

How Do We Have a More Productive Compensation Committee Conversation about ESG?

A Compensation Committee Series Webinar
Presented by NACD and Pearl Meyer

August 5, 2021

Meet the Presenters



Jeri Isbell is an independent board director of SiteOne Landscape Supply where she chairs the HR and compensation committee and is a member of the governance committee. She also sits on the board of Atkore International serving on the HR and compensation committee and the audit committee. In addition, Isbell chairs the nominating and governance committee of the Eastern Kentucky University Foundation board and is a director of the NACD Florida Chapter. She is an NACD Board Leadership Fellow and recently achieved NACD Directorship Certification®.



Daniel Sansone brings more than 40 years of senior leadership, general management, and financial experience as both an executive officer and a public company director to each of the boards on which he serves. He has served as a director of AdvanSix since its spin-off from Honeywell and serves as chair of the compensation committee and as a member of the audit committee. Dan is also currently a director of Ingevity Corporation, where he is on the compensation committee, and serves on numerous non-profit boards.



Mark Rosen is a managing director in the Charlotte office at Pearl Meyer. He has consulted on executive and board compensation issues for more than 25 years for a broad range of public and private companies, as well as tax-exempt organizations and academic institutions. He has extensive experience in working with large, multinational companies in the oil and gas industry. Mark is a certified public accountant and has extensive experience with benchmarking, retirement plan design, governance issues, and tax and accounting considerations. He serves on the board and is the audit committee chair of a private commercial real estate investment trust.

- Submit a question and receive your answer directly from the presenters, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.
- Presentation slides are available today at www.pearlmeyer.com/esg-comp-committee-conversation and within the webinar console.
- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/esg-comp-committee-conversation.

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Are ESG metrics right for your company?

- *Of course they are!* But should they be an incentive plan metric?
- Use of ESG incentive metrics in incentive plans is trending upward, but is this a “flavor of the month” or something your company should adopt now?
- Discussions are happening in real time.
 - We expect the prevalence of incentive plan ESG metrics for 2022 will increase materially
 - Data from 2021 proxies is already dated.

Companies evaluating whether to include ESG incentive metrics should ask:

What is the company's culture and its strategic priorities?

Are ESG goals critical to business success and value creation?

What do investors, customers, and employees want?

What are peers doing? Should XYZ be a leader or a fast follower?

Is there a robust process in place to collect and analyze relevant data?

Is it possible to set specific goals and make progress on ESG metrics?

What is the desired time frame for making progress?

