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2023 Use of Environmental, Social, and Governance Measures in Incentive Plans

FW COOK

2023 USE OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) MEASURES IN INCENTIVE PLANS

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EXECUTIVE SUMMARY

Over the last several years, as key stakeholders embraced the premise that a strong ESG proposition is essential to sustainable long-term growth, an increasing number of large companies have signaled the importance of ESG by incorporating ESG measures within their incentive compensation plans. We are now entering a second phase in the evolution of this ESG trend, as support for ESG-related shareholder proposals declines, and mounting pressure from investors and proxy advisory firms has shifted focus to transparency and rigor around ESG goals and how measures are tied to a long-term strategic plan and financial results.

Key Takeaways

The number of large companies disclosing ESG measures in incentive plans is relatively stable year-over-year (75% prevalence in 2023 vs. 74% in 2022).

Incorporation of ESG measures in annual incentive plans remains the most common practice, but a few companies also incorporate ESG in a long-term incentive plan.

Diversity & Inclusion and Environment & Sustainability measures are the most common ESG categories used in incentive plans in 2023. We saw an increase in prevalence from 2021 to 2022 for both categories, with an uptick for Environment & Sustainability in 2023.

The prevalence of ESG categories in incentive plans varies significantly by industry. Performance in Environment & Sustainability and Health & Safety outcomes has been a longstanding focus among the Energy, Utilities, and Materials sectors, and Human Capital & Culture and Diversity & Inclusion (D&I) measures are more commonly used outside these sectors.

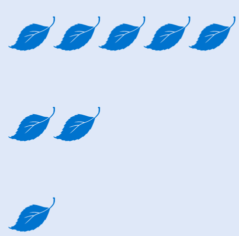
Companies are increasingly using ESG goals as stand-alone weighted measures and/or stand-alone modifiers. Our findings indicate that the use of stand-alone weighted measures now nearly matches the practice of including ESG goals in a broader assessment of individual performance (38% vs. 39% prevalence, respectively).

Most companies continue to disclose performance against ESG incentive measures on a qualitative basis, although the number of companies disclosing quantitative measures for ESG performance increased this year to 25% of the sample.

75% of Top 250 companies incorporate ESG measures in incentive plans

25% of companies disclose quantitative performance measurement in 2023

Prevalence of ESG Measures in Incentive Plans



Annual Incentive Plans only 68%

Both Annual and Long-Term Incentive Plans 5%

Long-Term Incentive Plans only 2%

Almost an equal number of companies are measuring ESG via an assessment of individual performance (39%) and as a stand-alone weighted measure (38%), followed by team-wide strategic performance (32%)

EMERGING TRENDS

Our study observed a leveling-off of ESG measure prevalence, a possible signal that the momentum to emphasize ESG performance in incentive compensation has indeed slowed. This year's study findings also align with our experience in seeing less focus and "airtime" in Compensation Committee meetings on this topic over the past year for reasons including:

- More challenging economic conditions turning focus to business improvements,
- Less pressure from institutional investors,
- Internal pushback regarding goal-setting calibration,
- Increasing politicization of the topic, and
- Board member/investor concerns over "greenwashing."

Companies that already include ESG measures are assessing how to respond to pressure from institutional investors and proxy advisory firms to include more rigorous/quantifiable measures and increase disclosure transparency around performance achievement and corresponding impact on company value. Many large institutional investors have been vocal that they do not hold strong views about whether ESG measures should be included in compensation plans. Investors are primarily concerned with <u>*how*</u> ESG measures are implemented, expecting clear targets that have a strong tie to long-term strategy while also being measurable and transparent. Comments provided to the SEC related to the recently implemented Pay Vs. Performance rules by Dimensional Fund Advisors (as well as other investors) offer a common perspective of investor concerns around ESG measure implementation as follows:

> "At some companies, the ESG metrics tied to executive compensation are well-defined and clearly relevant to the company's financial performance… But, in our experience, it is much **more common to see companies link executive pay to ESG metrics that are ill-defined or inherently difficult to quantify, which gives companies the ability to increase executive pay even if the executives are failing to increase shareholder value as measured by financial or return metrics."** (Dimensional Fund Advisors LP, 2022)[1]

While the major proxy advisory firms (ISS and Glass Lewis) do not have policies in place requiring ESG incentive measures, they are similarly focused on explicit disclosure of pre-determined, quantitative ESG targets and how such targets are linked to long-term strategic planning, which is also contributing to increasingly transparent disclosure.

