

Compensation Strategies for Managing Uncertainty

A ClearBridge CLEAR *thinking* Article

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Introduction

Turbulent Times

In recent years, we've experienced seemingly unprecedented global uncertainty: a global pandemic, significant inflation, supply chain shocks, the Great Resignation, and geopolitical turbulence (just to name a few!). Uncertainty has permeated the corporate world, impacting everything from long-range planning to talent management to supply chains.

While facing so many pressures, companies must continue to develop executive compensation programs that meet their business objectives through very challenging times. At the same time, companies continue to face mounting scrutiny on executive compensation designs. In order to help do this, establishing sound strategies for mitigating uncertainty can help companies continue to attract and retain key talent, while ensuring they are motivated, rewarded, and aligned with shareholder interests going forward.

Compensation Strategies

The aim of this *CLEARthinking* article is to provide a framework for companies as they assess the effectiveness of their current compensation programs in achieving their business and compensation objectives, despite broader uncertainty and volatility.

Specifically, this article outlines the following four compensation-related strategies:



Step 1: Develop Guiding Principles for compensation decision-making



Step 2: Assess Incentive Plans relative to these guiding principles and evaluate various design levers to balance potentially competing objectives



Step 3: Engage Key Stakeholders to gain feedback on compensation plans and ultimately garner shareholder support for Say on Pay proposal



Step 4: Use Compelling Disclosure in the proxy statement to tell your story to shareholders and shareholder advisory firms



Develop Guiding Principles & Assess Incentive Plans



Step 1: Develop Guiding Principles. Companies often find themselves balancing multiple priorities through their compensation plan design. During periods of uncertainty, it is especially important to provide clarity on the company's short- and long-term business and compensation objectives, as these objectives will serve as clear guideposts for all compensation decision-making.

These objectives should identify the key current priorities facing the business and be tailored to the current business environment. Prioritize as needed to ensure the guiding principles are crystal clear.

Potential Guiding Principles to Manage Uncertainty

- | | |
|---|-------------------------------------|
| ✓ Provide flexibility/discretion to address uncertainty | ✓ Attract and retain key talent |
| ✓ Motivate and reward for achieving key objectives | ✓ Align with shareholder interests |
| ✓ Reinforce desired individual/cultural behaviors | ✓ Demonstrate transparency/fairness |
| ✓ Balance internal and external perspectives | ✓ Instill ownership mentality |



Step 2: Assess Incentive Plans, including any adjustments for **In-Flight Incentive Plans** and/or new plan designs for **Go-Forward Incentive Plans**.

Step 2A: Assess In-Flight Incentive Plans: Consider if any adjustments are necessary to the performance goals or actual performance (for outstanding performance awards), based on the impact of broader macroeconomic factors. In determining if adjustments are warranted, apply your guiding principles in asking and answering the following questions:

- **Underlying Performance:** Was underlying performance strong prior to macroeconomic impacts? Were these items truly out of management's control, with little/no ability to mitigate?
- **Human Capital Objectives:** Does the need to reward the team (e.g., for retention) outweigh any potential scrutiny from shareholders or shareholder advisory firms?
- **Shareholder Perspectives:** Can rationale for any modifications be explained in a compelling way? Will pulling back on the magnitude of adjustments, for example, help sell the actions?

Remember the Big Picture! In applying any modifications (e.g., bonus adjustments), take a holistic view in determining final outcomes, considering your guiding principles. For example, if adjustments are small in magnitude but would send a strong signal internally, then it can be worthwhile to implement - but may be less so if the reverse is true!





Assess Incentive Plans (Cont'd)

Step 2B: Go-Forward Incentive Plans: Setting compensation plans for the new fiscal year provides an opportunity to “reset” and ensure alignment with key objectives. Provided below are some common approaches to address any business/macroeconomic uncertainty for incentive plans.

