



On the board's agenda | US

Trends in executive compensation

Introduction

The 2019 proxy season is largely over for calendar year-end companies, so it is a good time to reflect on a couple of key themes¹ in executive compensation that emerged during the season:

- Achieving significant shareholder support for “Say on Pay” remains a top priority for issuers.
- Institutional investors want executive’s compensation packages to align with long-term value creation.
- Environmental, Social, and Governance (“ESG”) policy and disclosure are increasingly important to investors, including assessing whether such activities should be linked to executive evaluations and/or compensation.

This publication is a summary of how these themes impacted the 2019 proxy season and what management, compensation committees and boards should understand going into the 2020 proxy season.

Say on Pay remains a top priority for companies and board members

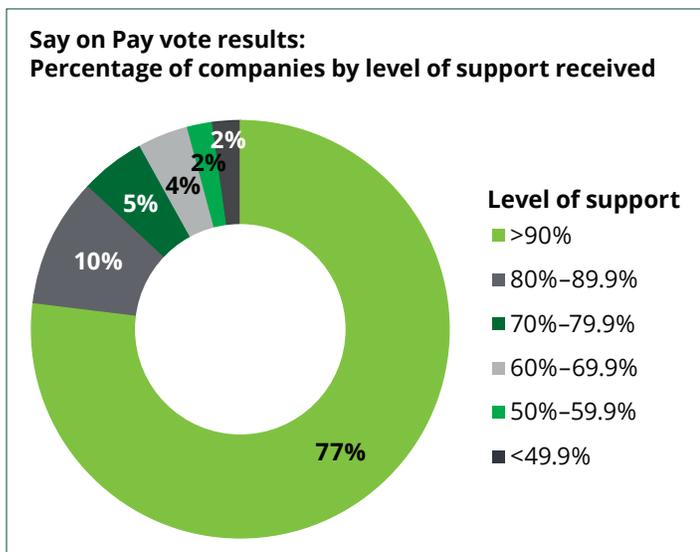
The focus on Say on Pay remains strong. Investor demand for more transparency, increasingly stringent proxy advisory firm voting policies, and heightened scrutiny from investors, especially activist investors, on compensation program design and performance goals, have made it increasingly important that companies effectively demonstrate that their executive compensation program is aligned with investors’ interests.

Companies seek to obtain overwhelming shareholder support (over 90%) for Say on Pay proposals, as this level of support signals that investors largely approve of the executive compensation program. Shareholder support of less than 90% is a warning that aspects of the executive compensation program may be out of line with shareholder expectations. One proxy advisory firm, as well as some institutional investors, consider shareholder Say on Pay support 

1. Themes as viewed by Deloitte Consulting LLP based on responses and feedback from management and compensation committees.

below 70% to be a failed vote, calling to management's attention the need to "fix" the executive compensation program.

The chart below shows the percentage of Russell 3000 companies receiving different levels of support as of July 31, 2019:²



Overall shareholder support for this year's Say on Pay proposals was high. As of July 31, 2019, 98% of 2,187 proposals at Russell 3000 companies passed, with average shareholder support of 91%, the same as last year. At a macro level, the voting results suggest shareholders support the majority of companies' executive compensation programs, both in terms of design and pay levels.

However, there were 13 companies whose shareholder support for Say on Pay dropped by more than 50 percentage points compared to last year. Our review of these companies indicates that the most likely reason for the drop was a perceived misalignment between pay and performance at 12 out of 13 companies, which could be attributed to the use of one-time awards (including awards made to the CEOs of seven of these companies). The remaining company tripled the CEO's annual long-term incentive award value compared to the prior year without a commensurate level of performance.

Other reasons for poor shareholder support of Say on Pay included:

- **Lack of performance-based long-term incentives:** Five of the 13 companies used only time-based long-term incentives. Performance-based long-term incentives have become integral to a well-designed executive compensation program, in the eyes of investors and proxy advisory firms, and often comprise 50% or more of top executives' long-term incentives.

