Pearl Meyer

NACD ELEVATE BOARD PERFORMANCE

The "S" in ESG: What Does the Data Say About Diversity and Inclusion in Executive Compensation?

A *Compensation Committee Series* Webinar
Presented by NACD and Pearl Meyer

September 24, 2020

Meet the Presenters

Roy Dunbar is the founder of private renewable-energy and property-development companies, serving in roles as CEO and chair of network solutions between 2008 and 2010. Dunbar was formerly president of Global Technology and Operations at MasterCard. Previously, Dunbar was with Eli Lilly, where he worked for 14 years, serving as president, Intercontinental Region, and earlier as chief information officer (CIO). As president, Intercontinental Region, he oversaw all business operations in the world's fastest-growing economies, including Brazil, Russia, India, and China. Dunbar served as vice president and CIO from 1999 to 2003, and is credited with having led Eli Lilly to rank as the most innovative user of technology in the pharmaceutical industry. InformationWeek named him CIO of the Year in 2003. Dunbar is a director of Johnson Controls and SiteOne. Dunbar was named to the NACD Directorship 100 in 2015 and is an NACD Board Leadership Fellow.

Jannice Koors is a senior managing director with Pearl Meyer and president of the firm's Western region. She has more than 25 years of experience in executive compensation and governance, and has consulted to companies of all sizes and industries. She advises company boards and management teams on all aspects of executive and director compensation design, performance measure selection and calibration, and related corporate governance issues. Jan is an NACD Governance Fellow, serves as faculty for the NACD's Director Professionalism and Master Class programs, and was recently named again to the NACD D100 list of the most influential people in corporate governance.

Ian Keas is a principal with Pearl Meyer, located in Denver. He advises clients on executive, key employee, and board of director compensation program matters. Ian has specialized experience in the energy and banking industries and not-for-profit organizations, as well as with companies experiencing significant transaction-related events such as IPOs and restructuring.

Housekeeping

- Submit a question and receive your answer directly from Pearl Meyer, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.
- Tweet live during the event today with **@NACD** and **@PearlMeyer.**
- Presentation slides are available today at www.pearlmeyer.com/the-s-in-esg and within the webinar console.
- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/the-s-in-esg.

NACD Credentialing Credits

Your participation in today's webinar earns you credits toward maintaining your NACD Credentials.

NACD Board Leadership *Fellowship*

If you're working toward maintaining your NACD *Fellowship*® credential, you will receive **1 skill credit.**

1 Skill
Fellowship Credit

NACD Directorship Certification™

If you're working toward maintaining your NACD Directorship Certification credential, you will receive **1 recertification credit.**

1 CREDIT
DIRECTORSHIP CERTIFICATION

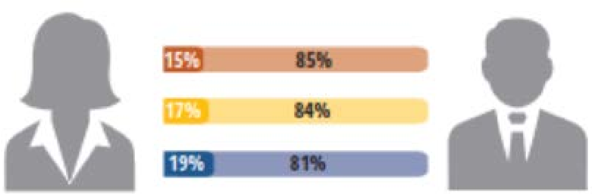
Agenda

- Setting the Stage
- Investor Perspective
- SEC Mandate Impact
- COVID and Social Unrest Impact
- Data Insights – Current "S" Practices
- Strategies for Implementing "S"

Setting the Stage

- Boards need to first look in the mirror and evaluate where they sit on the path to progress on "S" matters
  - Gender, ethnic and skillset diversity improving, but progress is needed
  - Critical to walk the talk to drive progress through organization – directors rank human capital management and diversity as top ESG concerns for their orgs

