Doing Well by Doing Good

Dollars and Sense: How to Integrate ESG into Compensation Programs

Vivian Coates, Partner,
Winston-Salem, NC

Jane Jeffries Jones, Partner,
Charlotte, NC

Gracie Smith, Associate,
Atlanta, GA

Summary

A broad range of stakeholders—including business leaders, legislators, institutional investors, proxy advisory services, stock exchanges, shareholders, employees, and the SEC—are calling for an increased focus on corporate sustainability and Environmental, Social and Governance ("ESG") progress. As a result, companies are looking for various ways to incorporate ESG into their individual corporate identities and functions, including by integrating ESG factors into their executive compensation programs. This article explores the "nuts and bolts" of incorporating ESG metrics into an executive compensation program, with a special emphasis on disclosure requirements for public companies.

Highlights

Step 1: The *What*—Identify Metrics Aligned with Company's Strategy and Long-Term Goals.

Step 2: The *How*—Decide Upon a Qualitative, Quantitative or Blended Approach.

Step 3: The *Where*—Incorporate Metrics into the Short-Term Incentive Plan (STIP) and/or Long-Term Incentive Plan (LTIP).

Step 4: Review Corporate Documentation and Establish Process.

Step 5: Keep Current Disclosure Rules in Mind.

This article follows Womble Bond Dickinson (US) LLP's June 23, 2021 panel entitled "Dollars and Sense: How to Integrate ESG into Compensation Programs." You can view the panel online on demand by registering here.

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Introduction

On June 16, 2021, the U.S. House of Representatives passed H.R. 1187 (the "Corporate Governance Improvement and Investor Protection Act"), which would require the Securities and Exchange Commission ("SEC") to establish rules requiring public companies to disclose certain ESG metrics, including metrics related to climate, board diversity, and employee management and welfare practices. While H.R. 1187 faces a long legislative road and may not ultimately become law, the bill highlights the elevated prominence of ESG in recent months, especially given the impact of COVID-19 on workforces and communities and the increasing emphasis on racial justice over the last year. Public companies may not yet be required to disclose ESG metrics by law, but vocal stakeholders—such as business leaders, institutional investors, proxy advisory services, stock exchanges, shareholders, employees and community activists, among others—are already calling for disclosures similar to those that would be required by H.R. 1187.

As the spotlight continues to shine on ESG, companies are looking for ways to incorporate ESG into their corporate identities and functions, including by integrating ESG factors into their existing executive compensation programs. On June 29, 2021, SEC Commissioner Allison Herren publicly called for corporate boards to tie ESG metrics to executive compensation.[1]

In addition, a 2020 survey of 338 global boards of directors by Willis Towers Watson showed that 32 percent of boards plan to tie ESG metrics to executive pay within the next 12 months, and an additional 37 percent plan to do so within the next three years.[2] While the desire to "do well by doing good" is there, the process for incorporating ESG factors into an executive compensation plan is complex and may seem overwhelming, considering the broad range of factors that could be covered by an ESG regime coupled with the many constituencies who can be expected to evaluate such programs. This article outlines current best practices for how companies, particularly public companies, should approach integrating ESG metrics into their executive compensation programs.

Step 1: The *What*—Identify Metrics Aligned with Company's Strategy and Long-Term Goals.

By incorporating ESG metrics into executive compensation programs, companies can signal to shareholders and other stakeholders that they are committed to long-term sustainability and bettering the communities they serve, in addition to being committed to strong financial performance and shareholder returns. However, the "E," the "S" and the "G" in ESG each cover a broad scope of metrics, ranging from safety and climate-related initiatives, to employee welfare and diversity, equity and inclusion ("DEI") initiatives, to stakeholder engagement and board composition. While it may be tempting to tackle a wide variety of ESG-related issues through executive compensation metrics off the bat, companies would be best served by identifying a limited number of ESG metrics most closely related to the company's unique strategy and long-term goals. For example, energy and utilities companies have a long history of focusing on environmental and employee safety issues, which are directly tied to that sector's operations. Across all industries, companies that already incorporate ESG into their executive compensation programs tend to incorporate human capital management metrics (e.g., diversity and inclusion, talent development, and employee engagement) most frequently.

Identifying the "best fit" when it comes to ESG goals is no easy task—approximately half of respondents in a recent Willis Towers Watson study stated that target setting, identifying performance measures, and defining performance measures are the most challenging aspects of tying ESG to executive compensation[3]. Yet selecting goals that are not correlated with a company's strategy and long-term goals can lead to reputational damage if a company is perceived as inauthentic in its ESG efforts. In addition, selecting too many ESG goals from the beginning can lead to a "foot fault" by the company, as resources are required for tracking and measuring progress for each selected metric. Companies should select a limited number of key goals that reflect special consideration of its own unique corporate profile and, where appropriate, careful engagement with key stakeholders, as opposed to selecting a broad array of goals that may look good

[1]Source: Al Barbino. "SEC Commissioner Says Exec. Comp Should Be Tied To ESG." Law360. June 29, 2021.
[2]Source: Willis Towers Watson. "ESG and Executive Compensation: Hearing from board members globally." April 2021.
[3]Source: Willis Towers Watson. "ESG and Executive Compensation: Hearing from board members globally." April 2021.

on paper but may be extremely difficult to implement. In addition, companies should consider whether identified goals are measurable and achievable, as resources must be allocated towards tracking and measuring progress for each goal.

