SEMLER INSIGHT

ESG & Human Capital Management

A BOARD'S GUIDE TO ESG AND INCENTIVES

PART 1: Effectively Identifying Top ESG Priorities

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As investors, regulators, and stakeholders increasingly recognize environmental, social and governance (ESG) risks and opportunities as financially material, companies are looking for ways to link management incentives with ESG performance on climate change, diversity and inclusion, and other key issues. Though integrating ESG goals into the existing compensation program may seem like the obvious next step, there are several processes that board members need to implement first—and critical questions that they need to address—to ensure the new compensation structure is appropriately tied to corporate strategy.

Guidance for boards of companies that have begun to integrate ESG issues into their corporate strategies and may be considering ESG in incentives.

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Ceres and Semler Brossy have teamed up to provide guidance to companies that have begun to integrate ESG issues into their corporate strategies and may be considering ESG in incentives. This three-part series focuses on that process, including guidance to corporate boards on how they can: 1) effectively identify and oversee top ESG issues, 2) focus and clarify efforts around establishing a select set of critical performance goals for material ESG issues, and 3) consider whether and how to integrate ESG metrics into incentive compensation programs. In this first article, we will focus on how companies can implement the foundational steps of board-level ESG oversight.

The board's role in ESG oversight

As stewards of long-term corporate performance, boards have a critical role to play in ensuring that companies are aware of, and able to navigate, an ever-evolving risk landscape—one that increasingly involves social and environmental impacts. It is the board's responsibility to ensure that processes are in place to identify material risks and opportunities—including those that arise from ESG concerns. In doing so, directors should look beyond the information they receive from management and actively inquire about processes employed and issues identified. This is not only best practice, but a fulfillment of director fiduciary duty, which includes the "duty of care," or responsibility to adequately inform oneself prior to making decisions.

The direct consequences of directors failing to take ESG concerns into account are growing. So-called Caremark claims, in which investors hold directors accountable for failing to implement or monitor key reporting systems, were dismissed for many years—but since 2019, five such claims have been allowed to proceed. Noting this trend, the Commonwealth Climate and Law Initiative recently published an analysis indicating that U.S. directors may be liable under the duty of care for failure to oversee climate risks, particularly if they ignore red flags from investors and other stakeholders. Such lapses may become increasingly obvious to investors as the US Securities and Exchange Commission (SEC) and other financial regulators implement and strengthen mandatory disclosure rules.

A first step for responsible board oversight is to assess the extent to which the company's existing processes allow for systematic identification and assessment of ESG risks—and whether those processes are inclusive of a wide range of perspectives, to allow the company to consider risks that may not already be on its radar. This may involve internal and external research, engaging employees and customers, and consulting experts, such as insurance brokers and risk managers, to identify the set of issues the company should examine. Many companies hire outside consultants to do a full organizational review to determine top ESG risks, in addition to reaching out to top shareholders and other stakeholders to collect their views.

It's important to remember that ESG issues present not only risks, but opportunities as well—new technologies, new product markets, and shifting customer preferences. Boards should ensure that management is also exploring the upside potential of ESG trends through strategic offsites or other regular meetings focused on defining and aligning the company's strategic plan. As the Ceres Roadmap 2030 notes, leading companies will recognize that the integration of sustainability into governance systems enables opportunity for improved performance, risk mitigation, cost reduction, increased revenue and competitive differentiation.

The board's role in ESG risk and opportunity identification and oversight

QUESTIONS FOR DIRECTORS TO ASK*

- ***Consider how ESG risks and opportunities could affect your company:***
  - What kind of risks or opportunities could ESG issues pose to the company?
  - How could these risks and opportunities interrelate?
  - When could these risks or opportunities manifest?
- ***Evaluate whether existing processes allow the discovery of ESG risks and opportunities:***
  - What is the company's process to identify risks and opportunities from ESG factors?
  - Which ESG risk factors is the company already tracking?
  - Is the company looking at the right range of sources—including investors and peers—to identify risks and opportunities?
- ***Be aware of assumptions in the risk and opportunity identification process:***
  - Did management assess ESG risks and opportunities that the company could face in 1, 5, 10 and 20 years?
  - What blind spots about ESG risks may exist in the risk identification process?
- ***Integrate identified ESG risks into the Enterprise Risk Management (ERM) process:***
  - Who owns the ERM process internally?
  - Does the ERM process consider ESG risks?
  - Is the ERM process agile?

* *Excerpted from "Running the Risk: How Corporate Boards Can Oversee Environmental, Social and Governance Issues" (Ceres, 2019)*

The company may already track some ESG risks within its Enterprise Risk Management system, without necessarily labeling them as social or environmental issues but rather as operational, supply chain or regulatory risks. Where material ESG risks are known, incorporating them into existing systems can help ensure they are taken seriously as business risks so that identification, prioritization and mitigation take into account their material financial impacts.

For many companies, existing processes are necessary but not sufficient for identifying ESG risks and opportunities—especially when the risks or opportunities are difficult to quantify or manifest over very long time horizons. In some cases, internal sustainability teams may be well aware of these issues, but the challenge is to incorporate them into organization-wide systems. Generally speaking, material risks identified in the company's sustainability report should also appear in the company's financial disclosures.

Boards should work with management to examine whether existing risk processes are sufficient, and how they might be strengthened. This may include evaluating business model assumptions. Practically, processes companies can adopt for identifying ESG risks can include megatrend analysis, SWOT analysis (which identifies strengths, weaknesses, opportunities and threats), impacts and dependency mapping, scenario analysis and facilitated stakeholder engagements. The Ceres report, "Running the Risk: How Corporate Boards Can Oversee Environmental, Social and Governance Issues" contains several toolkits to guide directors in these processes.

Board committee structure for ESG oversight

Integrating ESG considerations into boardroom decision-making on strategy needs to happen at both the full board and committee levels—with all significant ESG efforts being reviewed by the full board, at least at a summary level. In practice, this means directors need to ensure material ESG topics are standing items on the board's agenda in order to address them systematically and integrate them consistently into strategic planning and execution. Without a systematized approach, companies will be forced to react with a crisis response when negative impacts occur and can miss out on opportunities presented by new markets and shifting customer and employee expectations.

