C-SUITE

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Addressing the "S" in ESG

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Advising Compensation Committees Amidst ESG Reform

An interview with George Paulin, Senior Managing Director & Partner, Meridian Compensation Partners

George Paulin pioneered the role of independent board compensation consultant following the passage of Dodd-Frank legislation that created rules for consultant independence in the early 2000s. His career has spanned over three decades with primary clients including many of the largest and most valuable U.S. public and private companies across most industry segments.

Mr. Paulin has testified in Congress on executive compensation matters, appeared on CNBC, contributed to many business publications, spoken on college campuses and at numerous conferences, contributed to major business publications and was named to the National Association of Corporate Directors list of the 100 most influential people in corporate governance in multiple years.

Mr. Paulin serves as Senior Managing Director & Partner at Meridian Compensation Partners. He previously was with another major executive compensation consultancy, where he was successively the President, CEO and Chairman. He has a master's from the University of Illinois School of Labor and Employment Relations, and is a recipient of their Distinguished Alumni Award. He also is a recipient of the WorldatWork Distinguished Service Award. He is a member of the University of Illinois President's Council and the National Association of Stock Plan Professionals Advisory Board.

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As investor and public interest continues to rise regarding companies' approaches to ESG issues, big questions still remain with respect to how best to incentivize these types of goals in a corporate environment built upon valuing financial profit and shareholder return above all else. Therefore, boards of directors are in a difficult position to evaluate executive compensation-related risk in determining incentives based on non-financial ESG and human-capital goals. These issues are inherently difficult to quantify, and results aren't always clearly apparent or easily communicated, especially on a short-term basis. And then there's a simpler, more fundamental question: Should executives receive a bigger bonus for being ethical and keeping employees safe on the job, or is this why they are paid in the first place?

To answer complex questions like these, trusted compensation consultants come into play, whose profiles have risen in response to rapid economic and regulatory change over the past two decades. Given this backdrop, *C-Suite* spoke with George Paulin, Senior Managing Director & Partner with Meridian Compensation Partners, about his wide-ranging career spanning clients across Corporate America, how the rise of ESG imperatives is affecting compensation strategies, what levels of related risk boards have to consider in this new age, and what makes a board-level compensation consultant effective.

C-Suite: What led you to a career in executive compensation consulting, and why is this field important—both to you personally and to the corporate world at large?

George Paulin: Unless it was your family business, I don't think anyone plans a career in executive compensation consulting, like being a doctor or a fireman. Sometimes you are in the right place at the right time, and an opportunity presents itself.

After college, I worked in employee compensation at two large companies for about five years. Then, I moved into consulting where the professional side of my career met the business side, and I was hooked.

Professionally, it was fascinating the way executive compensation came together with finance and strategy. How do you use financial rewards for competitive advantage to message priorities, support a culture, etc.? How do you align the interests of passive investors (not as much anymore) with active managers?

Personally, I liked being part of owning and building a small business. When I started working with Fred Cook in the 1980s, there were a handful of employees in New York, and we wanted a national "brand." I moved my family to Chicago to start an office in the Midwest, then a few years later to Los Angeles to start a West Coast office. It was fun and personally rewarding to see the business grow. I feel that way now about making a contribution to Meridian's growth that has great momentum.

Currently, a group of small generally practitioner-owned firms provide practically all independent board-level compensation-related advisory services. It will be interesting to see if there is consolidation or other types of financial restructuring in the years ahead as the cost of technology and data escalate, committee charters expand into related areas of human capital management beyond direct rewards, and private-equity firms loom with capital to spend.

How has the role of the compensation consultant changed over the course of your career? What are some of the most important lessons you've learned as you've adapted to those changes?

Paulin: Until Sarbanes-Oxley and Dodd-Frank in the early 2000s, executive compensation consulting was mostly project-related, often with the same clients but with no regular, ongoing role. From that point on, public company compensation committees wanted a relationship with an independent consultant who was at the table every meeting and could be trusted to provide core annual deliverables to support the committees' independence and decision-making. The core deliverables that should be part of each year's compensation committee agenda and led by the independent consultant are selecting peer companies, assessing compensation risk, benchmarking CEO and other proxy officer pay levels, reviewing non-employee director compensation, and updating on pay-level and pay-structure trends, along with governance and regulatory developments.

Doing a project and maintaining a relationship are two different skill sets, especially for executive compensation consultants at the board level in an area where there are few absolutes. Everyone is an expert, and consensus usually takes compromise. I often analogize it to the audit committee and the outside audit partner but without GAAP. On top of good data, it takes trust, gravitas, objectivity and judgment informed from multiple perspectives—strategy, culture, talent market, investor relations, proxy advisors and regulators.

