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HCM Viewpoint

The Compensation Committee Planning Cycle

Considerations in a Year of COVID-19

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The Compensation Committee Planning Cycle

Compensation Committees ("CompCos") of publicly listed companies first and foremost have the responsibility to **determine and review the company's compensation policy and philosophy** in the overall governance context. In recent years, they have been faced with heightened demands voiced by different stakeholders such as shareholders, in a continuously changing regulatory environment. Additionally, the public interest in compensation-related topics has significantly increased over the last two decades, marked by e.g. the Minder-Ordinance initiative adopted in 2014. As a result, CompCos are faced with multiple and growing responsibilities and accountability relating to both **governance and compensation-related matters**.

Most recently, the COVID-19 pandemic has refocused the public's attention to Executive compensation. Moreover, as **unprecedented uncertainty in economic development and more volatile stock markets** are expected throughout 2020 if not longer, concerns over effects of COVID-19 on businesses and their implications on employees are growing. Even if no immediate changes or decisions in terms of compensation are taken, the impact of COVID-19 is still uncertain to some extent and **CompCos are well advised to re-evaluate their typical compensation-related planning and priorities**.

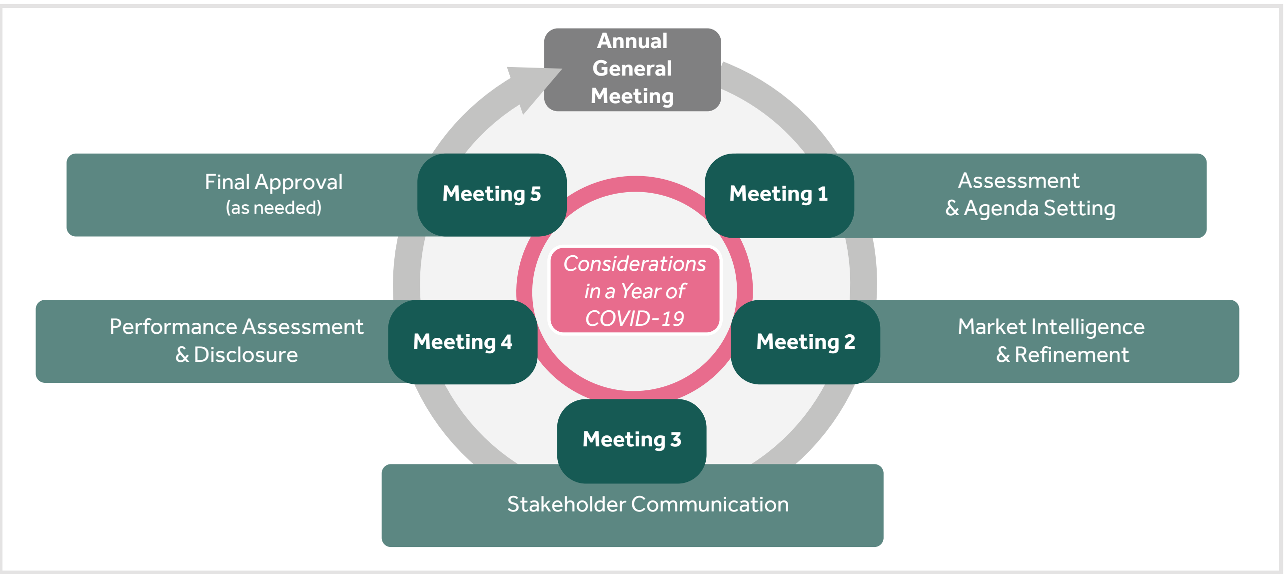
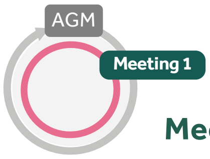


Figure 1: HCM approach to the CompCo's Planning Cycle – Considerations in a Year of COVID-19.

HCM's approach outlines the **key elements of CompCos' annual agenda** along a planning cycle from Annual General Meeting ("AGM") to the following AGM, and allows to specifically address topic matters, on what to prioritize e.g. during the COVID-19 pandemic within a predefined process.

Especially now, as the COVID-19 pandemic may put **strains on company finances and budgets** – including compensation spending – a carefully laid out and thoughtful planning cycle is essential for CompCos' overall efficiency and success.



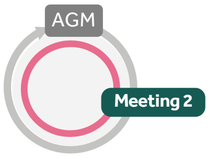
Meeting 1: Assessment & Agenda Setting

Following the AGM almost immediately, this opening meeting serves as an **opportunity to examine feedback provided by investors through Say-on-Pay** (i.e. compensation amounts for Board of Directors and Executive Management and often the compensation report), as well as review proxy advisor recommendations in order **to identify significant gaps, and set priorities** going forward. Also, when setting agenda items, a review of the company's talent situation and employees' as well as other stakeholders' interests can help in shifting the focus towards the elaboration of effective refinements throughout the year.