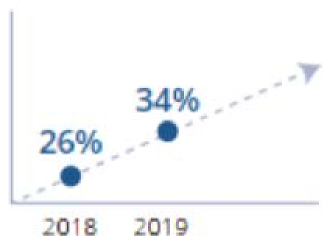
GENDER BALANCE

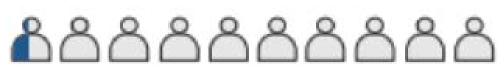


Source: NACD 2019-2020 Public Company Governance Survey; Main Data Group

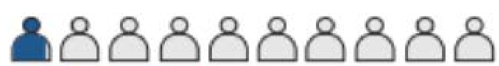
GENDER DIVERSITY

Percentage of new public company directors who are women





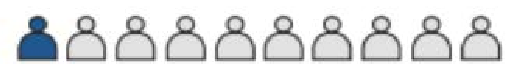
4% have a woman board chair



9% have a woman lead director

ETHNIC DIVERSITY

Percentage of new public-company directors who are non-Caucasian

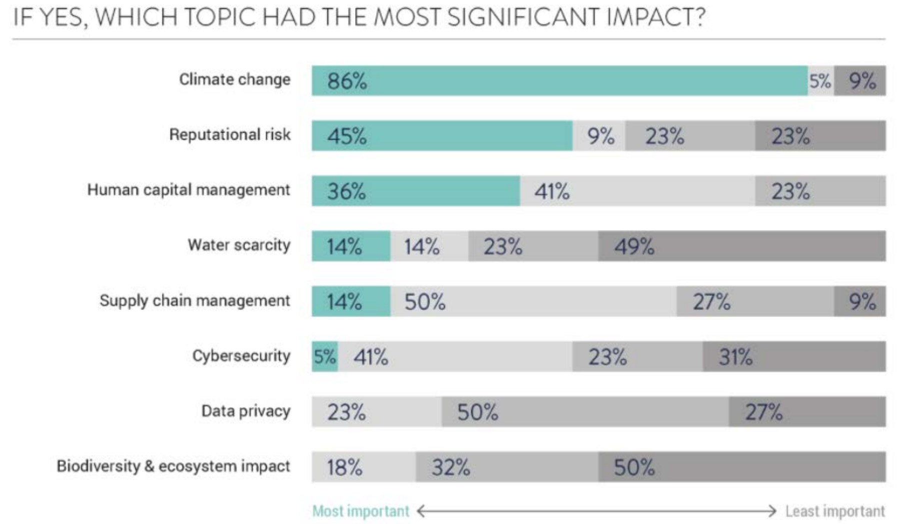


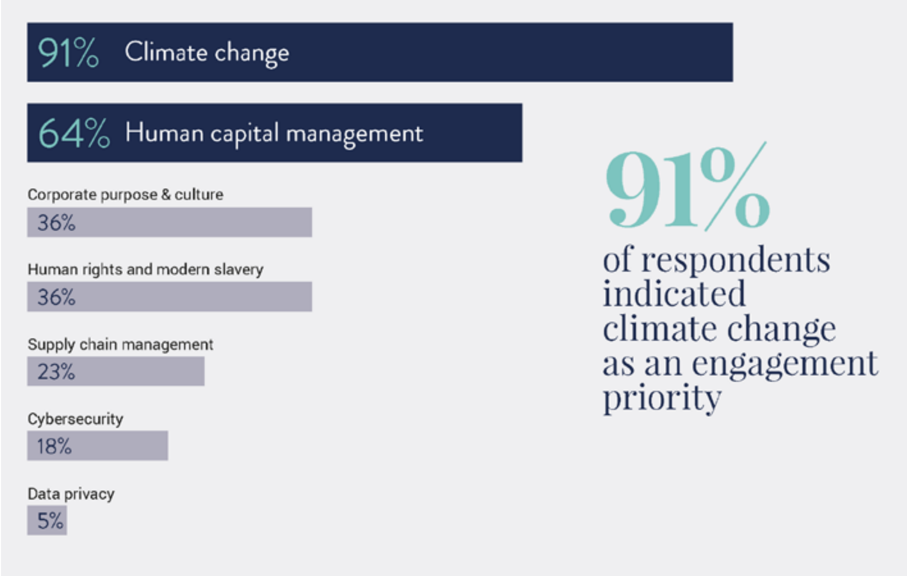
10% of directors are racial and ethnic minorities, not including women.[1]

[1] Kosmas Papadopoulos, "ISS Discusses U.S. Board Diversity Trends in 2019," *The CLS Blue Sky Blog*.

