June 2018

Executive Compensation Summer Checklist: Take Steps Now to Prepare for Your Year-End

Proxy season just ended, but that doesn't mean you can rest on your laurels for too long. Here are several steps you can take now to set yourself up for success heading into pay planning season.

For professionals involved in executive compensation, there's a natural feeling of relaxation that comes in the summertime after a busy spring season— a desire to recharge your batteries before the hectic activity of the third quarter and the drive to close the year in a strong position. While resetting is important, there's also an opportunity to take advantage of the slower summer months and engage in productive activities. Doing so will not only lighten your load later on, but better position your compensation planning for when it's time for the company to kick back into high-gear. Here's our summer checklist for staying on top of your executive compensation planning calendar:

#1: Schedule a Shareholder Meeting Postmortem

Anyone involved in executive compensation and corporate governance matters at a public company will want to debrief following their annual shareholder meeting. The compensation committee's summer meeting is the perfect venue to review and reflect on shareholder feedback and voting at the meeting— and to begin discussing any potential changes to the compensation programs that could be made in response to those results next year. This is also the time to lay out a roadmap for companies considering a proactive shareholder engagement campaign to gather more specific feedback from investors.

The postmortem discussion ideally should be held with the compensation committee chairperson or full committee, key members of top management, HR representatives, the head of investor relations, and the board's compensation and legal advisors.

A comprehensive postmortem meeting should include the following discussion and action items:

- **Review of proxy advisory firms' proxy reports on your company**. You'll want to examine the rationale for any negative ISS or Glass Lewis recommendations on Say-on-Pay, director elections and/or stock incentive plans, as well as any cautionary notes or issues flagged in their detailed write-ups (even if the vote recommendation was favorable). Even in the absence of major issues, there may be minor adjustments to governance and compensation programs the board can adopt to improve the company's governance profile in the eyes of proxy advisors and investors.

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- **Review the official Say-on-Pay advisory vote**. Did it go up or down from the prior year in a meaningful way? This may not be a troublesome development, but it's important to understand the forces behind voting changes.

- **Assess whether shareholder outreach is necessary**. If the Say-on-Pay vote was less than 80%, Glass Lewis expects a formal shareholder engagement process to take place and will look for disclosure around an engagement process in next year's proxy. ISS sets the threshold at 70%. If you decide a formal engagement process is needed, we recommend planning early. Ideally engagement should begin in the summer when there is plenty of time to discuss, reflect and react. If you decide to wait until right before next year's proxy, you'll often find it's too late to have meaningful discussions.

- **Debrief on the first CEO pay ratio disclosures**. Since this is the first year of this new disclosure, there are many questions worthy of asking, such as:

    - Did you receive any negative attention that might warrant supplemental disclosure or proactive communication next year?
    - How does your pay ratio compare to your peers?
    - Do you need to make any adjustments to the process of how the ratio was calculated and disclosed?
    - Has the pay ratio come up as a topic of conversation with any investors?
    - Are you plugged in to how the disclosure was received by your employee population?

#2: Review and Update Your Peer Group

Reviewing your peer group is traditionally one of the initial steps to the full executive compensation review that most companies undertake in the last few months of the year. However, it's worth exploring whether the process of peer selection can be moved into the summer months to help minimize and streamline the process later.

Before you start any review it's a good idea to dust off your overall compensation philosophy to examine if anything has changed and define your strategy in the competitive marketplace moving forward. Once you've done that, here are some key questions to ask and actions to take in deciding whether you need to change the composition of your peer group:

- Does the peer group as a whole feel balanced and representative of the desired competitive marketplace? If peers have made a change in their strategy, made a significant acquisition, had a change in their development progression or setback (for life sciences companies), does it still make sense to include them?

- What are the perspectives of proxy advisors, investors and other stakeholders on your peer group?

- Review peer groups of your key competitors. Is there anything to learn from their approaches?

- Review the most current financial, market value and other key company information of peer group companies to ensure their current financial profile fits within the size parameters you've set for your peer group. Typically we recommend that the majority of your peers be no smaller than half and no larger than twice the size of your company in terms of headcount, revenue and market cap. While you will still need to briefly review your peer group as a preliminary step in your annual compensation review, it should be a much simpler process with the majority of the analysis already taken care of in the summer.

#3: Evaluate Your Equity Strategy and Usage

The summer months also provide an ideal opportunity to check in on your overall equity usage and strategy and to start having preliminary discussions about any changes you might be proposing for next year. Due to its inherent complexity, equity compensation can be the most difficult part of your program to configure without months of preparation. If you are considering introducing new equity vehicles, for instance, you should begin socializing the concept with the committee and management— and considering the pros and cons— sooner rather than later.

- Review 2018 year-to-date equity burn rate, then project out remaining 2018 grants based on expected hiring, attrition and promotion activity. Gain an understanding of how this year's projected burn rate compares to prior years and why.

- Evaluate your burn rate in the context of ISS' 2018 industry-specific benchmarks, and consider the implications for next year. If your burn rate is materially above ISS limits, this could impact ISS treatment of a proposal to fund your stock incentive plans. Don't forget that ISS is likely applying a multiple in its evaluation to any full value shares you grant.

- Do you need to consider changes to equity philosophy, participation, eligibility levels or vehicle mix? If so, be sure to consider all potential effects of any modification. Any change made to participation or vehicle mix will directly impact every aspect of overall usage. Be sure to communicate the expected magnitude of such changes to all relevant parties. The last thing anyone wants in the compensation planning process is to be caught by surprise *after* changes have already been made.

- Has the compensation committee indicated interest in introducing or increasing performance-based vehicles for executives? You should begin modeling implications and soliciting opinions of management, your committee, and your key advisors on important design decisions (e.g. possible performance metrics and whether performance equity is a replacement or supplement to historical time-based vehicles). By starting this evaluation in the summer, you'll have a head start on any research you need to respond to questions or concerns from relevant stakeholders in the process.

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If you have questions about your executive compensation programs and want to speak with a member of our consulting group, please write to consulting@radford.com.

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