COMPENSATION COMMITTEE CHAIR ADVISORY COUNCIL MEETING BRIEF

Fall 2021

Directors Are Grappling with Ways to Tie Pay Incentives to Climate Goals Under Mounting Investor Pressure

In the fall of 2021, NACD, with Farient Advisors and Weil, Gotshal & Manges, brought together compensation committee chairs from Fortune 500 companies to discuss investors' increasing demands for compensation committees to tie pay and performance metrics to climate goals.[1] Companies are still on a journey to figure out the best way to accomplish this, and many issues around this topic are still unresolved. Participants discussed integrating climate goals into the corporate strategy and tying pay to this, setting climate-related goals, tracking climate metrics, and the best board composition for accomplishing all of this.

DEMAND FOR CLIMATE GOALS IS GROWING

Organizations that have climate-related goals are a lot more common than it used to be, and the number of companies setting such goals continues to grow. "According to a study by Farient Advisors and their partners in the Global Governance and Executive Compensation Group (GECN), last year about 25 percent of companies had environmental metrics in their incentive plans. It's up to 30 percent now," said Robin Ferracone, founder and CEO, Farient Advisors. Additionally, although only certain industries, such as energy and utilities, used to track climate goals in the past, the range is now broadening to include financial services and technology among others. "And the range will continue to grow, as both shareholders and management are very interested in it," Ferracone added. "We are even seeing more mid-cap and small-cap companies starting to get in the game." For this reason, tying pay incentives to climate goals is the next natural step, as doing so would hold companies accountable to meeting the goals. Investors have been making their desires in this area clear, as they are putting pressure on the US Securities and Exchange Commission (SEC) to require reporting on environmental, social, and governance (ESG) metrics.

[1] Note: The meeting was held using a modified version of the Chatham House Rule, under which participants' quotes (italicized) are not attributed to those individuals or their organizations, with the exception of cohosts.

CORPORATE STRATEGY AND CLIMATE STRATEGY NEED TO BE LINKED, THEN THE PAY WILL FOLLOW

As interest in measuring, reporting, and having climate-based incentives for compensation grows, investors have made it clear that they want to see corporate strategy and climate goals integrated. Therefore, boards and companies shouldn't think of these as separate entities, and once they've established an overall business strategy that incorporates climate strategy, they need to commit to executing it fully. As one delegate put it, "*What's exciting to me is [that] when companies speak about strategy and climate, they're not talking about separate things. They're thinking, 'Let me be aware of strategy and understand the commitment and then see how to apply these*.'"

Once companies integrate climate targets into their strategy, they also need to start setting performance and pay goals against that, Ferracone pointed out. "Pay follows strategy," she said. "Pay attention to the ways incentives can be impacted by behavior. For example, you can say, 'You weren't supporting our diversity goal or climate platform, so you won't see it in your bonus.' It's the culture things that set the tone."

IT'S OKAY NOT TO HAVE INCENTIVES. Most boards are still figuring out the incentive process when it comes to tying pay to climate goals. Even if companies don't currently have incentive plans in place that support climate goals, that doesn't mean that the board shouldn't pay attention to the strategy in relation to climate goals. Because measuring can happen in multiple ways, directors can give a set of standards on what to measure and report. There are also ways around not tying pay incentives to climate goals if an organization is still not ready to do so. If a company is a stellar performer in its industry and is a leader in environmental practices and communicates these facts well, then the company is more likely to appease investors without tying pay incentives to climate goals. "*You have to have all other elements in place and succeed at them to not have [pay incentives] as part of compensation*," said a delegate.

COMMUNICATION IS KEY. Delegates agreed that one area where companies can improve is with communication. Organizations need to communicate and share their strategy, climate goals, and success stories with shareholders regularly, especially if they don't have incentive plans in place that support climate goals. Companies shouldn't wait until there is an activist on their doorstep to engage with investors and other stakeholders; they should make communication with stakeholders via their websites, reports or other disclosures, and investor days part of their standard operating procedures. "Being strategic is the best way to be proactive," said Ferracone. Boards also need to make sure that what companies are doing internally is aligned with what they are telling the public. "Take inventory of what your company is publicly disclosing about climate and whether there is a clear link to the company's strategy. Investors and other stakeholders want to understand how the company's strategic direction supports ESG and vice versa," added Lyuba Goltser, a partner with Weil, Gotshal & Manges.

FOR BEST RESULTS, HAVE BROAD LONG-TERM GOALS WITH SHORT-TERM GOALS TO GET THERE

A crucial element of strategy is setting goals because a company needs to know where it's going to achieve that strategy. However, setting goals may feel like an uphill battle for some organizations, as addressing climate change and environmental issues are long term in nature and companies are used to setting short-term goals. "Companies need to start thinking of some of these goals in terms of longer-term planning, because climate change is long term," said Ferracone. "But they can break down the long term into short-term goals in terms of [asking], 'What steps do we take to get to long term?'" It is the board's responsibility to help management and the organization as a whole to see this bigger picture and then to determine the best way to implement the task of breaking it into smaller pieces. Once they've established the interim steps, boards can then think about how to integrate those steps into short-term bonuses.