The Investor Perspective

- ESG is increasingly impacting investing
- Investor scrutiny is driving board ESG agendas
  – Diversity (74%) and human capital (65%) are top two ESG issues boards are discussing with investors [1]
- Institutions are communicating desire for change – and are positioned and ready to force progress
  – As example, Blackrock has taken increased action this year;
    - Voted against 5,100 directors thus far compared to 4,800 last year – 1,500 of which for diversity concerns
  – State Street announcement on racial diversity





[1] *NACD 2019-2020 Public Company Governance Survey*

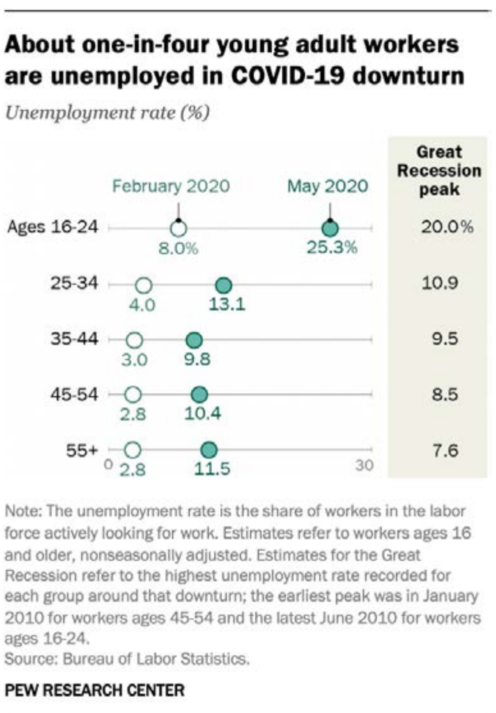
The SEC Gets Involved

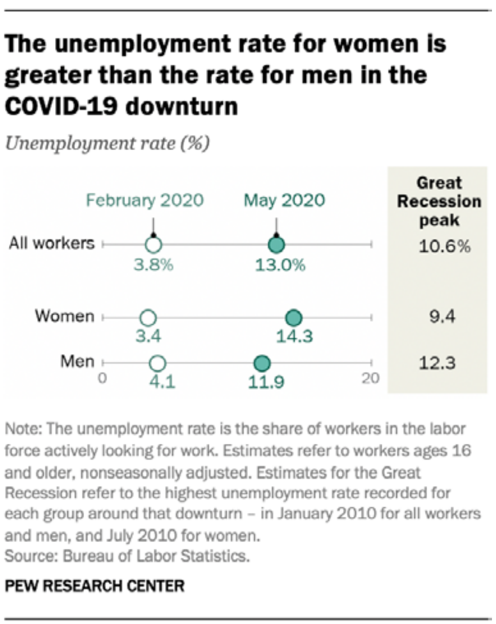
- SEC has mandated expanded human capital disclosure
  - No new "requirements"; rather a "principles-based" set of considerations
- Regulations will be in effect *for 2021 proxy season*
- Key issues for "principle-based" compliance:
  - Materiality
  - Nature of business and workforce
  - Policies that focus on development, attraction, and retention of broad-based talent
  - Use of quantitative and qualitative data
- Given current social environment, expect scrutiny, emboldened voices and increase in related shareholder proposals

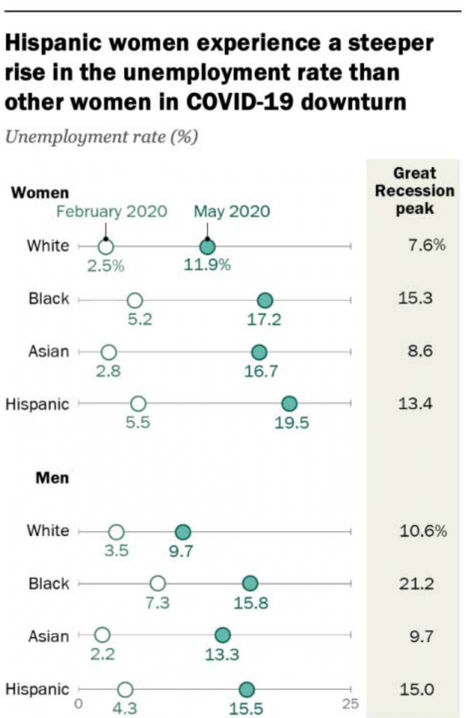
Impact of COVID

- COVID pandemic has severely impacted the workforce generally, with double digit unemployment numbers reported