Probably the most important lesson I learned on relationship management is that if you advise from the perspective of not risking the loss of a client, you will lose more clients over time than if you advise what you believe with the necessary knowledge and conviction.

What are the most critical trends in executive compensation today? In what ways did the events of 2020 change the perspective of compensation and benefits practitioners, including boards, HR leaders and consultancies?

Paulin: Disruption and uncertainty around COVID-19 that played out in 2020 and continue in 2021 have impacted executive compensation practices in a number of ways. Goals often are being set as late as possible, threshold-to-maximum financial performance schedules for determining earned incentives are generally wider, many long-term performance award plans are measuring annually against three-year goals, and a portion of long-term grant value shifted from performance awards and stock options to restricted stock for better predictability and retention. But these types of changes are more in response to the immediate situation than indicative of sustainable trends.

Five "big-picture" trends that boards, HR leaders and advisors involved in executive compensation should be watching are described briefly below along with some of their broad implications.

If you advise from the perspective of not risking the loss of a client, you will lose more clients over time than if you advise what you believe with the necessary knowledge and conviction.

Governance staffs of the big investment funds are voting more independently from the proxy advisors. Traditionally, Say on Pay approvals varied by +/-5 percentage points within a peer group for companies with FOR recommendations from Institutional Shareholder Services (ISS) and Glass Lewis. We are now seeing 10 to 15 percentage-point spreads, depending on the composition of a company's major shareholders. When there are contentious issues like financial adjustments that impact incentive earnouts or special awards, this can be the difference between success and failure. Proxy advisor policies still dominate the compensation committee discussion, but that needs to refocus going forward with more attention on the policies of the investment funds that are the major shareholders and whose influence continues to grow.

Non-financial metrics are increasingly supplementing financial metrics in incentive determinations. Big investment funds started the trend with their interest in ESG metrics, which the Business Roundtable endorsed in its statement on corporate responsibility in 2019. Since then, substantive transition has been slow. Many compensation committees were initially skeptical about adding more complexity that is difficult to disclose and more judgment that often benefits the executives and is criticized by proxy advisors and investors if it looks like arbitrary discretion. They needed to be convinced that linking executive incentives to ESG and human capital metrics would not be another passing fad, which now appears to be the case and momentum is growing.

There is more rigor and innovation in the financial goal-setting process. Financial goals are predominately based on performance relative to internal company business plans. The big investment funds have become critical of above-target earnouts when goals are not sufficient to drive acceptable shareholder value or when earnouts are higher for beating a flat-to-lower goal from one year to the next. Further, when compared to peers on a relative basis, they see that real earned pay and performance alignment is often random. Remedial actions in the works include greater consideration for directional performance and creating a sensible trend line of improvement, performance relative to peers, variance and predictive value of analyst estimates, and strategic metric definitions, including appropriate "hard-wiring" of non-GAAP adjustments and treatment of extraordinary/non-recurring items.

Upside leverage in real pay delivery opportunity is being used for competitive advantage and retention while differentiation in target pay continues to narrow. Compensation committees have primarily focused on setting target total compensation opportunities that include salaries, annual incentives assumed paid for achieving 100% of goals, plus the value of long-term equity at the time of grant as derived from GAAP and disclosed in proxy statements for the named executives. These amounts are obviously important for benchmarking. However, they do not reflect pay for performance, which requires analyses of real earned pay that has both realized (earned and paid) and unrealized (current tracking of unpaid) elements. More time is now appropriately being spent on these types of analyses for comparisons of relative pay delivery across peers versus relative financial and shareholder-value performance. Results are valuable for testing the rigor of goals, risk-reward leverage in payment funding schedules and the mix of long-term incentive grant types.

Narrative proxy disclosure is also entering a new phase. Several years ago the trend was using "plain English," next was starting with a strong executive summary, and then it was replacing narrative with graphs. Now, it is explaining your rationale, especially where judgment was involved. This evolution is being driven by two other previously described trends, which are investment fund governance staffs supplanting proxy advisors as the primary audience and increased complexity and judgment from adding non-financial metrics. Investors generally prefer pre-established, formulaic, weighted goals for determining performance-based incentive payouts. Non-financial metrics generally do not lend themselves to this type of measurement. Judgment is hard to quantify. Consequently, disclosure will have to meet a higher standard for clarity on how the judgment was informed to avoid an appearance of arbitrary discretion that is likely to be challenged.