Plan Design Lever	Applies to:		How Lever Helps Address Uncertainty
	Bonus	LTI	
Set Wider Performance Goal Range Around Target	✓	✓	• Accommodates wider performance outcomes above and below target goal
Set Target Goal as a Range	✓	✓	• Recognizes difficulty in projecting target performance
Measure Performance On Relative Basis	✓	✓	• Payouts aligned with level of performance vs. peers/industry (regardless of absolute performance)
Shorten Performance Periods	✓	✓	• Can set more realistic goals, recognizing shorter performance periods may be scrutinized externally
Increase Use of Individual Performance in Bonus Plan	✓		• Can help increase line-of-sight over the link between actions/performance and bonus payouts
Assess LTI Vehicle Mix vis-à-vis Key Objectives		✓	<ul style="list-style-type: none"> • Vary vehicles by level based on employee line of sight: <ul style="list-style-type: none"> » Restricted shares (retain value in up & down markets) vs. stock options (high upside potential & downside risk) » Service vesting (more retentive) vs. performance vesting (high upside potential & downside risk) » Cash-based vehicles (more clarity over payout) vs. equity-based vehicles (value subject to stock price)
Grant Cash or Equity Retention Awards		✓	• Targeted grants to key employees to achieve key compensation objectives (e.g., retention)
Use Average Stock Price for Share Determination		✓	• Helps mitigate short-term fluctuations in stock price on number of shares to grant for compensatory equity

Consider your Guiding Principles! In determining appropriate plan designs, make sure to balance achievement of key objectives, alignment with short- and long-term business needs, recognition of shareholder interests, and any other identified principles from Step 1.





Engage Key Stakeholders



Step 3: Engage Key Stakeholders, including both internal stakeholders (e.g., C-Suite leaders, Human Resources, Compensation Committee), and external shareholders to ensure all perspectives are considered in developing executive compensation plan designs.

Internal communication is important in order to ensure that there's alignment between all interested parties and final compensation-related decisions. Developing a workplan early on regarding (1) who to gain input from and (2) timing for gaining input (e.g., when to present to the Compensation Committee) can help provide a clear and seamless process.



Don't Forget! Remember to run any potential compensation plan modifications past both Accounting (to confirm any tax/accounting implications) and Legal (to confirm any legal implications and/or disclosure obligations).

Regarding external communication, gaining shareholder feedback is becoming a critical part of companies' overall compensation strategy for both current designs and potential modifications. Outreach is even more valuable in less "business as usual" environments.

Shareholder engagement efforts generally fall into the following two categories:

- **Compensation Feedback Outreach:** Outreach during the compensation cycle to gain shareholder feedback on potential decisions considered in current environment. This can provide valuable guidance on approaches to consider, and helps avoid any potential unintended consequences.
- **Post-Proxy Filing Outreach:** Outreach after the proxy statement is filed, in order to explain decisions/rationale to shareholders, to garner support for relevant proxy proposals.

Additional Commentary

Shareholders may have more flexible perspectives regarding compensation-related decisions for employees below the Named Executive Officers (NEOs) than for decisions for the NEOs, given the heightened external focus on executive compensation.



Use Compelling Disclosure



Step 4: Use Compelling Disclosure. Using effective proxy disclosure to explain compensation decisions and rationale/inputs is another tool to tell your story to shareholders.

- **Describe the Current Environment:** Demonstrate the impact of broader environment on the business and compensation plan, and how final decisions are aligned with business strategy, shareholder interests, and human capital objectives.
- **Explain Your Process:** Consider explaining the process taken and factors considered in final decisions, and if appropriate, any other approaches considered (and why those were not chosen).
- **The Clearer and More Specific, the Better:** Don't rely on using boilerplate language! Where possible, use charts, graphs, and/or tables to grab attention.
- **Consider Forward-Looking Disclosure:** If appropriate, describe compensation design for current fiscal year to demonstrate if prior year decisions were truly exceptions, one-time in nature, etc.



Did You Know? Both ISS and Glass Lewis consider the quality and thoroughness of compensation disclosure in their qualitative assessment of compensation plan designs.

Final Thoughts



Developing a compensation program that achieves all business and compensation objectives is never straightforward. Now more than ever, developing clear strategies for compensation decision-making helps ensure all parties are aligned to key objectives, decisions are being made through a consistent framework, and strategies are in place to explain the rationale internally and externally. And let's hope the next few years present less difficult challenges!

Contact Us

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