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An Equilar publication
Issue 36, Summer 2021

The View From the Top

An interview by Steven Borden with entertainment industry icon and corporate board veteran Debra L. Lee

Creating change through compensation

Equity pay in uncertain times

The necessity matrix and corporate boards

Interview with Lisa Shalett, Chief Investment Officer, Wealth Management at Morgan Stanley

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Telling Your Compensation Story

Considerations in drafting an effective CD&A

By Ron Schneider

DFIN

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There is no one-size-fits-all, or perfect template for a more communications-focused proxy or for the heavily scrutinized Compensation Discussion and Analysis (CD&A) section. Nor is there uniformity to compensation programs themselves. Savvy companies tend to follow practices that best suit their current stage of growth and competitive position, recognizing that even this is a moving target likely to evolve over time.

As investors' interests have broadened, most mature company proxies have evolved well beyond a *compliance-focused* response to SEC disclosure requirements, as laid out in Schedule 14A. For newer companies, this evolution to a *communications-focused* instrument still lies ahead as they mature and their ownership base evolves.

In this piece, we outline the steps and considerations that we review with clients to help them arrive at the appropriate organization, messaging content, navigability and design elements to communicate their often-unique compensation programs effectively to their investors. For many companies, this involves going beyond the "what" and detailing the "why" of compensation and related internal practices. Done effectively, this approach can help maximize investor understanding and thus build support for company compensation programs and their administration, while, at the same time, mitigating the impact of negative proxy advisor recommendations.

DFIN (also known as Donnelley Financial Solutions) supports over one-third of all U.S. companies with their proxies and other critical SEC filings and investor communications. This significant market share affords us a unique window into the evolving techniques companies are using to engage investors and gain their support for their corporate governance, executive compensation and sustainability programs. We apply these lessons, as well as our knowledge of areas of greatest interest to investors, to advise clients on messaging strategy. In providing creative design services, we follow our "design with a purpose" mantra. In our view, design should support the message and brand, drawing the reader's attention to key topics and making these topics both digestible and full of impact.

A Checklist for Compensation Disclosure

Companies providing stellar CD&As and other disclosures consider a number of elements when deciding how best to communicate. Most of the topics below generally belong in the CD&A, but others may also warrant discussion elsewhere, such as in substantive CEO and board cover letters, proxy summaries and in discussions of board oversight.

Voice. Ideally, the CD&A reflects the board's thinking in formulating and overseeing compensation programs that are often quite complex. Some companies make their own thought processes front and center with Compensation Committee cover letters immediately preceding the CD&A. Committee member photos can further "humanize" these leaders to investors and may even highlight elements of diversity within your boardroom.

Context and strategy. Before asking investors to support your compensation philosophy, program, and its results, remind them about your company's current strategies and performance. This is particularly helpful for large, long-term indexed (or passive) investors who want to vote thoughtfully, but may not be as attuned to the company's ongoing IR dialogue as are more active managers.

Both for the pragmatic issue of ease and to ensure message consistency, this reminder about strategy often involves repurposing recent IR disclosures at the start of the CD&A. Also, major investors tend to want a clear, credible statement of how the compensation program is aligned with and supports the business strategy. Put another way, when evaluating pay-for-performance alignment, investors focus on "which performance" is being rewarded—ideally, performance aligned with the already-articulated business strategy. However, the connection between pay and strategy is often absent, or unclear. So, connect the dots.

Organization and flow. Most companies start with the prior year's proxy and "mark it up," which tends to result in more content being added than is deleted. It may make sense to take a step back before drafting (or updating) content and start with a fresh outline. In this outline, ask yourselves: Is there a logical flow? Is there a consistent hierarchy of primary, secondary and tertiary topics and section headings? And are related topics located adjacent to one another?

Cascading detail. When it comes to describing the pay program itself, start with the overall compensation philosophy. Next, there should be a high-level overview of "at risk" pay (e.g., pay mix graphs), a more detailed overview (e.g., elements of compensation tables) and, finally, a full explanation of each element of pay. Remember that virtually every company claims to have a "pay-for-performance philosophy." Absent compelling detail, this can be a hollow statement.

Navigation. Different audiences are interested in different information, with many treating the proxy as a "reference" rather than a "reading" document. With that in mind, a consistent hierarchy of topics and the introduction of section heading styles described above make sense. In addition, useful navigational aids, including detailed Tables of Contents (TOCs), supplemental CD&A TOCs, or logic-flow roadmaps to content ("in this section, you will learn...") may be enormously beneficial.

Branding. Some companies have successfully integrated branding and product elements into the CD&A, as well as into the overall proxy. We've seen airplanes and other products in bar graphs, automotive dials in circle graphs, and related imagery in section dividers and page headers. Given the increasing focus on human capital and workforce diversity, many companies are featuring their employees throughout the document.

