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On the 2022 compensation committee agenda

KPMG Board Leadership Center

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The events of the last two years have solidified stakeholder expectations regarding the board's responsibility to oversee issues related to the company's workforce in addition to the more traditional topics of executive compensation and CEO succession planning. While this expansion has been called for by some stakeholders—including labor leaders and certain institutional investors—for many years, expectations for this level of oversight have continued to mount. Boards are taking a holistic approach to oversight of issues related to the executive suite and entire workforce, including part-time, gig workers, etc.

Accordingly, many companies have added oversight of human resources/human capital topics to the compensation committee's agenda, charter, and title (e.g., human resources committee, compensation and human capital committee). Throughout this article, we use the title "compensation committee" as an all-encompassing category of committees focused on compensation and broader human capital matters.

Drawing on our research, insights, and conversations with directors and business leaders, we have highlighted six issues to keep in mind as compensation committees consider and carry out their 2022 agendas:

- **Ensure that compensation plans are aligned with strategy and focused on key drivers of performance.**
- **Balance all components of total rewards, including benefits.**
- **Recognize the role of the compensation committee in the board's oversight of ESG.**
- **Understand investors' and other stakeholders' expectations for compensation and HCM.**
- **Reconsider compensation committee composition, charter, and operations.**
- **Revisit director and executive compensation for legal and regulatory soundness.**

Ensure that compensation plans are aligned with strategy and focused on key drivers of firm performance.

Despite the expanding responsibilities of the compensation committee, it is still important that the design of total rewards packages is sound. Step back and focus on the broader governance role of aligning the interests of executives and employees with those of investors and other stakeholders. Are the company's compensation policies and incentive programs sound and fair? Revisit incentive plans to ensure that they continue to provide appropriate motivational and retention goals. Do they drive the right behaviors and provide appropriate opportunity and accountability for these unprecedented times? Take into consideration any changes to the company's strategy that were made during the last two years to ensure that performance metrics and targets align with the updated strategic plan. It may be a good time to closely examine all incentive plan metrics, as well as payout ranges, to see that they not only adequately align with the company's strategic and operational goals and shareholder interests, but that they also have an appropriate level of resilience to withstand future unforeseen events.

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Balance all components of total rewards, including benefits.

Recent challenges have led many companies to change the way they think about supporting their employees. By focusing on supporting the whole person, employers have found that they have a more productive and loyal workforce. Compensation committees should understand how the company's compensation programs consider workers' needs beyond fair and equitable compensation levels. While the mix between base salary and short- and long-term incentive pay (with carefully calibrated performance metrics and targets) is still important, they are now seen as table stakes. Today, workers expect their employers to get each component of their total rewards package right and provide them benefits and programs that support their health and well-being and allow for the work-life balance that they desire. Whether it is a flexible work-from-anywhere policy, robust mental health benefits, specialized programs for caregivers, etc., the importance of balancing the demands of work with the challenges employees face outside of work can differentiate an employer in this tight labor market. Compensation committee members should ask for information about employee benefit utilization rates to help gauge whether the financial and human resources required to provide these programs are well spent and are driving employee satisfaction and retention.

Recognize the role of the compensation committee in the board's oversight of ESG.

The compensation committee plays a key role in the board's oversight of ESG issues. Governance of compensation plans has long been part of the committee's mandate, and compensation committee chairs have been engaging directly with shareholders on compensation-related topics more frequently since the SEC adopted rules requiring say-on-pay (SOP) votes in 2011. Although it remains to be seen whether the similarly named "say-on-climate" proposals will become standard—i.e., those proposals that emerged during the 2021 proxy season seeking a shareholder vote on a company's climate strategy—compensation committee members should be ready to discuss the extent to which climate risk and other environmental factors were considered in compensation plan design.

As discussed previously, the compensation committee is increasingly expected to take responsibility for the oversight of many workforce-related issues (part of the S in ESG), often referred to as human capital management (HCM). By expanding their remit beyond the C-suite to the entire workforce—including part-time and gig workers—the committee should consider which of the following HCM topics are material for the company, and monitor and disclose appropriate metrics for each: talent management (including succession planning at and below the C-suite; investment in workforce training and development, etc.); workforce diversity, equity, and inclusion (DEI); recruiting, hiring, and retention strategies; employee engagement, productivity, and turnover; and employee safety, health, and well-being. The importance of many of these HCM issues has been elevated by the events of the last two years, so the compensation committee may want to take a fresh look and carefully consider how to hold management accountable for those issues that are most important for the success of the company. In many cases, all of these issues should be on the committee's agenda.

The committee should also see that the company's HCM disclosures in Form 10-K (and in the company's ESG report, if applicable) are in sync with the areas determined to be most material for the business. Specifically, ensure that last year's HCM disclosures are revisited through this lens, and anticipate disclosure requirements expected in the form of a rule proposal from the SEC. Most importantly, encourage management to use disclosures to tell a story and provide quantifiable evidence of material HCM practices.[1]

Depending on where the company is on its ESG journey, the inclusion of climate, diversity, and other ESG metrics in incentive plans may be appropriate. A review of 2021 proxy statements of S&P 500 companies by Willis Towers Watson (WTW) found that 15% of companies included environmental measures in their executive compensation plans and more than 20% included DEI measures. WTW anticipates the prevalence of these measures to increase to 17% and 23%, respectively, for 2021 plans.[2] It is important that ESG issues are fully integrated into corporate strategy and clearly understood before they are included in incentive plan design. Responding to the annual policy survey from Institutional Investor Services (ISS), 86% of investors and 73% of corporate representatives said they believed incorporating ESG metrics into executive compensation programs was appropriate, and a majority of investors responded that these metrics should be specific, measurable, and clearly disclosed.[3]

Understand investors' and other stakeholders' expectations for compensation and HCM.