[1] *Dimensional Fund Advisors LP. (2022, March 3). Reopening Comment Period for Pay Versus Performance. Austin, Texas, USA: US Securities and Exchange Commission.*

KEY CONSIDERATIONS

As companies look to develop incentive programs that demonstrate alignment with business strategy, progress against articulated goals, and management accountability, discussion related to the incorporation and inclusion of ESG goals is of critical importance. Some often-cited concerns about the most appropriate way to introduce and/or evolve ESG measures and avoid unintended consequences include:

- Pressure to set highly aspirational and potentially unachievable goals to demonstrate commitment, resulting in criticism in the event of underachievement
- Conversely, pressure to set easily achievable goals to avoid potential criticism of underachievement
- Criticism from the proxy advisory firms and governance professionals for subjective measurement
- Suboptimal short-term reaction to longer-term challenges
- Questions from investors and other stakeholders about the importance of selected measures or rationale for those not included but viewed as being financially relevant

As companies are planning for 2024, it is appropriate to evaluate some key questions and factors regarding ESG measures and their inclusion in incentive plans:

1. ***Shareholder Engagement*** – What ESG measures are most aligned with the company's communicated business strategy and value creation? What expectations/policies do the company's major investors have regarding ESG incentive measures? What ESG measures are most important to investors? Has the topic of tying ESG to compensation been raised in past investor engagement sessions? What, if any, pushback can be expected from investors?

2. ***Balancing Multiple Stakeholder Perspectives*** – What are the business implications of including an ESG measure, recognizing that not all stakeholders embrace the same investment strategy, social agenda, or time horizon. If an ESG measure is included, which financial measure is de-emphasized (i.e., weighting reduced)? Once in the incentive plan, can an ESG measure be removed?

3. ***Disclosure*** – What level of disclosure can be provided? Are goals able to be disclosed quantitatively? Will greater detail open the company up to criticism for insufficiently ambitious targets or poor achievement versus stretch goals? Conversely, will less detail expose the company to criticism from proxy advisory firms and investors?

4. ***Status of Current Processes*** – Does the company have a measurement system to accurately track ESG measures? Does the governance structure assign ESG responsibilities to a specific board committee or multiple committees?

5. ***Signaling of Importance*** – Does the importance of ESG require its formal inclusion in incentive plans, or can ESG be effectively measured and disclosed outside of the plans? Does inclusion of specific ESG goals unintentionally imply others are unimportant?

6. ***Measurement of ESG Goals*** – Should ESG goals be independently weighted measures, incorporated as a modifier, or a part of team-wide or individual strategic objectives? Can stand-alone, achievable goals be set that foster progress? Should ESG goals be measured qualitatively or quantitatively? Is it important to preserve flexibility as circumstances evolve? Should ESG goals be measured at the corporate level and/or the business unit level for greater line of sight and accountability?

KEY CONSIDERATIONS

7. ***Diversity & Inclusion Goal Setting*** – Diversity and inclusion is the most common ESG measure category, and it is important to consider whether D&I goals should be set to measure outcomes or activities and inputs. How will this approach change over time? How does the type of goal affect the way progress is viewed by employees, investors, and other stakeholders?

8. ***Goal Setting Period*** – Because progress on many ESG measures will evolve over long periods (e.g., a decade or more, especially for climate change initiatives), it is natural to want to measure ESG performance in long-term plans. But does the company have forecasting precision over periods as short as three years? If discretion in measurement is retained on an equity-based, multi-year incentive plan, is the company willing to accept variable accounting on the award? To reduce the impact of variable accounting, should ESG measures apply exclusively to top-level executives in a long-term plan? If lower-level executives are excluded, does it raise questions about the importance of the measure and/or accountability across the organization?

9. ***Unintended Consequences*** – If qualitatively assessed, does this create the potential for criticism from proxy advisors? Does underachievement or setting a target goal below investor aspirations create possible public relations challenges or inconsistency with the company's Corporate Sustainability Report? Might possible underachievement attract moral criticism to the company, and could this risk encourage suboptimal decision-making?

Overall, the incorporation of ESG goals into compensation plans is an evolving topic, and there is no universal approach that works best for all companies. Companies should evaluate their unique business objectives, industry, company maturity, investor views, culture, and a variety of other considerations when building ESG measures into incentive plans.

METHODOLOGY

FW Cook conducted a study of the use of ESG measures in annual and long-term incentive plans among the largest U.S. public companies, consisting of the 250 U.S.-listed companies in the S&P 500 with the largest market capitalizations as of April 30, 2023 (excluding Foreign Private Issuers that do not have the same disclosure rules). The industry breakdown is as follows:

Sector	Cos.
Communication Services	**10**
Consumer Discretionary	**20**
Consumer Staples	**24**
Energy	**16**
Financials	**35**
Health Care	**39**
Industrials	**37**
Information Technology	**33**
Materials	**11**
Real Estate	**11**
Utilities	**14**
Total	**250**

Data were sourced from the latest proxy filings (as of June 1, 2023) and represent annual and long-term incentive programs in place during fiscal year 2022/23.