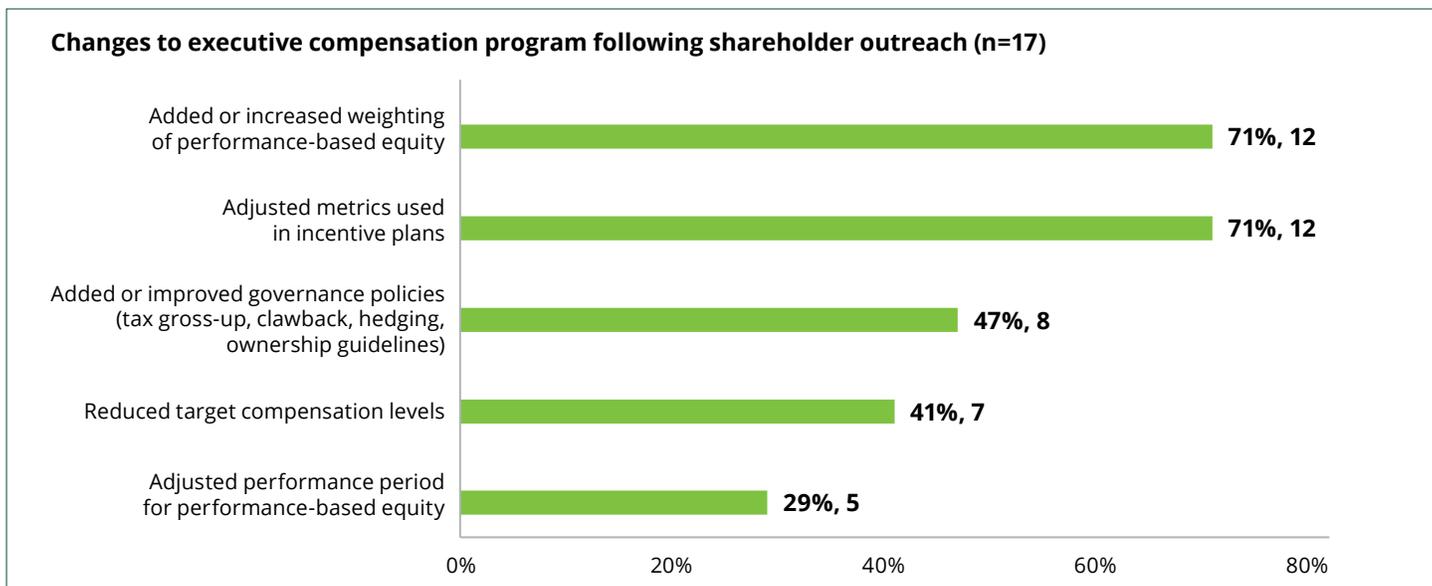
2. Deloitte Consulting LLP Internal Study based on publicly available information.

- **Performance periods for performance-based long-term incentives are too short:** Despite the difficulties in developing three-year performance goals, most companies follow this approach. However, three companies used a one-year performance period or three one-year performance periods, which proxy advisory firms view as too much overlap with the annual incentive plan.
- **Discretionary short-term incentive plans:** Shareholders struggle with short-term incentive plans that have a discretionary payout, due in large part to the lack of transparency and high degree of subjectivity exercised. While some level of discretion is generally acceptable, most companies limit the level of discretion in the annual incentive plan design to 20% to 30% of the bonus payout.
- **Peer group composition:** Since a company's peer group forms the foundation for benchmarking pay levels, shareholders may have concerns with a peer group that is too big, as it may lead to compensation benchmarks that are not reflective of the company's size or complexity.
- **Transparency and clearer disclosure:** When it comes to disclosure, clear, concise and transparent works best. Disclosure of pay elements closely scrutinized by proxy advisory firms and shareholders include short-term and long-term incentive performance metrics and targets, how those incentives align with company objectives, and how the company is addressing shareholder concerns. Failure to demonstrate proper alignment or to address shareholder concerns in one year is a potential recipe for a decrease in shareholder Say on Pay support the following year.

