2023 Compensation Committee Priorities

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Preparing for a recession and ensuring that executives have appropriate equity incentives top the list for the new year.

As we reflect on 2022 and progress into 2023, we anticipate a high degree of economic uncertainty and believe the most critical activities for compensation committees will be related to navigating a challenging economic environment. With that in mind, we have identified what we think are the top priorities for committees in 2023.

Pressure-Testing Incentive Plan Goals for a Potential Recession

With the prospect of a downturn coming in 2023, compensation committees will have to ensure incentive plan goals are challenging while also ensuring those goals are achievable in a potential downturn. Approaches committees can consider include widening performance ranges around the plan, incorporating relative performance measurement into the plan and adding greater discretion, particularly for short-term incentive plans. In order to mitigate shareholder concerns, it is better to build any adjustments into the plan design rather than make after-the-fact adjustments for the benefit of management. For example, it is better to widen the performance range at the beginning of the year than to make an adjustment at the end of the year to allow for management incentives when the management team failed to achieve the short-term incentive plan threshold level of performance.

2023

Ensuring That Executives Have Appropriate Equity Incentives

The total return on the S&P 500 index was down over 18% in 2022. This is the first year the index has declined since 2018. This represents performance for the index overall; certain sectors of the economy have been hit significantly harder than an 18% decline. Some companies may find that the retention hooks that they have on their executive team are not adequate, particularly if some (or all) outstanding performance plans are expected to pay out below target. In 2023, companies may want to consider making more robust equity grants or special awards for high-performing executives. Committees should proceed with caution, as shareholder advisors are averse to special awards. Attaching performance criteria to special awards will make them more attractive to shareholders, but compelling rationale and shareholder outreach will be critical. Another consideration for the committee is that with lower stock prices, the dilutive impact of any new awards will be more pronounced. If share usage becomes a major concern, the committee may want to consider a long-term cash plan in lieu of equity awards, especially deeper in the organization, where cash may be more highly valued given the volatility of stocks.

Addressing New Regulatory Requirements

In late 2022, the SEC finalized three regulations that touch upon executive compensation: pay versus performance disclosure, clawback policies and 10b5-1 plans. While the management team should be far along in developing the required tabular disclosure for the pay-versus-performance relationship, the committee should weigh in with its views on the related narrative and/or graphic disclosures. In this first year of the disclosure, we expect most companies to err on the side of less, rather than more, narrative. However, the committee should review to make sure there is reasonable alignment between pay and performance in the table. If there is a misalignment, the committee should understand what is driving it.

Later in 2023, the committee will need to work with management to review the clawback policy to ensure compliance with the new stock exchange listing standards, which will detail the clawback requirements. Most companies will need to modify their clawback policies, since the SEC rules make the clawback mandatory for current and former executive officers, and most policies currently in place allow for committee discretion. In addition, the SEC rules have broadened the definition of restatement that will trigger the mandatory clawback to include “little r” restatements. This is a departure from most clawback policies currently in place. We anticipate the new clawback will be in addition to, not instead of, current clawback programs, which tend to cover broader “triggers” for clawbacks, including malfeasance.

The committee should work with management to understand whether executives use 10b5-1 trading plans and then ensure that the company’s trading policy is aligned with the new rules and required disclosures for 10b5-1 plans. The new 10b5-1 rules will provide less flexibility to executives in establishing plans, as there are now required cooling-off periods before initiating a plan and no ability to have overlapping 10b5-1 plans.

Navigating a Challenging Shareholder Environment

Not surprisingly, shareholders are more critical of executive compensation programs when financial performance and stock prices are down. We expect that in 2023, shareholders will continue to closely scrutinize proxy disclosures for any evidence that compensation committees have exercised discretion in management’s favor at the expense of shareholders. It remains critical for compensation committees to provide a solid rationale for any pay decisions that they make and to ensure the management team has a robust and proactive shareholder engagement approach for understanding the perspectives of key institutional investors regarding executive compensation. While shareholders’ primary focus may be on the pay-for-performance relationship, committees should also be aware that institutional shareholders continue to raise the bar for ESG practices and will expect the proxy statement to tell an effective story about how the company is working to address all aspects of ESG. While shareholders are not necessarily requiring companies to incorporate ESG into the company’s incentive plans, they will expect management to describe the company’s plans to address shareholders’ ESG concerns and how they are measuring progress in these dimensions.

While 2021 and 2022 were driven by a white-hot labor market and a relatively strong post-COVID economic recovery, we think that 2023 will be a more challenging economic environment. We expect that compensation committees will need to be flexible and closely monitor economic conditions and their impact on executive compensation programs. As the committee makes decisions, committee members should be mindful of institutional shareholder perspectives and how to most effectively state why the decisions they made align with shareholder interests.

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