START WITH THE BASICS. Goals don't need to be detailed to start with. They can be broad and top-line goals, such as meeting supply chain targets or goals for reductions in carbon/greenhouse emissions or water consumption goals. They can also be more community-based, such as changing community attitudes toward the dangers of underage drinking, or they can be internal, such as tracking diversity, equity, and inclusion (DE&I) measures. If a company finds that it has many initiatives within silos, it needs to consolidate those initiatives around key themes.

BE ACCOUNTABLE. Boards need to hold management and the company as a whole accountable for executing the strategy and meeting climate goals—both long term and short term—for climate-based pay incentives to work, delegates agreed. One of the best ways to encourage that accountability is to communicate all goals and milestones publicly, according to several delegates. "It can say, 'Here's where we want to be in 2028. And here's what we will do next to get to that goal,'" said Ferracone.

If companies aren't sure what direction to take for a long-term goal, they need to listen to their investors and ask them good questions about their priorities. "*If we are not focusing on what investors want, then we're failing*," said one delegate. "*Have constant curiosity and always be listening to shareholders. And use those [steps] to drive the agenda*."

SETTING AND TRACKING METRICS IS ON A GROWING NUMBER OF RADAR SCREENS

The group agreed that for companies to tie pay and performance to climate goals, companies also need to set and track metrics related to their climate goals to collect data to inform their decisions around incentives. While a growing number of companies have started tracking such metrics, the vast majority are still honing their approach to the measurement process. Big, top-line questions remain: What measures are important to an individual company? What is the baseline? Where does it want to be? By when? What are its goals?

Investors are now asking companies to put baseline measures into their broader goals and strategy. Companies can get creative with how they start thinking about tracking climate-based behaviors while they're still figuring this out. Here are some examples:

- Some mid-cap knowledge-worker companies have virtual power purchase agreements with solar or wind facilities.
- When seeking financing, some companies are launching bonds or buying bonds for projects that are green.
- Some mid-cap companies are collaborating with suppliers to optimize their use of motor vehicles to drive fewer miles.
- When one delegate's company acquires another company, it looks at the acquisition's vehicle fleet and asks them to retire older, less efficient vehicles.
- The audit committee at one company monitors the company's supply chains with a checklist; the committee then reviews policies and procedures throughout the supply chains and reports on these frequently.
- One company that supplies a service instead of a product reviews its people diversity and tracks the percentages of its female and ethnically diverse leaders and asks other questions around its DE&I practices as well.

As shareholders put more pressure on companies to set and track metrics for climate goals, boards must ensure that the organization institutes these practices if the company isn't already following them. This is especially important because investors are also putting pressure on regulators to require ESG disclosure, and boards will need to be prepared. "Investors want SEC rules to include metrics and clear guidance on this, or on climate change in particular, because there are not enough metrics on this," said Goltser. "We will see more concrete disclosure on rule-making in these areas."

EVERY BOARD NEEDS TO DECIDE THE BEST COMPOSITION FOR ITS NEEDS; THERE IS NO SINGLE 'BEST WAY'

As boards become more involved in tracking ESG goals and eventually tying such goals to pay incentives, they need to make sure that they have the right levels of expertise and oversight for their organization's individual needs. However, debate still exists about where oversight for ESG should lie and what kinds of expertise are necessary for effective oversight.

Who should oversee ESG? Where oversight for ESG resides depends on the board's makeup. It rests within the audit or risk committee on some boards, while it's overseen by the governance committee on others. And some larger companies with boards that can support more specialized expertise have created a separate ESG committee. There is also some debate about whether ESG would be best overseen by the entire board rather than assigning responsibility for ESG risks to a single committee.

Have the right skills mix. Companies also have to decide what mix of skills they want on their boards regarding ESG. There is significant debate over whether having several individual ESG experts is necessary or if having generalists with competencies in certain areas would be more beneficial to the organization. "Boards need to have thoughtful discussions about which would work better for them," said Ferracone. "It's not a knee-jerk reaction." The right mix will also depend on the size of the company. "There is no one-size-fits-all answer," said Goltser. "Companies just starting out will focus on only the audit committee. Not every board needs an expert. Larger, more mature companies divide things up over committees."

Boards may also want to consider including ESG in their training agenda. The group concurred that training by outside experts seems to be the best option. "*We brought in climate change experts with two different points of view. It was very educational*," said one delegate.

What was clear among participants is that the climate journey that boards are on is both dynamic and complex. It is also a part of a broader, evolving trend around ESG. The desire for ongoing dialogue and learning is strong among board members, as is the realization that progress in this area will not be linear. But as with all business challenges, the board members present were focused on what they believed to be the best outcomes for their companies, investors, and broader stakeholders.

About NACD's Advisory Councils

NACD's invitation-only advisory councils bring together Fortune 500 committee chairs for peer-to-peer discussions and dialogue with key investors, regulators, and other stakeholders. The insights gained from these councils inform NACD's publications and educational programming for the benefit of all NACD members. Contact Chris Barnard at pcbarnard@nacdonline.org for more information.

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