For purposes of this report, we grouped ESG measures into the seven broad categories below:

	Environmental	Social			Governance		Broad ESG
Category	**Environment & Sustainability**	**Human Capital & Culture**	**Diversity & Inclusion**	**Health & Safety**	**Governance**	**Cyber Security & Data Protection**	**Overarching ESG**
Example of Measures	Reduction in carbon emissions Waste reduction Environmental stewardship	Employee engagement Succession planning Recruitment and retention Employee training and development Transforming culture	Gender representation Racial minority representation Inclusion survey	Fatalities Lost workdays Accident prevention Food or product safety	Regulatory compliance and internal controls Risk management processes Stakeholder engagement All-encompassing governance enhancements	Cyber security Fraud prevention Data governance	Implement overarching ESG or corporate responsibility strategy Recognition for ESG initiatives High ESG scores from external ratings agencies

Note – Our study excludes any measures that are temporary or related to one-time events. Measures established due to unique or transient situations are considered as one-offs, and therefore, are not included in this study, which captures only ongoing changes to incentive plans.

METHODOLOGY

The various methods of ESG incorporation and degree of disclosure were categorized as follows:

ESG Measurement Approach			
Individual Performance	**Team-Wide Strategic Performance**	**Stand-Alone Measure**	**Stand-Alone Modifier**
ESG measures are incorporated into a broader assessment of individual performance. The particular ESG measures used and/or achievement against the ESG objective may vary by Named Executive Officer	ESG measures are incorporated into a scorecard of objectives by which all Named Executive Officers are evaluated. The ESG measures are not a formally weighted component of the scorecard, and instead are typically considered as part of a holistic evaluation of performance used to determine payouts	ESG measures are a weighted component of the program and are individually considered in the determination of the incentive plan payout	ESG measures are not included in the core plan design but are secondarily applied to increase or decrease the overall award payout

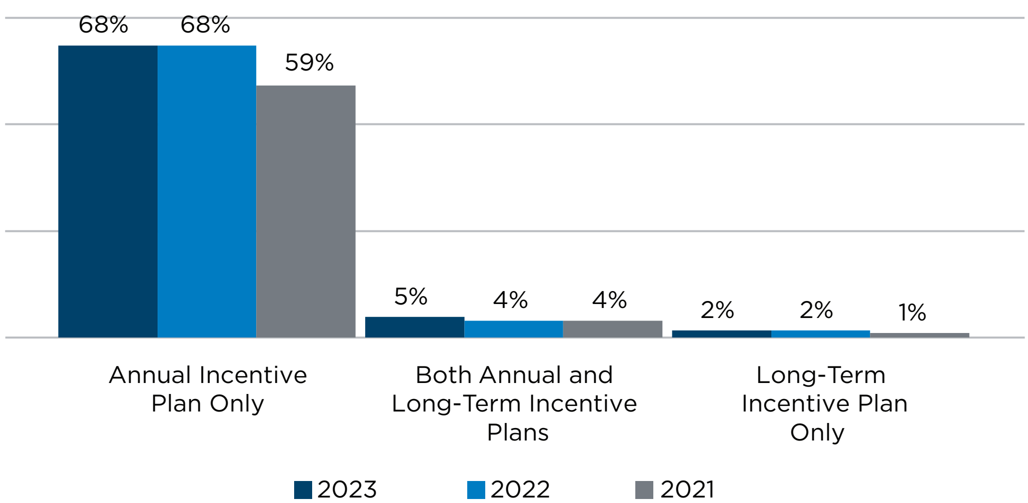
Disclosure of ESG Performance		
No ESG-Specific Performance Disclosure	**Qualitative Performance Disclosure**	**Quantitative Performance Disclosure**
ESG measures are listed among the factors that are considered in arriving at an incentive payout, but specific performance achievements are not described. Most common among companies using ESG qualitatively as an individual performance consideration	ESG performance is described qualitatively without any quantitative performance results disclosed. Includes companies that disclose a payout score for ESG without disclosing the underlying quantitative performance that was used to calculate the payout	ESG performance that was considered in arriving at a payout is disclosed quantitatively. Most common among companies using a stand-alone ESG measure or modifier
Note – it is possible to evaluate ESG performance quantitatively using pre-established goals but disclose the performance achievement qualitatively or not specifically describe achievement at all		

STUDY FINDINGS

Prevalence of ESG Measures

In this year's study, 75% of companies use one or more ESG measures in the annual and/or long-term incentive plan, essentially flat compared to 74% of companies in 2022. Most companies incorporate ESG measures in the annual incentive plan only, with low prevalence in long-term incentive plans.

