CompensationStandards.com

“The Top Compensation Consultants Speak”

Tuesday, March 14, 2023

Course Materials

<u>"The Top Compensation Consultants Speak"</u>

Tuesday, March 14, 2023

2 to 3 p.m. Eastern [archive and transcript to follow]

Our annual webcast focusing on what compensation committees should be learning about — and considering — today. Join these experts:

- **Blair Jones**, Managing Director, Semler Brossy
- **Ira Kay**, Managing Partner, Pay Governance LLC
- **Jan Koors**, Senior Managing Director and Western Regional President, Pearl Meyer

Among other timely topics, this webcast will cover:

- Early Trends in Pay vs. Performance Disclosures
- Clawback Policies: Strategic Views
- Updates on Equity Award Practices
- Compensation Committee Role in Human Capital Management
- Compensation Committee Role in ESG; Trends in Non-Financial Incentive Metrics
- Director Compensation Trends

<u>“The Top Compensation Consultants Speak”</u>

Course Outline/Notes

1. Early Trends in Pay vs. Performance Disclosures

2. Clawback Policies: Strategic Views

3. Updates on Equity Award Practices

4. Compensation Committee Role in Human Capital Management

5. Compensation Committee Role in ESG

6. Trends in Non-Financial Incentive Metrics

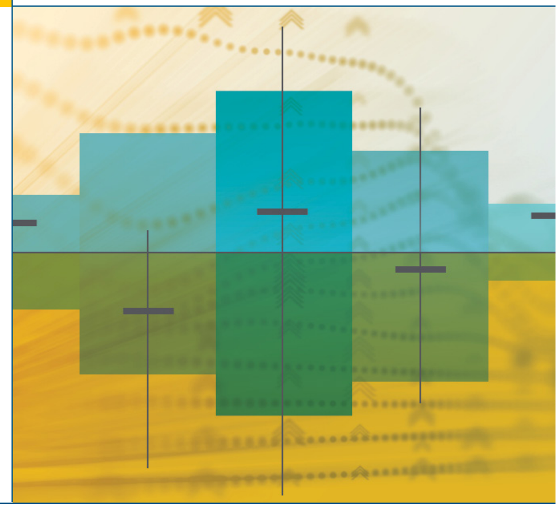
7. Director Compensation Trends

“The Top Compensation Consultants Speak”

Table of Contents — Course Materials

SEMLER INSIGHT

Executive & Director Pay Design



A Deeper Dive: FAQs on the SEC's Pay vs. Performance Disclosure Rule

NOVEMBER 2022

Michelle Garrett

Below we answered several common questions that have arisen as companies prepare for the Pay vs. Performance Disclosure (PvP) requirements.

PEER GROUPS

1. What factors go into selecting a peer group?

- The new PvP rules require disclosure of both company TSR and "peer group" TSR in the table, along with a description of the relationship between the company's TSR and that of its peer group. For these purposes, companies may look to either (1) the industry comparators/index used in the 10-K performance graph or (2) the proxy-disclosed peer group used to disclose benchmarking practices.
- Interestingly, the SEC has informally indicated that the compensation peer group may only be used if the company uses the peer group for "true benchmarking" rather than as only one factor in making pay decisions. If the SEC issues formal guidance on this point, using the compensation peer group may become undesirable for most companies.
- Considering the above as well as the disclosure implications of year over year peer group changes (see below), in our experience to date, companies are almost exclusively looking to the 10-K performance peer group. With this in mind, we'd recommend taking a closer look at this year's 10-K peer group to ensure it is correct, making any changes in advance of the first PVP proxy disclosure.

2. What should companies do if peer groups change year over year (if using something like the compensation peer group)?

- Under the PvP rules, changes in peer groups YoY must be reflected and explained in footnote disclosure to the PVP table. TSR comparison to the prior peer group must be provided in addition to the new peer group disclosure. What's unclear under the rules is whether minor changes to the peer group–for example, in the event of a peer acquisition or similar transaction–will need to be disclosed and the extent of such disclosure. As noted above, this may be another reason companies gravitate toward using an index disclosed in the 10-K.

TABLE COLUMNS

1. What disclosure is required when there are multiple CEOs in the same year?

- In cases where a company's CEO retires or is terminated mid-year, the company will be required to include separate columns in the PVP table for each CEO (for a total of four CEO columns).
- For years included in the table where the company had only one CEO, the additional columns will be empty.

FOOTNOTES

1. What do we need to know about the footnotes to the PVP table?

- While the PVP table and the calculations involved have received significant focus and attention, the rules also require extensive footnote disclosure, particularly around reconciling the Summary Compensation Table compensation with "CAP" numbers. The rules do not prescribe any specific form for this reconciliation; however, many companies may choose to include tabular footnote disclosure detailing amounts added to and subtracted from Summary Compensation Table compensation. For NEOs other than the PEO, this reconciliation will be on an average basis, which may introduce additional complexity in certain scenarios.

2. What footnote disclosure depth is required regarding PSU interim performance?

- In addition to requiring a reconciliation of SCT and CAP numbers, the PVP rules also require that any difference in assumptions used for equity award valuation for calculating SCT compensation and CAP be disclosed. Interestingly, in the case of PSUs, this may have the effect of disclosing additional detail about where PSU performance is tracking that is not disclosed elsewhere in the proxy statement. Grant date fair value—used for SCT calculations—typically assumes target performance, while year-end fair value—used for CAP calculations—will reflect updated performance expectations. It's not yet clear, however, to what extent specific disclosure detailing the performance expectations used to determine fair value for the CAP calculations is necessary.

> "Over the next couple of years, we're likely to see key metrics converge by industry and best practices for disclosure emerge, with disclosure practices becoming more uniform."

COMPANY-SELECTED MEASURE (CSM)

1. Can non-GAPP metrics be used as a CSM, and if so, is reconciliation to GAAP metrics required?

- The CSM to be included in the PVP table must be a financial performance metric but may be a GAAP or a non-GAAP metric. If the CSM is a non-GAAP measure, the company must describe how the number is calculated from the audited financial statements (consistent with the requirement when target levels of non-GAAP financial metrics are disclosed in the CD&A).
- Non-financial measures like number of accounts or ESG-related measures are not allowed in the table, even as an extra measure. Additional tabular disclosure in the footnotes is permitted, but we suggest if it's that important it is included in the CD&A. Non-financial measures may also be included in the additional tabular list of "most important" performance measures (as discussed below).

