Virtual Governance Summit 2020

PRESENTED BY Directors&Boards PRIVATE COMPANY DIRECTOR

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COMPENSATION ISSUES IN RECOVERY —
SETTING CEO AND SENIOR MANAGEMENT COMPENSATION

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Pay Governance
Advisory Services to Compensation Committees

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For today’s webinar

- Introduction by David Shaw, publishing director, *Directors & Boards* Magazine
- There will be time for questions. Enter them from your computer anytime during the presentation
- Presentation and supporting materials will be emailed to all participants after the webinar
- The webinar is 60 minutes
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With you today

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COVID-19 has had a dramatic effect on the welfare of individuals and companies around the world

- In addition to the health crisis caused by the pandemic, equity markets and retail sales have experienced dramatic declines, while jobless claims are being recorded at historic rates
- In response, companies are reexamining their approaches to internal systems such as technology, business contingency, human resources, and rewards
- While previous economic downturns have also had a significant impact on how companies approach compensation, two factors differentiate the impact of the COVID-19 pandemic from previous crises:

Timing

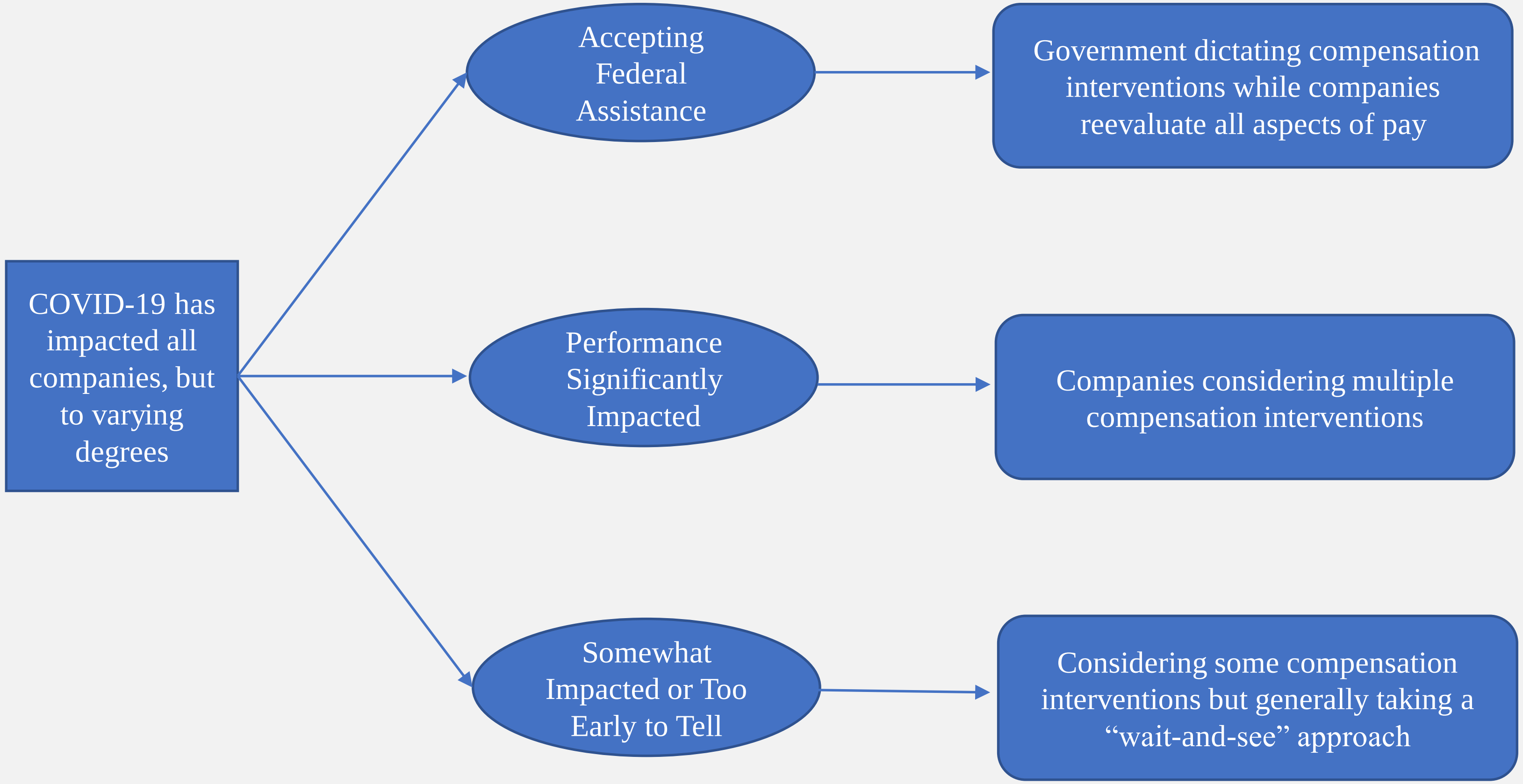
- The full effect of the crisis began in the U.S. in March rather than in September or October like several past economic shocks
  - In those instances, companies with calendar-fiscal years had several months to adjust budgets, forecasts, share utilization projections, and performance goals for the coming year to new economic uncertainties
- However, the COVID-19 crisis occurred shortly after most calendar-year companies had approved annual and long-term incentive (LTI) goals and after most equity grants were made for the year

