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Teneo Insights

20 For 20: 20 Imperatives for Fall 2020

Shareholder Engagement

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OVERVIEW

The once-in-a-hundred years global pandemic and once-in-a-generation global protests have created a seminal moment for companies and their leaders to reestablish and reinforce the basic tenets by which they run their businesses. The expansiveness of the role of the CEO and the board, as demonstrated by environmental, social, and governance (ESG) issues, will continue. Many changes are underway with the expanded attitude of stakeholder capitalism, the broader mandate of running a business, and positioning its governance. These changes will need to be communicated effectively to all stakeholders.

One of the first opportunities for companies to rearticulate their values, strategy, board roles, and management actions is in the cycle of fall shareholder engagement. For this pivotal year of 2020, the traditional fall shareholder engagement season takes on heightened significance. In that regard, how should companies prepare for those engagement discussions with investors, and what will be asked of them and their leaders?

BACKGROUND

The 2020 proxy season began amid rising acceptance of stakeholder capitalism and investors' heightened focus on ESG concerns. These themes featured prominently in shareholder proposals, and voting results suggest they continued to resonate with investors. As the 2020 proxy season moves to engagement season, the potential impacts of the COVID-19 pandemic and social unrest on the governance landscape are only beginning to be seen. The early weeks of the pandemic saw hundreds of voluntary and, at times, required[1] pay reductions for top executives and non-employee directors. Market turmoil eroded the value of outstanding equity awards and rendered some incentive goals unrealistic and potentially demotivating. However, proxy advisors and large institutional investors showed no signs that they would become more lenient on executive compensation, and the number of say-on-pay failures[2] increased compared to the prior year. Compensation Committees face the task of motivating executives, while being mindful of expectations from investors and employees.

Investor scrutiny won't be limited to Compensation Committees. Despite the prevalence of diversity statements and policies at U.S. companies, racial minorities in C-suites and boardrooms remain few and far in between[3]. While board gender diversity has been a key investor priority in recent years, comparatively little attention has been paid to racial and ethnic diversity. The disproportionate impact

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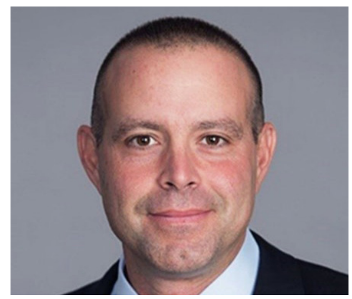

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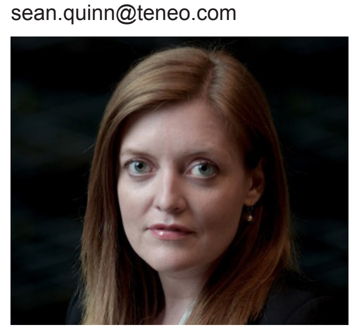

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[1] Per the Senate Stimulus Bill (H.R. 748, Sec. 4116), companies receiving loans under the CARES Act, were required to freeze pay and cap severance for employees making more than $425,000 and reduce pay for those earning more than $3,000,000.
[2] According to ISS Voting Analytics, 2.3% of Russell 3000 companies with meetings prior to June 1 failed say-on-pay in 2020, compared to 1.8% during the same time period in 2019.
[3] Currently just 0.8% of CEOs in the S&P 500 are African American.

of the COVID-19 pandemic on certain minority groups and national outrage stemming from the death of George Floyd while in police custody have catapulted racial and ethnic diversity toward the top of investor agendas. Expect investors to call for companies to move beyond diversity statements and policies towards concrete actions to increase their racial/ethnic profiles and address workplace issues that disproportionately harm minority workers.

20 IMPERATIVES

With the above background setting the stage for a critical offseason engagement, companies will be more prepared on key topics that will be top of mind for investors. We have provided below 20 imperatives and 20 questions – with a focus on diversity and executive compensation – that companies should ask themselves. These topics and questions provide guidance on how to approach the 2020 fall engagement period and look beyond the next several months to the 2021 proxy season.