The best way for boards to systematize ESG oversight is by amending one or more board committee charters to include formal responsibilities related to material ESG issues. This is important even for boards that are already engaged on ESG because charter language can outlast any individual directors or executives who may currently be driving that work—ensuring board oversight of ESG risks and opportunities both now and in the future.

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There are many models for board committee oversight, and pros and cons to each approach. One key decision is whether to establish a dedicated committee, such as a Sustainability Committee, versus integrating ESG oversight within one or more existing committees. For instance, an Audit and Risk committee could focus on material financial risks impacts of climate change, while a board's Human Resources and Compensation committee may be best suited to oversee human capital issues in the workforce, such as diversity and inclusion

Table 1. Sample Framework for Board and Committee Allocation of ESG Issues

	CLIMATE CHANGE	DIVERSITY & INCLUSION	WATER RESOURCES	HUMAN RIGHTS	PRODUCT SAFETY	COMMUNITY IMPACTS	WASTE & RECYCLING
Full Board							
Nominations & Governance							
Audit & Risk							
HR & Compensation							
Public Policy							
Sustainability							

and pay equity, and a Nominating and Governance committee may be the right body to ensure directors with appropriate ESG expertise serve in these committee roles. A simple mapping exercise of ESG issues and board committees can be useful, and may be modeled after table 1 above—adapted to fit the company's material issues and committee structure.

One of the advantages of a dedicated ESG committee is that it signals, both internally and externally, that there is commitment to keeping an eye on these issues and that they are important to the company—and ensures thoughtful deliberation of their business implications. On the other hand, a standalone committee can lead to siloed discussions of ESG topics, which might not be meaningfully connected to other business priorities that the board is driving. Integrating ESG oversight into an existing committee addresses this issue, but given increasingly crowded board agendas, it runs the risk of ESG issues being crowded out.

As of July 2021, around 88% of the S&P 100 had integrated ESG oversight into specific board committee charters. Nomination and governance committees were the most common placement for ESG oversight, with nearly half of companies (47%) placing responsibility there. The next most common placements were standalone sustainability committees (14%), audit, risk and compliance committees (10%) and public policy committees (10%). Around 4% of these companies integrated ESG oversight into multiple committee charters, and 3% placed it within a single committee other than the ones already mentioned. In the several months since, at least two companies that previously lacked committee-level responsibilities have integrated them—and, notably for this article series, about half of the Fortune 100 companies have expanded the names of their compensation committees to include broader human capital items including leadership or management development and people resources.

Table 2. Examples of committee placement of ESG risks (Running the Risk, Ceres 2019)

BOARD COMMITTEE	ESG RISK OVERSIGHT EXAMPLES	COMPANY EXAMPLE
Audit/Risk	• Ensure material ESG risks are brought to the attention of the full board • Ensure compliance with new ESG regulations • Disclose ESG risks in financial filings	Alphabet *(Audit and Compliance Committee)*
Nominating & Governance	• Include ESG in board skills matrix • Require board training on ESG • Integrate ESG in board performance evaluations	Mastercard [1] *(Nominating and Corporate Governance Committee)*
Compensation/ Human Resources	• Incentivize executives to take action on mitigating risks from ESG issues • Oversee policies and procedures on workforce development including safety and diversity • Engage with investors on ESG and compensation	T. Rowe Price *(Executive Compensation and Management Development Committee)*
Sustainability/ Diversity	• Review key sustainability programs and related goals... and monitor the Corporation's progress toward achieving those goals. • Review and discuss the Corporation's diversity, equity and inclusion policies, programs and initiatives.	PepsiCo *(Sustainability, Diversity and Public Policy Committee)*
Environmental Health & Safety	• Oversee acute and chronic impacts of hazards posed by the company to employees, contractors and the general public • Oversee company response to developing EHS regulations and development of policies to comply, including those related to climate change	Consolidated Edison *(Safety, Environment, Operations, and Sustainability)*

At a management level, because the impacts of ESG issues can manifest across multiple areas of a business, an important structural element of managing ESG oversight and efforts is cross-functional collaboration. Boards should ensure that the management team not only has expert leadership for its most material ESG issues, but also that those leaders are coordinating with other teams across the company and they have a voice in strategic decision-making for the business. By asking ESG managers and business leaders to regularly present to the board, directors help ensure that this cross-organizational collaboration is taking place.

At the end of the day, there is no single solution for how to structure board oversight and companies should choose a model that best fits their own situation—but some formalized committee-level responsibility is crucial. It's also critical to ensure that the oversight structure is reevaluated from time to time. Issues will continue to evolve, and the structures to address them will need to advance as well.

[1] *More information can be found in Mastercard's 2021 Proxy Filings.*

Below are examples of different approaches to committee oversight of ESG issues:

Table 3. Oversight Examples of ESG Issues

	COMMITTEE	CHARTER LANGUAGE
Nike	Corporate Responsibility, Sustainability & Governance Committee	*"Review and evaluate the Company's significant strategies, activities, policies, investments and programs regarding corporate purpose, including corporate responsibility, sustainability, human rights, global community and social impact, and diversity and inclusion."*
FedEx	Nominating and Governance Committee	*"Review and discuss with the Executive Vice President, General Counsel and Secretary, the Chief Sustainability Officer, and other members of management, at least annually, the Company's (i) corporate social responsibility strategies and programs, including with respect to sustainability, and (ii) management of sustainability-related risks."*
Alphabet	Audit and Compliance Committee	*"Review and discuss with management Alphabet's major risk exposures, including financial, operational, data privacy and security, competition, legal, regulatory, compliance, civil and human rights, sustainability, and reputational risks, and the steps Alphabet takes to prevent, detect, monitor, and actively manage such exposures."*

What about executive compensation?