ADDITIONAL MEASURES LIST

1. What information must be included in the 3-7 supplementary metrics list?

- Companies are required to disclose a tabular list of 3-7 "most important" performance measures used to link compensation to performance. The list may include non-financial measures as well, where three (or fewer, if the company uses fewer than three financial measures) financial measures have already been included on this list. The requirement is to provide only an unranked list of the measures themselves; the target or actual performance achievement levels need not be disclosed. While the rules do not require companies to disclose the reasons these measures are highlighted or any explanation of how the measures relate to executive compensation, it may be helpful to include a brief explanation.

2. Do companies need to incorporate the most important financial metric (Company-Selected Measure) in the 3-7 measures?

- Yes- the Company-Selected Measure included in the PVP table must also be included on the 3-7 supplementary metrics list.

3. How many performance metrics will companies likely include in the additional tabular disclosure?

- While it's hard to know precisely how many metrics companies will disclose and practice is likely to vary, this list should be consistent with what is already disclosed in the CD&A and investor materials. If metrics have been previously communicated and are not included on this list, investors may question why specific metrics were chosen while others were not. Conversely, if metrics are included on this list and not reflected in the CD&A or other investor materials, that's likely to raise questions as well. In addition, several shareholders have indicated they will be particularly focused on what metrics companies include on this list. Consistency with your other messaging around key business metrics/ measures of success will be important.

4. Are companies likely to disclose non-financial metrics, and if so, what sort of non-financial metrics are likely to be disclosed (e.g., ESG metrics)?

- As noted above, while best practice has yet to develop, we expect the list disclosed to be consistent with measures disclosed in the CD&A and investor materials, including non-financial metrics.

5. Can the list include more than seven metrics?

- No, the final rules limit the list to seven metrics. Additional metrics may be referenced in the narrative disclosure or discussed in the CD&A.

POTENTIAL UNINTENDED CONSEQUENCES

Questions have come up regarding scenarios that may give rise to unintended consequences or potentially skewed disclosure, including:

1. Newly public company with NEOs with different vesting schedules (for example, a founder with immediately vested equity and a management team with large grants at IPO with multi-year vesting).

- In this relatively common scenario for newly public, founder-controlled companies, the PVP disclosure for the CEO and the remaining NEOs will be strikingly different, with the CEO's award value remaining consistent from the grant date onward and the equity values of the management team fluctuating significantly as stock price fluctuates (and potentially even resulting in negative compensation values for years such as 2022). In this scenario, companies may wish to include additional narrative disclosure providing context for this disparity.

2. Choosing a Company-Selected Measure for pre-revenue biotech or similar companies.

- Companies such as pre-revenue biotech companies typically do not have compensation programs with incentives that pay out based on financial metrics, as they do not have meaningful financial results.
- Incentives in such cases are largely weighted towards stock options and bonus payouts based on the achievement of clinical milestones. While many of these companies may be either emerging growth companies entirely exempt from PVP requirements or smaller reporting companies exempt from the requirement to provide a Company-Selected Measure, some will not fall into either category and will be required to provide a Company-Selected Measure under the rules.

3

- However, if the company does not use financial performance measures to link compensation "actually paid" to company performance (or uses only measures disclosed in the table), then the company is not required to disclose a Company-Selected Measure but must disclose this fact.
- Alternatively, it's possible that "stock price" as a measure independent from TSR may be included as a "Company-Selected Measure" for companies in this category, subject to additional SEC guidance as to whether the stock price will be viewed as a measure distinct from TSR.

3. More than five NEOs in any given year due to new hires, promotions, retirements or other terminations mid-year.

- Suppose a company has more than five NEOs in any given year due to terminations or retirements mid-year. In that (common) case, the average NEO compensation may be lower relative to other years (given the larger denominator). This may raise questions, particularly if the average compensation is (artificially) lower in one year, and may be an instance where additional narrative or footnote disclosure explaining the factors driving these numbers will be helpful. Note that this may not be the case in the event the departing NEOs receive severance payments or new hires/promotions receive new hire bonuses or equity grants, in which case average pay may instead be higher for years with mid-year NEO departures and hires.

FUTURE OF PVP DISCLOSURE

1. How do we anticipate the PVP disclosure to evolve over the next few years?

- While our perspectives may evolve as other regulations are instituted, and investor and proxy advisor reactions to public disclosures occur, we expect that most 2023 disclosures will adhere to the "letter of the law" and provide little more. Over the next couple of years, we're likely to see key metrics converge by industry and best practices for disclosure emerge, with disclosure practices becoming more uniform. We may also see proxy advisors begin to incorporate disclosure and data into their current (or new) quantitative tests and potentially some additional rule clarifications and evolution. Ultimately, we'd expect to see steady state disclosure expectations emerge from stakeholders and companies, with a regular process in place for capturing and disclosing data readily. ■

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4

SEC Releases Final Rules Regarding Pay-Versus-Performance (PVP) Disclosures

JOHN ELLERMAN, IRA T. KAY, AND MICHAEL KESNER

Executive Summary

The Securities and Exchange Commission (SEC) released its final version of the rules mandated by Dodd-Frank regarding the disclosure of pay versus performance (PVP) on August 25, 2022. Initial rules were proposed in 2015, and follow-up proposals and invitations for comment were extended in late 2021 and early 2022 by the SEC. The SEC PVP disclosure is intended to provide investors with a clear analysis of the alignment of the top executives' compensation actually paid (CAP) with the company's financial and stock price performance. This analysis, while complex, may be viewed by investors as a window into the governance and workings of the company's pay for performance model.