Say on Pay Protocols

- This is the first severe economic downturn to occur in a post-Dodd Frank Say on Pay environment
  - Compensation programs have evolved in recent years toward systems that tend to comply with the preferences of shareholder advisory firms and large institutional investors
  - As such, goal-based, mechanical, and fully disclosed annual incentive plans and three-year objective performance plans now dominate executive reward systems at most companies
- However, expectations that incentive plans follow pre-set formulas while allowing for limited flexibility can be at odds with the extreme volatility of the current crisis

COVID-19 will have a widespread effect on compensation programs although the degree of impact will vary based on a company's circumstances

- In general, facts and circumstances have determined the actions taken or being considered by companies:



- However, companies across all of the above groupings are evaluating executive reward actions with a high degree of sensitivity to, and empathy with, affected stakeholders and communities
  - *The social, investor, and political ramifications of addressing executive compensation issues without an awareness of the overall crisis have the potential to be profound*

Compensation Considerations:
Companies Taking Federal Assistance

- As with TARP during the financial crisis, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") places executive pay constraints on companies accepting federal assistance
- Executive pay constraints apply to two groups of companies:
  - — *Airlines, air cargo, and businesses critical to maintaining national security*
    - Pay for employees making $425,000-$3 million in total compensation cannot exceed 2019 levels
    - Employees with more than $3 million in total compensation for 2019 will have their annual pay limited to $3 million plus 50% of any amount earned over $3 million in 2019
      - Thus, an executive that earned $9 million in 2019 would be capped at $6 million in 2020
      - "Total Compensation" includes salary, bonuses, awards of stock, and other financial benefits – comparable to Summary Compensation Table pay without pension change amounts
    - Severance awards are capped at 2 times 2019 total compensation
    - Restrictions apply over a two-year window, from March 2020 to March 2022
  - — *Other companies receiving assistance:*
    - Same restrictions as above but beginning from the date a company accepts aid until 12 months after the loan is repaid
- Beyond government-imposed restrictions, these companies have also:
  - — Implemented widespread executive salary reductions (decreases of 50% to 100%)
  - — Reduced board pay (decreases of 25% to 100%)
  - — Capped annual incentive payouts at 50% of target or set expectations that bonuses will be 50% to 100% less than 2019 levels
  - — Reduced 2020 equity grant values if awards were not made in January/February