We also examined 17 companies whose shareholder support for Say on Pay increased by more than 50 percentage points compared to last year. All of these companies included robust disclosures of their shareholder outreach efforts, fully summarized shareholder concerns and described, in detail, the changes implemented to address those concerns. On average, these companies disclosed contacting shareholders representing 64% of voting shares and received feedback, on average, from 44% of these shares.

The majority of the shareholder feedback and changes to executive compensation programs focused on: (1) aligning executive pay with company performance and shareholder returns, including an increased emphasis on performance-based equity and utilizing appropriate performance periods and metrics for short and long-term incentive awards, and (2) adopting or strengthening leading compensation practices, such as adopting meaningful stock ownership guidelines, incorporating claw back provisions in all incentive programs, and eliminating future tax gross-ups. The chart on the next page summarizes the most common shareholder concerns that were addressed. ➤





Some items to point out regarding responses to shareholder outreach this past proxy season from these 17 companies:

- Twelve companies added or increased the use of performance-based equity: five added performance-based equity to their long-term incentive opportunity, two increased the weighting of performance-based equity to 50% of the total long-term incentive opportunity, and the remaining five increased the weighting of their performance-based equity to more than 50% of the total value granted in long-term incentives (54%-60%).
- Twelve companies modified the metrics used in incentive plans: six reduced the weighting of non-financial goals (e.g., strategic, operational, individual performance) and increased the focus on financial goals in their annual incentive plan, one added additional metrics to its annual incentive plan, two added relative total shareholder return as a metric in their long-term incentive plan, one removed relative total shareholder return as a metric in its long-term incentive plan, and two updated its metrics to eliminate the use of the same metrics in both the annual incentive and long-term incentive plans.
- Eight companies made changes to their compensation governance policies: four adopted or increased stock ownership guidelines, three eliminated tax gross-ups, two adopted clawback policies, and one adopted an anti-hedging policy. Note: Some companies made changes to more than one type of policy.
- Compensation reductions were also part of the modifications that led to improved shareholder support, as seven companies reduced CEO total compensation by 30%, on average. Most of these reductions were made to long-term incentives, although some base salary reductions were also utilized.
- Five companies made adjustments to the performance period used in their performance-based equity, by increasing the performance period to 3 years.

Compensation-related shareholder proposals

Another lens for understanding shareholder priorities is executive compensation-related shareholder proposals. As of July 31, 2019, 36 shareholder proposals were submitted with respect to executive compensation: [➤](#)

Category	% of proposals submitted	Examples of proposals	Average support
Link executive pay to ESG	28%	• Link pay to sustainability, drug pricing, data privacy	21% (none passed)
Incentive plan calculations	25%	• Limit adjustments to GAAP earnings when calculating incentive payouts • Use of GAAP metrics rather than non-GAAP metrics • Eliminate the impact of share buybacks on incentive plan EPS calculations	10% (none passed)
Clawbacks	14%	• Adopt clawback policy • Provide disclosure of clawback recoupment activity	45% (two passed)
Internal pay equity	11%	• Provide a report on internal pay equity • Compensation committee to consider employee compensation when setting CEO compensation	7% (none passed)
Equity treatment	8%	• Limit accelerated vesting upon change in control	28% (none passed)
Limit executive pay	8%	• Limit above-market earnings on retirement plans • No grants allowed to executives if the company's stock price at time of grant is lower than any previously awarded equity held by executives	17% (none passed)
Equity retention/ownership	6%	• Adopt equity retention policy	25% (none passed)



Questions for the board to consider asking:

1. Is shareholder support for our Say on Pay proposal at an acceptable level?
2. Is our shareholder outreach sufficient? Have we received any concerns regarding our executive compensation program? If so, how are they being addressed and what changes to the program are being contemplated?
3. How is the company gauging potential shareholder reactions to significant changes being considered to the existing executive compensation program?