- However, data from recent Pew Research Center analysis shows an outsized impact on diverse populations

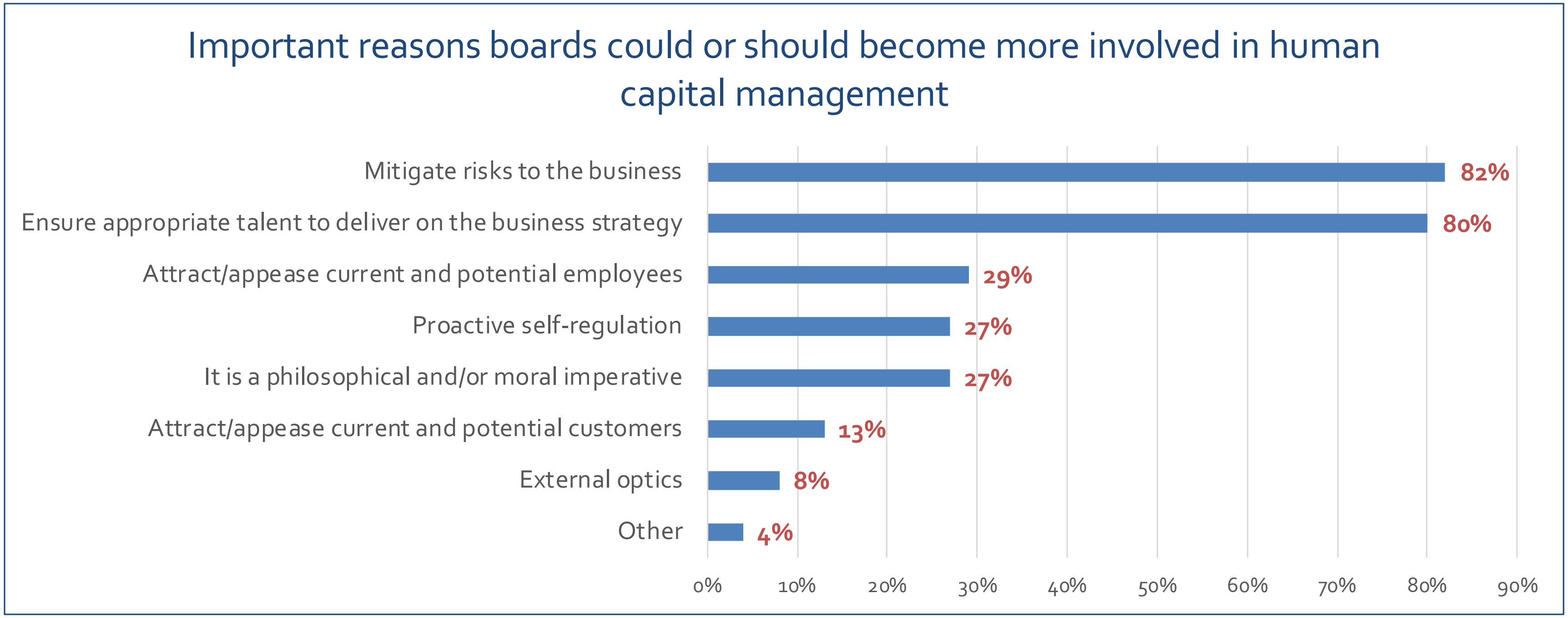






Impact of Social Unrest

- Events tied to social unrest and BLM movement have further elevated the conversation about diversity and inclusion
  - How do we measure performance and progress?
  - Should Diversity & Inclusion ("D&I") or other ESG-related measures be part of executive incentive plans? Should such metrics be in short-term or long-term incentives?