Pay Governance LLC has prepared this Viewpoint with the intent of providing our clients and interested parties with a comprehensive yet clear picture of this new SEC disclosure requirement. This Executive Summary provides a snapshot of the new rules. The sections that follow the Executive Summary provide our interpretation of the SEC rules along with some commentary on the implications of the new disclosure. We want our readers to know, however, that we will be providing additional analysis and recommendations regarding the rules in the weeks ahead as we have time to study the SEC's recommended rules more carefully.

We also encourage SEC-filing companies to begin gathering the data and developing the PVP discussion needed to comply with the new disclosure requirements. There is a great deal of disclosure detail that companies can begin to draft immediately; please refer to the last section of this Viewpoint where we have recommended steps companies can take to initiate this process.

The new rules will become effective for companies with fiscal year disclosures ending on or after December 16, 2022. This means that companies on a calendar year will need to include their PVP disclosures in their 2023 proxies. In the table below, we have provided an overview of the key disclosure requirements and have included the required tabular disclosure mandated by the new rules.

Element	Final Rules
Financial Performance Measures	• Cumulative total shareholder return (TSR) of the subject company and of the company's peer group • Net Income (in accordance with U.S. generally accepted accounting principles [GAAP]) • At least one Company-Selected Measure (must be a financial measure, but does not need to be based on GAAP) • Flexibility to include additional "registrant-selected" financial measures
Disclosure Time Horizon	• The 5 most recently completed fiscal years — initial disclosure will be for 3 years, building to 5 years of data over the subsequent 2 years

Element	Final Rules
Executives	• PEO (CEO) • Average of Non-CEO NEOs
Compensation	1. Total pay as disclosed in the Summary Compensation Table (SCT); and 2. Compensation Actually Paid (CAP), which is based on the SCT amount with adjustments listed below: - Excludes changes in actuarial present value of benefits under defined benefit pension plans but includes current year service cost plus the impact on prior year benefits of any pension plan amendments made during the fiscal year - Replaces the ***grant value*** of equity with 1) the ***fair value*** of equity grants made in the current fiscal year, 2) year-over-year changes in the fair value of prior year awards that either vested in or remained outstanding at the end of the current fiscal year using the vest date or year-end stock price, respectively, and 3) dividends paid on unvested equity awards
Other	• A tabular list of no less than three and no more than seven of the most important performance measures used to determine CAP for the current fiscal year - Must include a minimum of three financial measures - No need to rank order - May include non-financial metrics

Tabular PVP disclosure required by the final rules:

Fiscal Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO NEOs	Average Compensation Actually paid to Non-PEO NEOs	Value of Initial Fixed $100 Investment Based on		Net Income	[Company-Selected Measure]
					Total Shareholder Return	Peer Group Total Shareholder Return		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Year 1								
Year 2								
Year 3								
Year 4								
Year 5								

<u>*Notes:*</u>

PVP table:

- Footnotes are required to state the adjustments (exclusions and additions) made to the summary compensation total to calculate the CAP amount
- Footnotes are also required to list the non-PEO NEOs included in average compensation shown in columns (d) and (e) for each year

Tabular List of the company's "most important" performance measures:

Most Important Performance Measures (3 to 7 metrics w/o ranking)
Measure 1
Measure 2
Measure 3
Measure 4
Measure 5
Measure 6
Measure 7

Background

The SEC's 234-page release of the final rules appears to have carefully considered the often-conflicting comments received from investors, companies, consultants, and other interested parties in 2015 when the rules were first proposed. The final rules also reflect comments made in late 2021 as well as in 2022 when the rules were re-released by the SEC with several questions for comment.[1] The SEC acknowledges that the final rules will be more burdensome to comply with than the original proposal; however, the SEC believes that the additional effort will result in an improved level of accuracy in depicting PVP.

Required Disclosures in Tabular Format

The tabular disclosure required by the final rules is shown in the Executive Summary above. The primary tabular disclosure requires the reporting of the company's compensation, company and peer total shareholder return and company financial performance for the 5 most recently completed fiscal years. The other tabular disclosure is composed of a list of no less than three and not more than seven of the most important performance measures used to determine compensation for the current fiscal year. This list must include at least three financial metrics and may include non-financial metrics.

Compensation

Companies will be required to include total compensation reported in the SCT for the CEO and the average total compensation of the other NEOs, with each amount juxtaposed against the CAP for each of the past 5 years. Importantly, the SCT and CAP amounts are not directly comparable, as the SCT includes 1 year of equity compensation whereas CAP includes the fair value of the current year equity awards and the change in value during the current year of unvested prior year equity awards and awards that vested during the year. Thus, no inference should be drawn between the amount reported in SCT and CAP each year, and it is notable the SEC does not require a comparison of these two columns in the PVP discussion.

Performance Measures

Companies will be required to include four mandated financial performance measures: (1) company cumulative TSR, (2) the peer group's cumulative TSR (market cap-weighted), (3) net income (as reported on a GAAP basis), and (4) a company-selected metric (CSM). The CSM, according to the SEC, should be the metric the company believes is the most important financial metric for determining CAP in the current fiscal year. The company's CSM cannot be TSR or net income, as those metrics are already included in the table, and it must be included in the top three to seven tabular list of most important metrics. The SEC will also allow companies to include additional columns in the table for other financial CSMs they believe are important metrics for evaluating PVP.

The SEC acknowledges that in many cases the CSM may be a non-GAAP metric, and such metrics will require disclosure of a reconciliation to GAAP. The reconciliation disclosure is not likely to be burdensome for most companies because such disclosures are already required for companies using non-GAAP metrics in their earnings releases or incentive plans.

While the SEC requires the inclusion of both the company and peer group TSR in the PVP table (which presumably is intended to provide context on how a company is performing), the PVP table does not include peer company comparisons for net income, CSM, or peer group compensation data, which may leave out important context for fully evaluating PVP.

"Three to Seven" Tabular Disclosure

The SEC disclosure rules require companies to report no less than three financial measures and no more than seven measures, which are the most important metrics used by the company to determine CAP for the current fiscal year. The SEC allows non-financial measures to be included in the list, unlike the primary tabular disclosure, which is limited to financial measures, provided the three financial measure minimum is met. The three to seven list may include TSR or net income (if applicable) in addition to the other metrics. Initially, the SEC wanted the metrics to be presented in ranked order of importance; however, that requirement has been dropped.