Focus on Environment, Social, and Governance (“ESG”) factors

Financial goals such as profitability and relative shareholder return continue to dominate incentive plan metrics. However, more companies have adopted or are considering the inclusion of social and environmental goals in executives’ performance evaluations or as potential incentive plan metrics. While dozens, if not hundreds, of “raters and rankers” now track and evaluate a myriad of ESG practices being disclosed by companies, there is no standardized evaluation approach. However, boards are nonetheless increasingly recognizing the importance of incorporating ESG into metrics and initiatives relating to business strategy, risk, and compensation.

The reasons for this are many and complex, but the trend is real:

- There have been a number of studies^{3,4,5} indicating that sustainability factors influence financial returns and present an opportunity to drive long-term value.
- The Sustainability Accounting Standards Board (“SASB”) published the world’s first set of industry-specific sustainability accounting standards covering financially material issues within the past year.
- Major investors and the proxy advisory firms have added ESG policy and oversight, including SASB standards, to their extensive list of items for consideration.
- As mentioned earlier, 10 out of 36 compensation-related shareholder proposals submitted as of July 31, 2019, related to linking executive pay to social criteria such as sustainability, drug pricing, and data privacy.

Interestingly, the use of ESG metrics in incentive plans is not new. For example, manufacturing and energy companies have been using safety as a metric for many years, and a study⁶ conducted by one of the proxy advisory firms indicates that 35% of the S&P 500 include ESG metrics in their executive incentive plans. Other findings from this study include:

- ESG metrics are predominantly used in short-term incentive plans rather than long-term incentive plans.

3. “Linking Climate Engagement to Financial Performance: An Investor’s Perspective.” Sustainable Insight Capital Management. September 2013.

4. “Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility during the Financial Crisis.” Journal of Finance, Forthcoming. October 2016.

5. “Morningstar Indexes show sustainability is good for business.” Morningstar Blog. March 2019.

6. “Sustainability Metrics in U.S. Executive Compensation.” Glass Lewis. 2018.

- The type of ESG metric (safety, environmental, personnel/community, diversity, other/holistic ESG) varies widely by industry. Safety is the most utilized in Energy, Industrials, Materials, and Utilities companies, while Diversity is most utilized in Financial Services, Consumer Staples, Information Technology, and Communications Services.
- Approximately 30% of companies assigned a specific weighting of their incentive plan to ESG metrics, 15% used ESG metrics as a modifier to the final payout, and the remainder used ESG metrics as part of a broader metric category (such as personal goals or strategic objectives).

Management and boards—and compensation committees—are increasingly considering disclosure of various ESG factors and the extent to which such factors should be incorporated into the evaluation process and/or incentive compensation program. While hastily adding ESG metrics to incentive plans to satisfy shareholders and media seems inadvisable, the adoption of meaningful and measurable ESG goals can complement and balance the use of financial and operational goals that can better prepare the company for future success.



Questions for the board to consider asking:

1. Have we engaged our investors to gather their views on ESG as it applies to our company’s strategy and outlook? If yes, how are we incorporating their feedback?
2. Are we getting regular updates on the company’s ESG policies and progress from management?
3. Should we include ESG specific metrics in the performance evaluation process and/or incentive plan design and if we already have adopted such metrics, are they weighted enough to be meaningful?

Conclusion

Maintaining high levels of shareholder support for Say on Pay proposals requires constant vigilance from both management and the compensation committee, maintaining communications with investors, regular monitoring of proxy advisory firm and large institutional investor policies, continually reviewing pay practices and pay levels, and preparing pay-for-performance evaluations used by investors and proxy advisory firms prior to filing the annual proxy to identify and address potential pay for performance disconnects. The stakes have also been raised, as many large institutional investors are beginning to adopt policies to vote against compensation committee members for repeated negative votes on Say on Pay.

Regarding ESG, we note this is a trend that is evolving, and it is important for boards to stay abreast of the company’s ratings, evaluate opportunities to improve disclosure, and when appropriate, consider how such practices could or should be woven into executive performance evaluation or incentive plan designs. ➔

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