Compensation Considerations: Significantly Impacted Companies

- Companies significantly impacted by the crisis but that are not generally not taking federal assistance (e.g., oil and gas, hotels and leisure, retail) have enacted major human resources changes
  - — Employee layoffs, furloughs, broad-based compensation reductions, suspension of 401(k) matches, etc.
- In terms of executive compensation *actions taken to date*, many of these companies have:
  - — Reduced management salaries (ranging from 10% to 100%), with some companies differentiating reductions by management tier (CEO, executive leadership team, other executives)
  - — Reduced board cash retainers (by 20% to 100%, centering on 25%)
  - — Calibrated director equity awards using a historical average stock price rather than the current price
- However, in terms of *potential compensation actions*, a broad range of alternatives is being considered:
  - — Forfeiting the current annual incentive plan and creating a July-December incentive plan
  - — Re-setting long-term performance plan goals
  - — Shifting the weighting of incentive plan metrics from financial to operational/ESG/strategic/individual
  - — Changing individual performance objectives in light of new priorities
  - — Using discretion to determine incentive plan outcomes for the year
  - — Shifting future performance plan periods to shorter cycles
  - — Waiving or deferring assessment of share ownership guideline compliance
  - — For non-calendar year/fiscal year companies, moving to a quarterly or semi-annual grant cycle going forward and calibrating 2020 equity awards using a historical average price
  - — In extreme cases, canceling and replacing stock options (below the senior executive level)

Compensation Considerations: Less Impacted Companies

- Companies less impacted by the crisis have generally maintained full employee pay and benefit plans, including executive compensation programs
  - — That said, in a demonstration of solidarity with affected stakeholders, a limited number of less affected companies have announced executive and director pay freezes, reductions, or deferrals
- Many of these companies are considering a limited set of potential compensation actions:
  - — Establishing a set of guiding principles that will help steer the evaluation of compensation programs and year-end compensation decisions
    - Includes statements regarding: the role of judgement/discretion; potential constraints such as dilution and affordability; payout expectations; need for awareness of the current environment, etc.
  - — Adding the occurrence of a pandemic to permitted incentive plan metric adjustments
  - — Assessing whether the compensation committee has sufficient flexibility to exercise its business judgment to address incentive outcomes
  - — Affirming with the management team and board that the application of discretion will play a meaningful role in determining incentive plan outcomes for 2020
  - — For non-calendar year companies, assessing 2020 performance on a pre- and post-crisis basis, if possible
- Finally, even organizations less affected by COVID-19 (including those with positive shareholder returns for the year) will be very mindful of the current environment and the challenges faced by employees, customers, and key stakeholders as they evaluate 2020 pay outcomes