We've now covered the first steps that boards need to take, which include ensuring the company is identifying and prioritizing key ESG risks and opportunities, and formalizing and structuring board oversight of ESG. With those practices in place, boards can move towards measuring, monitoring and tracking key ESG metrics over time, establishing appropriate goals, communicating those metrics and goals to key stakeholders, and considering the metrics for incentives. These are subjects that will be covered in parts II and III of this series.

A BOARD'S GUIDE TO ESG AND INCENTIVES

PART 2: Focusing the Company Around ESG Priorities

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As discussed in part I of this series, A Board's Guide to ESG and Incentives: Effectively Identifying Top ESG Priorities, before an organization can link executive compensation to environmental, social, and governance (ESG) goals, it must establish methodologies for identifying material ESG risks and opportunities and board oversight. Once top ESG risks and strategic opportunities have been identified, a company will need to focus action on the key issues. From the board's perspective, this will involve two large buckets: goal setting and communication.

ESG goals tend to have long time horizons—often longer than the tenure of the current executive team. This is why, in our previous article, we emphasized the need to institutionalize ESG oversight—so that it can be consistently applied as executives come and go. But within the tenure of the current executive team, certain actions can be incentivized so that individual leaders do their part to keep the organization on track.

Setting ESG Goals

An essential function of a corporate board is to ensure that management is setting clear, meaningful goals that address organizational priorities. In the case of ESG performance, this often includes greenhouse gas (GHG) emissions reduction goals and diversity, equity, and inclusion (DEI) workforce goals, and may also include other material issues, such as water use or operational safety, depending on the industry.

Table 4. Setting Science-Based Net Zero Targets

ESG ISSUE	GOAL EXPECTATIONS	COMPANY EXAMPLE
Greenhouse Gas Emissions	Scope 1, 2, and 3 greenhouse gas emission reduction targets (including short- and mid-term milestones) aligned to the most current science, or set such a target within 24 months	JLL was one of the first companies to develop a science-based net zero target verified by the Science Based Targets Initiative (SBTi). This target aims to reduce emissions across all scopes by 51% by 2030, and 95% by 2040 from a 2018 baseline. PSEG has pledged to reach net zero emissions by 2030 and also to develop SBTi approved and aligned targets.
Human Rights	Policy that clearly articulates respect for the human rights of both direct and indirect employees, preferably aligned with UN Guiding Principles for Business and Human Rights.	HP, ranked #1 in ESG performance in 2021 by Newsweek, set a goal to assure respect for labor-related human rights for 100% of its key contracted manufacturing suppliers. HP conducts human rights due diligence assessments to identify and mitigate risks across its value chain and established a Racial Equity and Social Justice Task Force to drive industry change.
Diversity, Equity, and Inclusion	Targets to improve representation, on a path to achieving equity for women and other historically disadvantaged and underrepresented groups across the workforce.	Edison International aims to reach full gender parity for executive positions by 2030, a goal it set when it joined Paradigm for Parity, a coalition of business leaders dedicated to addressing the leadership gender gap in corporate America. Nike set a 2025 goal to increase representation of women and of racial and ethnic minorities in its corporate workforce and in leadership positions. Nike's goals also extend into its supply chain, with an aim that 100% of its suppliers will have gender equitable work places by 2025.
Water and Natural Resources	Policy or commitment, as is sector-relevant, to conserve and protect water and natural resources, on a path toward future resource positivity.	Amgen announced in 2021 the goals of reducing water use 40% and waste disposal 75% by 2027. Sub-goals include implementing specific projects and initiatives across its operations. General Mills establishes multi-stakeholder, science-based water steward action plans for 10 priority watersheds under stress, involving local communities, industry, agriculture and government in decision making and water protection.

These goals may seem simple in high-level communications, but the definitions behind them are nuanced and important. Taking GHG targets as an example, the company's goal may be "net zero emissions by 2040"—a very concise articulation of a complex goal. Boards and management should be able to answer questions from key stakeholders—like investors on:

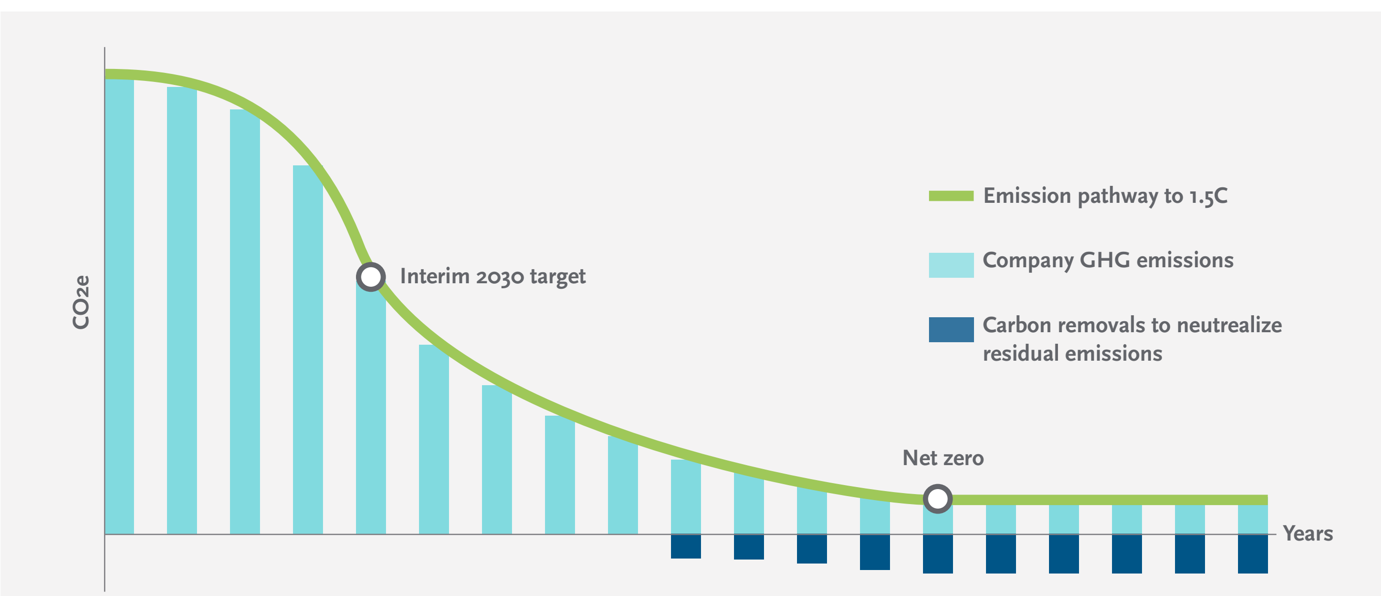
- Does this goal cover only operational emissions or does it include value-chain emissions? How are scopes 1, 2, and 3 being addressed? Has this goal been certified by the Science Based Targets initiative (SBTi) or at least filed with the organization for consideration?
- What will the role of offsets be in reaching net zero emissions? How extensively will they be used, when will they be introduced, and how have they been verified both for their environmental and social impacts?
- How will management oversee progress towards the goal? Is there a cross-functional team meeting on a regular basis? Have consultants been hired to do a GHG inventory?
- How is this goal being communicated, both internally and externally?