How do you see executive compensation playing a role in achieving ESG goals and supporting human capital management initiatives? How did COVID-19 and the social justice movements of 2020 impact the conversation around these issues?

Paulin: What started in 2020 as mostly token disclosure of workforce metrics with societal implications as part of discretionary individual performance assessments is now moving to the next stage. In real time, companies are moving past initial diversity, equity and inclusion (DEI) metrics to employee and product safety, as well as the environment in high-impact industry segments. The linkage to compensation is typically through annual incentives. The mechanism is adjusting earned awards for financial performance based on scorecards used as "modifiers" or carve-out a portion of the award funding.

This is an area where change is rapid, expectations and external pressures are high, and there is risk of unintended consequences. To effectively incorporate ESG metrics into executive incentives, the chosen metrics need to be directly related to key business and strategic priorities, measurable, applied to individuals who can impact the outcomes, and transparently disclosed.

Regarding DEI, an unintended consequence would be that a handful of the same qualified female or minority candidates just move from one place to another for more money. This would not address the important societal issue and is an example of how broader human capital management initiatives should converge with DEI. Real societal change will come from an ongoing commitment to appropriate recruiting, development, succession planning and education. I think the new human capital management disclosure requirements are a positive force for the necessary change, as is expanding compensation committee charters to designate them as the boards' agents for oversight.

As the conversation around these issues gains momentum, why are so few companies linking compensation plans to ESG/human capital metrics thus far? When do you anticipate this trend to increase in prevalence?

Paulin: All of the companies I know believe that DEI is the right thing for society and the economy, and that they share responsibility for protecting the planet. But many have deeply embedded "live-by-the-sword, die-by-the-sword" strategies and cultures built around EPS growth, ROIC and stock price. Consequently, responding to the new broader agenda needs to be carefully thought through. Walking before you run is not an excuse to move slowly as much as it is prudent.

Meridian just completed a real-time survey of the S&P 500 on ESG and human capital metrics with 315 respondents, which provides data on the progress made and the future outlook.

Sixty percent of the companies reported at least one ESG metric in their annual incentive determinations while only 5% did so in their long-term incentives. The latter is less prevalent in large part because of potential additional accounting costs, which apply if there is material discretion in the earnout of equity determined over multiple years. By category, 96% of the annual metrics were social, 39% were environmental and 10%

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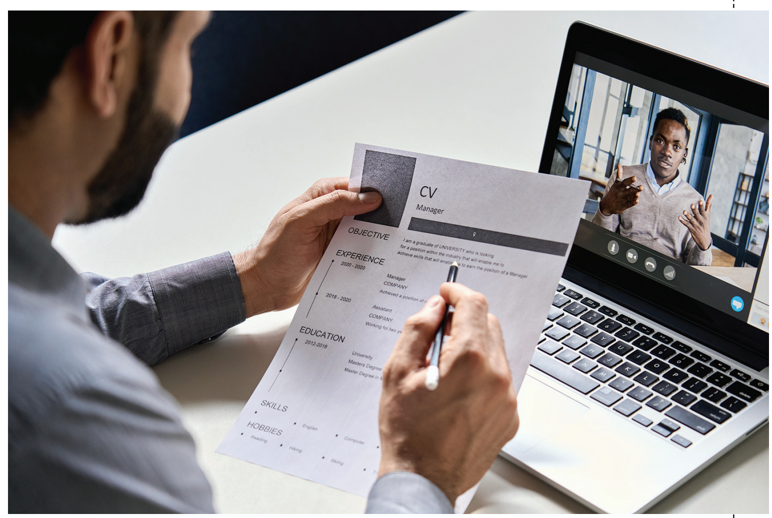

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were governance. Metrics reported in the few long-term incentives were generally environmental at companies in specific industries, as discussed later.

It is not surprising that by far the most prevalent metrics are in the social category and related to DEI. This is a highly visible area that generally applies to all companies, although few are setting quantitative goals until there is better perspective from market data. Additional human capital metrics on workforce safety, recruiting, turnover, development, etc., are also expected to be added to broader scorecards or dashboards in response to shareholder interest and recent disclosure requirements.

Environmental metrics are less frequently used because they are more critical in specific industries such as energy, materials, utilities and chemicals. However, we expect companies generally to take a detailed look at their products and business operations from the perspective of climate change, carbon footprint and emissions. Influential investment funds, including BlackRock, Vanguard, State Street and others, have identified these areas as major themes.