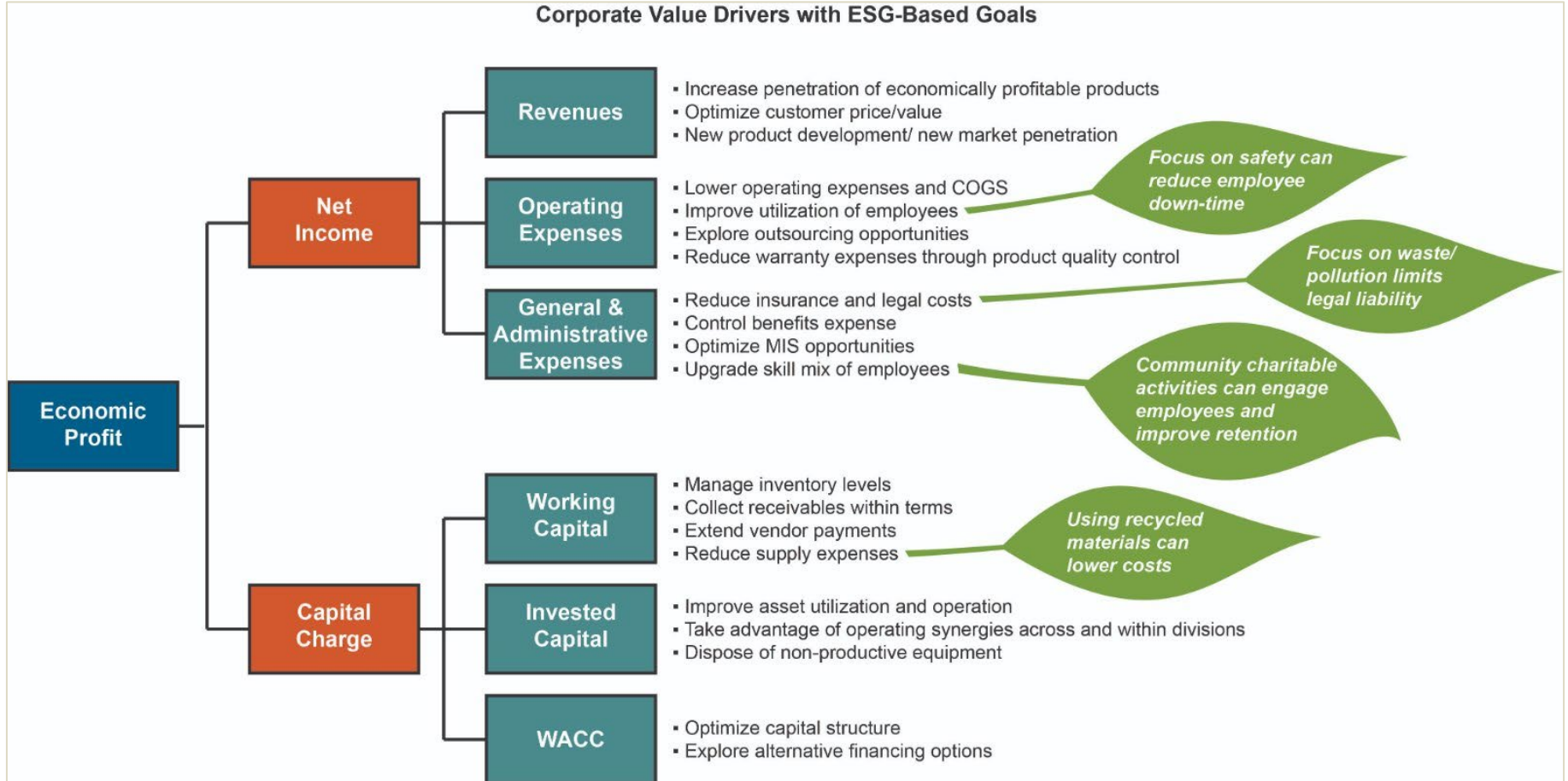
What are the assurance processes? Can results be audited?

Where Do Companies Stand on the ESG Continuum?



