct, a material reputational failure, a material risk management failure, or a material operational failure), and regardless of whether employment was terminated with or without cause. This would considerably expand the requirements of a DFA policy which requires clawback of incentive-based compensation triggered by a financial restatement. Where a company ultimately determines not to follow through with recovery, if the company does not provide a thorough, detailed discussion of its decision to not pursue recoupment, this lack of disclosure may play a role in GL's say-on-pay (SOP) vote recommendation.

Executive Ownership Guidelines

Executive ownership requirements should be clearly disclosed in the compensation discussion and analysis (CD&A), including a thorough discussion of how various equity awards are counted or excluded from the ownership level calculation. GL has also indicated that counting unearned performance-based full value awards or unexercised stock options without a cogent rationale may be viewed as problematic.

Proposals for Equity Awards for Shareholders

With respect to proposals for shareholders to approve individual equity award grants, where the recipient of the proposed grant also is a large shareholder of the company whose vote can materially affect the passage of the proposal, GL believes provisions that require a non-vote, or vote of abstention, from the recipient may help address potential conflicts of interest and will be viewed as a favorable feature.

Pay-Versus-Performance (PVP) Disclosure Impact

GL may use PVP disclosures mandated by the SEC as part of its supplemental quantitative assessments supporting its primary pay-for-performance grade. Specifically, the "compensation actually paid" data, along with other quantitative and qualitative factors, may support GL's recommendation in favor of an SOP proposal, even when there is a disconnect between pay and performance using GL's pay-for-performance model (e.g., where the company would ordinarily receive a "D" or "F").

Non-GAAP Reconciliation Disclosure

For companies that use non-GAAP metrics in incentive programs, clear reconciliations to GAAP results should be provided. Where significant adjustments were applied to performance results to determine incentive payouts, the absence of a thorough, detailed discussion within the proxy statement of the adjustments and their impact on payouts will impact assessment of the quality of disclosure and could impact the SOP recommendation.

Conclusions

While ISS and Glass Lewis recommendations may be closely followed by many institutional shareholders and these advisors are sometimes viewed as standard-setters for governance, they should not be the sole driver of compensation strategy and design. It is important that companies take a holistic approach in designing their plans rather than trying to strictly meet all advisor parameters. At the forefront, companies should focus on tying compensation to business and leadership strategy and stakeholder interests, while secondarily considering the impact of ISS and GL on voting recommendations.

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[1] Note as of the date of this Client Alert, ISS has not yet released its officiation 2024 Proxy Voting Guideline document, and there were no changes to Peer Group Selection Methodology or Pay-For-Performance Mechanics.

About the Author

Deborah Lifshey is a managing director at Pearl Meyer, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters.

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