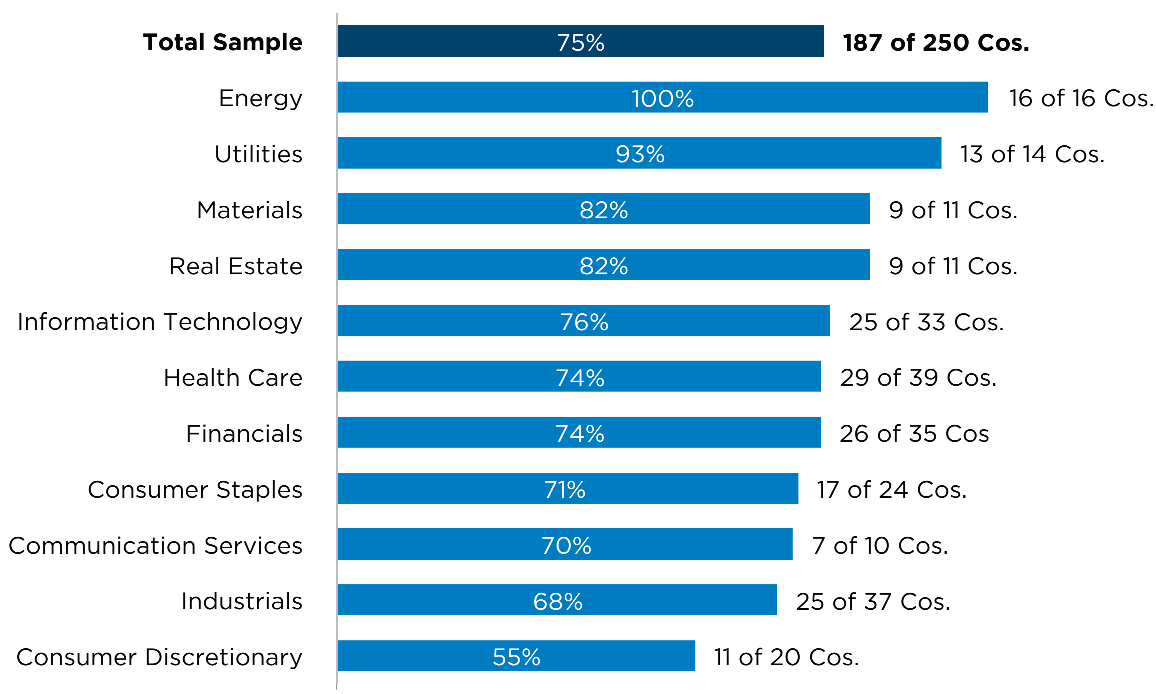
Prevalence of ESG Measures in Incentive Plans



The prevalence of ESG measures varies among sectors; however, at least 50% of companies in each sector incorporated ESG measures.

ESG measures are most prevalent among Energy and Utilities companies (consistent with last year's analysis and historical practice). 100% of Energy companies include an Environment & Sustainability measure in their incentive plans.

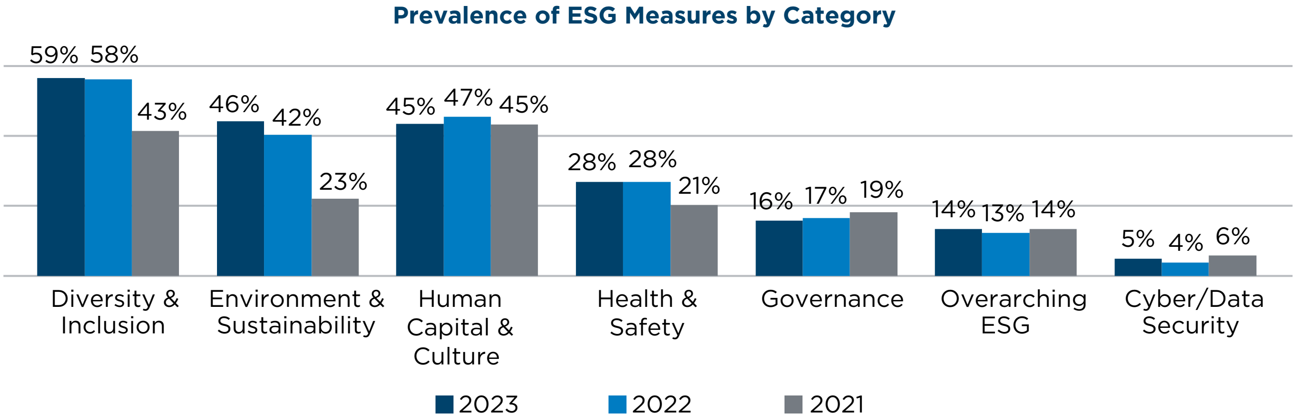
Prevalence of ESG Measures in Incentive Plans by GICS Sector



Note – "GICS " – Global Industry Classification Standard

TYPES OF MEASURES

Diversity & Inclusion continues to be the most common ESG category used in incentive plans, increasing in prevalence among the 250 companies sampled from 43% in 2021 to 58% in 2022 to 59% in 2023. 2023 saw a slight uptick in the use of Environment & Sustainability measures (increasing from 23% in 2021 to 42% in 2022 and 46% in 2023). All other measures were relatively stable in prevalence with increases/decreases ranging from 1%-2% year-over-year.