Additional Areas of Focus

The nature of your program (metrics-based, i.e., "formulaic" or discretionary). While neither type of program is right or wrong, explain why you feel your approach makes sense for your particular company. If formulaic, clearly explain the rationale for the metrics selected and their alignment with the business strategy. If discretionary, point out past instances of negative, as well as positive, discretion to guard against perceptions that the company is engaging in a "heads I win, tails you lose" attitude.

COVID pay impact. The pandemic affected many companies' performance, pushing some industries into survival mode. For these companies, TSR and other traditional performance measures may not fairly measure performance of management and the board. Consider describing company out-performance relative to peers in navigating this crisis to support the use of "resilience discretion," or other pay adjustments made by the compensation committee.

Investors have indicated that they will view the impact of COVID holistically across the company. For this reason, it may also be advisable to discuss CEO pay impacts alongside any impacts on the broader workforce. Investors want to know if management is sharing the pain, and how capital spending has been adjusted to ensure employee health and safety.

Performance metrics and their alignment with the business strategy. Often the link between metrics and business strategy isn't as clear to outside readers as it is to company management and to board members, who are very close to the topic. One point that can't be overemphasized is the importance of explaining your thinking and connecting the dots for first-time readers.

Avoid technical jargon and clearly define all acronyms. Also, make sure critical information is easy to locate. Instead of asking readers to search for metrics in the middle of a paragraph of text, consider making use of tabular highlighting.

Another way to make sure that metrics and their rationale can be easily located and understood is to include "elements of compensation" tables, in addition to a lengthier section that separately discusses each such element.

Increasingly, some new **non-financial metrics, including ESG metrics**, are being included. Typically, these metrics relate to workforce safety and diversity, equity and inclusion (DE&I), particularly in annual/short-term incentive plans. If metrics like these are newly adopted, they may deserve additional visibility in a CEO or board cover letter, proxy summary, and ESG and human capital discussions, as well as in the CD&A itself. With investors (and potentially the SEC) favoring the use of consistent materiality and reporting standards, investors will want to know if you are using SASB, TCFD, GRI or other standards in the CD&A, as well as in upcoming CSR reports.

The business mix and/or strategy have evolved. Strategy changes are quite common, but they do raise additional questions. How has the pay program evolved to support this transition? And are there corresponding changes to governance and compensation oversight practices? Good ways to address these questions are to overlay IR discussions of the business transformation with corresponding changes to governance and compensation practices in an impactful timeline format. This approach is also relevant for restructurings, turnarounds and leadership transitions.

Investor engagement. While once a "nice to have," a discussion of investor engagement is now a "must have." The best way to get credit for the best practice of engaging with investors is to address this engagement in disclosure documents. When we talk about investor engagement, we are discussing engagement with voters and stewardship officers at institutional investors. Key topics include governance, compensation and sustainability, as opposed to the traditional IR dialogue about strategy and performance. While some of these topics certainly may overlap, be clear about your definition of engagement.

If your recent voting results are good (increasingly, viewed as over 80% support), disclosing voting results and perhaps the scope and timeframe of engagement generally suffices. Following sub-par votes, as well as other situations where you anticipate greater scrutiny, it may be advisable to go the extra mile and disclose "what you heard" and "what you did" with this feedback. This doesn't mean you must automatically adopt every investor suggestion; and in fact, some feedback may be addressed through clearer disclosures of why you are sticking with your current practice(s). Either way, discussions like this demonstrate "responsiveness to the vote" and to investor views generally.

Be aware that not all investors follow proxy advisor recommendations in lockstep. Engaging only with proxy advisors and addressing their concerns may not address other concerns investors had that drove their votes. Unless you engage with investors, you may not uncover the true motivation behind the vote and may thus fail to address other pressing investor concerns.

Pay-for-performance story. While heavily relied upon by proxy advisors and many investors, TSR may not fully reflect superior executive performance, particularly in times of market turmoil. In such cases, it may be advisable to highlight performance against key strategic and financial metrics. Also, consider highlighting performance relative to peers or indices (i.e., "We out-managed the competition during COVID").

Some companies choose to disclose **alternative pay** (i.e., realized or realizable pay). When it comes to making this disclosure decision, bear in mind that many major investors purchase data sets from Equilar that automatically calculate these alternative pay measures, so many investors have access to this information whether or not you provide it directly.

Peer or comparator companies. If making comparisons, describe how peer or comparator companies are selected (e.g., by industry, market cap, revenues or employee headcount) and how they are utilized (e.g., pay benchmarking and/or performance measurement).

