THOUGHT LEADERSHIP FROM FW COOK

DELIVERING ON DIVERSITY

What does the call for stronger diversity, equity and inclusion efforts mean for compensation committees?.

BROADLY, THE PAST DECADE has seen growing momentum behind corporate diversity, equity and inclusion (DEI) initiatives. Events in recent years only served to accelerate that trend, with the #MeToo movement and social justice incidents coupled with revisions to the Business Roundtable's purpose of a corporation statement all fueling the pressure for boards to take a closer look at their oversight of the "S" component of ESG.

Often, this has resulted in the expansion of the compensation committee charter to include areas like culture, employee relations and engagement, explains David Yang, a managing director at FW Cook. "We've observed a significant uptick in DEI-related discussions in our work with compensation committees," he reports. "Those dialogues reflect a market push toward ESG-based investing, employee interest in having their organizations embrace ESG principles and community concern about the practices and values of the companies operating in their midst."

> **"AMONG ESG CATEGORIES USED IN INCENTIVE PLANS, DIVERSITY & INCLUSION SAW THE BIGGEST YEAR-OVER-YEAR INCREASE IN PREVALENCE."**
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> **—2021 Use of Environmental, Social and Governance Measures in Incentive Plans, FW Cook**

Within that ESG umbrella, DEI has become a particular focus of shareholders. According to ISS, the 2021 proxy season brought 130 proposals related to workforce fairness and safety, many of which requested information on DEI-related statistics like diversity metrics or racial and gender pay equity practices. "So, companies are not only responding to communities and employees, but also directly to shareholders," says Yang. "All of these pieces together have elevated DEI issues so that some companies that weren't at the forefront of having this conversation are being forced to have it in response to their shareholders."

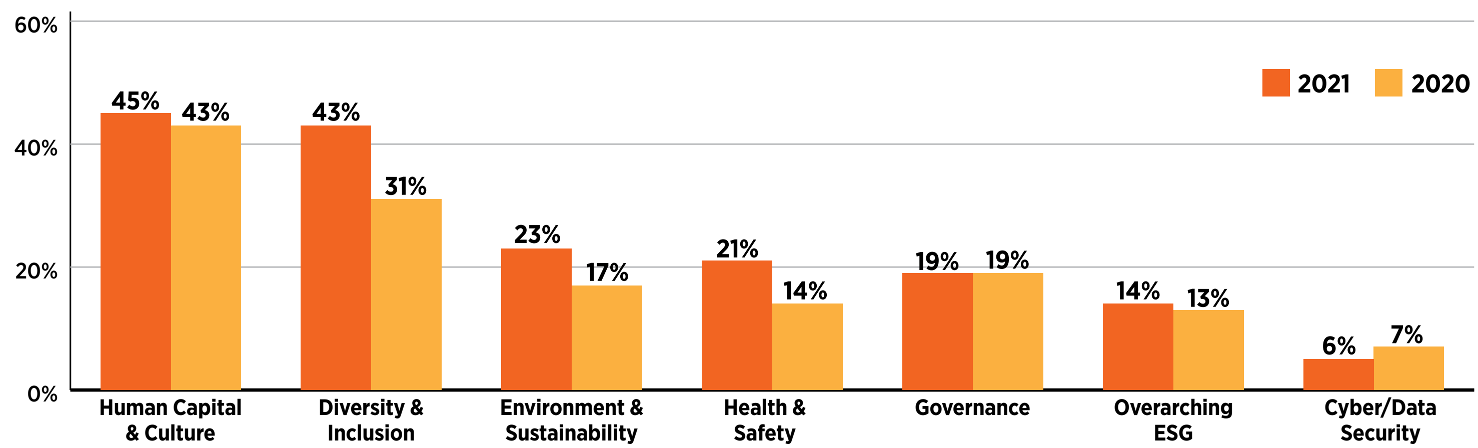
INCENTING THE 'S'

Increasingly, a major focus point of those discussions has been if and how to incorporate DEI goals into incentive plans. In fact, among ESG categories used in incentive plans, diversity & inclusion saw the year's biggest year-over-year increase in prevalence (from 31 percent to 43 percent), according to FW Cook's 2021 Use of Environmental, Social and Governance