The types of ESG measures used vary significantly by industry sector:

- The Energy and Utilities sectors have a high prevalence of incorporating measures tied to Environment & Sustainability and Health & Safety, which have been long-standing measures in these sectors.
- Human Capital & Culture and Diversity & Inclusion measures are commonly used across all other industry sectors.

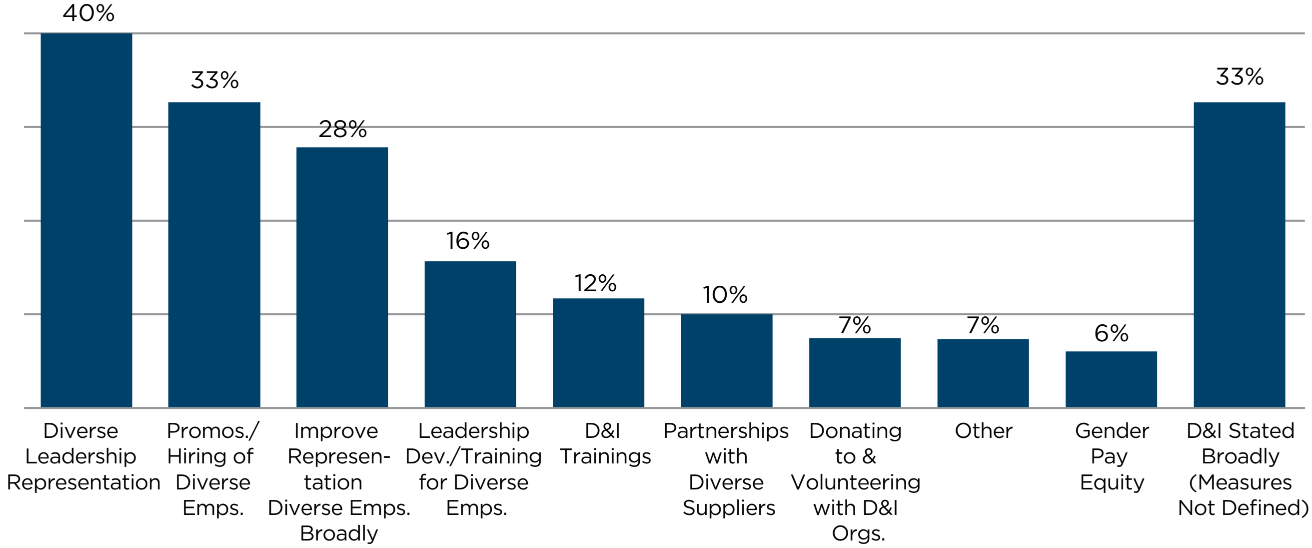
ESG Measures by Category							
Industry	**Diversity & Inclusion**	**Environment & Sustainability**	**Human Capital & Culture**	**Health & Safety**	**Governance**	**Overarching ESG**	**Cyber/Data Security**
Communication Services	60%	40%	50%	20%	0%	10%	10%
Consumer Discretionary	45%	30%	50%	20%	0%	5%	0%
Consumer Staples	50%	33%	42%	13%	4%	8%	0%
Energy	50%	100%	31%	88%	19%	19%	0%
Financials	74%	40%	66%	9%	37%	17%	14%
Health Care	59%	36%	56%	21%	21%	13%	5%
Industrials	51%	46%	30%	38%	19%	14%	3%
Information Technology	61%	33%	42%	12%	9%	27%	6%
Materials	64%	82%	18%	55%	9%	9%	0%
Real Estate	55%	45%	55%	0%	18%	9%	0%
Utilities	79%	79%	36%	86%	21%	7%	14%

TYPES OF MEASURES

Diversity & Inclusion Measures

Approximately two-thirds of companies with Diversity & Inclusion measures provided detail with respect to D&I focus areas; the remaining one-third of companies disclosed the use of broader (but undefined) D&I goals. The most common Diversity & Inclusion measures are goals surrounding diverse leadership representation, promotions and hiring of diverse employees across the entire company, and improvement in diverse representation across the entire organization.

Prevalence of Diversity and Inclusion Measures



Note – prevalence sums to greater than 100% because some companies incorporate D&I measures into incentive plans in more than one way.