Source: Pearl Meyer, NACD Governance Challenges, 2017

Strategy/Value Drivers and ESG Goals



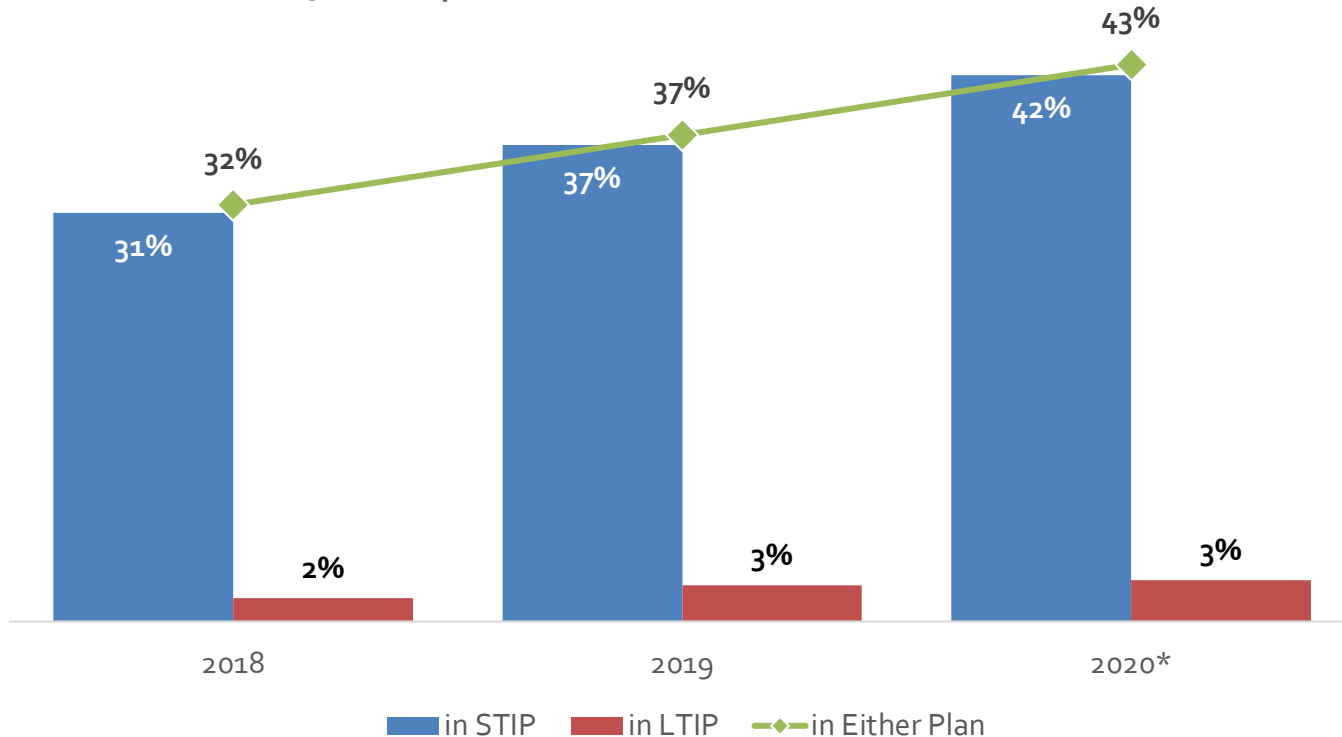
Source: Pearl Meyer, NACD Governance Challenges, 2017

S&P 500 Prevalence of ESG Incentive Metrics



- Prevalence of ESG metrics of any type in incentive compensation plans has already increased dramatically, especially among the S&P 500
 - Most of these companies include ESG metrics in their short-term incentive plan
 - Chart below reflects proxy filings through 6/22/2021, sourced from Main Data Group

S&P 500 Companies with ESG Measures in STI or LTI Plan



Environmental

- Environmental
- Carbon and climate
- Natural resources
- Waste and toxicity
- Sustainability