Executive and Board of Director Compensation Reductions

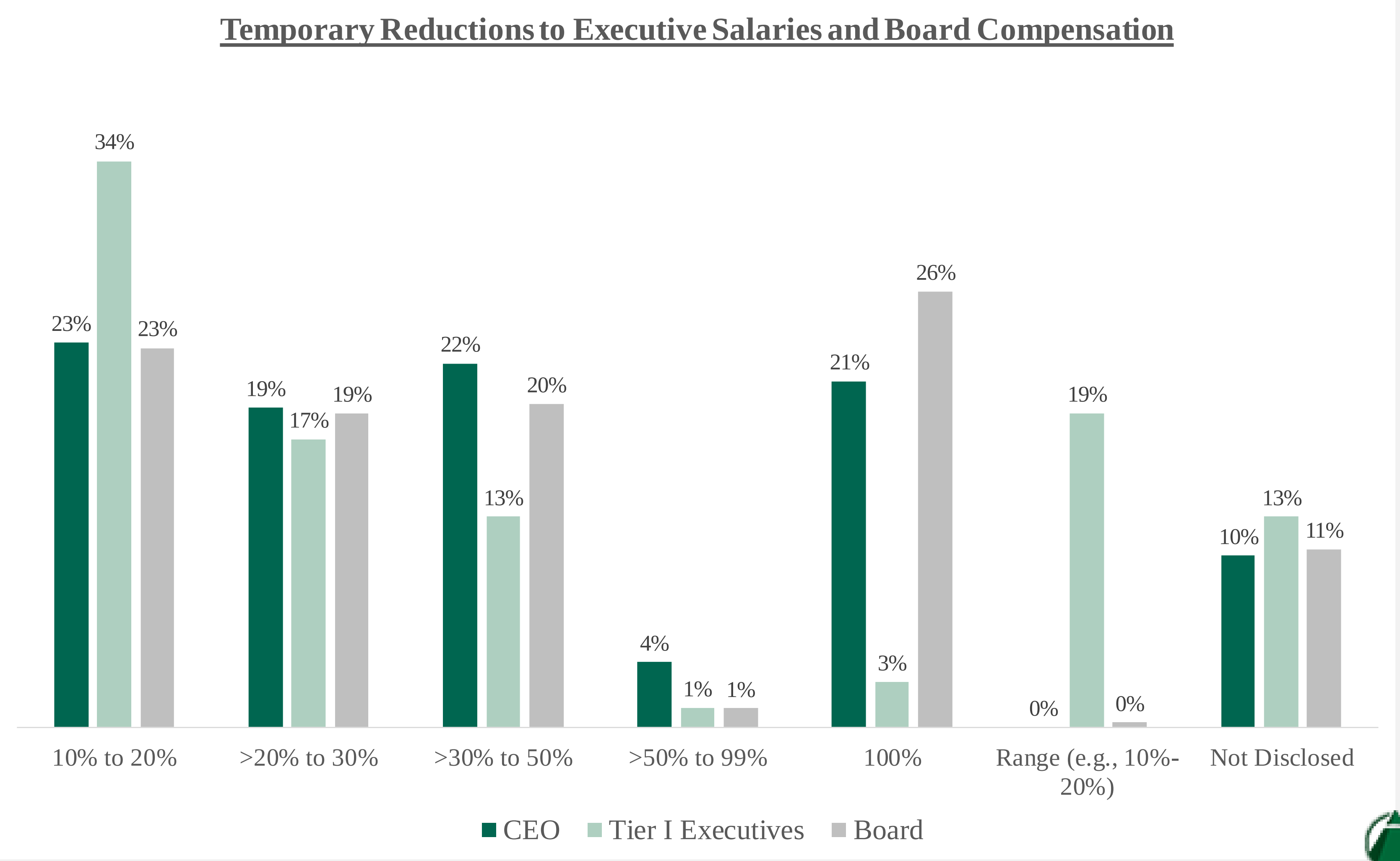
- Pay Governance is tracking executive and board of director pay actions as the economic impact and subsequent compensation changes related to COVID-19 continue to unfold
- As of **May 21st,** we have observed:
  - — Reductions in executive salaries at **560+** companies
  - — Reductions in board member compensation at **350+** companies; generally focused on cash retainers
  - — The majority of companies stated or implied these executive salary and/or board compensation reductions were indefinite and would be reevaluated throughout the year
- We have captured data for each company as follows:
  - — CEO (99% prevalence in total sample)
  - — Tier I Executives (91% prevalence in total sample)
    - Captures the level of reductions beyond the CEO for the next group of executives disclosed; in many cases, this group is broader than the Named Executive Officers (NEOs)
  - — Tier II Executives/Employees (31% prevalence in total sample)
    - Captures the next level of reductions beyond the Tier I Executives (e.g., a broader subset of executives or all salaried employees)
- The table below provides summary statistics for reductions in the total sample of companies in our database

	Base Salary Reduction(1)			Board of Directors Pay Reduction(2)
	CEO	Tier I Executives	Tier II Executives / EEs	
75th Percentile	75%	30%	25%	100%
Median	40%	20%	20%	40%
25th Percentile	20%	20%	10%	20%

(1) Deferred base salary compensation and/or make ups (e.g., offsetting equity award grants) have been treated as reductions.

(2) 73% disclosed reduction was to cash compensation, 7% indicated reduction was to total compensation and 20% did not specify.

