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Top 10 Questions for **Today's Compensation Committees**

April 2025

As proxy season begins, it's time to turn attention to the major compensation decisions ahead. Our annual Top 10 helps compensation practitioners, management, and directors consider key topics that will be important in the coming months.

1. What are the considerations in using adjusted metrics in incentive plans?

David Wise; Senior Client Partner

It has become commonplace for companies to adjust their earnings metrics from GAAP to non-GAAP outcomes as part of the annual incentive plan evaluation process. Over the past several years, investors and their proxy advisors have begun to look more closely at this topic than ever before, creating an area of significant scrutiny and potential for misalignment between management teams and their shareholders.

The most effective incentive plans aim to reflect the underlying operating performance of the business, without the impact of significant noise that may be non-operating or one-time in nature. For that reason, we find that making adjustments to financial results for incentive purposes is generally reasonable only when those adjustments align to the majority of the following five principles:

• Non-operating: the adjustment item is not reflective of the company's underlying operating performance.

• Controllable: the adjustment item resulted from unexpected circumstances that were beyond management's ability to reasonably predict or control.

• Reasonable: the adjustment itself passes the reasonableness test, meaning the company could reasonably explain to shareholders why the plan should not be affected by an adjustment of a certain magnitude.

• Special: the adjustment item resulted from special (likely unplanned) actions or one-time events that could negatively impact short-term results but were the 'right' decision for the long-term.

• Equitable: the adjustment considers positive and negative outcomes equally, and could serve to adjust 'in' or adjust 'out'.

As a pragmatic matter, it is always prudent to consider how shareholders and their proxy advisors will react to adjustments like these, so there are no surprises in their reaction to a decision. In that process, it is important to consider the magnitude and impact of the proposed adjustments. Whether or not aligned with the above principles, any adjustment that changes an incentive payout from zero to above-target will often receive ample and understandable scrutiny.

For this reason, disclosure has become a critical imperative for any company that either utilizes non-standard adjustments or an adjustment of a magnitude that investors may have difficulty understanding. In that event, an 'adequate' disclosure may no longer be sufficient; rather, such disclosures increasingly need to tell a clear story that investors can track about the walk from non-GAAP to GAAP, the rationale for each material adjustment and an explanation of how it aligns to the company's own principles. Proxy advisory firms are awarding points for the clarity of such disclosures, which in some cases may offset negative reactions to the content of the adjustment itself.

Although adjustments of this type attempt to get at the true operating performance of a company, they are not the final word. Committees typically retain flexibility to add or subtract elements after the year ends. This allows a second opportunity to sharpen consideration of management and company performance.

2. How do we safeguard retention with declining stock values?

Laura Balser; Senior Client Partner

For companies with highly volatile or declining stock values over the past few years, there is concern that the declining target value of long-term equity grants may create retention risk for key employees. When an incumbent's holding power is less than two times base salary, the ability for a new employer to "buy out" the equity is more feasible. To mitigate this retention threat, Korn Ferry is working with committees and management to apply short- and long-term strategies to safeguard retention.

Short-term retention actions typically involve cash and may have a greater retentive effect if stock values are depressed and company performance is waning. Companies may consider one or a combination of the following short-term actions to improve employee retention:

- Off-cycle or higher-than-normal merit base salary increases.
- Increases to annual incentive targets.
- One-time cash awards with multi-year service requirements.

While increases to base salary and/or annual incentive targets are often permanent, they can communicate the value a company sees in the incumbent. However, Korn Ferry believes the most retentive action of these three is a one-time cash award with a multi-year service requirement. These arrangements also have a corresponding clawback period, meaning that the individual would have to pay the company back some portion of the award if they leave before the service requirement expires. Generally, the award sizes range from 0.5 to 2 times base salary depending on the service requirements, typically one to two years.

Long-term retention actions are usually realized over a longer period of time, with a minimum of two to three years. Below are an array of alternatives we have seen employed:

- Equity mix changes to 100% time-based units.
- Temporary increases to long-term incentive grants.
- One-time special equity awards in time-based units with ratable vesting.
- Multi-year cash awards.

While these longer-term actions may be attractive to participants, they do come with downsides. Proxy advisors will criticize any shift to 100% time-based equity or other one-time awards. However, the temporary increase to long-term awards will not likely get scrutinized by the advisors as it may appear to be a routine change. A subsequent reduction in the LTI awards for participants will be viewed positively by external observers and stakeholders. Any increases to awards may come with unexpected 162m issues. Specifically, if any award pushes a participant within the definition of "covered employee," even during a single year, that individual will always be subject to the rule.