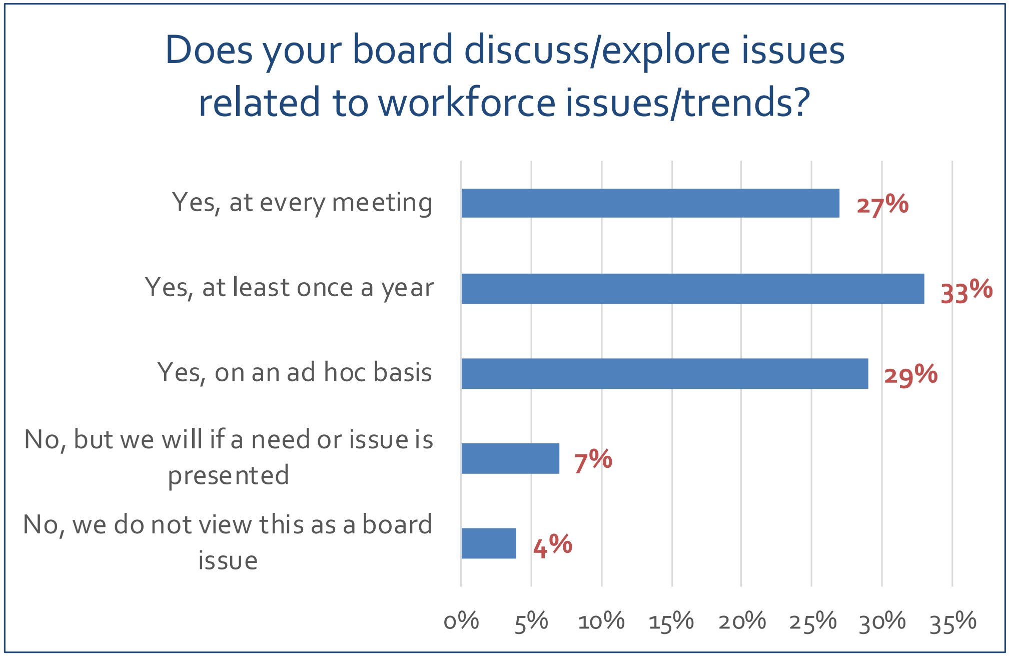
Source: Pearl Meyer On Point: Workforce Disruption 2019

Polling Question #1

- How often is your board focused on human capital strategy matters in meetings? (full board or committees where appropriate)
  - Regularly
  - Ad hoc basis
  - Not a topic of focus on its own

Corporate Governance Response

- Not a "check the box" exercise – this is a journey of constant improvement
- 77% of Fortune 100 already disclosing
- Boards including topic of "S" disclosures in shareholder engagement to ensure disclosures meet expectations



Source: *[Pearl Meyer On Point: Workforce Disruption](#) 2019*

Polling Question #2:

- Does your company drive improvement on D&I factors through executive compensation incentive metrics? In short-term incentives or long-term?
  - Yes, D&I is a factor in our short-term incentive plan(s)
  - Yes, D&I is a factor in our long-term incentive plan(s)
  - No, D&I is not included in our incentive plan payout determination

