Compensation Committee Briefing: Pay Strategies for 2022 and Beyond

No other board decision receives more scrutiny than executive pay packages—and the events of the past few years have only accelerated that focus. In the following pages, directors and board advisers share perspectives on the most pressing executive pay and human capital management questions facing boards today.

Executive Comp and Investor Expectations

Intangible assets comprise, on average, 52 percent of a company's market value, so it's only natural for stakeholders to seek more robust insight into how companies manage and invest in their workforce. The Council of Institutional Investors is pressing for enhanced Securities and Exchange Commission 10-K disclosure requirements that would facilitate greater consistency and comparability of human capital-related disclosures, explains Amy Borrus, executive director of the CII. In addition to supporting the requirement that pubic companies disclose their total number of employees, the CII seeks mandatory disclosure of the breakdown in the number of fulltime, part-time and contingent workers, as well as employee turnover rates.

"Beyond that we would generally support the SEC encouraging issuers to voluntarily provide additional material human capital metrics, preferably using a generally accepted private sector investor-focused framework," says Borrus, who says consistency will help investors compare companies.

"We are encouraged that the SEC's new chair, Gary Gensler, has put human capital management disclosure on the SEC's agenda." CalPERS is also advocating on behalf of investors as part of the Human Capital Management Coalition, a cooperative effort among 35 institutional investors that collectively represent more than $6 trillion in assets. Like the CII, the Coalition also seeks a head count broken down by type of worker, as well as three additional fundamentals: total cost of the workforce, turnover of management and diversity data.

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SEARCHING FOR CLARITY

The latter should be an easy lift for companies that already collect workforce data. “A lot of times they already have this data available, and it’s just a matter of disclosing it in a consistent and uniform way,” explained Tamara Sells, associate investment manager at CalPERS, who notes that the pushback from companies stems from a lack of clarity about what to disclose and how to disclose it. “When you don’t have consistent, universal standards, it’s quite hard to know what exactly you should be reporting.”

As momentum continues to build, panelists agreed, boards can expect further developments in disclosure expectations, including:

- Shareholder proposals requesting broader disclosures in areas like racial equity and pay gap audits or a diverse candidate search policy.
- A pandemic-fueled push for more information around worker health and safety provisions.
- Proposed legislation mandating disclosure of diversity in executive suites and the boardroom.

Companies should also consider approaching the evolution of disclosure as an opportunity, notes Sells. “The SEC rulemaking on human capital left a lot of flexibility for company disclosures around human capital measures and objectives, but it didn’t give any guidance or specificity as to how to do that,” she points out. “So, companies should be asking themselves, ‘What constitutes meaningful corporate action on human capital management for our particular business strategy over the long term? How can we take advantage of this current climate and turn this crisis into an opportunity for change for our company?’”

3 Action Items

Fallout from the pandemic, market volatility and rising stakeholder interest in ESG issues brought an uptick in say-on-pay failures and compensation-related shareholder proposals during the 2021 proxy season.

While the worst may be behind us, uncertainty continues to undermine efforts to align pay and performance. Panelists David Kokell, head of compensation research for ISS, and John Sinkular, partner at Pay Governance, highlighted three points of concern for boards and management teams.

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1. **Tying incentive pay to nonfinancial measures.** Introducing ESG metrics and other strategic goals may help offset the uncertainty plaguing pay-performance alignment, noted Sinkular, who suggests considering incorporating nonfinancial goals as a minority weighting metric for incentive pay.
2. **Disclosure of payments related to termination. A** rise in severance payouts is prompting scrutiny among investors. “Our view is that severance payments are only appropriate for either involuntary or constructive termination scenarios,” says Kokell. “If severance is going to be paid as an executive departs the company—and usually we’re talking about multimillion-dollar cash amounts here—investors need assurances that those amounts were contractually entitled. Without fulsome disclosure in that regard, investors have no real way to analyze that.”
3. **More effective shareholder engagement.** With 2021 marking the highest failure rate since the beginning of say-on-pay, ISS will be looking at how companies fare at hearing and addressing concerns. “One of the things that we look for is board participation,” says Kokell, “including whether the comp committee participated in those conversations rather than having them relayed through senior management or investor relations teams.”