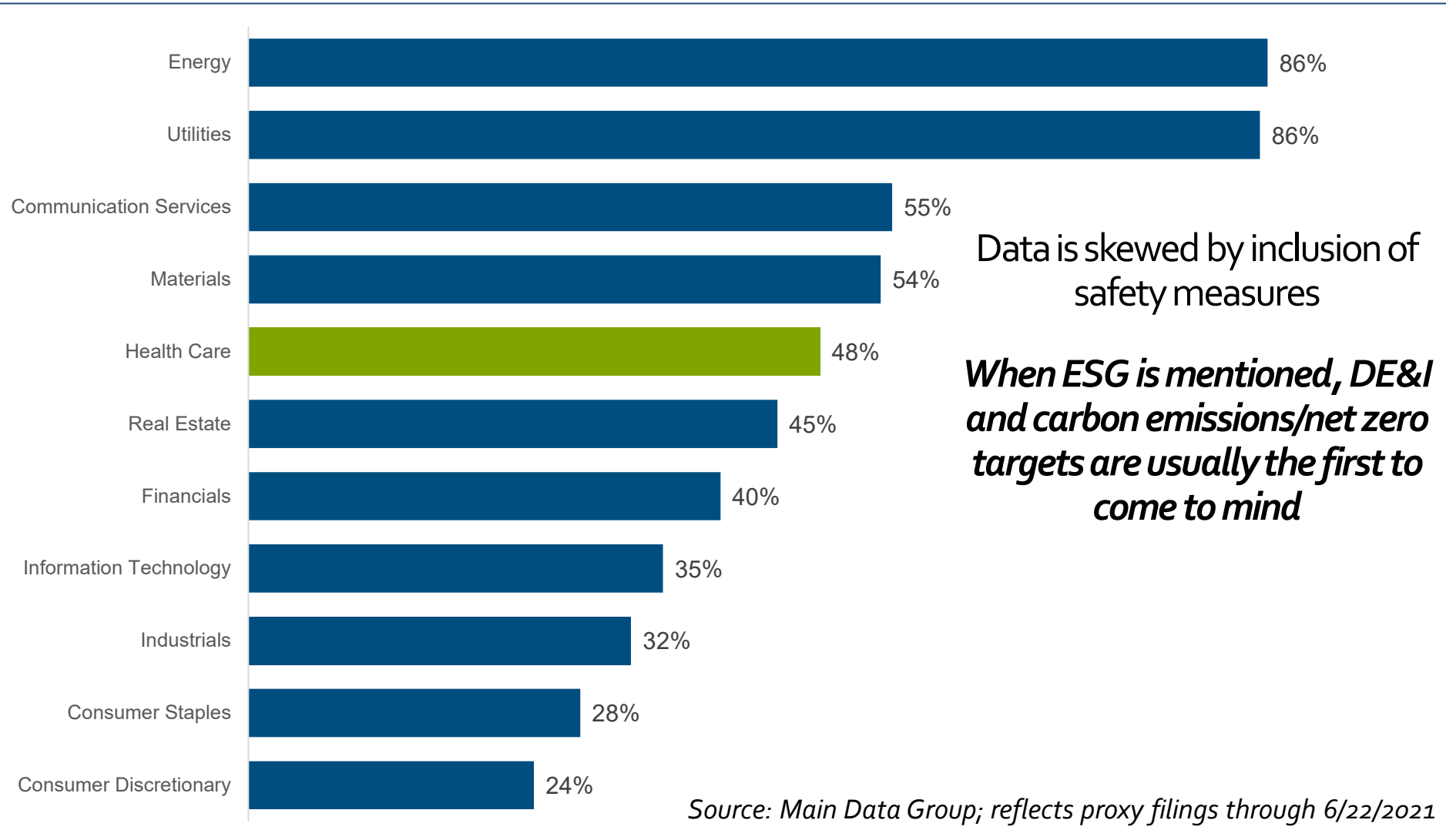
Social

- Human rights
- **Diversity and inclusion**
- **Labor, health, & safety**
- Employee satisfaction & engagement
- Stakeholders & society
- Product safety, quality
- Customer satisfaction

Governance

- Board structure
- Compensation
- Shareholder rights
- Audit & risk oversight

S&P 500 Prevalence of ESG Measures by Industry



Polling Question #1



Q: What is your industry?

- Energy
- Utilities
- Communication Services
- Materials
- Healthcare
- Real Estate
- Financials
- Information Technology
- Industrials
- Consumer Staples
- Consumer Discretionary
- Other

Placeholder for Poll Results



Polling Question #2



Q: Do you have an ESG metric(s) in your current executive compensation incentive program?

- Yes
- No
- Unsure

Placeholder for Poll Results



What's important to you?



- Nobody is starting from scratch
- ESG Metrics are published on company websites and sustainability reports
 - Companies have already communicated what is important
 - The narrative and many baseline goals are there
- However, with some measures, there may be a desire not to publish statistics, or the goals are “squishy” requiring more subjective evaluation
- Key points:
 - Sustainability/ESG is about the license to operate (e.g., safety in the past or current movement to reflect the population)
 - Customers and employees have expectations for fair, balanced treatment and operations
 - Context matters: global differences in definitions and cultural expectations of DE&I
 - The culture where you operate is key and US norms can't be applied to other regions

Should I implement this or no?