Considerations in light of COVID-19

CompCos are generally advised to assess if the COVID-19 has or expectedly will have a significant impact on their long-term business strategies and hence, will bear an impact on compensation. In this context, possible **adjustments in compensation levels** (e.g. temporary reduction of cash-based salaries or base fees) or **amendments in the compensation framework** (e.g. deferral of cash-based payments) should be carefully discussed to align Executive and Board compensation to this specific situation in a targeted manner. This typically includes a mindful review of the robustness of the compensation framework with regards to self-correcting measures, built-in discretion, and the inherent risks of amendment.

Additionally, for equity-based compensation, share price developments need to be carefully observed in view of **sufficiency of authorized share capital** and avoiding potentially perceived windfall (i.e. "hidden leverage") gains. Without going through these considerations, companies risk not adequately incentivizing and compensating their employees at a time where increased dedication is key.



Meeting 2: Market Intelligence & Refinement

The second meeting in the CompCo planning cycle involves the identification and prioritization of **possible refinements to the compensation practices**, often with the support of an external independent advisor who may challenge motions put forward. During this process companies are advised to consider their **competitiveness in attracting, motivating, and retaining talent** not only with regards to compensation levels but also to design, including the assessment of adequate performance measures for variable compensation (i.e. short-term incentive [STI] and long-term incentive [LTI]). In this context, an **independent level and/or design benchmarking** for the Executive Management and the Board of Directors is usually conducted on a bi-annual basis. Additionally, **yearly educational sessions** for example on recent market developments can be included at this point, to keep the members of the Committee informed on relevant regulatory and compensation-related topics. Ultimately, a minimally **bi-annual self-assessment** of the Committee to sustain overall efficiency is essential.

Considerations in light of COVID-19

Reflecting the impact of COVID-19 on companies' businesses, closely monitoring Executive performance becomes a central task to CompCos. Combined with updated financial forecasting for the remainder of the financial year, initial estimates on year-end variable payout levels are at hand (e.g. including risk-payout scenarios for outstanding LTIs). Even if a **wait and see approach might still be appropriate** at this time, a continued discussion on how CompCos engage (e.g. by accruing compensation in financial results) in this exceptional year sets **the base-tone for solid year-end decisions**. This may include assessing the appropriateness of target achievements differing between management levels, considerations about applying discretion and later disclosure on rationales in compensation reports in case of adjustments made.

To start a more forward-looking review, increased market uncertainty and a possible (re) orientation of the business in upcoming years are to be taken into account. Also, a comprehensive evaluation includes considering **refinements in the overall compensation framework**. Aligned with compensation strategy, these refinements may include (re-)defining appropriate performance measures (for example environmental, social and governance [ESG]-related) or considering design aspects such as increased built-in flexibility.

Meeting 3: Stakeholder Communication

Communication and **engagement with investors, proxy advisors, and other relevant stakeholders** are vital steps and require focused attention by CompCos. This third meeting also serves as an opportunity to start reviewing the performance of Executive Management of the current year and its implications for variable compensation (e.g. forecasted payout levels in STIs and LTIs). Additionally, a pre-discussion regarding **performance targets for the upcoming year and salary budgets** can be held. Finally, CompCos can start preparing a first draft of the compensation report, and the annual general meeting (AGM) invitation.

Considerations in light of COVID-19

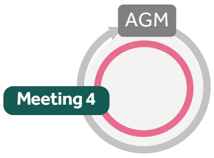
When **reviewing the latest performance of Executive Management**, more insights are gathered to make decisions about whether and at what degree compensation adjustments are to be taken more grounded.

In light of possible adjustments to compensation, a more **proactive engagement especially with major shareholders, proxy advisors, and other stakeholders** is advised to share rationales of planned adjustments. This approach is in line with proxy advisors' recommendations. For example, Institutional Shareholder Services (ISS) encourages Boards of Directors to provide contemporaneous disclosure to shareholders of their rationales for making compensation related amendments. Such disclosures will **provide shareholders with greater insights into the Board's rationale and circumstances** when the changes are made.[1]

Additionally, as CompCos initially discuss performance targets for the upcoming year, they are advised to think comprehensively about internal and external interests as well as expectations to **emphasize alignment between management and stakeholders**.

Further, disclosure requirements (e.g. in future compensation reports) as well as communication in relation to upcoming Say-on-Pay votes should be accounted for.

