Board's Opportunities and Challenges for Corporate Governance and Sustainability:
ESG-Based Incentive Plans lead the Way

*James F. Reda

Overview

Since 1978, the U.S. Business Roundtable ("BRT") has periodically issued Principles of Corporate Governance. Each version of their document put forth since 1997 has endorsed principles of "shareholder primacy" – the mantra that corporations need a path to profitability and, in turn, shareholder value or they have no reason or ability to exist. Following many years of "profitability above all" messaging, BRT's latest announcement encourages a different approach. This new statement, released in August 2019, emphasizes social responsibility. Superseding previous statements, it outlines a more modern corporate standard, defining a new social contract between business and society in which businesses and the capital markets create long-term value for all stakeholders. This is a substantial departure from the long-held, nearly universally accepted concept that corporations exist primarily to maximize shareholder value by maximizing profits. Indeed, it seems to be the dawn of a new era. **See Attachment A for a copy of BRT's August 2019 statement**.**

At the same time, large institutional investors such as BlackRock and State Street, pension funds such as New York Employees Retirement System, CalPERS, United Auto Workers and TIAA-CREF, and proxy advisors such as Institutional Shareholder Services have urged the U.S. Securities and Exchange Commission to require companies to provide more detail on their environmental, social, and governance ("ESG") factors.

These ESG factors are central to measuring corporate "sustainability." Sustainability – like corporate governance - has many meanings. Sustainability may mean *sustaining* the environment by reducing the carbon footprint. It may also mean *sustaining* the company's economic viability by continuing to attract and retain younger customers as well as employees and leaders. Regardless, the increased emphasis on sustainability creates a treacherous business environment. If not careful, some companies could find themselves trapped in a messy public relations nightmare, affecting the bottom line. A properly positioned ESG program may help avoid some of these pitfalls and will become more important for companies to adopt over time.

The evolution of ESG is in its nascent stage. With more design flexibility due to changes in U.S tax code that loosens the rigor of incentive plan structure, companies can now choose from a vast number of possible ESG performance goals. It is not yet clear how these ESG goals may increase shareholder value. The overall goal of investors, pension funds, and proxy advisors is to use ESG performance goals as a catalyst, urging companies to make positive changes in the long term without overly focusing on near-term profits. As a result, companies are adopting a diverse variety of ESG goals that extend anywhere from safety (a long-term staple in the oil and gas industry following major environmental events) to diversity of the employees as well as management and senior management.

The crux of the discussion surrounding ESG issues is the tension between the short- and the long-term. Much of the reaction to BRT's "new" position highlights this tension. Either the BRT got it completely wrong — and the purpose of the corporation is to

maximize immediate returns to shareholders — or the BRT is right (at least partially). However, few really know which ESG factors are correlated with maximizing shareholder and which factors are not correlated.

Leadership and tone at the top are obvious corporate culture influencers. What might be less apparent is how decisions on compensation structure shape, steer and promote corporate culture. As part of this shift in the goals of the corporation, compensation committees are considering nonfinancial metrics relating to ESG factors for executive incentive plans. The logic is that executives will focus on goals that measure their long-term success.

Ten years ago it was likely that the compensation committee's oversight stopped at the top-5 senior executives (including the CEO). To adopt to this new stakeholder concept (where employees are on par with shareholders), the role of the compensation committee continues to evolve as it broadens its oversight responsibilities to include succession planning (other than the CEO and other executive officers) broad-based compensation and benefits, diversity and inclusion, employee culture, and employee engagement. This broadening of the role of the compensation committee emanates from the larger companies and filters down to smaller compan ies over time, like many other changes.

ESG Factors Are Becoming More Prominent

Some companies are embedd ing ESG-related non-financial metrics in their executive incentive plans. Given the increasing attention paid to companies' ESG practices, more compensation committees may wish to do so—especially for ESG factors that are relevant to business strategy, quantifiable, and verifiably measurable.

The Conference Board's CEO and Executive Compensation Practices (2019 edition), of which I am an editor, as well as other summaries show that ESG-related performance goals currently remain far from common in senior executives' compensation packages, but their adoption by some boards should not be ignored. In 2018, they were found in 71 Russell 3000 companies' compensati on disclosures. They almost always apply to short-term incentive plans and seem to be limited to three main categories: environmental compliance, (workforce or product) safety, and diversity of employees and inclusion of all types.