Social goals are also very nuanced and require careful definition. Take, for example, the seemly straightforward goal of gender equality, which raises the following questions:

- If the ultimate goal is 50/50 representation, what is an achievable timeframe?
- Does this apply to all employees or just the leadership level?
- If at a leadership level, how is that defined?
- What programs should be incentivized in order to reach that goal?
- Should transgender rights be addressed within these goals?

Once management and the board have fully articulated these ESG goals, they can be seen as specific destinations on a longer journey. The company will need to map out a route to get to each of them by defining interim targets with dates, creating business plans, and allocating the necessary capital. For example, achieving GHG reduction targets may involve decarbonizing the company's capital stock and committing to align future capital expenditure with the Paris Agreement's objective of limiting global warming to 1.5 degrees Celsius.

Fig. 1. Greenhouse Gas Emissions Targets



Source: Based on a graphic from the Foundation for Science-Based Net Zero

Developing Interim Targets and Transition Plans

Ambitious goals can only be achieved if strong steps are taken to get there. For addressing the climate crisis, long-term (e.g., decades-long) mitigation goals need to be broken into shorter term goals that executives can address during their tenure. Pathways to net zero by 2050 or even 2040 will need interim targets for 2030—and standards are evolving around these, with an ambition of 50% reduction recommended by groups like the Science Based Targets initiative (SBTi) and Climate Action 100+.

As we write this in 2022, even those interim climate targets are quite far away—and there is a growing push by investors and advocates for companies to develop "transition plans" to plot the steps needed in smaller and more actionable increments.

The Ceres Roadmap 2030 provides a blueprint of action steps companies need to take to succeed in a sustainability challenged economy and it lays out critical milestones they should reach in five-year increments to stabilize the climate, protect water and natural resources, and build a just and inclusive economy. Those steps include key business integration actions that embed ESG goals in strategic planning, governance, disclosure, and throughout the value chain.

Beyond breaking down goals into manageable timeframes and action steps, companies also need to break down responsibility for implementation into specific teams and individuals—creating clarity around how executives and employees can and should impact ESGperformance. Nike, for example, established 29 targets for 2025 focused on "People, Planet and Play" and holds everyone in the company accountable for achieving them, especially top management whose compensation is tied to those targets.

Investor expectations for credible business plans are still evolving, but some general guidelines can be found in Ceres' Investor Guide to Corporate Greenhouse Gas Commitments. This resource defines strong transition plans as those that:

- Set interim GHG reduction goals that will support the company's longer term goals.
- Cover carbon dioxide, methane, fluorinated refrigerants, and nitrous oxide.
- Specify the investments, projects, and actions a company will take to meet its goals.
- Apply to the entire value chain and all business units under the company's operational/financial control.
- Include engagement in policy advocacy that, at minimum, aligns with the company's own GHG goals, and ideally aligns with the goals of the Paris Agreement.
- Disclose the company's use and reliance on carbon credits.
- Annually disclose the company's progress towards its GHG goals.

While there is an intense focus on climate targets and climate transition plans right now, these ideas apply to other ESG goals as well, such as diversity and inclusion. For instance, in 2018 Goldman Sachs set a goal to eventually have 50% of its global talent represented by women. To get there, the company set interim gender diversity goals that include that:

- Women make up 50% of campus analyst hiring by 2021
- Women make up at least 30% of UK senior talent (VP or above) by 2023
- Women make up at least 40% of VP-level executives by 2025

In the case of zero-tolerance goals, such as worker safety or forced labor, reporting incremental progress towards the ultimate goal may not be appropriate; "fewer on-the-job fatalities" simply doesn't capture the critical importance of keeping all workers safe. In these instances, the company can report on steps taken to ensure the ultimate goal is met as soon as possible. These steps may include supplier agreements signed, factory audits conducted, or safety trainings completed.

Where interim targets are appropriate, they can encourage managers to take the initial steps that will build a foundation for pursuing the broader goal, and subsequently can reveal whether a company is "on track" at any point in time—or whether course corrections are needed. In addition, these interim targets and plans are essential to reassuring investors and other stakeholders that the ESG goal itself is a credible one. Companies are no longer receiving credit simply for ambition if that ambition is not backed by key actions.

Establishing a Stakeholder-Centric Communication Strategy

Once companies have broken down longer-term aspirational goals into interim steps, companies can communicate both sets of goals to employees and external stakeholders in the context of the broader ESG story. Such goals become real and purposeful only as the full organization incorporates them into their daily operations.

For goals set to meet basic performance standards, boards can ensure management emphasizes steps they're taking to align with peers and external expectations. For "differentiation" goals requiring exceptional performance, boards can receive updates from management on how their progress compares to ESG leaders to ensure that goals are sufficiently challenging.

Companies will be more effective in their communication if they're able to link their ESG strategies to the company's mission and purpose. Starbucks ties its aspirations to have a positive impact on people, communities, and resources to its mission to inspire and nurture the human spirit. Companies will also benefit from providing details on the company's current state relative to both interim goals and longer-term aspirations. A scorecard that tracks a company's progress can be shared both internally and externally. Communicating progress against peer benchmarks or company rankings such as those on Just Capital can likewise help shape the overall narrative.