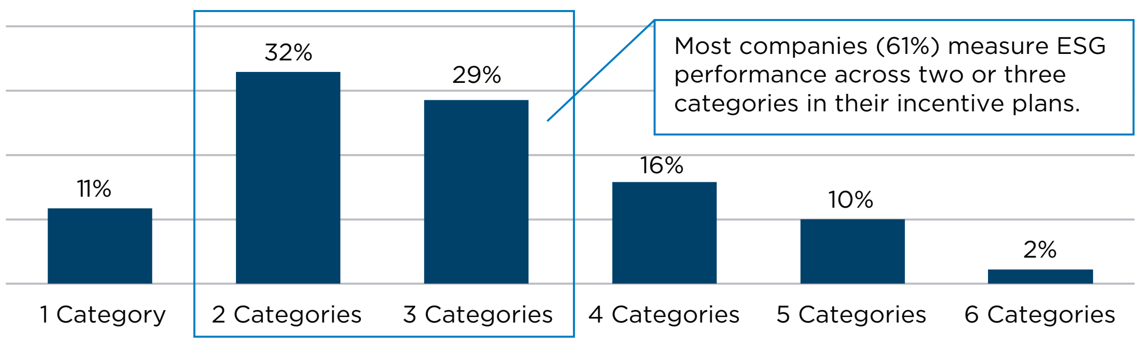
HOW ARE ESG MEASURES INCORPORATED INTO INCENTIVE PLANS

Among the 187 companies in the sample using ESG measures in incentive plans, the majority incorporate measures from two or three ESG categories and disclose performance on a qualitative basis.

Number of ESG Measures

Most companies in our sample cover two or three of the seven different ESG categories listed on page 5 in their incentive plans, which suggests that companies are focusing on select ESG categories rather than ensuring all categories are covered.

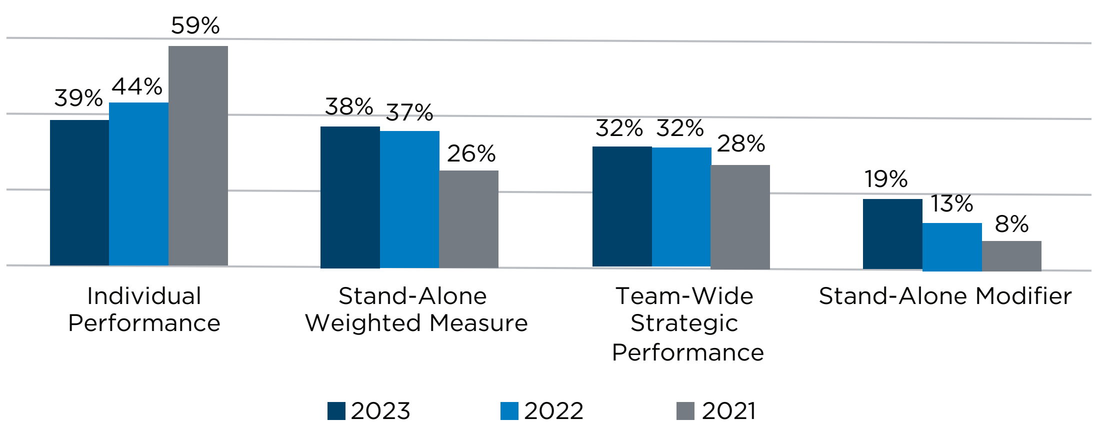
Number of ESG Measures by Category (Among Companies using ESG measures)



ESG Measurement Approach

This year's findings indicate that almost an equal number of companies are measuring ESG via an assessment of individual performance and as a stand-alone weighted measure, followed by team-wide strategic performance. Measuring attainment of ESG goals within individual performance has substantially decreased in prevalence since our 2021 report findings (59% prevalence in 2021 vs. 39% this year), while stand-alone measures and modifiers increased in use. This suggests that companies may be responding to proxy advisory firms' and institutional investors' preference for more rigorous, quantifiable, and measurable ESG goals.

Prevalence of ESG Incorporation (Among Companies using ESG Measures)