Calculating CAP

The disclosure of CAP was mandated by the Dodd-Frank legislation, but Congress left the SEC with significant discretion on how to define it for PVP comparisons. In the chart and discussion below, we have summarized the key components of CAP.

Begin With SCT Total Compensation

−	Pension and equity amounts reported in SCT
+	Pension value attributable to current years' service and any change in pension value attributable to plan amendments made in the current year
+	Fair value of equity compensation granted in current year (valued at year-end)
+	Dividends paid on unvested shares and stock options (SOs)
+/−	Year-over-year change in fair value of prior years' unvested equity or equity that vested during the year or was outstanding at year-end* plus dividends paid on unvested equity
=	**Compensation Actually Paid**

* Change in fair value of prior year unvested awards that vested in current year are valued at vest date

Fair Value of Equity Included in CAP

The amount of equity to be included in the calculation of CAP, according to the SEC, is intended to closely follow the concept of realizable pay.

The final rule requires that equity granted during the year be valued at year-end. In addition, year-over-year changes in the value of unvested equity granted in previous years are to be included in the calculation of CAP based on the year-end fair value or vesting date value if such vesting occurs during the year. Forfeitures of awards are included in the fair value calculation. This fair value requirement allows companies to report the value of equity at year-end, which corresponds to the stock price used in calculating TSR and is generally aligned with the current year financial measures.

The following table provides an illustration of how the equity fair values are calculated. While not required by the SEC, it could be useful to include such a table in the PVP footnotes to help explain how the equity component of CAP was determined (in the same way perquisites and benefits are disclosed as a footnote to the Other Compensation column of the SCT). The example assumes a company grants 50% performance shares (PSUs), 25% stock options (SOs), and 25%-time vested restricted stock units (RSUs). The PSUs cliff-vest on the third anniversary of the grant date, whereas the SOs and RSUs vest ratably over the 3 years following the grant date. Performance criteria for the PSUs include 50% weighting based on relative TSR and 50% weighting based on cumulative operating income over the 3-year measurement period.

Determining Equity Component of CAP

	Fair Value of Current Year Equity Awards at 12/31/2022	Change in Value of Prior Years; Awards Unvested at 12/31/2022	Change in Value of Prior Years' Awards That Vested in Current Fiscal Year	Equity Value Included in CAP Amount
	(a)	(b)	(c)	(d) = (a) + (b) + (c)
PSUs	$5.0	$0.7	$1.0	$6.7
SOs	2.5	0.5	0.1	3.1
RSUs	2.5	0.4	0.1	3.0
Total	**$10.0**	**$1.6**	**$1.2**	**$12.8**

In the year of grant, each award is valued at year-end based on the valuation principles set forth in ASC 718 (column a). Thus, the PSUs that are linked to relative TSR will need to be valued using a Monte Carlo simulation with updated valuation assumptions, including the year-end stock price. The PSUs tied to the cumulative operating income metric will be valued based on year-end stock price and an updated assumption regarding the probability of such awards vesting. The SOs will be valued based on an updated Black Scholes or binomial model calculation based upon updated valuation assumptions (including the use of year-end stock price). The RSUs will be updated for the year-end stock price. It is understood that accrued dividends on such awards will also be included in the fair value calculation.

In addition, awards granted in prior years that remain unvested at year-end will be re-valued, and the increase or decrease in the fair value will need to be accounted for if such awards will be included in the current year CAP amount (column b).

Finally, awards that have vested (or are forfeited) during the current fiscal year will be valued as of their vesting date, and any increase or decrease from the prior year value will be included in the current year CAP (column c).

The sum of these components represents the equity value included in the CAP amount (column d).

Dividends Paid on Unvested Shares

The SEC also requires that dividends paid on unvested shares or SOs also be included in the CAP amount. As previously noted, accrued dividends are already included in the CAP amount.

Pension Amount to be Included in CAP

The SEC requires (1) "the actuarially determined service cost for services rendered by the executive during the applicable year" (the "service cost") and (2) that the entire cost of benefits granted in a plan amendment during the covered fiscal year be included in CAP for the CEO and other NEOs. According to the SEC, these amounts are calculated each year for financial statement purposes and will not require significant effort to obtain the required information for the PVP table.

Executives Included in the PVP Table

The new SEC disclosure rules require the company to report SCT total compensation and CAP values for both the CEO and the average of the other NEOs included in the SCT. For some companies, these executives may change frequently, and the SEC requires that the SCT and CAP amounts included in the PVP table reflect the executives listed for that year's proxy.

In the case of two CEOs in a particular year, the SEC requires companies report each CEO's SCT compensation and CAP separately by adding additional columns to the table for each CEO. This is not permitted in the case of two CFOs or terminated executives that are included in the SCT, as the amount reported for other NEOs is based on the average of the reported NEO executives.

Calculation of TSR Values

The SEC specifies in the new rules that companies should report cumulative TSR in the same manner as required in Item 201(e) of Regulation S-K. Item 201(e) requires companies to assume an initial $100 investment in a company's stock at the beginning of the disclosure period and to report the value at the end of each year based on stock price and the reinvestment of dividends in the company's stock.

In transitioning to the new rules during the first year, the SEC requires companies to report 3 years of cumulative TSR as follows:

- 2022 cumulative TSR based on 2020-2022 results
- 2021 cumulative TSR based on 2020-2021 results
- 2020 cumulative TSR based on 2020 results

The 2023 and 2024 cumulative results will be added in subsequent years' tables as follows:

- 2023 cumulative TSR based on 2020-2023 results
- 2024 cumulative TSR based on 2020-2024 results

Beginning in 2025 and every year thereafter, the cumulative TSR calculation will be reset each year, which may create comparability issues. For example, the cumulative TSR calculation for the 2025 fiscal year will assume that $100 was invested at the beginning of 2021 and will require that cumulative TSR be recalculated for 2021-2024 assuming 2021 is the base year (versus carrying over the cumulative TSR calculations for 2021-2024 from the prior year proxy statement). The changes in cumulative TSR will likely require additional explanation, as one year's PVP table may show compensation that is fully aligned while a subsequent year may imply a lack of alignment because of the reset in the starting date for calculating cumulative TSR.