Step 2: The *How*—Decide Upon a Qualitative, Quantitative or Blended Approach.

After identifying and selecting certain ESG metrics, companies should decide how those metrics will be implemented in the company's executive compensation program.

Qualitative Approach

A qualitative approach allows the company to exercise discretion in terms of incorporating progress across ESG metrics into assessments of individual performance, and achievement measures may differ for each individual executive. For example, a company may include diversity progress or leadership as a performance component without assigning a numeric weighting to that metric. While qualitative approaches provide flexibility, they also lend themselves to less transparency in terms of how the metrics are applied across different executives' evaluations, and are therefore more difficult to evaluate objectively. In addition, a qualitative approach would encompass incorporation of subjective metrics (e.g., "Implementation of a DEI Council" or "Implementation of New Sources of Sustainable Raw Materials") that necessarily will require compensation committee discretion in assessing achievement.

Quantitative Approach

Using specific weighted metrics or numeric modifiers that are formulaically tied to target payouts represents the most quantitative approach. For example, a company may weight diversity progress as a specific percentage of the performance pool, directly tying progress toward the stated goal towards the target payout. While use of weighted metrics provides for greater transparency, companies still must assess whether measuring progress quantitatively is achievable and assessable, and whether it has the monitoring processes in place to accurately measure progress. Stated differently, the quantitative metric may only be as accurate as its inputs. In addition, a quantitative approach would encompass incorporation of objective metrics (e.g., "5% reduction in GHG emissions over the prior year" or "Increase female and minority executive leadership by 10%").

Blended, or "Scorecard," Approach

Since ESG progress can be difficult to quantify based on the identified metrics, many companies take a middle ground by incorporating a "scorecard" approach. For example, a company may include diversity progress as an unweighted key performance indicator within a broader category (such as "People and Talent"), and assign the broader category a specific numeric weighting in the performance pool. Incorporating a scorecard allows the company to measure all executives by the same standard, but also allows for the company to exercise discretion in comprehensively evaluating each executive's performance to determine payouts. This approach also allows companies to adjust definitions, measurements and targets over time as the process for measuring ESG progress further evolves.

Step 3: The *Where*—Incorporate Metrics into Either the Short-Term Incentive Plan (STIP), the Long-Term Incentive Plan (LTIP), Or Both.

As of 2020, 51 percent of S&P 500 companies that already tie ESG metrics to executive compensation incorporated ESG metrics into their STIPs, while only 3 percent incorporated ESG metrics into their LTIPs.[4] The clear preference for incorporating ESG progress into short-term awards is explained by the challenge of setting long-term ESG goals. However, the long-term nature of most ESG goals may better align with measurements over long-term performance periods. Yet even for companies that choose to incorporate ESG metrics into their LTIPs, some ESG goals may extend even beyond the stated long-term performance horizon. For example, the goal of becoming carbon-neutral may take years to attain, yet a company may feel strongly about tying steps towards attaining this goal to its executive compensation program.

AS OF 2020

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[4]Source: Willis Towers Watson. "ESG and Executive Compensation: Hearing from board members globally." April 2021.

One option could be the implementation of "hyper" long-term incentive programs that use a longer performance period (e.g., 10 years) to directly correlate with the achievement of a long-term ESG goal. Such a plan could also incorporate an early payout to reward achievements that are ahead of schedule and before the performance period ends. Alternatively, companies could break down the larger long-term goal into components that are measurable in "shorter," or overlapping long-term performance periods. For example, a company may set the goal of becoming carbon neutral by 2050, but may choose to incorporate a reduction in carbon emissions by 15% by 2024 as compared to 2021 levels into its LTIP. In addition, companies can further emphasize the long-term nature of these goals through the use of stock ownership guidelines, equity retention policies and clawback policies.

If a company chooses to incorporate ESG metrics into its STIP (as many certainly do), the company should ensure the short-term metric ties directly to the company's long-term vision.

In both STIPs and LTIPs, companies should keep in mind the "G" – governance – element by careful assessment of the programs to ensure that they do not involve excessive risk and that they encourage conduct that is in the company's best interest.

Step 4: Review Corporate Documentation and Process.