R3K – Compensation D&I Metrics

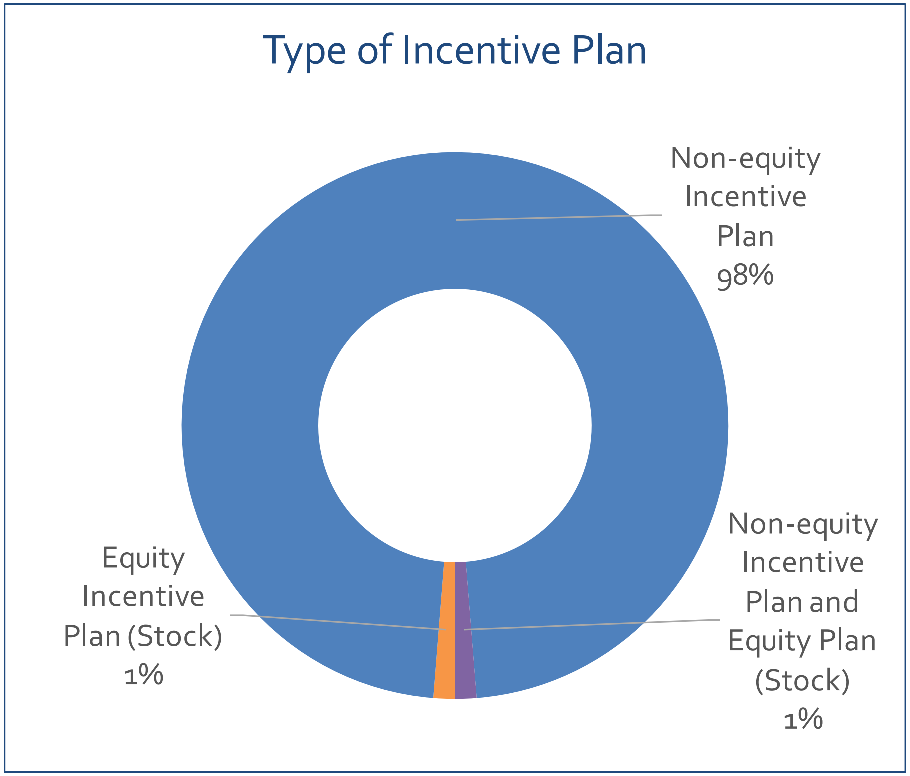
- In 2020, 79 companies in the Russell 3000 (i.e., 2.6%) reported including D&I in their incentive plans
  - The companies represent a wide range of industries
  - Most are larger firms, with 72% of reporting companies (57 of 79 companies) in the S&P 500

GIC Industry	Number of Firms	Revenue ($M)	Market Cap ($M)
Communication Services	8	$37,363	$66,126
Consumer Discretionary	4	$40,689	$16,321
Consumer Staples	6	$20,931	$54,223
Energy	7	$31,930	$25,580
Financials	10	$7,508	$20,079
Health Care	8	$10,828	$60,523
Industrials	10	$18,844	$34,861
Information Technology	6	$31,631	$258,213
Materials	6	$11,293	$34,174
Real Estate	4	$1,784	$25,200
Utilities	10	$10,443	$29,862
Grand Total	**79**	**$19,367**	**$54,253**

Source: Main Data Group

Where Are D&I Metrics Found?

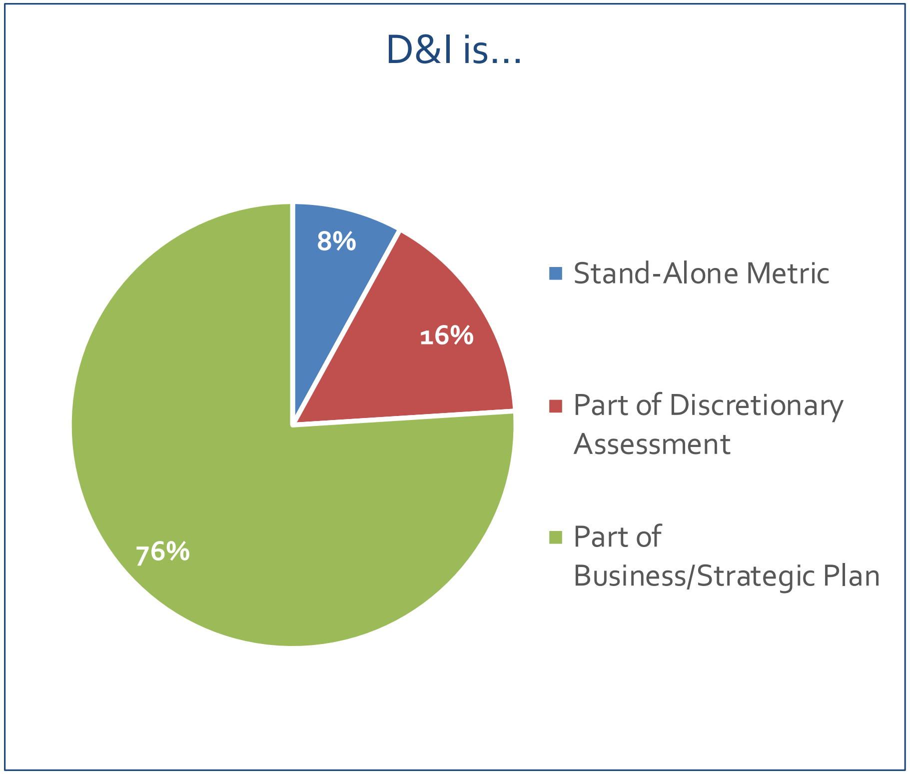
- D&I metrics are found almost entirely in the annual, *non-equity incentive plan*
- Only two firms have included D&I metrics in their equity incentive plans



Source: Main Data Group

How Are D&I Metrics Incorporated into Incentive Plans?