Peer Group TSR Calculations

The SEC will allow companies to use the peer group reported in the Item 201(e) disclosure or a peer group disclosed in the CD&A that is used for "compensation benchmarking purposes." Item 201(e) requires the use of a published industry or line of business index. In addition, Item 201(e) also allows companies to use a company-selected peer group.

Although not entirely clear, we believe the final rules allow a company that discloses a relative TSR peer group in the CD&A to use that peer group in the PVP table. However, the peers' TSR must be market cap-weighted when included in the PVP table.

Additionally, the SEC also requires that if the peer group or industry/business index group used to determine TSR changes between years, the company must provide an explanation for the change and provide a side-by-side comparison of TSR for the two peer sets over the applicable measurement period.

Additional Reporting and Disclosure Items

Companies will be required to explain the relationship between the CAP for the CEO and the average CAP of the other NEOs with respect to each of the performance metrics included in the PVP table (i.e., TSR, Net Income, and the designated CSM). In addition, companies must explain the relationship of the company's TSR to its peers. This disclosure may be reported in a narrative or graphical format or a combination of the two.

Footnotes to the PVP table are required that identify the adjustments (exclusions and additions) to the SCT compensation amounts used to calculate CAP and the names of the other NEOs for each fiscal year.

Placing the PVP Disclosure Section in the Proxy

The SEC allow companies to include the PVP disclosure anywhere in the proxy. The SEC received several comments recommending this disclosure be integrated into the CD&A but decided against it because such placement "may cause confusion by suggesting that the registrant considered pay-versus-performance relationships in compensation decisions, which may or may not be the case." The PVP disclosure must be tagged in inline XBRL, which — according to the SEC — will make the information easy to locate for small and large investors alike.

Special Exemptions and Rules Applicable to Selected Companies

Special rules are applicable to Smaller Reporting Companies, Emerging Growth Companies, foreign private issuers, registered investment companies, and companies that have recently gone public. With respect to Smaller Reporting Companies, they will only be required to disclose 3 years of data (2 years in the initial filing year). Additionally, such companies will not be required to report peer group TSR data, a CSM or list the three to seven most important performance measures. Emerging Growth Companies, foreign private issuers, and registered investment companies are exempt from all PVP disclosure requirements. Companies that have gone public recently are only required to report information for those years in which they were public entities.

Pay Governance's Recommended Next Steps

In order to get a head-start on this extensive new disclosure requirement, companies may wish to consider some of the following activities:

1. Begin compiling the cumulative TSR and CAP data for 2020 and 2021, as these amounts can be calculated now and are not dependent on 2022 year-end stock prices or equity awards granted or vested in 2022;
2. Estimate the 2022 cumulative TSR and CAP data and prepare a proforma PVP table;
3. Start analyzing the three to seven performance metrics that are driving pay outcomes for 2022 and identify from the list which metric(s) would be appropriate for inclusion as the CSM(s);
4. Determine which peer group to use for TSR comparisons in the PVP table and evaluate the correlation of the company's TSR with alternative indices/peer groups; and

5. Begin work with the pension actuary regarding the retirement amounts to be included in the PVP table CAP amounts for 2020 and 2021 from both qualified and non-qualified retirement plans.

In preparing initial drafts of the PVP table and the accompanying narrative it may become clear that the CAP calculations and PVP table do not adequately capture the company's pay for performance story. In these instances, it may be useful to consider a supplemental discussion to the PVP disclosure that presents an analysis of realizable pay and reporting of 3-year and 5-year performance and TSR data relative to peers.

Over the course of the next several weeks, Pay Governance will devote more time to studying and analyzing the new SEC disclosure rules. We will communicate with you by providing additional Viewpoints sharing our findings, conclusions, and recommendations.

General questions about this Viewpoint can be directed to John Ellerman (john.ellerman@paygovernance.com), Ira Kay (ira.kay@paygovernance.com), or Mike Kesner (mike.kesner@paygovernance.com).

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[1] Pay Governance submitted comments in both 2015 and 2022, primarily about the definition of CAP and misalignment of the original timing of the CAP and performance periods. The SEC does reference our and other comment letters numerous times. The SEC acknowledges that the new definition of CAP was influenced by the comment letters.

SEC Finalizes New Clawback Rules

MIKE KESNER AND LANE RINGLEE

Introduction and Background

On October 26, 2022, the Securities and Exchange Commission (SEC) adopted the final rule requiring that all listed companies adopt and disclose a clawback policy as required under Dodd-Frank. These final rules follow the SEC's issuance of proposed rules in July 2015, which laid dormant until the re-opening of two separate comment periods in October 2021 and June 2022.

The new clawback rule requires that a listed company adopt and disclose a policy for the recoupment of incentive compensation from its current and former executive officers in the event the company is required to prepare "an accounting restatement due to material noncompliance" under the securities law (colloquially referred to as a "clawback" policy).

The final rule also requires national exchanges to prohibit the listing of any security of an issuer that does not develop and implement a clawback policy that complies with the new rule.

Recap of the Final Rules

The key provisions of the final clawback rules include the following:

Area	Regulation
Covered Group	• Applicable to current *and* former executive officers (Sec. 16 definition) who received incentive-based compensation during the three fiscal years preceding the date of the restatement • Newly appointed executive officers are not subject to clawback for prior periods (this is a modification from the proposed rules)
Triggers	• Restatements that correct errors that are material to previously issued financial statements ("big R" restatements), or • Restatements that correct errors that are not material to previously issued financial statements but would result in a material misstatement if (i) the errors were left uncorrected in the current report or (ii) the error correction was recognized in the current period ("little r" restatements) — Excludes "out of period" adjustments (corrections of immaterial errors recorded in the current period) — Excludes revisions due to internal reorganizations impacting reportable segment disclosures or changes in capital structure (e.g., stock splits, stock dividends, etc.)