Preparing for Employee Communications

Effective communication requires understanding the audience's starting point. Pulse surveys can help companies learn how employees currently see the company's ESG commitments and efforts and indicate employees' receptivity and eagerness to work on related initiatives. Short "pulse" surveys repeated over a few months tend to yield better results than one long survey.

Differences in survey responses across business functions, geographic locations, or demographics could justify targeted communications for specific subsets of the employee population. The surveys can also provide companies a helpful window into the organizational culture, especially as to whether employees feel included and heard.

Boards will benefit from further management insights from exit interviews and external rating sites such as Glassdoor. While these sources may be less representative, they often provide a depth and frankness missing in the surveys.

Embedding ESG into Company Culture

Companies can communicate their ESG goals not just for transparency but also to change behaviors. Messaging should be released at regular intervals, rather than all at once. Ideally, it would be included in existing communication channels to reinforce the idea that ESG is now a normal part of company activities—not a "flavor of the month." Regularly posting progress against ESG goals in common areas in corporate offices, manufacturing plants, distribution centers, and other employee hubs as well as on the company website can also help to generate excitement and focus among employees. Progress against interim goals could be disclosed in a scorecard format using a "traffic light" color coding system where "green" would reflect successful and timely achievement of goals, "yellow" would reflect in-progress performance, and "red" would reflect shortfalls or delays. Disclosing specific action steps that led to key accomplishments and/or steps that can be taken to address shortfalls can be helpful guidance for employees.

Many companies regularly discuss financial or strategic accomplishments at town hall or all-hands meetings. The same can be done for communicating ESG accomplishments. Nike takes an 'always on' approach and uses a variety of platforms, including global all employee meetings, Q&A forums with its Purpose leadership team and leader messaging to embed Purpose across the business, as well as various internal content series featuring the people and initiatives that help deliver against its commitments.

It is important that the CEO and senior leadership members are visible in presenting updates on ESG goals and initiatives and report on measurable progress in subsequent staff meetings. Each ensuing discussion reinforces the reality and normalcy of the goals and demonstrates how short-term actions help accomplish long-term goals. Companies can also use town halls to introduce employees to internal leaders tackling material ESG issues to show commitment and buy-in and make ESG commitments more real. From there, companies can help facilitate collaboration between sustainability, human capital, risk, and business leaders to break down barriers and align employees across the organization on common goals.

Business leaders can encourage employee teams to brainstorm methods for employees to engage with corporate ESG priorities, and then distribute these engagement initiatives to the broader workforce. People are far more committed to carrying out plans that they devise themselves.

Employee resource groups for members of underrepresented groups, often developed and organized by employees, are a popular way to help meet goals on diversity, equity, and inclusion by fostering a greater sense of belonging and promoting retention of diverse employees. These groups can also serve as a channel for communicating ESG priorities, as a resource for developing ideas for further ESG or DEI initiatives and updates, and as a way to help gather more in-depth feedback on the implementation of existing initiatives.

Employees are critical in driving progress against ESG initiatives, so companies must ensure they effectively communicate the initiatives at the right time and fully embed them into the company culture.

Communicating with Investors

As for external stakeholders, investors increasingly want to hear more about companies' ESG strategies so companies should ensure that their ESG narratives respond to that interest and are consistent across all platforms. Aside from the required disclosure in the 10-K, companies have an opportunity to showcase their goals and accomplishments in other areas. For some companies, the proxy is becoming a one-stop shop—Starbucks has taken this approach. Other companies include sections on ESG on their websites or in separate standalone ESG reports. Voluntary disclosures often provide room for longer narratives that describe how ESG initiatives tie into the corporate mission. Macy's Human Capital Report includes video testimonials from employees and examples of initiatives.

There are good examples of companies disclosing ESG commitments in investor presentations to demonstrate the importance of ESG relative to other financial and strategic priorities. Lowe's recently included its ESG initiatives on the first page of its 2022 financial outlook presentation before diving into its strategy and financial expectations for the upcoming year. Disclosing specific goals also helps to reinforce a company's commitment to ESG. Sonos includes both short- and long-term goals in its Sustainability and Climate Impact report. To take it one step further, companies can publish a scorecard of their interim goals. These scorecards would signal to investors where companies stand in terms of executing against their longer-term aspirational goals.

Finally, companies can use existing shareholder outreach to share the ESG goals and understand investor priorities and expectations. Directors—typically the board chair or lead independent director—increasingly participate, confirming the board's role in overseeing ESG matters.

Highlighting ESG to Other Stakeholders

To spread awareness of company ESG efforts more broadly beyond employees and investors, companies can include ESG in branding and marketing materials. In 2020, JetBlue was the first U.S. airline to commit to carbon neutrality for all domestic flights. Passengers heard all about the airline's goals in this area through marketing materials on flights. Panera's mission for a "healthier and happier world" is evident in its menus—the company has partnered with the World Resources Institute to measure the carbon footprint of menu items and label low-carbon entrees as Cool Food Meals.

Companies can also explain supplier requirements and expectations in support of ESG programs. BD's website discloses its supplier code of conduct with standards of social responsibility, environmental stewardship, ethical practices, and governance.

As companies further develop their ESG strategies, boards will want to consider the best ways to reinforce the goals, including linking them to executive incentive plans. This topic will be covered in the last article of this series. Including ESG metrics may not be the right approach for all companies, but it can offer an additional lever to ensure leaders' attention and accountability as well as another avenue to demonstrate a company's ESG commitment.

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PART 3: Integration of ESG into Compensation

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As discussed in part I of this series, A Board's Guide to ESG and Incentives: Effectively Identifying Top ESG Priorities, before an organization can link executive compensation to environmental, social, and governance (ESG) goals, it must identify material ESG risks and opportunities and establish board oversight in these areas. In part II of the series, A Board's Guide to ESG and Incentives: Focusing the Company Around ESG Priorities, we covered the subsequent steps of ESG goal-setting, implementation planning, and communication with both internal and external audiences. Now, we turn to the final stage of this journey: incentivizing ESG performance through executive compensation mechanisms.

