A Conversation with Susan Choe, Senior Director and Bill Ultan, Managing Director, Morrow Sodali's Corporate Governance Consultancy

Susan, since you and Bill are deep into proxy season, can you discuss some key compensation themes or highlights for 2020?

SC: *There are several noteworthy items to highlight for 2020, that potentially could have a material impact on a company's say on pay. So first the use of special one-off awards, second program changes that were made for the following fiscal year and not the year under review. Third, the push to include ESG performance metrics in incentive programs and lastly, updates to the ISS and Glass Lewis quantitative pay for performance assessments.*

Can you tell me a bit more about the use of special one-off awards?

SC: *The focus in the past generally centered around the magnitude as well as whether performance criteria were tied to the awards. Now there are increasing questions on the repeated use of special grants. So if the company grants these types* *of awards on a recurring basis in successive years or even several years apart, investors are raising concerns about the efficacy of the compensation program. In other words, investors are asking whether the compensation program is flawed and needs reexamination and redesign.*

BU: *Today one of the most common triggers for opposition beyond pay-for-performance disconnects are the use of one-time grants, especially those that are not tied to performance criteria.*

Now the second point you raised, Susan, pertains to post fiscal year compensation decision.

SC: *That's an interesting one. Historically we've observed that when it comes to assessing a company's Say on Pay, ISS and Glass Lewis generally took into account the pay programs and decisions associated with the fiscal year under review. They do, however, note in their analyses, company disclosure that pertains to any changes and or decisions that apply to the following year and beyond. But going forward, we believe that concerns around post fiscal year decisions may play a bigger role than in the past. We know that Glass Lewis recently clarified and formalized its position, that it will review significant post fiscal year changes, especially if changes touch upon issues that are deemed material to the firm's recommendations. We also recently observed an instance where ISS opposed the company's Say on Pay, partly due to pay issues related to the following fiscal year decisions.*

Bill, your thoughts on the topic?

BU: *One high level comment: As Say on Pay has evolved over the last decade, companies and boards have continued to struggle with how to gain support for decisions that the Compensation Committee may have made multiple years earlier. So Susan's point about additional disclosure is critical. It speaks to the broader communication effort to provide context for these decisions.*

It seems that ESG is all around us and it's one of the most widely discussed topics today. How does that tie into your third point about integrating ESG performance metrics into executive compensation programs?

SC: *You're absolutely correct, it has been and continues to be one of the most prevalent topics that investors are raising during engagements with their portfolio companies. They're keen to understand whether and how ESG factors are being considered when determining executive pay. When we speak to our clients and their boards, they do tell us that they're seriously and closely examining the viability of incorporating ESG metrics into their pay programs, but they do express concerns over the difficulty in determining which metrics are most effective. Also companies with strong sustainability programs evaluate holistically the company's ESG performance as it is truly embedded into their long-term strategy. In essence, executives are already being measured on these ESG factors. We don't recommend that a company take the plunge merely because some of its peers have begun to do so or tie a small percentage to an ESG metric narrowly for the sake of favorable optics. It's a very multifaceted process with significant consequences and that must be undertaken with care.*

BU: *Even when the measures are qualitative (not quantitative), a board benefits from highlighting the focus and impact that ESG factors have on executive compensation.*

Susan, since the updates to the ISS and Glass Lewis quantitative pay for performance models seem to be a perennial issue, can you briefly describe what your clients can expect in 2020?

SC: *On the ISS front, while relative TSR (Total Shareholder Return) will continue to be the dominant metric in the quantitative screen, the firm is replacing the use of GAAP metrics with four Economic Value Added (EVA) metrics and a Financial Performance Assessment (FPA) test which serves as a modifier in determining the overall quantitative pay for performance concern rating. The GAAP metrics will continue to be included in the reports, but ISS had indicated that they will be for display purposes only. The significance of this change is that there is little visibility into the ISS EVA calculations, not only for the target company but also for its peers. This means less transparency and more uncertainty about how a company will fare under the ISS model. For Glass Lewis, due to a data vendor change from Equilar to CGLytics, the firm has indicated that there will be notable changes to a company's peer group in 2020, which obviously can have a material impact on the quantitative pay for performance outcome.*

Bill, anything further on the ISS and Glass Lewis pay for performance model updates?

BU: *It's worth observing the continuous pattern of advisory firms moving the bar on Say on Pay speaks to why it's so important for issuers to stay connected to their actual shareholders and make sure they are clearly articulating the Compensation Committee's rationale for pay decisions, the merits of the program, and the connection to performance and strategy. We can count on ISS and Glass Lewis continuing to redefine their methodologies on this issue.*

Susan, any last minute advice?

SC: *One of the most important areas that we advise our clients on is on the quality of their disclosure and corporate reporting. Especially as companies prepare their proxy statements for 2020, in particular the CD&A, since we're talking about compensation, not only is effective disclosure critical, but it's often a determining factor in mitigating investors' and proxy advisors' concerns about the merits of pay programs.. How a company crafts its story and messaging will go a long way in resonating with a company's top holders and other stakeholders and it remains the most important medium of communication next to direct engagement.*

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