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MERIDIAN COMPENSATION PARTNERS

BlackRock Clarifies Its Perspective on Executive Compensation

BlackRock Investment Stewardship (BIS) recently issued an update to its general principles on executive compensation applicable to U.S. companies.

The BIS principles supplement BlackRock's proxy voting guidelines for U.S. companies. These principles provide BIS's insights on executive pay programs, which emphasize BIS's view that such programs should serve the objectives of "*long term investors*."

> The BIS publication identifies several important questions for compensation committees to consider as they design and implement executive compensation programs. For example:
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> - Are pay programs adequately aligned with business strategy?
> - Is there an appropriate balance between motivation and retention that works well across a range of market conditions?
> - Are awards adequately tied to sustained improvements in performance and long-term value creation?
>
> These and other issues identified by BIS reflect timely and appropriate questions especially given the impact of macroeconomic events on executive pay programs and outcomes over the past several years.

The updated BIS principles focus on the following three areas: (i) factors in developing pay program designs, (ii) key program design characteristics and (iii) BIS's engagement with public companies.

Factors in Developing Pay Program Design

BIS encourages boards and compensation committees to consider the following factors with respect to the design and operation of executive compensation programs:

- Balance between retentive and motivational components in compensation program design to promote long-term performance.
- How the compensation program rewards long-term financial value creation, sustained across the duration of the program's performance period.
- How pay underpins strategy, with clear disclosure of the rationale for selected performance metrics.

- Resiliency of pay program across dynamic market environments and the business cycle.
- Responsible use of discretion to reinforce alignment of pay and shareholder returns.
- Clear disclosure of pay decisions in exceptional situations.

Key Program Design Characteristics

BIS recommends that boards and compensation committees focus on the following program design characteristics:

- **Resiliency**. Market turbulence creates a perceived need for boards to intervene with special retention awards or adjustments when performance-linked awards are not likely to pay out. BIS urges companies to develop resilient programs that balance retention and motivation and deliver reasonable pay outcomes across a broad range of market conditions, thus limiting the need for extraordinary measures in volatile economic environments. BIS notes that given increased uncertainty of business outcomes, these considerations may impact compensation committees' decisions regarding the mix of performance-based and service-based award types, absolute and relative performance metrics and metrics based on total shareholder return and operational and/or financial factors.
- **Sustainability**. BIS recommends tying a significant portion of awards to metrics that measure performance through the full period of the long-term incentive plan (typically at least 3 years) since compensation programs should encourage long-term financial value creation that is sustained across the full business cycle or duration of the awards.
- **Alignment**. Compensation programs should reinforce corporate strategy. BIS finds it helpful when compensation programs provide direction to the management team about the key value drivers that deliver long-term benefit to shareholders. BIS defers to compensation committees to determine which metrics are most relevant to a company's business, positioning and strategy. However, BIS appreciates clear disclosure of the rationale for selecting performance metrics and how those metrics encourage the delivery of long-term financial value to shareholders, as well as disclosure that provides insight into the incentive plan goal-setting process.
- **Flexibility**. BIS acknowledges there are some circumstances where special action by boards is aligned with long-term value creation, and it believes boards should retain the ability to exercise discretion, when warranted. However, they also note that adjustments should always be made in the best interests of long-term shareholders. BIS also notes the increased use of front-loaded multi-year awards in recent years. BIS observed that such awards may limit a committee's ability to make course corrections over a multi-year period, increasing the potential for windfalls and retention risks.
- **Clarity of Disclosure in Unusual Situations**. Large-scale overhauls of compensation programs, executive transitions and corporate transactions such as initial public offerings (IPOs) require companies to explain their compensation strategies clearly. "Good disclosures tend to be concise and to the point" and "relevant information can be shared without extending disclosures to unnecessary lengths," BIS advises.

BIS's Engagement with Companies

When engaging with companies, BIS seeks to understand the following:

- **Program alignment with corporate strategy**: If a company's plans focus entirely on market-based metrics, how is the board overseeing management on strategic priorities? What balance of long-term operational and financial metrics provides this focus?
- **Compensation committee oversight**: How does the compensation committee maintain current knowledge of compensation practices? How does the company identify and mitigate the most significant compensation-related risks?

- **Consideration for the purpose of various awards**: How are performance and retention aspects of a pay program balanced? Do the change-in-control severance provisions align management with long-term shareholder interests?
- **Periods of leadership transition, transformation, etc.**: What lessons has the board learned in prior succession planning experiences? When discretion is used, what are the intentions going forward to normalize the compensation plan and to help shareholders know what to expect year-over-year?
- **Transparency**: Does the company adequately equip shareholders with insight into incentive award goal setting without compromising its competitive advantages? For recent IPOs subject to less stringent reporting requirements, how does the board adequately explain to shareholders the connection between the company's compensation policies and shareholder value creation?
- **Risk-mitigation policies**: How often does the compensation committee review and update risk-mitigating policies such as stock ownership requirements or stock holding guidelines?

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