If you've recently adjusted your peer group(s), to counter concerns about cherry picking, explain why you added and/or deleted specific companies. To address concerns about use of "aspirational" peers, consider disclosing your size relative to peers on key criteria. Disclosing additional information beyond size, such as relevant financial measures (ROIC, ROA) or workforce information, may induce investors and proxy advisors to lend greater weight to these company-selected peers than to the often-disparate peers chosen by proxy advisors.

"Our company is unique and so we employ **nonstandard pay practices**" is a statement that needs some support. If you feel your unique practices are right for your company and thus in the best interests of investors, that is fine, but recognize that you have a higher obligation to clearly explain your thinking. Otherwise, these nonstandard practices may be underappreciated or misunderstood.

"We haven't made any dramatic year-over-year changes, but rather a series of **incremental changes** over the past several years" is another common statement. Investors appreciate your pointing out changes from the prior year so they don't have to uncover these changes themselves. To gain credit for incremental change over a period of years, a timeline of changes and the rationale for how these changes came about can demonstrate a longer-term shift or a new direction altogether.

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Further topics that may be included in the CD&A, and/or elsewhere, include:

- Your **human capital** story. For many companies, this will largely be framed by their COVID experience—how they managed through the turmoil and steps they took to ensure employee health and safety while maintaining productivity and collaboration. A company's human capital story may be partially addressable in the CD&A, particularly in discussions of pay equity among diverse employee populations.
- **Pay ratio.** This is not necessarily a part of the CD&A, but it warrants mentioning. The good news is that most companies have found that earlier concerns about pay ratio disclosures haven't come to pass, and these disclosures are typically a non-event. That said, if your ratio diverges significantly from that of companies considered to be your peers or competitors, OR if your pay ratio has recently changed, consider putting this in context in terms of any shifting strategies, recent M&A or other events that may have impacted the business model and thus the workforce profile.

A Few Last Considerations

Use of design to enhance readability. We don't believe that every page requires design elements; rather, design should be used judiciously to highlight key messages and break up dense text. Useful design features include callouts or "pull quotes," graphs, timelines, tabular and bullet sections, page and table header treatments, and company branding and other visual elements. Here, we urge restraint and recommend against being "overly creative" since showing something a new way means investors haven't seen that type of presentation before and may have to spend more time figuring it out. Used judiciously, tried-and-true visual and design elements are often the most effective.

Color. Besides enhancing the general appearance, use of company colors can extend a company's brand into its disclosure documents, and importantly, can help to differentiate sections of graphs. If there are concerns about the impact of color on print costs, apply the broader color palette to the SEC-filed and web-hosted version (as adding color digitally can be very cost effective or even free).

Avoid graphs with multiple shades of a single color such as blue or gray because asking readers to rely on a tiny color key for interpretation can lead to misunderstandings.

About DFIN (Donnelley Financial Solutions)

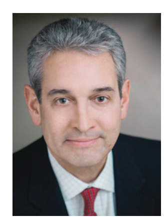
DFIN is a leading global risk and compliance solutions company. We provide domain expertise, enterprise software and data analytics for every stage of our clients' business and investment lifecycles. DFIN SaaS offerings, including eBrevia—data extraction powered by Artificial Intelligence, Venue Virtual Data Room and ActiveDisclosure, support critical issues with teams working remotely, specializing in: enhanced security and workflow management tools, providing innovative ways to collaborate exchange and manage SEC compliance and transactions.

Online version. Many readers access documents online: some at the SEC site, some at platforms drawing from SEC filings and others at company websites. In addition to cost-effective color, there are a range of additional interactive and navigational features that can be added to the online proxy, including hyperlinked tables of contents and links to company and director videos. In addition, enhanced, interactive proxies can be housed within specially designed proxy microsites that also include the 10-K or annual report, a sustainability report, convenient voting buttons and other important features.

Peer disclosure benchmarking. Many of our clients tell us that they aren't seeking to be on the vanguard of proxy innovation, yet they don't want to be perceived as communication laggards by their investors. Since your peer companies may be innovating from year to year, it's important to regularly review the level of disclosure and design that they're providing to guard against inadvertently falling behind. Many of our proxy and sustainability disclosure consultations start with such peer reviews.

Conclusion

Remember, not all companies need to fully address each of the above elements every year. That said, conscious consideration of this checklist on an annual basis, combined with new information from your investor engagement program and peer company reviews, can help ensure you tell a full, credible and digestible story that gives investors what they are looking for—and hopefully, a little more. CS



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For examples of how leading companies handle these compensation considerations, as well as a range of other board, corporate governance, ESG, and related proxy disclosures, please see DFIN's "Guide to Effective Proxies," available at ***bit.ly/3elpILx****.*

Create proxy statements that resonate with your investors.

DFIN is the industry leader in proxy statement design, printing, filing, hosting and distribution. Our end-to-end annual meeting solutions have you covered at every angle.

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