1. First, companies should begin by reviewing their STIP and LTIP to confirm that the use of ESG metrics is permitted by the current programs. Companies should also review current award agreements to determine whether amendments are necessary.
2. Second, companies should utilize board-level and compensation committee resolutions to "build a record" that can be used to establish exercise of fiduciary duty and proxy statement support.
3. Third, companies should review other corporate documents such as their compensation committee charters to confirm whether duties should be expanded to account for the incorporation of ESG metrics and that the committee is performing its specified responsibilities. Compensation committees expanding the scope of their charters need to exercise caution to confirm that they are adhering to it in carrying out their responsibilities.

Step 5: Keep Current Disclosure Rules in Mind.

The regulatory landscape for ESG disclosures is ripe for change, and it is difficult to predict what types of disclosures will be mandated by law – or evolve as best practices – in the next few years. However, it is clear that the materiality threshold in terms of ESG disclosure is evolving towards a more heightened standard. Even before any additional regulations take effect in the future, there are current disclosure requirements to keep in mind. Disclosure requirements may be triggered across Form 10-K, Form 10-Q, proxy statements and Form 8-K if a company materially amends or adopts an executive compensation program as a result of incorporating ESG metrics.

- Item 402(b) of Regulation S-K requires disclosure in the proxy statement's Compensation Discussion & Analysis ("CD&A") of any policies regarding (i) the allocation of awards between short-term and long-term compensation, (ii) the structure and timing of specific forms of compensation, (iii) specific items of corporate performance taken into consideration in making compensation decisions, and (iv) whether discretion has or can be exercised to reduce or increase award sizes, among other considerations. Item 402(s) of Regulation S-K also requires CD&A disclosure of policies regarding adjustments to the company's compensation policies and practices to address changes in its risk profile, as well as material adjustments a company has made to its compensation policies and practices as a result of changes in its risk profile.
- In addition, Item 5.02(e) of Form 8-K requires disclosure of (i) entrance into or adoption of any new compensatory plan, contract or arrangement, (ii) material amendments or modifications to a compensatory plan, contract or arrangement, and (iii) material modifications to a material grant or award under a compensatory plan.
- Companies should step back and consider whether any ESG information is material and should be included to prevent disclosures from being misleading, even if not currently explicitly required under Regulation S-K, Regulation S-X, or other disclosure rules. Rule 12b-20 of the Securities Exchange Act of 1934 requires disclosure in periodic reporting of further material information, if any, in addition to information expressly required "as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."

Looking Ahead / Final Takeaways

The landscape of ESG disclosure continues to evolve on an almost daily basis, and more and more companies are tying ESG metrics to their executive compensation plans. Companies considering incorporating ESG metrics into their executive compensation plans should start with the most important question—***what*** metrics most closely align with the company's unique strategy and long-term vision, and are these goals measurable and achievable? Then, companies should consider ***how*** progress towards ESG goals will be reflected in the executive compensation programs (qualitative, quantitative, or blended), and ***where*** the progress toward ESG will be incorporated (STIP and/or LTIP). Throughout this process, companies should review, revise and amend their corporate documentation as necessary to allow for the incorporation of ESG metrics, keeping in mind that certain securities law disclosure requirements may be triggered if compensation plans or award agreements are modified. Ultimately, any decision to integrate ESG factors into an executive compensation program is a fiduciary decision on the part of the board and compensation committee, subject to the board's duties of care and loyalty.

Womble Bond Dickinson regularly advises private and public companies on executive compensation and related matters. If you need assistance or have any questions regarding the issues discussed in this alert, please contact Vivian Coates at (336) 721-3727 or vivian.coates@wbd-us.com, Jane Jeffries Jones at (704) 331-4953 or jane.j.jones@wbd-us.com, Gracie Smith at (404) 962-7545 or gracie.smith@wbd-us.com, the Womble Bond Dickinson attorney with whom you usually work or one of our Public Company Advisors Team attorneys for more information.

Vivian Coates is a dynamic member of the Firm's Corporate and Securities Practice Group and a member of the Public Company Advisors Team. Vivian has worked on deals in the US, UK and beyond for public and private companies and venture capital/private equity firms in numerous sectors, including technology, hospitality, health care, manufacturing, consumer goods, and banking and finance.

Jane Jeffries Jones has more than 25 years of experience representing clients in executive compensation and corporate matters. She is a partner in the firm's Corporate and Securities Practice Group and represents many of the firm's public securities team (PCAT) clients. Jane also has significant experience advising private equity firms, startup companies and other domestic and global companies with respect to executive compensation and related matters.

Gracie Smith is an associate in the Corporate and Securities Group and a member of the Firm's Public Company Advisors Team. Her experience includes public and private offerings of debt securities, exchange offers, and mergers and acquisitions, along with general corporate matters. She also counsels clients with respect to ongoing SEC compliance and related corporate governance matters, investor relations and disclosure issues, and shareholder proposals and engagement.

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