

Setting Incentive Targets in a Time of Economic Volatility and Increased Uncertainty

The process of setting performance objectives for long-term incentive awards is complicated by the uncertain and volatile context within which compensation committees exercise their judgement as to the appropriate metrics and corresponding targets for performance-based incentives. The factors that make it challenging to determine multiple-year objectives include the impact of legislative and regulatory actions, such as trade restrictions and tax law changes, uncertain global economic trends, the ongoing impact of the COVID pandemic, and other potential disruptions in the global economy. While some of the sources of uncertainty impact companies across industries, there are also factors that may be specific to a given sector that produce additional uncertainty and volatility. These uncertainties have led many compensation committees to question their ability to set reasonable multi-year performance objectives.

In times of uncertainty, compensation committees may seek alternative design approaches to mitigate the risk of setting what may turn out to be overly aggressive or overly conservative long-term performance targets given the potential volatility that may result from such policies over the life of three-year long-term incentive grants. With that in mind, presented below are alternative approaches, and corresponding pros and cons of each approach, that companies may find helpful as they attempt to address the challenges of setting long-term incentive targets in an uncertain and potentially volatile business climate.

1. Long-Term Performance Objectives Based on Annual Performance Goals. As was observed during the financial crisis, companies may find it advantageous to simplify their long-term incentive design by setting one-year performance goals that determine the long-term award payout and require that such payouts be delivered in shares that vest over a multi-year period. By way of example, the 2021-2023 three-year performance award would be based on performance against the 2021 objectives but payout would be deferred into shares that vest at the end of 2023.
 - a. Advantages: Eliminates the need to set multi-year performance objectives that may prove to be too easy or too difficult as a result of the economic uncertainties corresponding to the COVID pandemic and the pace of the economic recovery. Such an approach would need to be coupled with clear disclosure as to the rationale for the temporary change in the structure of the awards. It also retains a longer-term focus by deferring the one-year payout into shares that still vest after three years.
 - b. Disadvantages: Investors and proxy advisors have historically been critical of one-year goals in long-term plans, and it is uncertain if such criticism will be easily assuaged by company concerns over short-term

volatility. It often helps if the company can explain that its rationale is clearly disclosed for the one-year targets and the duration of the temporary arrangement.

- c. Other Considerations. Investors often express concern when there are duplicative annual and long-term incentive metrics and care should be taken to clearly explain why the performance metrics chosen are key to driving long-term performance and achievement of company strategy.
2. Relative Metrics to Index Performance. Another approach to mitigate volatility of the policy environment is to use relative metrics. This may include relative metrics that are specific to the company's industry, with the metrics compared to the company's peers, an industry index (if a specific industry is targeted). It may also include the use of a broader market index (such as the S&P 500 or Russell 3000) if policy changes that are more broadly applicable are included.
 - a. Relative Metrics to Company Peers. In the event a particular policy change targets the company's industry, but not business generally, indexing long-term performance to the company's peers is an approach worth consideration.
 - i. Advantages: This approach would help mitigate the chance that the company performance metrics would, given factors impacting its industry, turn out to have too much stretch or not enough stretch and thereby produce unintended incentive plan results. The use of relative measures may help to mitigate industry-specific influences by comparing the company's performance to other companies that may be similarly impacted by policy and economic influences.
 - ii. Disadvantages: The design would need to guard against situations where the company outperforms its peers but TSR is still negative, thereby weakening alignment with shareholders while rewarding the company's relative performance. To guard against this potential disconnect with shareholders, companies may want to consider limiting the maximum payout under a long-term incentive to some percent of target compensation (e.g., 80% of targeted payout) when total shareholder return is negative over the three-year performance period. This has become a widely accepted practice.
 - b. Relative TSR of a Broader Market Index. If policy changes have a broader impact across industries, companies may want to index long-term performance to a larger peer group, such as the S&P 500, S&P 1500 or Russell 3000.
 - i. Advantage: Helps to mitigate general policy and economic influences that impact industries in general and equity markets.
 - ii. Disadvantage: May not mitigate industry-specific impact as relative performance tends to regress to the mean the larger the performance group. May reduce the linkage between line-of-sight

financial and operational objectives that incentive participants can more directly impact.