Area	Regulation
No Fault	• The recovery of compensation must be made on a "no fault" basis, without regard to whether any misconduct occurred or an executive officer's responsibility for the misstated financial statements
Recovered Amount	• The amount of the recovered incentive compensation, calculated on a pre-tax basis, is the amount that exceeds what the executive officer would have received based on the restated financial statements • In the case of incentive compensation that was based on total shareholder return (TSR) or stock price, companies may use "reasonable estimates" to determine the impact of the restatement on TSR or stock price to determine the recoverable amount — This calculation must be filed with the applicable exchange • The rules do not require a clawback if it is determined by the Compensation Committee or Board of Directors to be impracticable. The SEC defines impracticable to be *situations where the direct cost of hiring a third-party, such as a lawyer of consultant would exceed the amount to be recovered or if the recovery would violate home country law* — To avail itself of this exception, a company must make a good faith attempt to recover the erroneous compensation and document the cost of recovery — In the case of a violation of home country law, the company must obtain a legal opinion from counsel that a recovery is impermissible under local law
Definition of Incentive Pay	• Incentive-based compensation is defined as *any compensation that is granted, earned, or vested based upon the attainment of a financial reporting measure used in the Company's financial statements or non-GAAP measures, metrics, and ratios, plus stock price and total shareholder return (TSR)* • The final rules do not apply to time vested stock options, time vested restricted stock/units, base salaries, tax qualified retirement plans, or discretionary/subjective bonuses not linked to attainment of financial measures, including bonuses tied to operational/strategic measures — We suggest companies review the representative list of operational and strategic measures provided by the SEC in the final rule to evaluate which of its existing financial measures might be subject to clawback (e.g., an increase in same store sales is considered a financial metric, whereas an increase in store openings is considered an operational metric)
Disclosure Requirements	• **Policy**: Must be disclosed as an exhibit to an issuer's annual 10-K • **Execution**: Companies are required to disclose in the proxy: — Date required to prepare the accounting restatement; — Aggregate dollar amount of clawback and analysis of how the amount was calculated; — Aggregate amount that remains unrecovered at the end of the current fiscal year;

Area	Regulation
	— If the clawback is attributable to incentive compensation based on stock price or TSR, the estimates used to calculate the clawback amount and methodology used; and — Amounts owed by each executive officer that is outstanding more that 180 days or longer • The SEC allows aggregate disclosure for executive officers who were not NEOs to protect their privacy • Disclosure of recovered amounts will be in a new column on the Summary Compensation Table and reduce the "total" and applicable column (e.g., non-equity incentive plan) amounts • **Checkbox:** in addition to the above disclosure, the 10-K must include two new checkboxes on the face of the 10-K — One checkbox indicates whether prior year period financial statements included in the filing have been restated — The other checkbox indicates if a restatement triggered a clawback during the current fiscal year
Board/Committee Discretion	• **Limited discretion:** Issuers must recover incentive compensation unless the recovery is determined by the Compensation Committee (or independent Board members if there is no Compensation Committee) to be impractical (as discussed above); Boards do have discretion as to the means of recovery (e.g., setting up a deferred payment plan for recovered amounts), but are required to act promptly
Indemnification Prohibition	• Indemnification of executive officers against the loss of incentive compensation is prohibited • Companies are also prohibited from reimbursing executives for premiums paid for third-party insurance
Lookback Period	• Lookback period starts on the date the issuer (board, committee, or management) concludes that a restatement is required (or should have known a restatement was required) or a regulator, court or other legally authorized entity determines a restatement is required by the issuer
Effective Date	• The stock exchanges have 90 days after the final rule is published to update their listing standards to include the clawback policy requirement. The listing standard must be effective no later than one-year following the publication date in the Federal Register. Companies will be allowed a 60-day grace period to adopt a clawback policy following the effective date established by the applicable exchange • **Transition Period:** The final rules provide that each company is required to comply with the recovery policy for all incentive-based compensation (i) received or (ii) granted, earned, or vested by current or former executive officers on or after the effective date of the applicable listing standard (as opposed to the effective date of the rule). Compensation agreements entered prior to the effective date are not grandfathered

SEC Clawback Rules-Implications and Considerations

Companies will need to adopt new or review and amend existing clawback policies, to comply with the new rules. Some of the changes might require:

- The inclusion of all active and former executive officers — not just the executive officer(s) whose misconduct led to the restatement;
- The removal of Compensation Committee or Board discretion to pursue a clawback (unless the "impractical to do so" exemption applies) or determine the amount of clawback;
- The inclusion of "little r" restatements as a clawback trigger; or
- The adjustment of clawback trigger to ensure the policy would recover compensation regardless of fault or misconduct leading to a restatement.

This may also be a good opportunity to evaluate other aspects of existing clawback policies including whether (i) the clawback triggers should include misconduct, material violation of the company's code of conduct, or action/inactions that led to significant reputational damage to the company or (ii) an expansion of incentive plan participants that would be subject to some or all the clawback triggers. For example, non-executives could be subject to the clawback trigger for a material violation of the company's code of conduct, but not a restatement.

In addition, a recent Department of Justice (DOJ) memorandum on corporate criminal enforcement indicates one of the factors it will consider in evaluating remediation and the effectiveness of compliance programs will include whether compensation systems that are designed to deter and penalize misconduct and reward compliance, (i.e., clawbacks) are implemented. Thus, the inclusion of a general misconduct trigger in a clawback policy might help mitigate DOJ penalties and other actions.

A copy of the final SEC rule can be found **here**.

General questions about this Viewpoint can be directed to Mike Kesner (mike.kesner@paygovernance.com) or Lane Ringlee (lane.ringlee@paygovernance.com),

WorldatWork

SEC Adopts Executive Compensation Clawback Rules

OCT 28, 2022

On Oct. 26, the US Securities and Exchange Commission (SEC) voted to adopt new rules requiring securities exchanges to adopt listing standards that require issuers to develop and implement a policy to recover erroneously awarded incentive-based compensation received by current or former executive officers. According to reports, the clawback requirements are meant to hold corporate leaders accountable for the errors, whether they're the result of fraud or simply mistakes.