Directors should be well versed in the issues of greatest concern to the company's shareholders and other stakeholders. Compensation committees can gain insight into these issues by reviewing shareholder proposals filed during the last proxy season as well as

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the level of support they received. A review by Sullivan & Cromwell of shareholder proposals submitted in 2020 and 2021 found that those related to DEI (e.g., workforce and management diversity, and gender and racial wage gaps) were supported by an average of 47% of votes cast in 2021, compared to 24% in 2020.[4] Those related to other HCM issues (e.g., mandatory arbitration, anti–sexual harassment policies, paid sick leave) received average support of 27% of votes cast in 2021, compared to 23% in 2020. During the 2021 proxy season, proxy advisors and investors also scrutinized disclosures of amendments to executive compensation plans made in 2020, in certain cases resulting in lower or failed support for SOP proposals.

A clear understanding of compensation plan structures is paramount for shareholders and proxy advisors in supporting companies' annual SOP votes. A review of these votes at S&P 500 companies by Sullivan & Cromwell found that pay-for-performance concerns and a lack of "compensation committee communication and responsiveness" were the top reasons that ISS recommended voting against SOP proposals in 2021.[5] At the end of the 2020 season, proxy advisors and shareholders said that they would take a critical look at companies' disclosures of any amendments made to compensation plans due to the COVID-19 pandemic. During the 2022 proxy season, shareholders will likely look for explanations of how executive compensation plans are tied to meaningful financial performance measures and support goals related to the reduction of greenhouse gas emissions, transition to net-zero economy, and material HCM metrics.

Reconsider compensation committee composition, charter, and operations.

Given the changing responsibilities of the committee, take steps to help ensure that the committee is fit for purpose. Review the backgrounds of committee members to assess whether they have sufficient expertise in strategic and tactical human resources issues to provide the C-suite, including the CHRO, the appropriate level of oversight and guidance. Consider the cadence of committee meetings to allow sufficient time for the discussion of additional topics, review of new metrics, etc. Examine how the committee works with other board committees to execute its responsibilities efficiently and effectively, e.g., working with the audit committee when selecting financial performance measures for incentive plans and the determination of material HCM metrics to disclose in the 10-K, and working with the nominating and governance committee when evaluating the effectiveness of the company's DEI programs and identifying director candidates with human resources experience. Review the committee's charter to confirm that it reflects current responsibilities and practices.

Revisit director and executive compensation for legal and regulatory soundness.

As many high-profile CEOs announced cutbacks in executive compensation during the recession caused by the pandemic, many boards opted to temporarily reduce or forgo their board retainers or otherwise reduce director compensation. Reinstituting these payments may provide an opportune time to revisit the structure and level of director pay, as boards integrate additional oversight responsibilities and companies adjust to respond to these unprecedented times.

Additionally, in response to shareholder concerns about excessive levels of pay leading to litigation in recent years, many boards have imposed a limit on director compensation—either for cash compensation, equity awards, or both. According to The Conference Board, the percentage of Russell 3000 companies with no limit on director pay decreased from 51.3% in 2017 to 38.5% in 2020.[6] Compensation committee members should work with outside advisors, including counsel and compensation consultants, to review how their director compensation structures and levels compare to industry and proxy peers. Disclosure of the director compensation planning process should be clear and robust. Compensation committee members should be prepared to explain to shareholders why their director compensation plan is appropriate to attract and retain their board members.

In October 2021,[7] the SEC reopened the comment period for its July 2015 proposal[8] to implement clawback rules called for under the Dodd-Frank Act, and dozens of new comment letters have been submitted. Therefore, compensation committees should work with counsel to review their clawback policies to make sure they are in line with the proposed rules and stakeholder expectations.

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[1] Paul Washington et al., Brave New World: Creating Long-Term Value through Human Capital Management and Disclosure, The Conference Board, 2021.

[2] Willis Towers Watson, "Next frontier in executive compensation," June 24, 2021.

[3] ISS Governance, "2021 Global Benchmark Policy Survey Summary of Results," October 1, 2021.

[4] Sullivan & Cromwell, "2021 Proxy Season Review Part 1 – Rule 14a-8 Shareholder Proposals," July 27, 2021, p. 6.

[5] Sullivan & Cromwell, 2021 Proxy Season Review: Part 2, Say-on-Pay Votes and Equity Compensation," August 23, 2021, p. 5

[6] Mark Emanuel et al., Director Compensation Practices in the Russell 3000 and S&P 500: 2021 Edition, The Conference Board, May 2021.

[7] U.S. Securities and Exchange Commission notice, "Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation," October 14, 2021.

[8] U.S. Securities and Exchange Commission proposing release 34-75342, "Listing Standards for Recovery of Erroneously Awarded Compensation," July 2015.

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