CalPERS' Executive Compensation Analysis Framework

Frequently Asked Questions

April 2021

Introduction

The Frequently Asked Questions should be read in conjunction with CalPERS' Executive Compensation Analysis Framework, which describes our quantitative and qualitative analysis of compensation plans in detail. This document provides answers to commonly asked questions from our engagements on executive compensation with directors and management of our portfolio companies.

QUANTITATIVE ANALYSIS FAQs

Why do you use a 5-year performance period when the market practice is 3 years?

In order to effectively evaluate long-term company performance across all industries, we use a 5-year performance period in our pay-for-performance (P4P) model. However, depending on a particular company's business model or product cycle, some companies may use a performance period (for long-term incentive compensation) that's less than 5 years, while others may believe a performance period of greater than 5 years is more appropriate. In general, we believe long-term incentive compensation shouldn't use a performance measurement period that's less than 3 years. Furthermore, as explained in the Qualitative Analysis section below, we prefer a minimum 5-year holding period requirement on equity awards from grant date.

Which components of pay are included in your realizable pay?

Our realizable pay includes the following:

- Salary and Bonus – actual salary earned and actual non-incentive bonus received
- Short-term incentive plan (STIP) cash – actual STIP cash awards earned
- Time-vested equity – intrinsic value of stock granted at target
- Time-vested options – Black-Scholes value of options granted at target
- Performance-based equity – intrinsic value of the equity granted at target and earned
- Performance-based options – Black-Scholes value of options granted at target and earned
- Long-term incentive plan (LTIP) cash – value of LTIP cash awards granted at target and earned

Which peers are used in your model?

We use the Equilar market peers as the default peer group in our model, but we also evaluate the model output using a company's own disclosed peers. Equilar applies a standardized approach to peer group selection, using an algorithm that takes into account the company disclosed peers as well as other companies that identify the company as a peer. The standardized approach allows us to apply the same peer group selection methodology across our entire universe of portfolio holdings.

What do you consider to be problematic peer group benchmarking practices?

We consider opportunistic peer group selection and pay targeting to be one of the main drivers of upward pay momentum.

- Using different peers for benchmarking pay than those used to benchmark performance. This is usually accompanied by the use of peers outside of that company's sector or industry
- Targeting peer median pay when long-term historical performance is lower than peer median. If a company's historical performance is at the 25th percentile of peers, it seems unjustified to target pay at the 50th percentile of peers

We believe peer group selection should take into account factors such as size, geographic footprint, business model, sector, and industry amongst others. In setting target pay, historical performance relative to appropriate peers must be factored into the equation. We would like to see comprehensive disclosure in the proxy regarding the appropriateness of selected peers and how target pay has been adjusted for historical relative performance differentials.

Does your model take into account CEO changes?

Our model is CEO agnostic. It's meant to measure pay and performance alignment, or lack thereof, over a 5-year period. A change in CEO, without a change in the design, structure, and practice of the compensation plan, doesn't in and of itself improve alignment. We do take into account material changes to the compensation plan if there is comprehensive disclosure in the proxy of the changes to enable us to prospectively assess future alignment. We are assessing how effective the compensation plan is in incentivizing executives to create sustainable long-term shareholder value.

Does your model account for companies in highly cyclical businesses?

Our model is based on relative comparisons to peers for both pay and performance, and thus accounts business cyclicality if the peers used are from the same sector and/or industry. This is why it's important for companies to use similarly-situated peers when setting pay instead of using peers outside of their sector and/or industry for setting pay, and then using a different set of peers for measuring performance.

Does passing your quantitative P4P model guarantee a "FOR" vote?

The quantitative model is one of two components of our executive compensation analysis framework, the other being the qualitative analysis. As such, there is no threshold quantitative passing score that guarantees a "FOR" vote. The output of the model informs our decision-making process and does not necessarily drive it. We perform further analysis of peers to assess their appropriateness and how they impact the model output. We also consider qualitative factors, which we view as risk mitigators and guardrails, to ensure that executives are always focused on long-term sustainable value creation. We use both quantitative and qualitative analysis in aggregate to decide how to cast our vote.

QUALITATIVE ANALYSIS FAQs

What do you consider to be short vesting periods for long-term equity awards?

We consider 5 years to be the preferred minimum vesting period for long-term equity awards. In practice, we typically accept 3-year cliff vesting schedules with an additional 2-year holding requirement as being equivalent to a 5-year vesting period. In general, we are not supportive of equity awards with ratable vesting structures. We don't consider 3-year ratable vesting to meet the minimum standard, unless an additional holding period is in place. To discourage short-term focus ahead of separation, we also prefer longer post-separation holding periods (i.e. two years).

How do you consider stock ownership guidelines and holding period requirements?

While we support stock ownership guidelines, we prefer a minimum 5-year holding period requirement on equity awards from grant date. More specifically, we prefer that executives be restricted from selling the after-tax equity earned as a result of the shorter performance period until at least 5 years from the date of the equity grant so as to increase alignment with the interests of long-term shareholders. For example, if the equity vesting period is 3 years, we would like the equity awards to have an extra 2-year holding period requirement, such that the executive can only be able to sell it after a total of 5 years from the grant date.

Stock ownership guidelines aren't always a good substitute for holding period requirements. We have observed that the typical stock ownership guideline of 5x annual salary, or others like it, can easily be met with one year's annual equity grant. Some companies consider both vested and unvested equity towards meeting stock ownership guidelines, which means an executive is able to meet, and sometimes surpass, the ownership guidelines at the time of each annual equity grant. Even where companies consider only vested shares, stock ownership guidelines can easily be met without real substance when companies have short vesting periods of monthly, quarterly, or yearly.

Is CalPERS against the use of discretion by the compensation committee?

We are not against the use of discretion per se. We want to see judicious use of discretion. We use the following framework to look at the use of discretion, one-off awards, and other adjustments:

- What is the triggering event? Is it an externality outside of management control or is it a result of past management actions that did not pan out as promised?
- Is there comprehensive disclosure of why and how discretion is being applied?
- Is there a demonstrable history of discretion being applied symmetrically, that is, a history of both positive and negative discretion being applied?
- Is discretion being applied equitably across the organization or just reserved for executives?

- What is the impact on long-term incentives? Is discretion being used to opportunistically award equity at depressed stock prices?
- What are peers doing? Is flight risk a real possibility given that everyone is in the same situation?
- Are the one-off awards sufficiently tied to long-term performance?

Which performance metrics do you consider appropriate for compensation?

We don’t prescribe specific metrics for companies to use. We believe the compensation committee should identify the appropriate metrics and disclose the rationale for their choice, including how the chosen metrics are expected to drive long-term sustainable value creation for that particular company. Additionally, we discourage companies from using similar metrics in both the short-term and long-term incentive plans. The duplication of metrics for the STIP and LTIP could result in paying executives twice for achieving the same performance. We also discourage companies from using too many metrics as this can lead to unnecessary complexity, lack of line of sight, and has the potential to reduce the effectiveness of the plan by providing executives with multiple opportunities to earn incentive awards.

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