- In majority of companies (76%), D&I goals are mentioned as part of the business or strategic plan (which has weight in the incentive plan)
- 16% list D&I as being considered during the discretionary assessment process
- Only 8% have a stand-alone D&I metric in their incentive plan



Source: Main Data Group

Survey Data Offers a More Recent Look

- ~80% of respondents say D&I is an important (46%) or among the most important (34%) organizational priorities
- 49% have a formal D&I program and an additional 38% are considering one
- 48% have at least one individual whose sole job is leading the organization's D&I efforts
- However, only 17% reported including D&I in incentive plan performance metrics for leadership; although another 24% are considering it
  - Note that this is an improvement relative to backward-looking R3K data (i.e., 2.6% prevalence in 2020 proxies)
- KPIs on diversity hires and promotions are most common

Why Should Companies Consider D&I in Executive Compensation?

- Recent Deloitte research on human capital trends found strong prevalence of companies believing D&I is a competitive advantage
- As highlighted by the data, companies are increasingly tying executive compensation to D&I initiatives to encourage and demonstrate progress – and to be able to tell the right story

> In 2018, Mr. Jones linked 10 percent of annual bonuses for himself and other top executives at his company, FirstEnergy, to diversity goals, and increased the number to 15 percent the next year. "I've got experience that suggests that if you tie compensation to the things you want to have accomplished, you are much more successful at getting them accomplished," he said.

- Companies that elect not to do so will be increasingly criticized by investors

Should Compensation Committees Be Paying for "S"?

- Why Companies Should
  - Key goals and objectives that tie to value creation
  - Demonstrated shortfalls that need improvement
  - Signals the importance of D&I to the company
- Why Companies Shouldn't
  - Already have strong culture around "S"
  - History of clearly demonstrated goals and consistent progress reporting
  - What financial metric becomes "less important"?
  - Hard to develop quantitative metrics without "unintended consequences"

Progress on "S" is a journey – metrics included in compensation do not need to be permanent. Regardless of decision to compensate or not, it is important for companies to develop a reporting framework on the matter.

Pitfalls to Watch

- Diversity and inclusion are not the same thing – need separate metrics and benchmarks
  - Keep pay equity in mind – diversity and inclusion success doesn't automatically translate to equity
- Beware the moral hazard of tying pay to improved performance
  - Employees "strong-armed" to respond positively to engagement surveys
  - "Revolving door" hires to meet diversity quotas
- Many states prohibit employment discrimination based on race, color, gender, national origin, etc. Initiatives that intentionally prefer female and minority candidates and employees can create legal liability

Key Takeaways

- Audit process on "S" is key to getting started – organizational needs, board status, CEO involvement, and organizational health to absorb change initiatives
- Create reporting framework to compensation committees, whether executives are paid on "S" or not
- Identify "S" areas of focus and value creation opportunity; assess need for tying to compensation
- Monitor culture for change – just because something is important it doesn't have to be compensated, and when compensated it doesn't have to be permanent

Pearl Meyer

NACD

Questions

Don’t Miss Our Next Webinar

Join NACD and Pearl Meyer for our next Compensation Series webinar on December September 10, 2020 at 2:00 PM (ET)

Register Today

Archives of earlier webinars in this series are available at www.nacdonline.org/webinars or www.pearlmeyer.com/knowledge-share

NACD Credentialing Information

Interested in NACD director credentials?

NACD DIRECTORSHIP CERTIFICATION

Certification.NACDonline.org

Certification@NACDonline.org

NACD Fellowship
The Gold Standard Director Credential

NACDonline.org/Fellowship

NACDFellowship@NACDonline.org

Thank You