ESG Category Breakdown

	ENVIRONMENTAL	SOCIAL			GOVERNANCE		BROAD ESG
	Environment & Sustainability	Human Capital & Culture	Diversity & Inclusion	Health & Safety	Governance	Cybersecurity & Data Protection	Overarching ESG
EXAMPLES	Reduction in carbon emissions	Employee engagement	Gender representation	Fatalities	Regulatory compliance and internal controls	Cybersecurity	Implement overarching ESG or corporate responsibility strategy
	Waste reduction	Succession planning	Racial minority representation	Lost workdays	Risk management	Fraud prevention	Recognition for ESG initiatives
	Environmental stewardship	Recruitment and retention	Inclusion survey	Accident prevention	Stakeholder engagement	Data governance	High ESG scores from external ratings agencies
		Training and development		Food or product safety	All-encompassing governance enhancements		

Prevalence of ESG Measures by Category



Measures in Incentive Plans report.

"Being able to say that a specific portion of the incentive plan, whether annual or long term, is going to be tied to our diversity and inclusion effort sends a much clearer message about a company's commitment to DEI than a company statement," says Elaine Yim, a principal at FW Cook. "There is definitely more of a push toward addressing the question: how do we hold our executives accountable for results being accomplished in a meaningful way?"

Yet, defining meaningful DEI goals to link to incentive pay is no small feat. The lack of standardized performance metrics is a significant hurdle, particularly when coupled with the fact that what constitutes a meaningful goal varies widely by company and industry. "When you select measures to use for compensation purposes, it's important that employees understand the measure and how they can affect it," says Yang. "With DEI measures, that's often not the case. Some employees may feel the measure is too broad-based and that they lack the ability to affect those outcomes."

What's more, companies that move too quickly toward embracing quantifiable measures and linking them to pay risk a backlash. Metrics viewed as too rigorous or unfair will disgruntle plan participants, while those viewed as too easy to achieve may raise shareholder ire. Mindful of this minefield, many companies are taking a calculated approach to incorporating DEI metrics into incentive pay formulas, says Yang, who reports that most companies that employ DEI measures in their annual incentive plans apply a scorecard or individual performance assessment rather than a quantitative metric with an explicit weighting.

"Currently, the majority of companies factor DEI into individual performance evaluations or build a scorecard around multiple ESG initiatives that are important to them and objectively assess how they progress against these initiatives," he explains. "Those goals can be quantifiable—for example, movement in diversity or gender representation at different levels of the organization—but few companies employ them in a formulaic basis for a compensation payout. At this point, the scorecard approach is a way to get your feet wet and educate your participant base about expectations before committing to a formulaic approach."

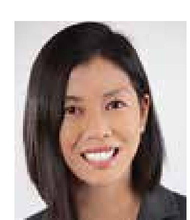
THE RISE OF THE CDO

The need to focus more intensely on DEI is leading management and boards to seek a more robust understanding of cultural and talent issues. As a result, many compensation committees are calling for regular updates on culture and HR issues, and more and more companies are creating or elevating the role of the chief diversity officer (CDO).

"Now that the members of the compensation committee have this additional interest or obligation to review DEI initiative results and workforce diversity trends, they need someone to be able to build that capacity and report on their findings," explains Yim, who says board members and management are taking a keener interest in the role and, at times, even in having the CDO report directly to the CEO. "CDOs are the ones charged with providing answers to questions, such as: 'To what extent does the company staff feel a sense of belonging and inclusion? How does that compare with management's view of diversity and inclusion in the organization—and, if there's a gap, how will we close it?'"

Boards that aren't focused on these issues yet should start thinking about them, says Yang. "DEI should be an ongoing dialogue because environments change, shareholder expectations change, and, if you don't get on top of it and are suddenly faced with shareholders who care about this, you will be playing catch-up," he says. "That's not to say you need to be at the forefront of ESG incentive pay program design—but you do want to make sure that you have these conversations so that your organization is prepared if there's a shift in the future."

David Yang, a managing director at FW Cook, advises public and privately held companies on all aspects of executive and board compensation.



Elaine Yim, a principal at FW Cook, advises tax-exempt organizations on executive and board compensation practices.