Governance metrics most often reported were cybersecurity, data privacy and ethics. Prevalence in this category may never match the others because many companies believe the related concerns are more appropriately addressed in compensation risk-mitigation policies like clawbacks, etc., than performance-based incentives. For example, should an executive earn a bigger bonus for being ethical? Measurement and disclosure also are complex.

What are the biggest risks companies face today resulting from executive compensation decisions? What are some triggers for these risks, and what can companies do to mitigate potential fallout?

Paulin: Executive compensation regulations have a history of doing more harm than good, in my experience. But Dodd-Frank rules mandating proxy disclosure of "potential material" compensation-related risks that took effect in 2009–2010 are an exception. At that time, compensation committees generally amended their charters to add annual compensation risk assessments as part of their regular agendas. Part of my responsibilities as independent advisor to the committees has been to lead the risk-assessment process.

I generally tell the committees and management there are three things they should be able to confirm through the risk assessments that analyze relevant program design and administrative provisions. The first is that their program has appropriate balance for risk mitigation, such as short- and long-term performance goals, cash and equity, formulas and discretion, etc. The second is that they have all of the necessary policies in place for risk mitigation, including ownership guidelines, hedging and pledging prohibitions, and compensation-recoupment provisions. Finally, the third is that none of their incentive and commission arrangements below the executive level create significant behavioral risks requiring remedial redesign.

The Dodd-Frank rules were initially enacted coming out of the financial crisis in 2007–2009. At that time, non-executive plans at some of the financial services companies were a concern. An example was paying commissions on revenues from selling alternative-investment products that created high balance-sheet leverage, which the risk-assessment process was ultimately able to identify and address. Subsequently, concerns were raised at consumer-facing firms by incentives to cross-sell products and services, which were identified and remedied through the process as well. Most recently, the #MeToo movement, data breaches, discriminatory workforce practices, etc., highlighted "reputational" risk. Again, annual risk assessments have been effective in facilitating stronger compensation clawback and forfeiture policies that go beyond the previously limited ability to recoup compensation only for management misconduct that resulted in a material financial restatement.

We are now entering a period when there will be expanded compensation-related risk from the exercise of broader committee judgment in determining incentives based on non-financial ESG and human capital metrics. These metrics are inherently difficult to quantify and will require judgment. As discussed earlier, the judgment will have to be well informed to avoid arbitrary discretion that risks misaligning pay delivery with shareholder value.

In what ways do compensation consultants help bridge the gap between boards, HR leaders and external stakeholders?

Paulin: I do not see a gap that needs to be bridged between boards and HR leaders on most executive compensation issues. Both groups generally share common interests of using financial rewards to support company strategy that are served by having the objective, outside perspective of an effective compensation consultant.

What makes a board-level compensation consultant effective? In my experience, it is simply focusing on the core areas for maintaining independence that I listed earlier until you build trust in your judgment, and the role expands and continues.

Let the numbers on the ability of independent advisors to add value to the compensation committee process speak for themselves. Proxy disclosure rules require companies to disclose their independent compensation committee advisors. These rules do not require the committees to have independent advisors. However, taking the S&P 500 as an example, almost all have them, except for a few with controlled ownership.

Meanwhile, an area in which compensation consultants should work toward contributing more is shareholder engagement, necessary when there are actions outside of "standard practice," and the business rationale needs to be clearly understood for Say on Pay support. Here, responsibility inside companies typically shifts from HR to investor relations, where there are other expert resources, often with better contacts on the governance staffs of the investment funds but not as close to all of the considerations, leading to the actions that made the engagement necessary in the first place. This process needs better coordination to overcome the view by many on the investment fund-governance side that the compensation consultants have an inherent management bias because that is who ultimately pays for their services.

> "All of the companies I know believe that DEI is the right thing for society and the economy, and that they share responsibility for protecting the planet."

What opportunities are you most excited about at this point in your career, and how does your role at Meridian afford you the chance to focus on those?

Paulin: Working with clients on day-to-day executive compensation matters related to supporting their business strategies and cultures is what I like to do. I am not a golfer, my kids are grown and there are still a few hours left in the day for Netflix.

There is outstanding collaboration at Meridian to address challenging, emerging issues. Most notable are measuring and disclosing performance against ESG metrics; understanding a broad array of investor proxy-voting policies different from the proxy advisors; strengthening financial goal-setting in the face of continued economic and public health uncertainties; and using long-term incentive design to leverage real pay delivery for competitive advantage, when the underlying regular programs are more and more alike. Also, be ready for a number of SEC initiatives based on their pending agenda, as well as tax reform that likely will have executive compensation implications. CS

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