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3. Is benchmarking CEO pay the best approach for us?

Irv Becker; Vice Chairman, EP&G

Chief Executive Officer (CEO) pay quantum is always a hot-button issue. Korn Ferry has produced pay surveys for more than 20 years and, with few exceptions, CEO pay has steadily increased.

In 2008, the median CEO total direct compensation within the largest 300 US publicly traded companies was $7.5M. That number more than doubled, growing to $15.6M in 2022. CEO base salaries exhibited a modest 2.3% CAGR, while long-term incentives exhibited a more impactful 5.0% CAGR during this period.

There have been a variety of reasons for the increases, including consequences, both intended and unintended, from market trends, new laws, economic swings, and perhaps even shareholder expectations. The so-called "ratcheting effect" of benchmarking is also partially to blame.

Benchmarking is an important tool for compensation committees looking to incentivize and retain top talent. Without benchmarking, companies would be at constant risk of overpaying or underpaying executives. Benchmarking itself is not the problem, but it may be somewhat one-dimensional.

Given the continued scrutiny on CEO pay, we need to think about new ways to benchmark CEO pay. We call this new approach CEO Pay Quantum Review. This review includes a number of different perspectives and approaches to sizing CEO pay and the CEO job size. Here are a few of the analyses that should be performed in order to get a more multi-dimensional view of CEO pay quantum:

- CEO pay relative to peer CEO pay (Target, Realized, and Realizable Pay).
- CEO pay relative to their direct reports' pay.
- CEO pay relative to employee pay.
- CEO pay relative to shareholder return.
- CEO pay relative to other metrics of financial performance.
- CEO pay relative to the CEO job size based on job responsibilities, complexity of the job, etc.
- CEO job size relative to their direct reports' job size.
- CEO tenure compared with peer CEO tenure.

The insights from each of these different perspectives should help committees better triangulate the right pay target for its CEO. At a minimum, it gives the committee more information and a more holistic view of CEO pay quantum.

4. Should we use non-financial goals in the LTI program?

Tony Wu; Associate Client Partner

As companies put more emphasis on improving the link between their executive pay program design and their areas of business focus, we see more attention to the use of non-financial metrics (NFMs) in company performance-vested share (PSU) plans. While NFMs have some prevalence in annual incentive (AIP) programs, they are rare within PSUs, which more classically are intended to align more with longer-term investor outcomes.

For the right company, this yields a missed opportunity, as the use cases for long-term NFMs are endless: the hotel chain that engages in a long-term campaign to improve its net promoter score; the airline that ranks last in its airplane controllable completion factor and sets out to overhaul it; the manufacturer that invests in reducing customer rejection rates. All of these situations could benefit from a long-term incentive that vests, in part, on the basis of marked improvement in these measurable areas.

Using NFMs in the PSU will not be for everybody, but for the right situation, these programs can have impact. Here are five key implementation considerations:

- Choose an area of true business focus that correlates to value. Inclusion of an NFP in the PSU

will be unusual, making it a potential area of attention from investors; to that end, it is ideal if the metric is something the company addresses in earnings calls and that is a well-understood marker of good strategy execution – and that as a result ideally holds some correlation to how the stock may move. The metric should be something that the business must execute on and ideally improve upon to build a more sustainable, better business long term.

• Choose a metric that is objective and measurable. Objectivity and measurability are critical when it comes to any metric, but even more so for one attached to equity. Trust us that you do not want to deal with any metric that requires discretion to trigger vesting, or where the rules of measurement are not clearly defined, as this can yield liability accounting, which may cause your CFO to come and find you.

• Know what 'good' looks like but cast a wide net. Companies with years of experience setting three-year financial goals can still struggle with it. Setting NFM goals is no different. It is critical to choose a metric where you can set a viable three-year goal. When first using these metrics, it is a good idea to consider a wider performance range than normal, which leaves more room for the plan to finish in the money.

• Diversify the risk. Companies will be hard-pressed to utilize a single NFM to govern the entire PSU. As such, add at least one financial metric with heavier weighting. The reality is that any inclusion of an NFM in the PSU will send a strong signal to plan users, and by linking more of the award to objective financial metrics, you are more likely to avoid a situation where the entire PSU payout grossly misaligns with financial performance. Another consideration is the overall impact on the performance orientation of a long-term program when NFMs are added. A company taking a portfolio approach to equity grants (e.g., 50% of the grant vests based on time and 50% vests based on performance) may dilute the financial portion of the program if the NFM weighting is too great.

