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Executive Pay Increasingly Tied To DEI Goals

Despite Pushback, One-third of The S&P 500 Link Pay to DEI Aims

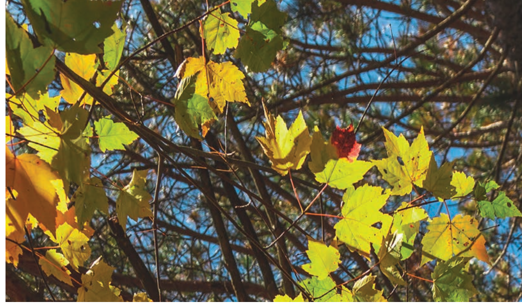
Before 2020 and the declaration of a global pandemic and civil rights action after the murder of George Floyd in the U.S., the explicit use of ESG measures, such as DEI, in executive pay was rare. And while still not majority practice, an increasing share of companies are adopting DEI measures.

The numbers keep growing. More than a third (38%) of S&P 500 companies now tie a portion of their executive incentive plans to diversity, equity, and inclusion (DEI) measures, according to recent research from Farient Advisors. What this signifies is a higher degree of confidence among the largest public companies in using DEI as a performance measure.

When compensation committees such as those at Starbucks or Verizon link a percentage (e.g., 5%) of executive pay to DEI goals, for instance, they are essentially directing senior leaders to focus significant time and energy to improving DEI performance. To employees, investors, and other stakeholders these companies are communicating that building a diverse and inclusive workplace culture is a top priority and that executives will be held accountable for achieving such goals.

The business case for increasing DEI is well-justified. In addition to the important culture-enhancing benefit of supporting DEI, more companies recognize that a diverse and inclusive leadership team produces better performance. A definitive three-part study by McKinsey & Co. “shows not only that the business case (for DEI) remains robust, but that the relationship between diversity on executive teams and the likelihood of financial outperformance has strengthened over time.[1]”

There also is often a need to demonstrate to all stakeholders—consumers, suppliers, activists, regulators, and the media—that DEI matters to the company. And this external signal has become increasingly important as issues of inequality and its negative impact on society are top of mind. Customers and employees want to feel they are buying from and working at companies that are doing the right thing. Linking executive pay to the achievement of DEI goals clearly communicates this message.



Sector Differences

Financial services and utility companies—presumably because they are highly regulated and part of the local communities in which they operate, tend to be at the forefront of sectors that link incentives to DEI goals. Two thirds of all utility companies and more than half of the financial services firms in the S&P 500 use or mention DEI in their incentive determination process, according to Farient research.

Conversely, the information technology and industrials sectors, have the lowest prevalence, with 25% of those S&P 500 companies using or mentioning DEI metrics in their executive incentive plans. The companies in these sectors that have adopted DEI measures recognize a need to strengthen diversity in both their companies and their industries. IBM, for example, added a diversity modifier to its 2021 STI plan based on the improvement in representation of executive women globally, and the improvement in representation of Black and Hispanic executives in the United States.

Prospective vs. Post-Performance Measures

Also significant, according to Farient's research, is the greater use among S&P 500 companies of using "prospective" measures (i.e., companies setting goals in advance of the fiscal year) rather than reporting on progress after the year is complete. Prospective measurement is generally preferred among investors, as it suggests a commitment to improve on the measure, rather than an after-the-fact report on it. Of companies using DEI measures, 56% are now using prospective measures, while the remainder use post-performance considerations.

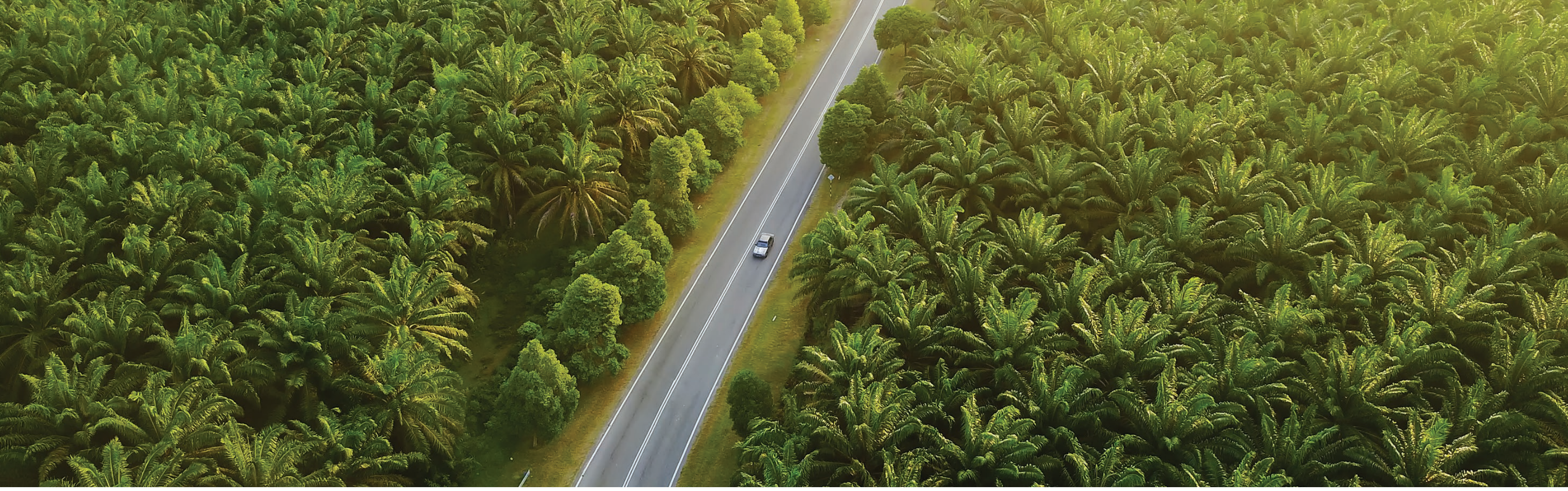
In our review of corporate proxy statements, two examples stand out: one shows the use of prospective measures and the other "post-performance" considerations:

- **An example of prospective measurement:**

  The **AES Corporation**, an electric power distributor, includes in its long-term incentive (LTI) plan a prospective diversity measure tied to the increase of women within leadership roles and the increase in representation of historically underrepresented groups throughout its U.S. employee population

- **An example of post-performance measurement:**

  Dover Corporation, a global manufacturer of industrial products, lists the individual achievements of the CEO in its short-term, incentive plan. These accomplishments relate to the company's strategy to help ensure its culture continues to take an inclusive approach that values diversity – i.e., using post-performance considerations



Quantitative vs. Qualitative Reporting

Companies are quantifying their DEI ambitions to a greater extent. Quantitative data refers to information that can be counted, measured, and given a numerical value. Qualitative data is descriptive and expressed by language rather than numerical values. Of the S&P 500 companies that use DEI as a prospective measure in their incentive plans and disclose their measurement type:

- 57% use quantitative DEI factors
- 43% use qualitative DEI factors

When DEI measures are used on a prospective basis, the most prevalent measurement type is representation, measuring and targeting the overall breakout of the workforce by gender and/or ethnicity. Additionally, of the companies that use DEI as a prospective quantitative measure, 63% disclose a specific quantifiable goal.

Some companies are choosing to disclose the annual reporting required of all private-sector companies employing 100 or more people by the U.S. Equal Employment Opportunity Commission. While these “EEO-1” filings are treated as confidential by the federal civil rights watchdog, some companies are using the data contained within these filings to measure the gender and ethnic makeup of their workforce. This helps to establish a baseline against which progress on diversity can be measured.

Examples of companies that use incentives tied to gender and/or race representation are:

ALLIANT ENERGY a utilities company, which in its STI plan uses three measures of DEI: percentage of people of color in its workforce, percentage of women in its workforce, and overall dollars spent with diverse suppliers

MARATHON PETROLEUM an energy company, which in its STI plan uses two measures of diversity, targeting 30% women and 30% Black, indigenous, and people of color (BIPOC) in its workforce

STARBUCKS a coffee retailer, which in its most recent LTI plan is targeting improvement in Black, indigenous, and LatinX representation at the manager level over a period of three years

A Fault Line

Measuring DEI performance is not without its challenges.

For example, Starbucks began tying a portion of executive compensation to DEI commitments in 2020. In August, the coffee chain was sued by a shareholder who alleges that Starbucks' use of DEI goals is discriminatory. The National Center for Public Policy Research objected to Starbucks' goals to increase the number of employed Blacks and other people of color, to award contracts to "diverse" suppliers and advertisers, and to tie executive pay to diversity.

The plaintiff, in its filing[2] with the Spokane County Superior Court, alleges the defendants, including 35 directors and officers and founder and former CEO Howard Schultz, are "virtuous advocates" and that their decisions to promote greater diversity require "race-based decisions that benefit minorities, and violate state and federal laws."

Lawsuits in general tend to have chilling effects and it remains to be seen whether the court finds validity in the Center's argument. Regardless, we predict that companies and their boards will increasingly continue to tie executive compensation to environmental, social, and governance objectives, including DEI. As the civil rights leader Jesse Jackson once remarked, "Inclusion is not a matter of political correctness. It is the key to growth."

[1]McKinsey & Co., "Diversity Wins: How Inclusion Matters," May 19, 2020; retrieved September 26, 2022

[2]*National Center for Public Policy Research v Schultz et al*, Spokane County Superior Court, No. 22-2-02945-32, retrieved September 26, 2022

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