The oil and gas industry is particular sensitives to ESG issues as they have been criticized for major oil spills (BP oil spill in 2010), boycotting of energy companies for being complicit in global warming phenomena (ExxonMobil in 2019). Notable examples of ESG implementation include:

- *Chevron:* Adopted a short-term incentive plan linking 15 percent of its short-term incentives to the greenhouse gas emission targets);
- *LyondellBasell Industries:* Links as much as 20 percent of its CEO's short-term incentives to the company's performance with respect to personal and process safety standards, and also considers environmental incidents as an overall plan adjustment factor; and
- *Verizon:* Announced an annual incentive plan with a target of having at least 58.9 percent of its workforce composed of women and minorities.

In general, compensation committees could consider exploring the use of ESG and other extra-financial performance metrics—whether in the individual performance portion of an incentive plan or, for those goals that cannot easily be attributed to key individuals, as modifiers to the overall plan funding. The main challenge posed by these indicators of performance is ensuring the objectivity of their measurement and avoiding the perception that they may be arbitrarily “earned”. However, the practice, which could be tested for a very modest portion of the incentive program and gradually extended over time, could signal to the investment community and other stakeholders that the company appreciates how long-term shareholder wealth is also a function of extra-financial ESG-related business performance.

Investors May Encourage Extended Vesting and Performance Measurement Periods for LTI Awards

To encourage longer-term performance, just as investors' emphasis on “pay for performance” has led to an increase in the percentage of CEO compensation delivered via stock awards, so investors may encourage companies to extend the vesting and performance measurement periods of such awards. In the S&P 500, the portion of CEO pay represented by stock awards (including restricted stock and performance-based shares) exceeded 50 percent for the first time in 2018, while stock options, perks, and change in pension value have been on a clear declining path.

For CEOs in the Russell 3000, stock awards now represent almost 40 percent of total pay. This trend may be contained in the future by softening stock market results, but it will continue to be supported by investors' demand for pay-for-performance alignment and the scrutiny over excessive pay. The documented shift to stock-based awards that vest over time is meant, among other things, to promote long-termism.

In the coming years, in particular, compensation committees may be asked to consider extending the vesting period (and associated performance assessment period for performance- based shares) beyond the traditional three-year period. Institutional investors, on their part, have started to signal their interest to longer performance evaluations.

Greater Discretion May be Met with Negativity, if Not Managed Closely

While compensation committees enjoy greater discretion in designing and implementing performance-based compensation, they could find themselves on a collision course with investors if they choose metrics that investors do not view as appropriate or use their discretion in a manner that is viewed as de-linking pay from performance.

U.S. public companies are relying on performance-based stock

awards more than ever, despite the removal of the performance-based deduction exemption under IRC Code 162(m). This is, in part, because performance-based equity awards are viewed as critical in optimizing pay and performance alignment. In 2017, performance-based stock awards surpassed 50 percent of the total long-term incentive (LTI) award value for the first time ever among the Russell 3000, increasing to 51 percent from 48 percent in 2016. In 2018, performance-based awards jumped even more significantly, to 57 percent. Indeed, since 2017, performance-based stock awards have represented more than 50 percent of the total value of long-term incentive plans among mid-market companies, a practice that was previously observed only among the largest organizations

While the reliance on performance-based stock awards has increased, companies now have greater flexibility in the design and implementation of those arrangements because they no longer need to meet the technical requirements of Section 162(m). Specifically, the tax deductibility of performance-based compensation components was subject to a number of conditions, including the approval of the incentive plan by shareholders and the restricted use of discretion. Now that companies can no longer claim deductibility for this compensation, compensation committees can consider using a wider variety of metrics and can exercise more discretion (including through modifiers or yearend adjustments) in determining the ultimate number of performance-based shares paid to executives.

Nevertheless, compensation committees should be careful in choosing metrics that investors will accept as valid indicators of corporate performance and should be aware that taking advantage of that higher degree of discretion in making yearend adjustments to financial metrics could put the company at odds with institutional investors, especially if economic and market conditions deteriorate. Institutional investors, in particular, continue to argue against the amount of discretion companies retain in adjusting the non-GAAP (general accepted accounting principles) performance metrics included in incentive plans, complaining about the adequacy of disclosures included in the Compensation Discussion and Analysis sections (CD&As).