Executive and Board of Director Compensation Reductions (continued)



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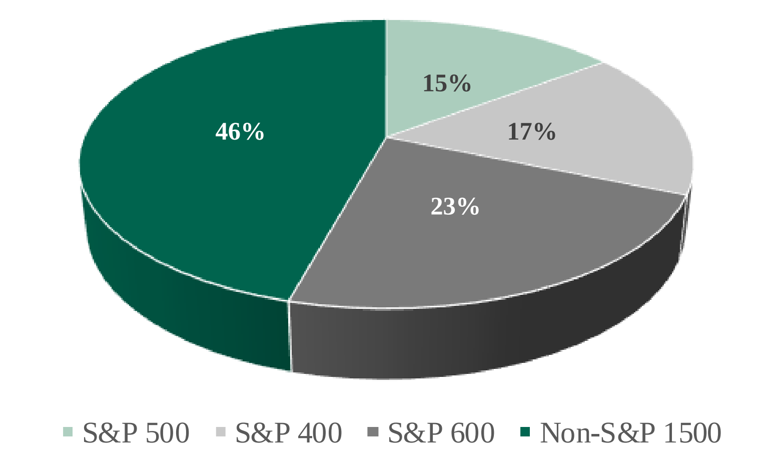
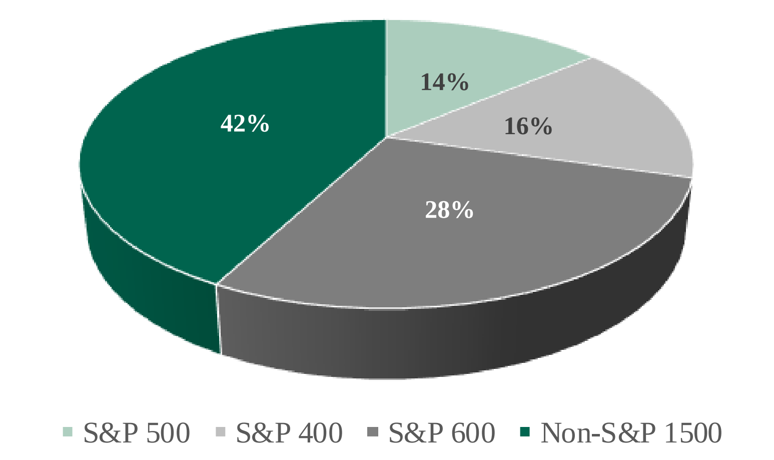
Executive and Board of Director Compensation Reductions (continued)

Executive Pay Reductions Data Sample



Board Pay Reductions Data Sample



S&P Industry	Leading Industries Disclosing Pay Reductions [1]									
	Total Sample		S&P 500		S&P 400		S&P 600		Non-S&P 1500	
	Executive	*Board*	*Executive*	*Board*	*Executive*	*Board*	*Executive*	*Board*	*Executive*	*Board*
Specialty Retail	10%	14%	1%	2%	1%	2%	4%	5%	4%	5%
Hotels, Restaurants and Leisure	9%	7%	2%	1%	2%	1%	1%	2%	4%	3%
Health Care Equipment and Supplies	7%	6%	1%	1%	1%	1%	2%	1%	3%	3%
Machinery	5%	6%	0%	1%	1%	1%	2%	2%	2%	2%
Oil, Gas and Consumable Fuels	5%	6%	1%	1%	1%	1%	1%	1%	2%	2%
Textiles, Apparel and Luxury Goods	4%	4%	1%	1%	0%	0%	1%	1%	1%	1%
Energy Equipment and Services	3%	3%	0%	0%	0%	0%	1%	1%	2%	2%
Equity Real Estate Investment Trusts (REITs)	3%	5%	1%	1%	0%	0%	1%	2%	1%	2%
Household Durables	3%	4%	0%	0%	1%	1%	1%	1%	2%	2%
Commercial Services and Supplies	3%	3%	0%	0%	1%	0%	0%	1%	2%	2%
Health Care Providers and Services	3%	3%	1%	1%	0%	1%	1%	1%	1%	0%
Media	3%	1%	1%	0%	0%	1%	0%	0%	2%	1%
Trading Companies and Distributors	3%	3%	0%	0%	0%	0%	1%	1%	2%	2%
Auto Components	2%	3%	0%	0%	1%	1%	1%	1%	0%	1%
Airlines	2%	1%	1%	1%	0%	0%	0%	0%	1%	0%
IT Services	2%	2%	0%	1%	1%	1%	0%	0%	1%	0%