• Consider a TSR cap or governor. Having the non-financial portion of the PSU vest at maximum during a period where the stock underperformed would likely sink its use in future programs. Having some cap or downward modifier if absolute TSR is negative, for example, helps keep the entire award value in proportion to outcomes for shareholders.

5. Should we care about ISS approval on equity plans?

Cory Morrow; Senior Client Partner

Equity plans consistently receive an overwhelming level of shareholder support despite ISS "against" recommendations. For annual meetings through the first half of 2024, there were 596 proposals in the Russell 3000 to amend or approve equity plans. Of these, only five companies (less than 1%) failed to earn majority support from shareholders. However, ISS's equity plan analysis – the Equity Plan Scorecard – is designed to give an "against" recommendation to roughly one-third of proposals.

The high level of shareholder support should not come as much of a shock. If equity plans are not approved, companies would typically resort to using cash for both short- and long-term incentive programs. Burning through cash in this manner is not a preferred course of action – and shareholders know it. Moreover, there is little alignment between executives and shareholders if cash is used. For these reasons and others, shareholders are motivated to approve equity plans and voice any objections about compensation practices through other means – namely, the say-on-pay vote.

It is also important to understand that, unlike low support for say-on-pay, there is no subsequent ISS review if an equity plan does not receive support over a certain threshold. As such, most equity plans simply need majority shareholder support to be approved and become effective. This should provide some relief to compensation committees as they prepare their next equity plan request.

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6. What do the PvP disclosures tell us after year 2?

Kurt Groeninger; Senior Principal

Pay-versus-performance has added minimal understanding to a company's approach to pay. Shareholders and compensation professionals alike still have trouble deciphering what the tables mean, given the irrational rules around calculating compensation actually paid. Executives are also confused, with many expressing disbelief over what the tables say they were paid.

While the new disclosures lack any real utility, it is important to note that both ISS and Glass Lewis have not demonstrated any reliance on the information. Both proxy advisors have stated that the pay versus performance disclosures may be considered during a say-on-pay assessment, but this would only occur if the initial quantitative pay-for-performance tests show a misalignment. In reality, we have seen no widespread evidence that the new disclosures are being taken into account when providing recommendations. Rather, the information is presented only factually with no subsequent analysis performed. Given this, there should be no concern about how the PvP disclosures "look" for purposes of proxy advisors.

While external perspectives on PvP tables appear to be largely immaterial at this point, corporate boards still have an obligation to review and internalize the data. Members should understand if there are any large changes in the compensation actually paid and what the causes are. Big swings in pay may be due to stock price fluctuation, but something else may be at play. Work with management to understand what the PvP tables are saying about the compensation program.

7. Why is ISS criticizing our goal rigor?

Kurt Groeninger; Senior Principal

ISS bases its say-on-pay recommendations on a set of published policies. These policies are often supplemented through unpublished internal practices. These practices are the trade secrets ISS often relies on when making its recommendations.

One of the more confounding internal practices ISS relies upon focuses on goal rigor. ISS will often criticize a company's incentive program by suggesting that the goal was not sufficiently rigorous. The problem is that ISS is in a poor position to judge the difficulty of any performance targets, and their internal practice shows it.

ISS takes a crude approach to judging performance targets. The first approach looks at whether the disclosed performance target in the most recent fiscal year is set below actual performance in the prior year. For example, your company will get criticized if the 2024 revenue target was set at $100 million but the company pulled in $130 million in the prior fiscal year. Setting the target below actual performance in the prior year is bad enough, but it will get criticized more heavily if performance exceeds that of last year. The second rigor test focuses on the number of times an STI or LTI pays out at maximum. ISS will highlight a concern if there are at least three years of maximum or very near-maximum payouts. These maximum payouts suggest the compensation committee may not have been setting particularly challenging goals.

If either of these two situations apply to your company, there is still a way to address the rigor issue. The CD&A must demonstrate the reason for the lowered goal and why it was still challenging. Three to four sentences explaining the rationale, in easily understood terms, can be a good defense. An alternative would be for the compensation committee to exercise discretion to reduce the payout to account for the lowered goals. Such a step is not typically advised, but it is a potential tool for committees looking to avoid proxy advisor criticism.

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8. What do we do about non-competes now?

