LEADERSHIP STRATEGY

Why More Companies Are Linking CEO Pay To ESG

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Incorporating ESG measures within an executive compensation program is easier said than done. GETTY

An important new governance survey suggests an increasing willingness to consider linking a company's ESG performance measures to executive incentive compensation. Such a practice would demonstrate a significant corporate embrace of social responsibility principles. But implementing such measures may present boards and their compensation committees with practical implementation challenges.

The new survey from The Conference Board, “Linking Executive Compensation to ESG Performance” (the “Survey”), essentially concludes that tying some portion of executive compensation to ESG principles is becoming a mainstream governance practice. Indeed, Survey data suggests that the percentage of S&P 500 companies that have adopted ESG performance measures is increasing at a steady pace—from 66 percent in 2020 to 73 percent in 2021.

But perhaps the real value of the Survey (prepared in collaboration with Semier Brossy) lies in two distinct factors: first, its review of the range of different approaches that companies and their boards are taking to implement ESG incentive goals, and second, its reminder of the challenges that arise when boards incorporate ESG incentives into executive compensation arrangements.

The Core Conclusion: A key Survey take-away is the application of ESG-based incentive compensation goals is not an isolated activity, but rather reflects the practice of “the vast majority of S&P 500 companies.” The most accepted approach noted by the Survey is the use of diversity, equity and inclusion (DEI) related goals, which rose from 35% in 2020 to 51% in 2021. In addition, an increasing share of S&P 500 companies are linking carbon footprint and emission reduction goals to executive compensation (from 10% in 2020 to 19% in 2021).

Differing Approaches. There is no “one size fits all” approach in how companies factor ESG into executive compensation. The Survey identified several different examples of this practice, including: (i) the “Stand-Alone Method,” incorporating ESG through specific (often quantitative) metrics; (ii) the “Business

Strategy Scorecard," including and assessing ESG goals as part of a broader scorecard of ESG or nonfinancial business priorities;(iii) the "Individual Performance Assessment," by which ESG is considered as part of an executive's individual performance rating, which is often a discretionary assessment by the company's compensation committee; and (iv) the "Modifier," by which ESG is used to adjust the financial performance rating, the overall rating, or the payout under a compensation plan.

The Message. According to the Survey, a primary motivating factor for incorporating ESG measures into executive compensation, is to both (i) emphasize to investors the priority a company attributes to its ESG initiatives, and (ii) to support the satisfaction of company ESG commitments.

The Concerns. The Survey is not, however, "pollyannish" with respect to the practice of tying compensation to ESG measures, and identifies a number of concerns which are worthy of board attention.

-First is the risk of raising investor skepticism if the ESG incentive compensation program lacks a strong “business case,” if the identified incentive goals are vague or easily achievable.

-Second is the challenge associated with developing appropriate and reliable data points that can be applied by the compensation committee in measuring and reporting actual performance against ESG goals.

-Third is the need for companies to tailor the ESG incentive model to their own necessities, as opposed to “simply following the trend,” as the Survey warns against.

-Fourth is the value of applying ESG-related incentive goals to a one or two year “test run” to evaluate their true relevance, test their accuracy and evaluate management acceptance levels,

-Fifth is the communication challenge-the company’s ability to message to the full range of its constituents why this particular incentive compensation model will “move the needle” in terms of overall corporate purposes.

-Sixth is the internal organizational awareness of the difficulties that can be encountered in measuring how ESG performance goals can impact compensation.

External Factors. The Survey results notwithstanding, there are several other factors that should be taken into consideration when evaluating the advantages and disadvantages of tying some portion of executive compensation to ESG principles.

The first overriding factor is the extent to which ESG remains a controversial corporate/ governance practice. The incoming Republican majority in Congress has made no secret of its opposition to ESG principles. Specific ESG-related conflicts are currently ongoing at the state level, with competing positions by state attorneys general on whether limits exist to regulatory authority to impose the EPA's climate disclosure rules. The fundamental corporate law debate over shareholder v. stakeholder capitalism continues to attract attention.

A second factor is the executive compensation committee's ability to monitor an ESG-related component of its existing incentive compensation program. There is some concern that there is too much use of incentive compensation (including clawbacks) to motivate executive behavior. Note in this regard is the Department of Justice's renewed corporate fraud enforcement initiative, which identifies compliance-driven compensation incentives and penalties as an element of an effective compliance program.

A third factor is growing external concern (especially from the academic sector) that while ESG ratings services may offer key insights into the nonfinancial impact of companies, major limitations exist in their objectives, methodologies, and incentives which impact the informativeness of their assessments.

Over the last several years, investors and related constituencies have advocated for incorporating ESG-related goals within executive incentive compensation programs. And, as the Conference Board's important new Survey indicates, many companies have in response adopted their own related programs. While these results suggest that the use of ESG compensation goals is moving into the executive compensation mainstream, board and executive leaders should be cautiously deliberate before adopting such a program.

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