I. New Normal

1. **THE ABILITY TO PIVOT: How did we adapt our leadership in our response to recent events?**
Companies have demonstrated the ability to pivot quickly during the outbreak of COVID-19, with virtual meetings, work at home plans, employee safety, redeployment of manufacturing, liquidity and cash flow management, and calls for additional diversity. Investors will want to understand how the business leaders navigated the challenging environment.

2. **RESETTING OUR STRATEGY: How are we reassessing and resetting our strategy, business, brand, and reputation to align with the new normal?**
Over the medium and long term, the new normal may call for a different strategy, brand changes that mitigate inclusiveness concerns, or a reprioritization of business lines. Stakeholders will view the strategy through a new lens and expect companies to do the same.

II. Board Oversight of Risk

3. **CLARITY OF OVERSIGHT EXPECTATIONS: How is our board overseeing risk and setting expectations for the management teams given the expanded stakeholder mandates?**
Boards have responded to the pandemic and protests by overseeing sweeping changes in the way companies work and articulating statements in support of racial equality. Board directors that participate in shareholder engagement will be asked about the board's oversight role in these areas.

4. **PRIORITIZATION OF RISKS: How is our board reassessing and setting its priorities around risk management and communicating priorities to shareholders?**
The ability of a board to carry out its fiduciary duties depends not only on a clear articulation of expectations, but an understanding of risks and how the risk priorities change. Operational risk, reputational risk, financial risk, activism risk, and cyber risk have all been impacted by the events this summer.

III. Focus on Diversity

5. **BOARD DIVERSITY: Have our current policies resulted in a sufficiently diverse board?**
Many investors believe that "diversity of thought" cannot be achieved without gender, racial and ethnic diversity. Formal board policies on racial, ethnic and gender diversity will quickly be "table stakes". In addition, companies will be asked to disclose the racial/ethnic profile of their boards – collectively and/or individually – within the 2021 proxy statement.

6. **DIVERSITY DATA: Are we transparent enough with our employee diversity and pay gap data?**
   Some investors have requested that companies disclose the demographic data of their overall workforce, such as Equal Employment Opportunity data ("EEO-1"). Several have sponsored shareholder proposals requesting this information, a few of which have received majority shareholder support. As a result, many companies have begun to do so. This presents challenges for companies with a global workforce.

7. **POLITICAL SPENDING: Do our political activities, contributions, and lobbying align with our views on diversity?**
   In recent years, investor advocates have been asking companies to ensure there is alignment between their political activities and their stated views on climate change. Organizations advocating for racial justice add another dimension to that same logic – is there appropriate alignment between the political candidates the company supports and their views on diversity?

8. **DIVERSITY GOALS: Should we set and disclose concrete diversity goals?**
   The evolution of sustainability reporting has led to the practice of companies setting and disclosing concrete goals, typically relating to the environment. It is less common for companies to set and disclose any goals relating to social issues. However, the current environment could prompt investor calls for goal setting on this issue as well.

9. **EMPLOYEE HEALTH: Do we have a good story to tell on employee health and safety? Are we telling it effectively?**
   The COVID-19 pandemic has focused company attention on the health and safety of its workforce. The racial justice movement has some connective tissue to employee health and safety as reports indicated that minorities suffered worse COVID-19-related outcomes. Companies have an opportunity to expand disclosure on how they are helping their workforces deal with these issues.

10. **COMMUNITY SUPPORT: What steps are we taking to promote racial justice within our organization?**
    Many companies have provided community organizations with generous donations to promote racial justice. However, there is skepticism that donations alone are enough to address racial inequality. Investors will ask companies how they are helping their communities, such as enhancing education and providing healthcare and job training for the minority community.

11. **GLOBAL SUPPLY CHAIN: Are we doing enough globally to advocate for a diverse supply chain and human rights?**
    The cause for racial justice has received tremendous global support, perhaps indicating that this issue is not unique to the United States. Organizations like the UN Global Compact have been in place for quite some time for this reason. Companies that have a global presence should ensure that their focus on these issues is viewed with a global lens.