Once a company has prioritized material ESG issues and communicated meaningful goals, boards and management teams can explore executive compensation linkages to ESG performance. This consideration may be internally motivated to drive accountability towards key strategic outcomes—and/or it could be externally motivated in response to pressure from investors or other stakeholders. While continued investor momentum toward impact and sustainable investing may add pressure on companies to include ESG in incentive plans, it is important for companies to conduct shareholder outreach to understand investor expectations as they can vary. For instance, the 700 global investor signatories to Climate Action 100+ look for disclosure as part of their Net Zero Company Benchmark assessment and whether "the company's executive remuneration scheme incorporates climate change performance elements." Alliance Bernstein, on the other hand, expects that all companies should include at least one objectively measurable ESG metric in the incentive plan[1].

Even though external pressure for ESG pay linkages are rising for many important reasons, corporate boards need to be thoughtful about compensation objectives and design, and whether or when ESG metrics in incentives are right for their company's circumstances.

Is an ESG incentive right for your company?

As a first step, boards should consider putting ESG metrics into pay when the metrics are important drivers of strategy. From there, boards need to be clear on why they are considering tying ESG metrics into pay. For example, is it to increase the emphasis and drive accountability, respond to external pressure from specific stakeholders, or simply signal importance? Answers to these questions will dictate the most effective incentive design and participant scope. Driving accountability will lead to more specific, carve-out metrics, whereas signaling importance might result in ESG as an individual goal or modifier. For companies looking to achieve multiple objectives, ESG metrics may be strong candidates for inclusion in incentive plans.

Companies should also holistically consider ESG in the context of other strategic priorities and the limited 'real estate' in incentive plans—choosing to measure one priority invariably will cause the de-emphasis of another. For example, a company may decide to focus 70% of its annual incentive program (AIP) on traditional financial priorities and 30% on strategic and operational objectives. How that 30% is sub-divided is important. Similar to how companies strive to balance various financial objectives, companies will need to determine the relative emphasis of ESG performance versus other strategic and operational focus areas and decide how much of that 30% to focus on ESG versus innovation, productivity, or other considerations.

If the board decides to incorporate ESG into the pay program, directors need to be thoughtful about which specific ESG metrics will be most effective and what message they send to participants and outside parties. The following questions can help to narrow in on the metrics that are right for the company:

- Is the metric focused on a critical strategic priority?
- Is the metric reflective of a comprehensive, balanced assessment of performance?
- Is there clarity about what outcomes define success, and do participants have clear line-of-sight into how they impact outcomes?
- Is there an opportunity to improve on the metric?
- Is there willingness to maintain the use of an ESG component for an extended time period, even if the company's strategy or performance shifts over time?
- Is measurement towards the goal absolute and/or relative?
- Is there a way to incorporate stretch goals?
- Is the company willing to disclose externally how and why missed goals were not achieved?
- Are goals measurable within the incentive plan timeframe?

As with the addition of any metric to an incentive program, when companies cannot affirmatively answer these questions, the likelihood of unintended consequences or misaligned incentives increases. Companies that are unsure about any of the above questions may do better by addressing accountability outside pay programs, as described in the final section of this article. Alternatively, companies could consider tracking a measure through a pilot program for a year or two before formally incorporating it into incentives—as they might with any new area of focus. Over time, responses to the above questions may change, so even if ESG metrics are not appropriate today, boards should plan on revisiting these questions at least annually.

[1] *Source: Alliance Bernstein 2020 Engagement Campaign Report, April 2021.*

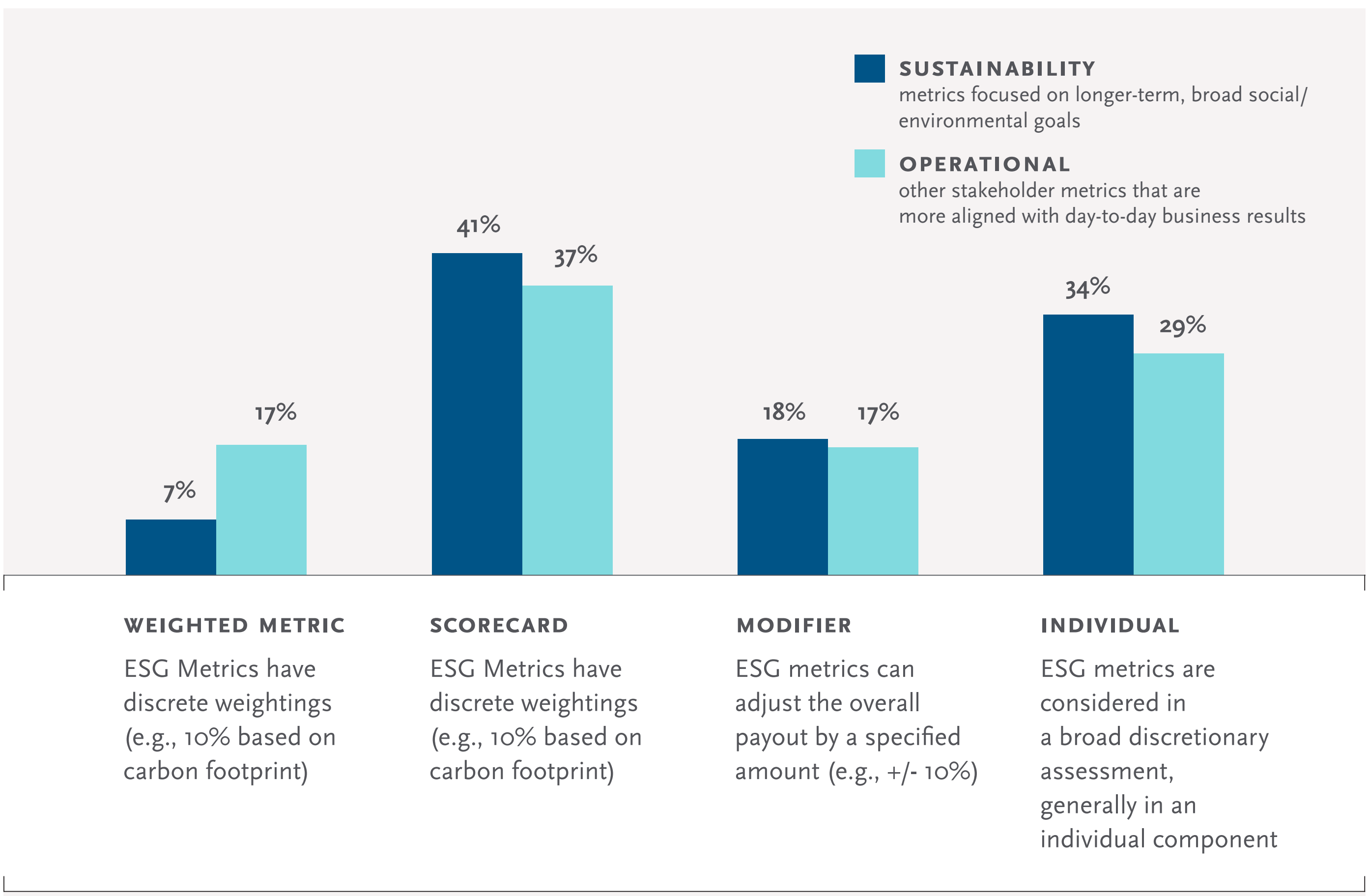
How should ESG performance metrics be structured in your incentive plan?