ESG and Incentive Pay

Already, 58 percent of companies include at least one ESG metric in their annual incentive plan, according to a recent study by Meridian. But rather than rush to follow suit, companies should consider following a four-step process:

1. **Start with the big picture.** Step back and assess your organization’s readiness for including ESG metrics in your incentive plan, says Ani Huang, CEO of the Center on Executive Compensation. “Don’t just jump in feet first without taking a good look at the current situation at your company, what changes you think are reasonable to make and how that will play with the other goals stated in your comp plan.”
2. **Sharpen your focus.** Rank your priorities and decide where to start. “Part of the challenge is that ESG covers so many different areas,” says Virginia Rhodes, partner at Meridian Compensation Partners. “Ask your organization, ‘Which ESG metrics are most important for your business, and are they measurable for you?’ This, again, requires data and analytics that many companies are still struggling to achieve.”
3. **Find your short- versus long-term balance.** Prudential Financial chose to recognize inclusion and diversity as a long-term strategic goal by setting goals three years out rather than annually, explains Kate Tekker, head of global total rewards and HR operations. “We were afraid measuring annually might lead to quick decisions that might not be best for our long-term talent strategy,” she says. “Three years provided a thoughtful amount of time to make the right decisions and track our progress.”

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4. **Make it meaningful.** If incentives are deemed too small or goals too insignificant, an attempt to tie ESG metrics to them could backfire by alienating outside stakeholders. “Activist investors and the media are really zeroing in on these disclosures, saying, ‘This company has a 5 percent metric on D&I; that’s hardly anything. What does that say about their commitment?’” says Huang. “You can actually have a worse consequence than not doing anything.”

Curating Culture

Difficult to measure and even harder to change, culture is a thorny issue for boards. Directors shared their views on getting a true read on how closely behaviors in the workplace align with corporate values.

ON ASSESSING CULTURE…

Elizabeth Beshel Robinson, Board Member, Bank of New York Mellon and Russell Reynolds Associates: It’s challenging as a board member to try to get at that truth [about culture]. The boards I’ve worked with that felt more successful have been ones where the management is self-critical and willing to come in and talk about where they see shortcomings and try to unearth the things that they see as problematic. In the last 15 months of the pandemic, where we haven’t been meeting in person and you haven’t been able to just have those informal check-ins, it’s been really challenging to break through the surveys, break through the metrics. I’m looking forward to getting back to board meetings in person for that reason.

Hubert Joly, Former CEO, Best Buy; Board Member, Johnson & Johnson and Ralph Lauren: One of the things we did at Best Buy that was very powerful was get the board outside of the boardroom early on. We took the board to the San Francisco market probably a year after I joined the company, and we had an employee panel. They were not prepped to say anything good, but for really, the front-liners to share with us what it was like on the frontline and the issues they were encountering. This was transformative. And, as a result of that, at least once per year, we would take the board to a market or warehouse or something like this. We would also invite the board members to attend our annual big gathering of the store managers. where they would really get a sense of the culture and the place.

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ON WHAT TO ASK…

Anthony Abbatiello, Leader, Global Leadership & Succession, Russell Reynolds Associates: There are two main things boards should be asking. The first is, what are the absolute leadership behaviors we need to drive the strategy? There's a disconnect between the strategy and the way work is getting done within the organization that is typically a leadership behavioral issue. It's not values, it's not mission statement or raison d'etre. It's about understanding the specific traits and behaviors that underpin achieving strategic goals—growth, expansion of global markets, innovating new products and services.

The second is looking at the alignment, what we call cultural maturity. How well are those behaviors aligned between employees up through the leadership, and then across all the functions and geographies in the organization? When there is very little alignment between leaders and employees and very little alignment across the organization, we call that the danger zone on those behaviors. Because ultimately, we want to have leaders and employees believing in the same values that we value, or having the same beliefs, and we want to see that consistently across the organization. That alignment, that cultural maturity, those are the two most important things.

ON ADDRESSING ISSUES…

Joly: The model of leadership used to be a leader as the superhero who's got all of the answers, controls everything, is there to save the day, and is driven often by power, fame, glory, or money. The new leadership model in this 21st Century era is much more purposeful, but vulnerable and authentic. My most frequently used phrase now is, "My name is Hubert, and I don't know, and I need help."

So [you need] a CEO and a leadership team who know that this is not a dog-and-pony show, that the board is a resource that can help crack some of the most difficult challenges. Bad news should travel as fast as good news, and that there should be an openness to conversations around the challenges. If the tone at the top is very much, "Everything is fine. I got it," that's a source of worry.

