Expansion of Compensation Committee Oversight

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Companies are seeking to formalize board-level oversight of ESG; human capital management (HCM); diversity, equity, and inclusion (DE&I), talent development; and succession planning. Companies are facing external pressures to address these areas and the compensation committee is usually the logical board committee to exercise this oversight. As a result, this committee's responsibilities are growing in both scope and complexity.

External Focus on ESG and Human Capital

The focus on ESG issues has increased in recent years and was accelerated by the pandemic. A few years ago, compensation committees focused on officer compensation, and succession planning and talent development were the only material non-compensation agenda items. Today, issues like DE&I and HCM require a significant expansion of the committee's oversight role. Media attention created more visibility into the potential impact of these issues. Further, large institutional investors and proxy advisors are expecting companies to actively address and disclose these topics. In November 2020, the SEC formalized this trend by requiring companies to discuss human capital management and metrics in their 10K disclosures if they are material to understanding the business.

Effects on Compensation Committees

These changes are greatly expanding compensation committees' responsibilities. Companies are initially judged or rated on their public disclosures, so committees are specifically overseeing those disclosures. Because committees provide oversight and guidance, not day-to-day operational management, meetings now feature input from more business leaders, such as the Chief Diversity or Chief Sustainability Officer.

The influx of data has increased exponentially—what would have been a safety report may now include employee wellness, mental health and inclusivity. Other reports may include human capital issues such as workforce demographics, diversity, and equitable pay. These reports are complex and present unique challenges for compensation committees. Committees must become less transactional and more strategic—rather than focusing on where the company is today, they must consider where the company is headed in the future.

Many ESG and HCM initiatives are not easily reflected in financial or quantitative metrics and making progress on them can take several years, so committees must determine how to compensate appropriately for these outcomes. Interestingly, a recent study by Meridian found that ESG metrics are more often included in annual incentive plans, not aligned with the long-term nature of these initiatives, but likely a reflection of initial uncertainty about how best to measure these goals.

Formal Changes to Compensation Committees

Many companies are making a simple but significant change—they are changing the committee name to reflect the broader scope. What may have been called the HR or Compensation Committee might become the People, Culture, and Compensation Committee. While technically unnecessary, a name change can send a strong external signal that the company has increased its focus beyond.

More importantly, companies are actively expanding compensation committee mandates. Best practice is to annually review the committee mandate for relevancy and to establish a work plan that includes key priorities. Mandates are being expanded to include:

- Talent development and succession planning
- Analyses of DE&I programs, including pay equity and equity of: performance ratings, promotional opportunities and high potential designations
- Human capital strategy and organizational culture
- Human resources programs and practices, including recruitment, hiring, and training
- Implementation of policies and strategies related to HCM
- Monitoring and reporting on related leading indicators and lagging outcomes (e.g., requirements for diverse candidate slates and representation of certain groups across employee cohorts, respectively)

Many committees are adding additional meetings in late spring or early summer (a typically quieter meeting period for calendar year-end companies) to allow time for the Committee to discuss these important matters. At these meetings, the committee may devote significant time to understand management's goals and progress on:

- DE&I
- Succession planning and talent development
- Employee wellness, engagement, and company culture

Allocating Responsibilities

We often discuss ESG as a singular concept, but in practice, ESG initiatives are often assigned to different committees. Responsibility for "S" (formerly Sustainability, now Social) initiatives is typically allocated to the compensation committee. However, oversight of Environmental initiatives can be allocated to either a health and safety committee (especially in safety-sensitive industries like energy and mining) or the risk committee. Governance oversight is usually allocated to the nominating and governance committee. In each case, committees are reporting the full extent of their work to the board, especially on those issues that are most critical to the business.

There is no right or wrong way to allocate responsibilities—the ideal structure depends on factors that range from company size and industry to strategic priorities. As companies increase the prevalence of ESG and HCM metrics in incentive compensation, it likely makes sense to increase cross-committee collaboration. The audit committee will typically provide insights to the compensation committee on financial performance and risk, the safety committee can provide input on environmental, safety and related performance, and the nominating and governance committee can provide input on governance issues and performance.

Recommendations for Committee Changes

ESG and HCM initiatives are complex and require advanced data analyses and insights. More importantly, if companies are to monitor and compensate for these initiatives appropriately, they must align to the business strategy and support both short- and long-term business goals.

The first step is ensure that the right people are in the committee meeting to ask the right questions and share the right data. The committee needs access to experts and the managers and leaders responsible for executing day-to-day programs, to paint a picture of where the company stands today and what possibilities exist for future progress.

Conclusion

For investors and stakeholders, ESG and HCM metrics will only become more important in the future. To achieve forward progress on these initiatives, organizations must figure out how to compensate for them appropriately. Climate and HCM metrics like DE&I present special challenges, in that performance may be difficult to measure and companies are unlikely to move the needle on these issues in the short term.

Compensation committees must prepare to evolve with changing priorities by allowing for more complexity and expanded oversight. They should seek input from company stakeholders and access cross-committee collaboration for a more holistic view of performance.