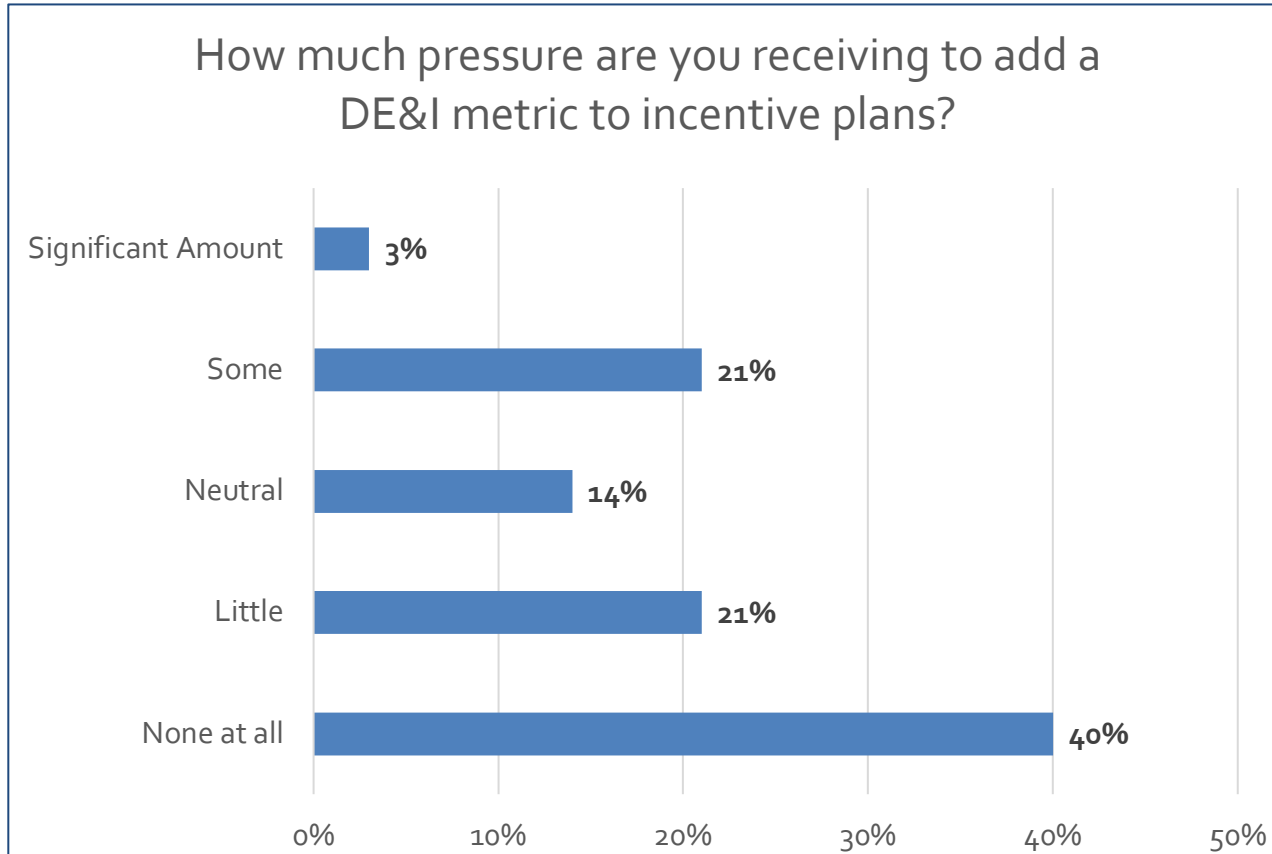
- Just because you can or should measure it doesn't mean it has to be in the incentive plan
- Some very important metrics are not included in incentive plans
 - e.g., safety, compliance, foreign corrupt practices act, succession planning/development
- What will we eliminate if we add an ESG measure?
 - In a weighted plan, there is only 100%
 - If we lower the financial metric to add an ESG metric, are we saying that metric is more important than profits? Probably not. Any incentive plan is about balance.
- Incentives support changes in culture and/or accelerate movement against existing values, but they don't drive it – leadership does
 - Executives are not normally “coin operated”; they do the right thing because it's the right thing, not because they are being paid for it
 - The alternative view is what gets paid for gets done
 - It's ultimately all about balance

Q: How much pressure are you receiving to add a DE&I metric to incentive plans?