Although many companies have had some sort of clawback policy in place, one of the biggest changes with the new rules will be what will trigger the clawbacks. For example, the SEC asked whether the clawback policy should be applied to both "Big R" and "little r" restatements.

According to Cooley PubCo, "Big R" restatements "correct errors that are material to previously issued financial statements," while "little r" restatements "correct errors that are not material to previously issued financial statements but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period."

"By expanding the scope of these triggers, the SEC could potentially be turning 'little r' things to 'Big R,'" said Deb Lifshey (https://www.pearlmeyer.com/meet-our-team/deb-lifshey), managing director at executive compensation consultancy Pearl Meyer.

The good news for companies is that they have time to refine their clawback policy. Lifshey recommends companies start figuring out and planning for their policy at the start of 2023. Communication will play a big part in that strategy, Lifshey said, because the plan applies to compensation from current or former executives that was paid during the three years before the time that a restatement was required.

"A lot of work needs to take place," Lifshey said. "Once these rules are published, the clock starts ticking."

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The Softening Economy and Incentive Design: A Compensation Committee Top Concern

ADVISOR BLOG
FEBRUARY 2023

Many compensation committees have labored lately over incentive plan design for the obvious reason: Will the economy soften or even enter a recession this year, and how might that impact business? They are also pondering how this year is different from the past two years when the COVID and post-COVID environments created havoc with incentive plan design and goal-setting.

The answer is that, although similar in upheaval, we may have a tougher hill to climb. Institutional investors will be less tolerant of modest financial forecasts accounting for potential supply chain problems, labor and part shortages, factory shutdowns, inflation, and other factors that may impact a company's performance in 2023. Investors may feel companies have had several years to deal with these COVID-related issues, and that reliable forecasting and more dependable performance should once again be the norm.

Compensation committees can combine two tools to help create effective incentive designs in an uncertain economy: Creative goal-setting approaches and the liberal use of discretion.

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Goal-Setting

My colleague Matt Turner recently wrote a blog, "Small Steps to Mitigate Risk and Create Resilience in Executive Compensation Goals," where he outlines several tactics enhancing the goal-setting process:

- **Get Profit and Growth Forecasts as Right as Possible:** Understand and take into account industry and peer performance and shareholder expectations when setting forecasts.
- **Control Volatility with Incentive Plan Metrics Collars:** Collar interest rate swings, price shocks from supply chain disruptions, exchange rates, and other significant factors that may impact your financial results to avoid extreme outcomes. Management should not be unduly enriched or punished for highly uncontrollable results. Limit your adjustments to the annual incentive plan with no adjustments in the long-term plan to provide a balance.
- **Widen Incentive Plan Performance Ranges:** If the committee typically sets ranges of plus or minus 10 or 20 percent around the target, the range may need to be 30 percent or more to manage more unpredictable outcomes.
- **Use More Time-Vested Equity:** A well-designed incentive plan has a retentive effect, and in volatile times, the long-term incentive plan may need to weight time-vested equity more. We've seen companies make this change over the past few years. Shareholders and proxy advisory firms, in particular, may object. Still, senior executive turnover can be highly disruptive and impact financial performance more than a poor goal-setting approach in a wavering economy.

Financial Results Adjustments

Most committees and boards include or exclude certain items in the financial results used to determine incentive plan funding and award levels. Consider reviewing and modifying the criteria used to make these adjustments to account for changes in your business plans or strategies in an uncertain economy. Sometimes, the committee may not have written guidance covering potential financial adjustments. It is always a good idea to draft a statement with a list of potential adjustments, realizing a company can never anticipate all possible adjustments. Still, the committee and management team should discuss potential changes early in the year to avoid acrimonious year-end discussions.

Using Discretion in Tandem with a Modified Goal-Setting Approach

Compensation committees can use discretion in many ways. And discretion means encouraging the committee to exercise judgment more often, if needed, to get the right result. Combining effective goal-setting techniques with liberal use of judgment, when needed, is a powerful incentive plan design tool.

Allow for Greater Use of Discretion

Many annual incentive plans include non-financial goals. Consider including more strategic or individual goals allowing the committee to use judgment to assess performance against goals more freely. Some goals or situations that can benefit from exercising judgment include:

- Milestone goals in the annual or long-term incentive plan where progress on or the attainment of the goal is not completely measurable;

- Critical ESG goals in the incentive even if goal-setting is hampered by a lack of historic data;
- Progress on diversity, equity, and inclusion;
- Goals supporting the movement of a company's portfolio of companies from an industrial concentration to a tech orientation; and/or
- Identifying and developing the next generation of leaders.

Increase the Non-financial Goal Weight

It is not uncommon for an incentive plan to include non-financial goals with a 20% weight but there is nothing magic about this percentage. A plan could include a 30, 40, or 50% non-financial goal weight with the understanding the 40 and 50% weights are far less common. Still, this design gives committees the ability to exercise more judgment when discussing performance.

Do Shareholders and Proxy Advisor Firms Really Frown Upon Using Discretion?

The answer is clearly no, but they get cautious and skeptical if a company does not explain the factors they took into account in assessing performance using discretion. A company must disclose in the CD&A, in as much plain-English detail as possible, the factors the committee considered when evaluating performance.

Proxy advisory firms consistently ding companies for inadequate explanations when committees apply judgment. And shareholders may question why a company's incentive awards were substantial in an otherwise weak financial year. Conversely, a well-written CD&A in plain English will address many questions shareholders and proxy advisory firms will have in understanding the relationship between award levels and performance and how committees used discretion to align pay and performance.

Although committees should not constantly change plan designs or incorporate too much judgment in assessing performance, these goal-setting techniques with enhanced discretion can help committees maintain effective incentive designs that motivate, incent, and retain talent in uncertain times.

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SEMLER BROSSY

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ESG & Human Capital Management

Design Thoughtful Scorecards for ESG Measures in Incentive Plans

FEBRUARY 2023

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Rachel Ki

Organizations are facing increasing pressure to consider whether environmental, social and governance (ESG) and human capital management (HCM) have a place in their compensation programs.