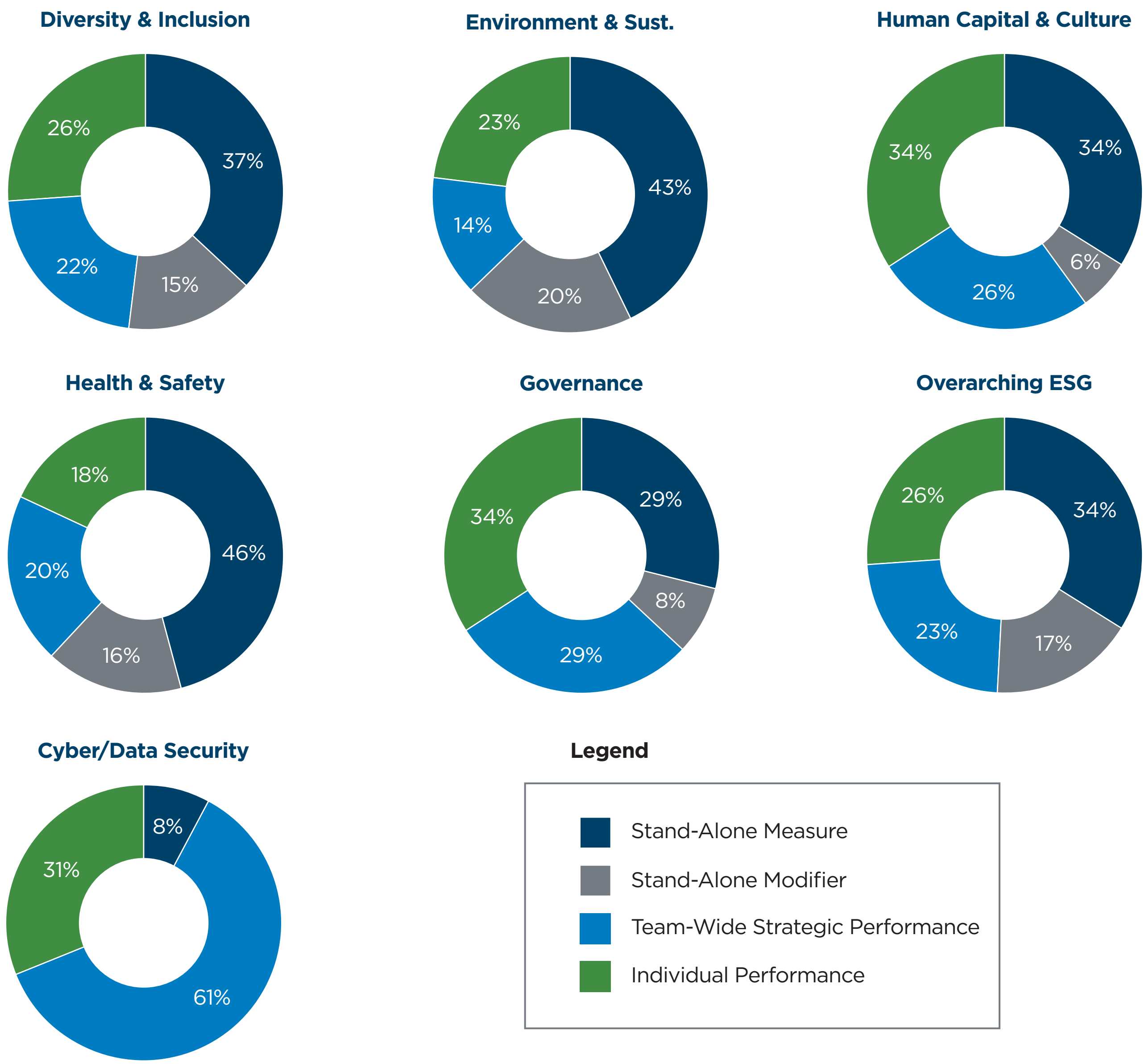


Note – prevalence sums to greater than 100% because some companies incorporate ESG into incentive plans in more than one way (e.g., a company may use one stand-alone ESG measure in addition to an ESG measure as part of an individual performance assessment).

HOW ARE ESG MEASURES INCORPORATED INTO INCENTIVE PLANS

The following exhibit presents a breakdown of the most impactful ESG measurement approaches in incentive plans by measure category:

- Stand-alone measures are the most prevalent approach to measure performance in the areas of Diversity & Inclusion; Environment & Sustainability; Health & Safety; and Overarching ESG.
- The use of stand-alone measures or individual performance are equally prevalent performance measurement approaches for Human Capital & Culture.
- Team-wide strategic performance remains the most common approach to measuring performance in Cyber/Data Security.



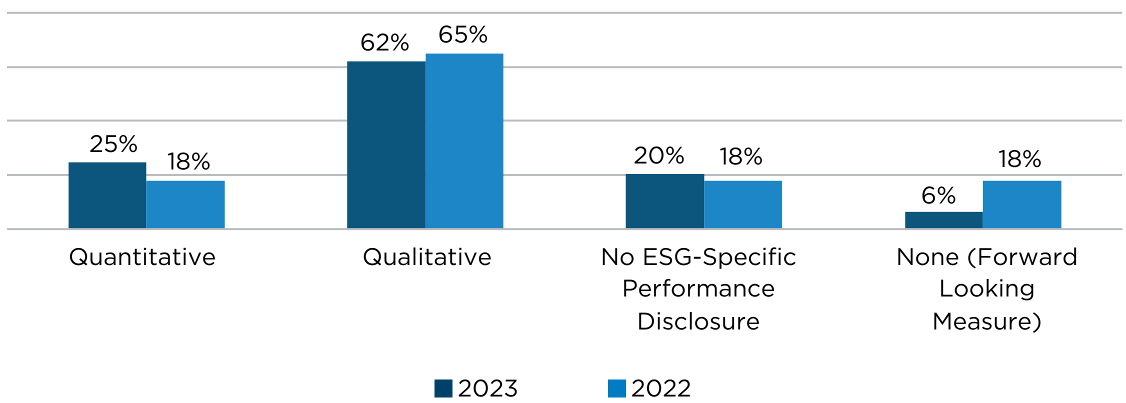
Note – in cases where companies incorporate the same ESG category in more than one way (e.g., stand-alone measure and individual), they are counted according to their most impactful incorporation of ESG (i.e., stand-alone measure > stand-alone modifier > scorecard > individual).