Todd McGovern; Global Consulting Leader, EP&G

The Federal Trade Commission (FTC) attempted to ban non-compete agreements, but legal challenges in Texas put a nationwide stop to the rule. For now, the FTC's bid to upend this core contractual arrangement is done, but should we still be concerned?

Given the outcome of the 2024 presidential election, federal attention on the matter is likely done, at least for the next four years. State legislatures may push ahead, however. For example, several states that currently ban non-compete agreements in some fashion; and any significant action by New York on the topic would likely have nationwide effects.

Despite the Texas ruling, there are steps the board and management should consider taking in the event restrictions on non-competes become more commonplace.

Step 1: Monitor the situation. Boards and management do not need to take immediate action. Board members should monitor any developments in case there is some action by federal regulators or state legislatures to curtail non-compete agreements.

Step 2: Take inventory. What is the company's current approach to non-competes and who has them? This information may be valuable in understanding the full picture of the company's retention efforts.

Step 3: Consider alternatives. What happens if non-competes are eventually banned at the federal or state level? It may be worth considering compensation arrangements intended to retain individuals for a longer period of time. This may require moving towards contracts of fixed duration, potentially for up to a five-year period. Also consider moving towards cliff vesting of time-based equity as opposed to the more common ratable vesting. Along these lines, increasing equity while decreasing cash incentives may be a potential option. Finally, boards may want to consider eliminating lump sum severance payments and only pay severance until hired by a new company.

9. Succession planning: What are the compensation costs of getting it wrong?

Jonathan Mason; Associate Client Partner

The lack of a robust CEO succession plan has many downsides for a company, but the one we do not talk about enough is the cost of it. We have seen a number of cases in which the lack of a strong leadership bench led to a special retention package for the current CEO. In these situations, compensation committees are put in a difficult position when there are no no viable CEO successors and the retirement-eligible CEO sought additional compensation to retain their services for several more years. While the reasons for this situation are always unique, the fact remains that building the next generation of leaders is critical…and cheaper.

The succession planning process requires a high degree of involvement from the board of directors. While the board is firmly in the oversight role, directors should be constantly and actively engaged in talent management and succession. Unfortunately, this is not always the case.

Committees often get complacent with the current chief executive or put off succession planning because of recent turnover in the role. A new CEO does not mean the board gets to take a year off from planning for the next transition.

To stay focused on succession and avoid the potential for unwanted costs, boards should consider a CEO "progression" approach that puts leadership candidates onto developmental paths to bolster the skills, experiences, and perspectives they will need to drive corporate performance. Progression planning is a continuous process in which CEO candidates are identified years in advance and developed based on the strategic priorities that will define success.

The board cannot drive this progression process, but it can hold the current CEO accountable for its success. After all, the lack of suitable leadership candidates is the fault of the current CEO, not the candidates themselves.

This process and its oversight are often secondary concerns of boards. However, progression of executive talent can pose risks to the organization and rightly should be overseen by the board. Done well, progression planning will not only improve your ability to select the best CEO—it will also ensure that you are developing executives who fit the business strategy as it evolves.

10. What should we do about personal security perquisites?

Kurt Groeninger; Senior Principal

The recent murder of a UnitedHealthcare executive has many compensation committees questioning whether security benefits are now a necessity for some personnel. An examination of this kind makes sense, and there are several factors to understand.

First and foremost, the board should conduct a third-party risk assessment to understand the threats for each member of the senior executive team. The board should not act alone or take an executive's word for it on whether or not some form of security detail is required. It is also important to know that personal security comes in many different forms and cost levels. Approximately 18% of the CEOs in the S&P 500 have some type of security perquisite. The perquisite costs range from a few hundred dollars for cybersecurity protections to over $20 million for around-the-clock security personnel.

If some type of personal security benefit is required, these costs will still show up as a perquisite in the Summary Compensation table. Even if the board requires security for an individual or it is company policy to provide such a benefit, the SEC has made clear that these costs are not "integrally and directly related" to job performance and must be disclosed as perquisites. The SEC's view on this is unlikely to change despite the recent tragic event.

Proxy advisors generally do not raise significant concern with the cost of security perquisites. Committees should expect a note of concern from ISS if the security costs moderately exceed $1 million. However, this concern will not likely be used as a driver on the say-on-pay recommendation. On the other hand, and in more extreme cases, ISS has used security costs of $10-20 million as part of an adverse recommendation. Given the recent events, we expect a rapid evolution in the cost and prevalence of security benefits in 2025. This may trigger some reluctance on the part of ISS to criticize larger security packages in the near term.

About Korn Ferry

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