Despite their long-term nature, most ESG metrics are in the AIP (57% prevalence in the S&P 500[2] as of March 2021, and we expect this number to rise), with fewer than 5% of S&P 500 companies incorporating them in the long-term incentive plan (LTIP) for a number of reasons. ESG goals often have time horizons of five years or more, making it challenging to fit within the typical three-year LTIP performance period. These longer timeframes may also extend beyond some executives' tenures. This is especially true with the recent study of the average Fortune 500 CEO tenure of 4.6 years[3]. Companies may also find it helps from a motivational standpoint to break long-term goals into annual milestones, which are better suited in the AIP. Another factor may be scope: to apply these incentives to a broader set of employees, many of whom may not participate in an LTIP, embedding them in the AIP makes sense. Accounting rules also dictate that LTIP goals are objective to ensure favorable accounting, limiting the ability to exercise discretion. More European companies incorporate ESG metrics into the LTIP, but it is still not a majority practice. We expect the discussion to continue, and practices to evolve, on the best placement of ESG incentive metrics.

[2] *Source: ESG + Incentives 2021 Report Issue 3.*

[3] *Source: Chief Executive, Increase Your Chances of Survival as CEO.*

Fig. 2. Distribution of Sustainability vs. Operational ESG Structures—S&P500 *(n=287)*



Source: ESG + Incentives 2021 Report Issue 3. Data as of March 31, 2021.

Table 5. Sustainability vs. Operational ESG Metrics

Various measures of stakeholder interests are often categorized as ESG. We split ESG metrics into two categories: sustainability and operational ESG metrics.	
SUSTAINABILITY ESG METRICS *Measures concerned with longer-term, broad social and environmental goals*	**OPERATIONAL ESG METRICS** *Other stakeholder metrics that are more aligned with day-to-day business results*
• Carbon Footprint • Community Engagement • Company Culture • Diversity, Equity, and Inclusion • Emissions/ Chemical Containment • Energy Efficiency • Sustainable Sourcing • Waste Reduction • Water Consumption	• Customer Satisfaction • Cybersecurity • Employee Satisfaction • Product Quality • Safety • Talent Development • Turnover/Retention

Incorporating measures into **individual performance** assessments may be a good starting point. Still, it can be challenging to move the needle with this approach, particularly if companies do not clearly define specific goals and base the performance assessment on qualitative criteria, which can be subjective. ESG measures in individual assessments are often one of many goals and not shared across executives, diluting their prominence and the shared sense of purpose.

A **scorecard** approach may be most appropriate for linking pay to multiple strategic and operational priorities, including ESG. For example, a scorecard can assess innovation in products and processes in addition to diversity, equity, and inclusion (DEI) and environmental goals. Alternatively, a company may include improvements in productivity, success in a new channel, and new product sales in a scorecard alongside ESG metrics. The most effective scorecards limit the number of metrics to four or five well-communicated priorities and clearly define goals at the outset of the performance year.

Companies looking to drive meaningful progress against just one or two ESG priorities may choose to assign an **explicit weighting** for these priorities in the incentive plan. This approach elevates ESG issues but reduces the ability to apply discretion, increasing pressure on the goal-setting process. Incorporating some level of board discretion to override incentive achievements can be important if something unexpected happens, such as a major oil spill or product recalls.

As ESG strategies evolve and data becomes more accessible and standardized, boards can refine their approach to AIP integration.