HOW ARE ESG MEASURES INCORPORATED INTO INCENTIVE PLANS

ESG Performance Disclosure

Despite most companies continuing to describe ESG measure performance achievement qualitatively (e.g., met/exceeded expectations, improved relative to last year, etc.), there has been a year-over-year increase of 7% in the number of companies that quantitatively disclose the performance achievements used to arrive at an incentive payout. Again, this suggests an evolution in approach as companies respond to mounting pressure from proxy advisory firms and institutional investors to increase the transparency around use of ESG measures:

Disclosure of ESG Performance Achievement (Among Companies using ESG Measures)

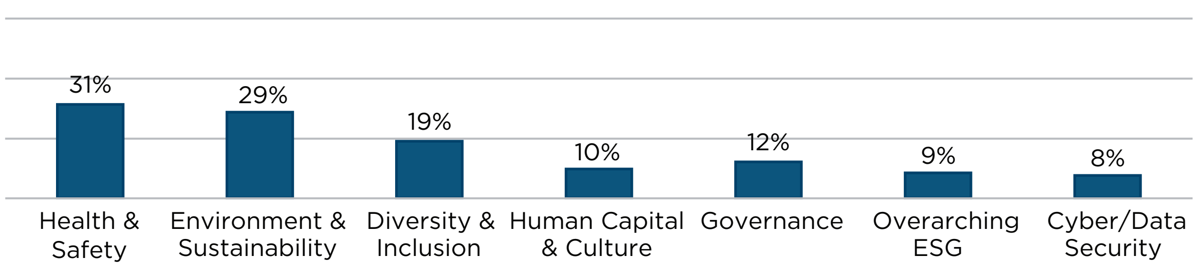


Note - prevalence sums to greater than 100% because some companies disclose performance in different ways for different ESG measures (e.g., quantitative disclosure for one measure and qualitative disclosure for another).

Twenty percent (20%) of companies did not specifically describe how they performed on a given ESG measure; this is most common for companies that use ESG measures as part of individual performance assessments, only noting that the measure was considered in determining the incentive payout. Six percent (6%) of companies had no disclosure related to performance achievement, but will begin incorporating ESG performance in incentive plan payouts next year.

Consistent with prior years, the most prevalent ESG categories that are measured quantitatively are Health & Safety and Environment & Sustainability measures:

Quantitative Performance Disclosure by ESG Category



ENDING REMARKS

This year's study indicates that the incorporation of ESG measures within incentive compensation plans among large cap companies has reached a plateau. Over the last year, shareholders have become increasingly vocal about their expectations for complete transparency, and we anticipate continued pushback and scrutiny in this area going forward.

In response to the mounting pressure for more robust disclosure regarding the selected ESG measures, the rigor of targets, the determination of corresponding payouts, and their connection to bottom line performance, we observe a shift towards more stand-alone plan measures/modifiers and quantitative achievement disclosure. The minimal change in the selection of ESG categories (with the exception of an uptick in Environment & Sustainability measures) suggests that most companies have selected what they believe are the most suitable ESG measures for driving financial performance and shareholder value creation, and significant changes are not likely in the near future. As these trends evolve, companies should continue to evaluate their unique business circumstances in determining whether to formally incorporate ESG measures into their incentive plans, and if so, how these measures should evolve to meet stakeholder expectations.

FW COOK PROFILE

FW Cook is an independent consulting firm specializing in executive and director compensation and related corporate governance matters. Formed in 1973, our firm has served more than 4,000 companies of divergent size and business focus from our offices in New York, Chicago, Los Angeles, San Francisco, Atlanta, Houston, and Boston. We currently serve as the independent advisor to the compensation committees at a substantial number of the most prominent companies in the U.S.

Office Directory and Contact:

New York
(212) 986-6330

Chicago
(312) 332-0910

Los Angeles
(310) 277-5070

San Francisco
(415) 659-0201

Atlanta
(404) 439-1001

Houston
(713) 427-8300

Boston
(781) 591-3400

Website: www.fwcook.com

Authors

This report was authored by **Sara Salzbank**, **Corine Lu**, and **Elaine Yim**. Questions and comments should be directed to **Sara Salzbank** at **sara.salzbank@fwcook.com** or **212.299.3718**.

Research Team

The following consultants were involved in research for this report: Shane Anderson, Nico Braverman, Samuel Cooper, Nikhil Das, Blake Davidson, Rebecca Jordan, Agampreet Saluja and Stafford Schmidt.