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Takeaways for 2022 and Beyond

Coming out of a year when carefully set strategic plans and performance goals were derailed by a series of unforeseen—and unforeseeable—events, panelists offer perspectives on what we learned from the upheaval.

After all the events of the past 18 months, what lessons do you think will stick with us for a very long time?

Roy Dunbar, Board Member, Duke Energy, Johnson Controls International, and SiteOne Landscape Supply; Former Board Member, Humana, Lexmark, iGate, and EDS Corp: One of the takeaways from 2020 was cost of capital, the amount of debt, and the degree to which a company had ready access to liquidity… If you go back to February, March and April 2020, especially April, there was a tremendous amount of concern on the part of corporations as to whether they had the liquidity to actually weather the crisis. That's a perennial lesson that came up in a slightly different form. Companies on whose boards I sit have all, in one way or another, acted on it, actually reducing their cost of capital and having a capital structure that is much more friendly to any type of eventuality that we can currently imagine.

Kim Korth, Board Member, Stoneridge: The biggest thing is that people have to be very careful how far out they can go with suggesting they can predict future performance. At Stoneridge in 2020, we were targeting a very, very good year, and then all the car companies closed, for the most part, manufacturing facilities for April and May. As a compensation committee chair, we had to say, okay, the budget that we use, and everything we're gonna look at doesn't make any sense, so we did go on a discretionary perspective. We said we wanted to pay attention to how competitor groups are doing, peer benchmark, etc. But going forward, you have to have something that you're measuring yourself against, so figuring out how you can make that something that you can predict successfully, given the shortening timeframe and the speed of change happening in so many areas, is going to be an ongoing conversation for a lot of boards over the next few years.

Matt Turner, Managing Director, Pearl Meyer: While ISS and Glass Lewis provided some forbearance and allowed for positive discretion on incentives, they still demanded that there be a good explanation, that there be good context, and that there be some modesty in the final numbers around performance and incentive payouts. But we can't count on that going forward. A special case is only a special case if it only happens once in a while; if it happens every year, that's part of business. So yeah, I think you're right, that there will be a higher hurdle for positive discretion.

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It's easy to compare traditional targets like total shareholder return, but how are companies going to deal with some of the additional, qualitative performance measures being pressed for now?

Korth: We're having a lot of conversations on the compensation committee and the board about figuring that out. For example, we have a desire to be able to ensure that we are adding sufficient talent as we're growing globally. And we've changed the mix of where from an 80 percent North American-dependent company to about a 40 percent North American-dependent company. We can be told by the CEO and the leadership team that we're making sufficient investments, and we're adding new people, but we need a little bit more color commentary around that. So, we actually have a sub metric that focuses on talent acquisition, and what's the mix that we have, and the number of years that someone's been here and how the succession planning is going, etc. It's the same kind of methodology you need to use with diversity and environmental goals… we need to develop a capability of coming up with metrics that make sense. So a lot of really interesting strategic conversations are gonna take place around those subjects.

Dunbar: Some of the elements of ESG come really hard and fast. They were bubbling in 2018, '19, but 2020 really bought the mark. And I don't think a lot of companies have the history of how those metrics really behave in order to necessarily set hard quantified goals, which they will then report on back to their shareholders. So it may well be worth using this year as a year where they're tracking what they have gathered, what they think they understand, see how it plays out in 2021, but view it as a qualitative measure, in a public communication, so that, in the next cycle, let's say 2022, there is enough confidence in understanding that particular metric, that it can then be in there with a goal, a year hence. It's going to be a journey, a succession of steps. So qualitative, initially, with clear intent to become quantitative.

Turner: It's a multi-year process to put something in place. Make sure that you have the board and the senior executive team on board with kind of a common definition of success. And when you've got a measurement category that doesn't lend itself to a single measure, may not lend itself completely to a quantitative measure, having conversations throughout the year is another aspect of new performance goal-setting. It's not a once-a-year process, throughout the year, at least quarterly in board meetings, you should be having discussions about progress, looking at a scorecard, evaluating it, talking about the exceptions, and making sure that people have a common understanding of what the objectives are around these measures. That can lead you to the point where things can get more quantitative when you've got more experience with it.

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