- Significant amount
- Some
- Neutral
- Little
- None at all

Placeholder for Poll Results





Source: Pearl Meyer Quick Poll, July 2021, 299 responses

Readiness: How do I know if we're ready?



Questions to ask to evaluate a metric to determine if it is a good one:

- Financial materiality of the ESG measure for shareholders/investors?
- Clearly defined quantifiable goals and timeline (trailing/short term/long term/future)
- Objective or subjective measure?
- Is the result measurable against the defined goal?
- Is the accountability of the outcome of the ESG practice clearly defined? Who's the responsible person/group for the outcome?
- Can the metric result be audited? Is measurement consistent across the organization?
 - Is there a defined process to monitor the progress of the goal? Do you define what the time interval in which the goal is evaluated? For example, if a company is using an ESG metrics in STI annual plan, then company should have clearly defined annual monitoring process in place to evaluate annually.
- Is the metric in line with ESG metric prevalence across the industry or peer group?
- Has the company used any standard/benchmark/index etc. to compare or disclose their performance for the ESG practice? For example, SASB, CDP, DJSI, OSHA, GRI, WEF-IBC, and others

Polling Question #4

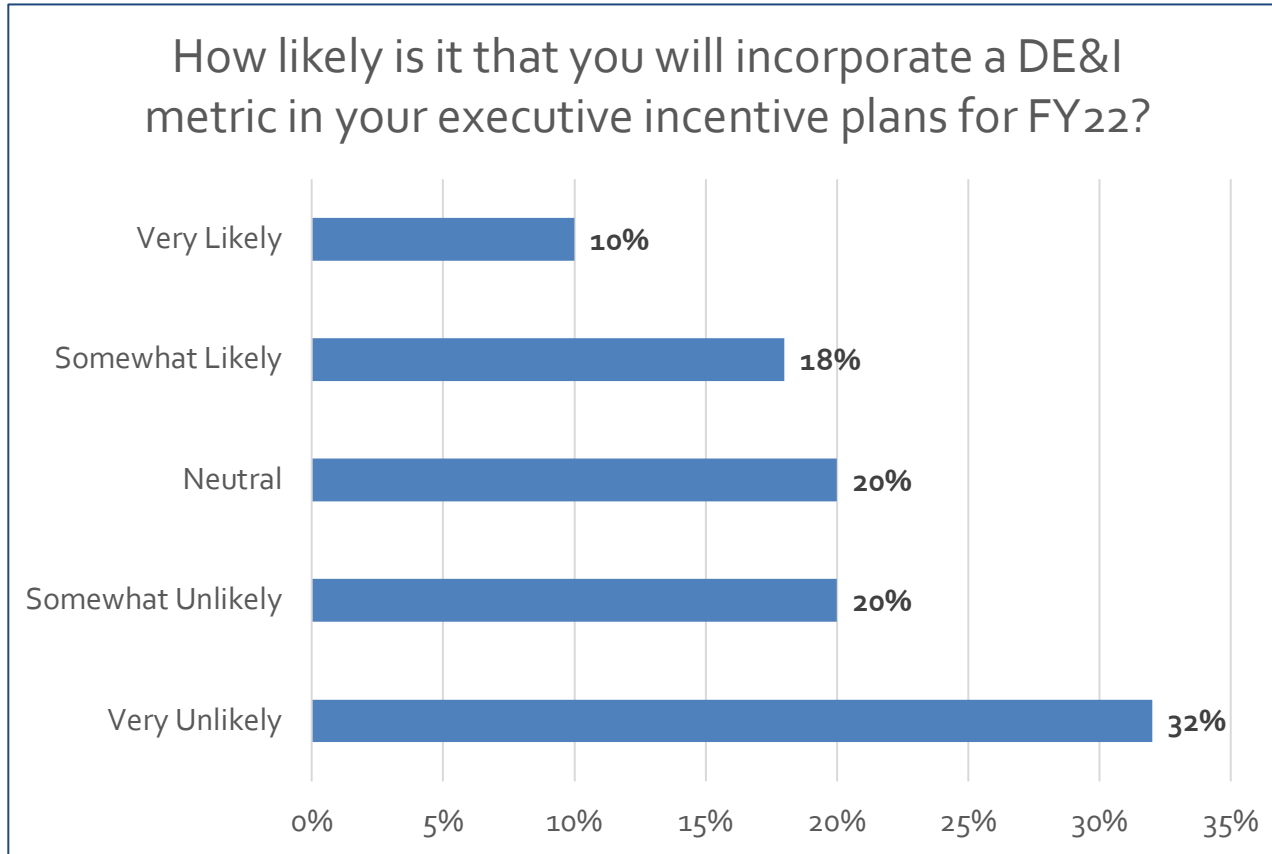


Q: How likely is it that you will incorporate a DE&I metric in your executive incentive plans for FY22?

- Very likely
- Somewhat likely
- Somewhat unlikely
- Very unlikely

Placeholder for Poll Results





Source: Pearl Meyer Quick Poll, July 2021, 289 responses

How would it be implemented?

- Three basic models
- Weighted plans – An annual plan may be 80% financial, 20% non-financial
 - For example, half of the non-financial may be an ESG measure 10% of the total incentive
 - If you add an ESG measure, what's supplanted? Why is this measure more important than what it replaces or what
- Modifier – ESG metric is a multiplier (+/- 20% for example)
 - Existing plan is retained, payout is increased or decreased by as much as 20% based on ESG metric performance
 - May be more appropriate for subjective metrics
- Part of an overall pay level-setting
 - Salary adjustments