Table 6. Comparison of ESG Structures in Annual Incentive Plans

APPROACH AND EXAMPLE	WHEN TO USE	ADVANTAGES	DRAWBACKS
INDIVIDUAL MEASURES (carve-out and modifiers) ***EXAMPLE:*** ***Comerica has individual metrics for each executive ranging from supplier diversity and sustainability goals to support for diversity, inclusion, and social justice activities***	• To signal that ESG progress is important but subordinate to pressing financial and operational goals • When ESG measurements are being developed •To drive individual accountability	✔ Consumes less real estate in the incentive program ✔ Allows for discretion in assessing impact of individual contributions	✘ ESG goals and objectives may not be clearly defined, which could be perceived by stakeholders as greenwashing ✘ Impact can get lost within the total incentive program ✘ May lose team focus
SCORECARDS (carve-out and modifiers) ***EXAMPLE:*** ***CVS Health has a downward workforce diversity modifier based on the Company's progress in achieving greater diverse leadership representation during the year*** ***EXAMPLE:*** ***Coca-Cola will have 10% of its bonus tied to quantitative and qualitative diversity, equity, and inclusion goals in 2022***	• To increase prominence of ESG into the incentive plan balanced with flexibility to establish goals and determine outcomes	✔ Allows balance with other strategic priorities (e.g., innovation, productivity) ✔ Can mitigate some challenges of setting incentive plan goals for ESG metrics (e.g., GHG emission goals can be difficult to reliably quantify and measure)	✘ With multiple metrics, the impact/importance of any one metric is relatively small ✘ Requires a high level of continued communication to provide clarity
SPECIFIC, WEIGHTED METRICS ***EXAMPLE:*** ***American Water Works has two separate environmental goals (drinking water program compliance and drinking water quality), each with a 7.5% weighting and quantitative goals***	• A "burning platform" to make progress on a given ESG measure • When ESG is a fundamental business priority	✔ Puts ESG metric prominence more on par with traditional financial measures ✔ Makes the goals clear and definitive	✘ Limited ability to use discretion, which can be a disadvantage where a company is new to setting ESG-related goals and measuring progress ✘ Increases pressure on metric selection and goal-setting given the higher scrutiny placed on selecting a small number of weighted metrics

What about ESG in long-term incentives?

Many ESG metrics have goals set for 10 years out or more, making it challenging to incorporate within typical LTIPs with a 3-year performance period. Accounting rules dictate that LTIP goals are objective to ensure favorable accounting, limiting the ability to exercise backward-looking judgement which creates another significant hurdle to ESG adoption in the LTIP. Companies may need to think beyond existing one-year bonus and three-year performance share unit (PSU) programs.

Below, we offer a few creative ways ESG might be rewarded in the long-term incentive plan for companies with clear long-term commitments outside of the traditional PSU program. These approaches are currently uncommon, but some outside-the-box thinking can help to mitigate the challenges with "shoehorning" ESG metrics into existing programs.

Table 7. Creative Approaches for Incorporating ESG in Long-Term Incentive Plans

APPROACH	HOW IT WORKS	KEY CONSIDERATIONS
LONGER-TERM AWARDS	**Lengthen vesting and/or holding periods to 5-7 years, rather than the traditional 3-year period that the majority of LTIPs have in the US** (more common in European pay programs) and include an ESG metric with a longer-term goal (e.g., 5 years)	**5-7 years starts to edge into timeframes over which ESG outcomes translate into share price and may align with a company's longer-term 2025 or 2030 goals,** but if granted once (vs. annually with overlapping performance periods), the timeframe may be long for some executive participants who may not be in the role for the full timeframe and for individuals entering or leaving the company during the period
MODIFIER to current time-based equity awards	**Add a modifier to restricted stock units (RSUs) of up to 15-20% of the final award.** Modifier would apply if performance was significantly above or below a target range of goals (i.e., requires significant outperformance for an upward modifier to be applied). Goals must be objectively measurable to ensure favorable accounting	**Separates ESG from the current PSU construct and provides flexibility |while companies work on forecasting and setting rigorous, long-term goals.** Allows for ESG goals to penetrate deeper into the organization as participation is usually deeper for RSUs than PSUs
SEPARATE ESG AWARD	**Grant separate ESG awards in cash or equity tied to specific, critical future ESG milestones attached to certain dates** (e.g., achieving gender parity in leadership roles by 2030, achieving net zero emissions by 2035, etc.). Awards may pay out above target if the goal is achieved sooner, and below target if the goal takes longer to achieve. Awards would be forfeited if the milestones are not achieved within the specified timeframe (i.e., there should be a date in which the milestone expires)	**Reduces the difficulties of setting annual or 3-year targets, which may not fit well with ESG goals.** Could overemphasize speed and may not promote goal achievement in a sustainable, cost-effective manner

How else can companies drive accountability?

In addition to incentive solutions, companies can reinforce accountability on ESG and human capital management (HCM) priorities through strong disclosure, reporting, and performance management. Salesforce publishes quarterly equality updates sharing progress against its hiring and representation goals. General Mills launched 2030 and 2050 greenhouse gas (GHG) emission goals and reports annual progress against those goals across its supply chain from packaging to shipping to selling. Promoting individuals and providing development opportunities to those who provide leadership and make strong contributions to a company's ESG goals or values can send a powerful signal and help move the needle on progress against ESG priorities. Promotions are also compensatory since added responsibilities often come with pay increases. Finally, companies can celebrate success on ESG priorities in other ways aside from compensation through internal and external communications.

A company's ESG journey requires a tailored strategy—there's no one-size-fits-all approach to accountability. But for many companies, linking ESG goals with executive compensation incentives can drive accountability internally, increase visibility externally, and support ESG performance across the organization. As we've discussed throughout this series of articles, boards need to understand their company's material ESG risks and opportunities, ensure that management sets meaningful goals and interim milestones, and drive accountability through tailored strategies—which may include executive compensation incentives. Before implementing ESG goals into pay, companies should gain confidence in their measures and know the downstream implications to ensure an effective incentive design and optimize ESG progress. When thoughtfully designed, ESG metrics can create strong reinforcement between a company's overall strategies and ESG initiatives—and executive pay incentives can create the urgency that drives meaningful change. ■

Glossary of Key Terms

ANNUAL INCENTIVE PLAN (AIP)
A plan for compensation that is earned and paid (typically in cash) based upon the achievement of performance goals over a one-year period.

LONG-TERM INCENTIVE PLAN (LTIP)
A plan for compensation that is earned based upon the achievement of performance goals over a longer period of time (often three years). Most commonly in the form of equity vehicles vs. cash.

RESTRICTED STOCK UNITS (RSUS)
A type of stock-based compensation granted to employees that are subject to a vesting schedule.

PERFORMANCE-BASED RESTRICTED STOCK UNITS (PSUS)
Similar to RSUs, a type of stock-based compensation granted to employees but are subject to the achievement of performance goals over a longer period of time (often three years).

WEIGHTING VS. MODIFIER
Individual measures and scorecards can either have an explicit weighting (e.g., 20% of the bonus payout) or be structured as a modifier to a bonus payout (e.g., +/- 15% of the bonus payout).

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