(1) Reflects industries with prevalence of 2% or greater (from total sample). Data rounded to nearest 1%.

How might proxy advisors react to 2020 pay actions?
Institutional Shareholder Services (ISS)

- ISS and Glass Lewis have issued advisory papers providing indicative guidance on how they will approach COVID-19 related executive compensation actions
- Both proxy advisors said they expect contemporaneous disclosure of any executive compensation program changes (i.e., companies should issue 8-Ks describing the changes vs. waiting until 2021 proxy filings)
- However, beyond the call for near-immediate disclosure of compensation actions, the guidance issued by ISS and Glass Lewis diverged
- ISS reiterated that they use an established approach and set of principles to assess executive compensation and that they would continue to apply their standard approach when evaluating 2020 pay actions
- However, ISS did address some specific potential pay changes that companies may be contemplating:
  - — ISS implied that shifting to a less performance-based LTI system (e.g., replacing PSUs with RSUs or stock options) will be problematic, even in a COVID-19 environment
  - — ISS stated that they generally oppose the modification of goals for in-process LTI performance cycles
  - — ISS reiterated its requirements for any option repricing program:
    - Delaying any replacement options for at least one year following the stock price decline
    - Requiring the exchange to be "shareholder value-neutral"
    - Obtaining shareholder approval for the program
    - Excluding officers and directors from the plan
  - — Finally, ISS said that companies should provide an "adequate explanation to shareholders of the rationale for any changes"

How might proxy advisors react to 2020 pay actions?
Glass Lewis

- By contrast, Glass Lewis's "guidance" was more of a threat:

  "Companies with strong pay structures will be challenged to abide by them and firms with less robust programs will be forced to choose between lying in the bed they've made or changing arrangements and guaranteeing shareholder ire"

- Glass Lewis warned companies to expect a "marked increase" in shareholder concerns if they:
  - — Increased their share dilution and burn rates
  - — Changed incentive hurdles
  - — Shortened vesting periods
  - — Provided inadequate disclosure regarding the exercise of discretion
  - — Took measures to keep executives whole
- Glass Lewis also stated that executives and employees "should not expect to be worth as much as they were before the crisis"
- Glass Lewis concluded with a dire warning:

  "Trying to make executives whole at further expense to shareholders and other employees is a certainty for proposals to be rejected and boards to get thrown out – an open invitation for activists and lawsuits onto a company's back for years to come."

What could we see by the end of 2020?

- The current environment is highly volatile with limited visibility as to when we may enter a more "normal" economic and operating environment
- This being said, we do have some compensation predictions for 2020/2021:
  - — Discretion and business judgement will have an unprecedented impact on incentive outcomes since the advent of Say on Pay
    - Further, post-162(m), most companies now have the ability to exercise positive discretion
  - — We expect annual incentive outcomes to be at the lowest overall levels since the financial crisis
  - — Further, we expect to see companies using lower payout factors for management awards (as a percent of target) than for broader employee base payouts
  - — Due to proxy advisor pressure, 2020 will see a record number of non-required 8-K filings on compensation changes
  - — More companies will need to return to shareholders for additional equity reserves in 2021 as share pools become depleted more rapidly due to low stock prices
  - — There will be "musical chairs" with regard to stock option usage
    - Some companies will plan to grant options for the first time in many years given lower stock prices and potential "wealth restoration", while others will abandon option use altogether due to dilution and motivation concerns for companies with multiple tranches of deeply underwater options

Questions and Conversation