 - Size of annual incentive opportunity
 - Size of long-term incentive grants

American Express

About: The company is headquartered in the US, listed on the NYSE, has a \$135B market cap, and more than 63,000 employees.

Its ESG Incentive Plan:

- Short-Term
- Stand-alone metric
- 15% of total plan

Goal: “Quantitative Talent Retention and Diversity Representation”

Description: “Globally increase minority and women representation and management levels and retain our key talent”

Results: Goals were achieved at or above target levels in 2019; target levels not disclosed

Northrup Grumman

About: The company is headquartered in the US, listed on the NYSE, has a \$58B market cap, and more than 59,000 employees

Its ESG Incentive Plan:

- Annual incentive plan is based entirely on financial metrics
- A qualitative scorecard is used to evaluate against ESG priorities
- Not meeting identified goals can result in downward adjustment of annual incentive plan funding

Goals: ESG priorities in the qualitative scorecard include quality, customer satisfaction, engagement and inclusion, operational efficiency, diversity, environment sustainability, and safety

Komatsu Limited

About: The company is headquartered in Tokyo, listed on the TYO, has a \$25B market cap, and more than 90,000 employees

Its ESG Incentive Plan:

- Long-Term
- Numerical goals are environmentally related and consider greenhouse gas reductions and increased use of renewable energy sources
- LTI payouts also reflect external organizations' evaluation of the company's environmental impact

Goals:

- Reduction of environmental impact: Decrease CO₂ emissions by 50% between 2010 and 2030
- Reduction of environmental impact: Increase renewable energy use to 50% of total by 2030

- Evaluate what is truly strategic
- Use incentives to communicate what is important and support achievement of the strategic initiative
- Balance the long term with the pressure to act urgently
- Determine acceptable levels of subjectivity versus objectivity and qualitative measures with quantitative measures
- Communicate all the good things you're already doing

Q&A

You can submit a question through the "Ask the Experts" box on the right side of your screen.

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