[1] ISS Policy Guidance, Impact of the Covid-19 Pandemic, April 8, 2020.



Meeting 4: Performance Assessment & Disclosure

In a fourth meeting, CompCos make **final performance evaluations of Executive Management** and its corresponding manifestation in the annual STI. Furthermore, decisions regarding LTI grant amounts and LTI vesting, if applicable, are taken. Also, the approval of targets and payout curves for LTI plans which include performance measures for the next grants, may be discussed during this meeting. At this point, an additional **outside-in view considering both shareholder interests and management expectations**, can support the overall decision-making discussion. Additionally, overall Say-on-Pay budgets for Executive Management and Board of Directors are to be prepared in view of shareholder voting at the upcoming AGM. A **closing review of the compensation report and the AGM invitation** is conducted, and the AGM speeches are prepared.

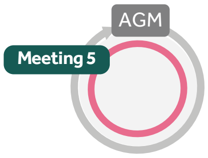
Considerations in light of COVID-19

Overall, disclosure of discretion in compensation is crucial for publicly listed companies. For example, the Swiss stock exchange (SIX Swiss Exchange) stipulates that **discretion must be explicitly and clearly disclosed**. Therefore, the compensation report must state whether compensation is set based on discretionary decisions and elaborate the rationale behind these.[2]

While explicit discretion (e.g. provisions to overrule the STI or LTI) is generally not a red flag to proxy advisors, they usually comment on it. Thus, proxy advisors such as ISS and Glass Lewis **insist on the importance of transparency in disclosure** of the articulated rationale for changes to compensation plans. Specifically, Glass Lewis will vote against any companies whose proposals are unjustified such as in case of poor pay-for-performance.[3]

When conducting a final performance evaluation of the Executive Management, CompCos are advised to reflect upon the impact of COVID-19 by quantifying and correcting for outside influences, if measurable.

[2] SIX Swiss Exchange, Corporate Governance Directive, January 2016.
[3] Glass Lewis, Coronavirus Pandemic Governance Resources, April 29, 2020.



Meeting 5: Final Approval (as needed)

Finally, in a fifth step, a meeting or call is reserved (as needed) to **approve the final compensation report, the defined Say-on-Pay amounts, and the AGM invitation**. The output is shared with the entire Board to ensure full alignment and formal governance approval of these items.

Conclusion

CompCos are facing **increased challenges and scrutiny due to higher market uncertainties** in relation to the reality of COVID-19 to fulfill their responsibilities. Given the rather unique nature of this year, a **comprehensive approach to the planning cycle** of CompCos is essential. This includes setting the right priorities and focusing on adequate measures which balance all stakeholder views. A thoughtful and coordinated process ensures the necessary flexibility to act appropriately to the specific business situations, for which reason the right timing is key. Additionally, a **proactive approach to stakeholder engagement** as well as communication and disclosure are essential to prepare for next year's AGM. In general, CompCos are advised to **carefully balance potential actions**, as needed, and differentiate measures within the organization accordingly.

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Nadine Balmer has over 20 years of international consultancy experience in Zurich and Toronto. She has led numerous projects in the fields of executive compensation, value-based management, and corporate governance in various business sectors. In addition, she has supported companies in the adaption of their compensation systems through transformation phases like the implementation of new strategies, IPOs, mergers, or succession processes. In this context, she is also in charge of guiding our CompCo advisory practice. Before joining HCM, Nadine Balmer worked for several international firms in the fields of organizational development, executive compensation, and process optimization. She holds a Master in Accounting & Finance from the University of St. Gallen and a Master of Science from the Ecole Polytechnique Fédérale de Lausanne (EPFL).

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Samuel Leder joined HCM in 2019 and focuses on governance aspects of compensation-related matters, as well as the design and set up of performance management systems and incentive strategies for Executives. Samuel Leder holds a bachelor's degree from the University of Zurich (UZH) with a major in Business Administration and minor in Banking & Finance. He is currently completing his master studies in Business Management at the University of St. Gallen (HSG).

About HCM International Ltd.

HCM, a truly independent advisor, supports numerous Boards and CompCos of publicly listed and privately-owned companies, including by providing an objective outside-in view on the compensation system, disclosure levels, and performance target setting for variable compensation incentives. Overall, supporting clients in critical processes which are closely monitored by all stakeholders, including shareholders and proxy advisors.

HCM has extensive experience working with companies around the world. In each case, we factor in a company's individual situation and complexity. As governance and compensation experts, HCM also supports companies in ensuring that governance systems and managerial incentives are properly calibrated to promote sustainable financial and long-term corporate success.

Should these topics interest you, please do not hesitate in contacting us for a non-binding discussion anytime.

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