3. Compensation Committee Judgment. We are hearing more frequently from investors a preference that the committee use discretion to adjust payouts if the performance under an incentive plan is not reflective of the intended pay for performance relationship of the awards. However, there has been a general mistrust by certain investors, proxy advisors and critics of executive pay of the use of committee discretion in determining incentive payouts. The word “discretion” is often interpreted as indicating an arbitrary or overly pro-management exercise of the committee’s power to adjust incentive payouts. Given that committees make a sincere effort to be evenhanded and deliberate in determining incentive payouts, weighing controllable and uncontrollable influences on results, it may be more correct to use the term “informed judgment” when describing the committee’s decision process regarding incentives. It is critical, however, that if the committee exercises its judgment in adjusting award payouts, the company should disclose factors upon which the decision was based. For example, in approving the incentive plan, the committee may determine in advance (and disclose) that it will set a particular range of performance (also known as a collar) within which it may exercise judgement to determine the appropriate payout and the specific contingences that would be considered. The use of committee judgement should be evenhandedly applied to increase or decrease payouts as circumstances warrant.
 - a. Advantages: Committee judgement can be applied to increase or decrease compensation as the circumstances warrant. Where a collar exists, stakeholders have a reference point for committee decision-making. Committee judgement also allows directors to address unexpected or contextual factors that may result in an overly generous or unreasonably low payout, given the performance provided.
 - b. Disadvantages: Exercise of positive adjustments to incentive payouts can put the committees at odds with certain stakeholders. Such adjustments may be opposed by investors who are more focused on formulaic pay arrangements.

As companies explore alternative approaches to addressing potential unintended consequences of setting performance targets and determining incentive arrangements in periods of uncertainty, the mix of long-term incentives or the leverage in the payout schedule for various levels of performance may be adjusted. Examples of alternative design considerations include following:

4. Use of Overlapping Award Cycle to Adjust Future Performance Incentives. The degree to which award/performance cycles are overlapping provides a natural approach to mitigating risk by allowing companies to adjust the performance objectives for a new long-term incentive award cycle each year. As opposed to end-to-end award/performance cycles (e.g., granting awards for a three-year cycle and waiting to grant a new award until the end of the current three-year period), overlapping annual awards provides the opportunity to adjust objectives

based on annual swings in the economic context within which the company operates. If awards are not granted on an annual overlapping cycle this would be an area to consider for mitigating future risk in setting performance objectives.

- a. Advantage. Overlapping awards allow company to revise the performance objectives each year for changes in the business or economic climate.
 - b. Disadvantage. Having multiple awards with differing terms outstanding at the same time may create communications challenges for the company.
5. Revisiting the Mix of Long-Term Incentives. During periods of uncertainty it may be advisable to revisit the mix of long-term incentives to provide enhanced retention of talent and to mitigate potential uncertainty. Currently, the most common mix of long-term incentives consist of performance-based stock (roughly 59% of the total award), stock options (18%) and restricted stock (22%), according to FW Cook report of award practices among large US-based companies.¹ To help mitigate the risk of target setting in periods of uncertainty, the mix may be altered to place more emphasis on the longer exercise period corresponding to stock option awards or to increase the emphasis on restricted stock as a way to enhance retention.
- a. Advantages. Revisiting the mix of pay can mitigate the risk of talent drain where circumstances warrant. Changing the mix can also help mitigate uncertainty until longer term targets can be set.
 - b. Disadvantages. Changes in the mix must be accompanied by clear disclosure explaining the context. Failure to clearly explain the changes can lead to criticism by shareholders or proxy advisors seeking consistency.
6. Flatten the Payout Curve. Within the design of performance awards, making the payout schedule flatter to dampen the impact of under or over-achievement of goals or to bracket payout opportunities for different levels of performance (e.g., 95% to 105% of goals produces 100% payout of targeted incentives, 90% to 94% results in 95% payout, etc.) may help to guard against unintended windfalls or shortfalls due to the difficulty of setting multi-year performance objectives.
- a. Advantages. Mitigates the effect of overachievement of goals by paying a lower amount for a higher level of performance. Mitigates the effect of underachievement by providing a longer payout curve thus guarding against shortfalls.
 - b. Disadvantages. In times of lower performance, may generate criticism by some stakeholders who seek a lower payout amount for the same performance. In times of very good performance, may create concern by executives that payouts were lower than warranted by performance.

¹ FW Cook, 2020 Top 250 Report, <https://www.fwcook.com/content/documents/publications/10-21-20%20FWC%202020%20Top%20250%20FINAL.pdf>

Economic uncertainty often generates concerns among companies and their compensation committees about setting appropriate long-term incentive targets. There is no one approach that will work in all circumstances and every approach involves tradeoffs. However, it appears that investors are increasingly willing to entertain both design changes and the use of committee judgement when accompanied by clear disclosure. Thus, companies should be aware of and explore the alternatives that make the most sense for their particular situations.