12. **ESG RATINGS: Are we engaging effectively with the ratings firms?**
    We have written before about the prevalence and importance of ESG ratings firms. How a company responds to calls for racial justice and the global pandemic will undoubtedly impact its ESG ratings, and therefore its access to capital. It is important to ensure that non-shareholder stakeholders and ESG ratings firms understand how the company is addressing this issue.

IV. Impacts on Executive Compensation

13. **EXECUTIVE SALARY REDUCTIONS: How do our salary decisions made during the pandemic align with broader compensation?**
    Although many executives took salary cuts to both reduce costs and show solidarity with employees experiencing pay cuts, furloughs, or layoffs, some have criticized these as insufficient, while others are concerned that executives could be made whole later.

14. **CONSISTENT GRANT VALUES: How will our year-over-year grant values be perceived by investors?**
    Maintaining year-over-year grant values during periods of extreme stock price volatility poses a unique set of challenges. While lowering annual grant values may raise retention and motivation concerns, proxy advisors and many shareholders expect lower grant date values when the stock price is low, as granting more shares has a dilutive effect. The recent stock market rally has only increased the scrutiny of significant gains from equity awards at the height of the pandemic.

15. **GOAL MODIFICATIONS: Are we making any goal modifications, and what is our view on the use of discretion?**
    While some shareholders oppose any changes to incentive awards at this time, others acknowledge that modification or discretion may be necessary, either in the form of non-GAAP adjustments, new goals, or changes to metrics. Companies that lower or adjust incentive targets due to outside factors should prepare for shareholder questions and heightened disclosure expectations.

16. **TIME BASED AWARDS: What are the implications of replacing at-risk incentives with time-based awards?**
    Some incentive performance goals set at the beginning of the year may no longer be feasible or motivating for plan participants. At the same time, uncertainty and limited visibility challenge companies' abilities to set new goals. Incorporating more time-based awards preserves intended award value, but is likely to draw investor and media scrutiny.

17. **ESG METRICS: Should we consider including ESG performance metrics in our executive compensation program?**
    Most companies have a pay-for-performance philosophy. However, limited visibility into financial metrics has challenged traditional incentive goal setting. At the same time, shareholders increasingly expect pay to be aligned with broader stakeholder interests.

18. **ABOVE TARGET AWARDS: Are we paying out above-target relative-TSR-based awards?**
    While many shareholders value relative TSR as a metric, they emphasize the importance of factoring in absolute shareholder returns. Paying TSR-based awards above target during a down market could draw shareholder scrutiny and media criticism.

19. **OPTION REPRICING: Should we consider stock option repricing? If so, how should we proceed?**
    With some outstanding stock options underwater, an increasing number of companies have contemplated repricing or replacing stock options. Proxy advisors have strict policies in place governing stock option repricing. Running afoul of these policies carries risks, including low voting support for Compensation Committee members in subsequent years.

20. **ONE-TIME AWARDS: How can we balance the need to retain executives with managing the interests of various stakeholders?**
Proxy advisors generally do not support off-cycle retention awards. While necessary in certain cases, one-time awards may draw scrutiny, particularly if employees have been adversely affected by layoffs. However, this year, proxy advisors and investors will consider executive pay decisions in the context of other workforce issues.

LOOKING AHEAD

Notwithstanding the significant disruption brought by the pandemic and social unrest, business leaders can view the fall engagement season as an opportunity to articulate the basic principles underlying their organizations. Investor priorities have evolved and will continue to evolve in the coming months. Therefore, staying current on investor and proxy advisor priorities – and being prepared to speak to them – is a must-do this year. Additionally, engagement teams should be prepared to communicate the board's risk oversight and the company's preparedness regarding further disruption stemming from a potential "second wave" of the pandemic, additional protests, or continued market volatility. Companies that acknowledge this "new normal" and plan accordingly will find themselves well prepared for proxy season 2021.

We will continue to update our clients on the governance implications of the crisis and expectations of investors and proxy advisors. Please reach out to us with any additional questions.

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