The First ESG Factor: CEO to Worker Pay Ratio

Scrutiny of executive pay could intensify, prompting the need for greater transparency on the pay-for-performance alignment and the far-reaching strategic benefits that incentive plans are meant to generate. One of the first broadly implemented ESG factors is the CEO to worker pay ratio. A review of the introduction, implementation and history may inform how other ESG-related factors will work.

So far, pay-ratio disclosure, which became mandatory for most SEC-registered public companies in January 2018, has not led to the extensive negative press coverage that some had anticipated. But public scrutiny could intensify amid deteriorating economic conditions and during a presidential campaign that will likely debate the implications of the widening income gaps observed across the country. In fact, this report found that, in 2018, the value of the median S&P 500 CEO total compensation package was 167 times the pay of the median company employee.

The issue of inequality in the United States has been inextricably tied to executive compensation since the financial crisis of 2008. It has influenced the legislative agenda and has become a growing

concern for institutional investors, some of which have a specific fiduciary duty to safeguard the economic interest of large groups of employees and retirees. In the last two decades, in particular, wages at the top of the income distribution have outpaced the growth of the median worker's salary, magnifying income gaps and thrusting inequality to the forefront of public policy discussions. In 2018, median total compensation for the Russell 3000 CEO increased by 12.5 percent, up from the 9.9 percent of 2017, for a total 69.9 percent growth since 2010.

Tasked with the delicate role of balancing the need to compete for top talent with the expectation to reward performance and avoid overpaying, today more than ever, the compensation committee cannot ignore how its decisions will be perceived by employees and the public. They may find it helpful to include in proxy statements a description of the compensation policy that elaborates on the rationale for the weights assigned to individual compensation components and the choice of performance metrics. It should be thorough and clearly articulate how the boards of directors intend to align pay and performance milestones.

The Potential Economic Downturn Further Fuels the Importance of Gaining Investor Support

Compensation committee agendas are being shaped by the increasing emphasis on pay for performance, the greater flexibility companies enjoy in the design and implementation of incentive plans and the continuing close scrutiny by investors, and other stakeholders—scrutiny that is likely only to increase in the event of an economic or market downturn.

In addition, the utility of incorporating ESG factors will be tested when the next economic downturn occurs. One possible outcome is that companies roll-back or eliminate their focus on ESG and retreat to focusing solely on profits. The other possible outcome is that companies stand firm and maintain their ESG focus as it is in their long-term interests to do so.

When the next recession or slowdown occurs, it will be a first for millennials that have truly come of age. Many of them entered the workforce, or tried to, during the wreckage left by the last downturn. Millennials are now becoming primary customers, or the customers of your primary customers. Many of them will be in political power in the next 5- to 15-years, and their view of economic slowdowns will be shaped by an environment of increasing wealth and opportunity disparity.

Compensation committees should be aware that the challenges described above may only be exacerbated by an economic or stock market downturn. They would therefore benefit from continuing to develop the skills needed to successfully engage with large institutional investors and gain their voting support. Compensation policies and design issues—especially those related to plan design and pay for performance—are now often discussed with investors in the "off season" rather than in the weeks immediately prior to the company's annual shareholder meeting. Nonetheless, some investors are continuing to submit shareholder proposals on compensation-related topics, such as equity retention, limits to golden parachutes, clawback policies, and gender pay-gap disclosure.

Conclusion

The view among many investors continues to be that that executive compensation (especially CEO compensation) is a topic best discussed by the chair of the compensation committee or another board member – not management. In today's business environment, it is critical that one or more compensation committee members are prepared to engage with investors on the company's executive compensation programs, including on topics relating to the mix of compensation, incentive plan design (including the choice of metrics – including ESG factors), and any discretion the committee may have exercised.

***Mr. James F. Reda** is the Managing Director and Executive Compensation Service Line Leader at Gallagher HRCC, USA*

****Attachment A.***

U.S. Business Roundtable: Redefining the Purpose of a Corporation – Issued August 19, 2019

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- *Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.*
- *Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.*
- *Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.*
- *Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.*
- *Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.*

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country. ■