Semler Brossy's "2022 ESG + Incentives Report" found that 70% of the S&P 500 companies already have ESG and HCM metrics in their incentive program, a 23% increase from last year. Despite the rising external pressure, companies need to first identify top ESG and HCM priorities that are material to the overall strategy and establish a set of performance goals for these priorities.

For companies that are early in their ESG and HCM journey and considering a link to incentives, a scorecard may be a good starting point to help address some of the issues that come along with setting ESG and HCM goals. The structure of a scorecard provides flexibility to measure and assess various priorities while motivating shared accountability across a group of individuals.

A scorecard design can help mitigate the challenges that are associated with goal setting — it's a portfolio of financial and/or strategic objectives, including ESG and HCM goals, that are often unweighted. As there is typically a breadth of ESG and HCM priorities within a single company, the scorecard approach allows the flexibility to assess more than one priority at a time (versus having to choose just one or two metrics for a weighted metric design).

Furthermore, scorecards are typically shared across the executive leadership team, emphasizing shared contributions to priorities critical to the company.

Once these critical steps have been completed, companies can then explore whether ESG has a role in incentives and, if so, be thoughtful about incentive structure and design as well as goal setting.

Key Takeaways

CHALLENGES ARE PRESENT IN INCENTIVE DESIGN. While more companies are adding ESG metrics into incentive programs, doing so can present some challenges (e.g., balance with other priorities, durability over time, calibration and goal rigor, etc.).

SCORECARDS CAN ALLEVIATE SOME OF THESE CHALLENGES. The scorecard approach for ESG-linked compensation can mitigate some of those challenges.

ESTABLISH AND STICK TO GUIDING PRINCIPLES. Companies will want to keep in mind a set of principles as they think through how to structure an effective scorecard for ESG incentives.

A VALUABLE STARTING TOOL IN ESG INCENTIVE DESIGN. When thoughtfully designed, the flexibility built into a scorecard structure may be particularly valuable for newer companies in their journey of ESG and HCM within incentives.

Setting incentive plan goals for ESG and HCM metrics can be particularly challenging to get right for any company. If set incorrectly, targets can be achieved while still missing the mark on broader progress toward a company's ESG and HCM strategy. For example, representation goals lend themselves to quantitative measurement, which can be achieved without advancing the broader goals of inclusion and equity — especially in the short term.

On another front, goals may be difficult to quantify and measure reliably, particularly for sustainability and emissions metrics. Even if quantitative goals are available, it may not be clear which metrics should be prioritized given the limited real estate in incentive plans.

Potential Pitfalls of Setting ESG Goals

Once a company decides to incorporate ESG and HCM into its incentive program, it must be cognizant of the potential pitfalls and consider the differences between ESG and HCM metrics and traditional operational and financial goals when setting ESG and HCM goals.

- **Balance with other priorities.** Placing an ESG and HCM metric in your plan could signal importance to both participants and external audiences over other priorities that are not included in the incentive program. The company will want to ensure the incentive program appropriately balances various business and strategic priorities more broadly.
- **Durability over time.** Companies will need to ensure that ESG and HCM goals can withstand shifts in strategy in the near- to mid-term and won't be irrelevant in the event companies need to pivot. For example, a change in strategy may necessitate a hiring strategy shift (such as expanding hiring in one part of the world over another), which would create significant headwinds on a representation goal.
- **Calibration and goal rigor.** With any metric, companies should ensure that the goals are appropriately stretched and allow for meaningful progress while being realistically attainable with the available resources. Investors are also asking companies to raise the bar on their disclosures and transparency regarding the rigor of their goals. However, it can be difficult for companies to pressure-test on the front end given the

asymmetrical visibility of the compensation committee with goal setting and the absence of external audit standards that ensure consistency. Companies will also need to consider how to calibrate the upside and downside leverage of ESG and HCM metrics. Given the broader nature of ESG and HCM goals, there is a question of whether to allow for above-target payouts just for doing the right thing.

- **Consistency with communications.** Companies should ensure that the incentive goals are aligned with prior or go-forward internal and external communications.
- **Internal and external context.** Consider other company actions throughout the year that may impact how the compensation committee might assess the performance of the ESG and HCM goals. For example, even though greenhouse gas emissions targets for the year may be on target, a major environmental event caused by the company may eclipse that achievement, increasing the importance of allowing committees the ability to interpret results and exercise discretion.

How to Structure a Scorecard

Scorecards allow companies to establish objective targets, but the compensation committee has the flexibility to evaluate performance against those targets at year-end and assign a payout commensurate with the overall performance (versus having rigid performance curves).

When thinking about how to structure an effective scorecard, these are some principles to keep in mind (Table 1).

Most companies in the earlier stages of their ESG and HCM journey will choose to incorporate other operational and strategic priorities beyond ESG and HCM within the scorecard to ensure balance in performance measurement. However, as the ESG and HCM journey becomes more mature or in cases where ESG and HCM are viewed as a critical strategic edge, some companies have chosen to move towards scorecards that contain ESG and HCM priorities only.

Table 1: Scorecard.

Consider the balance between the full range of strategic priorities, including but not limited to ESG and HCM	**Include a limited number of measures (e.g. three to four priorities) to avoid diluting influence to incentive program outcomes**	**Establish specific definitions of success required to achieve a payout upfront and have a rigorous assessment process at year-end**	**Allow for some level of discretion to account for shifts in the business of strategic context and to balance trade-offs made during the year**	**Represent a meaningful enough portion of the incentive to adequately motivate executives, while being balanced against financial priorities**

We've provided a couple of company examples below:

BOSTON SCIENTIFIC ANNUAL INCENTIVE PROGRAM

45% Adj. Net Sales	40% Adj. EPS	15% HCM Scorecard

0.0X-1.5X Individual Modifier

15% weighted metric based on diversity and inclusion, employee engagement and retention, and environmental goals (each area weighted 5% for a total of 15%).

COMCAST ANNUAL INCENTIVE PROGRAM

70% Financial	• Adjusted EBITDA (35%) • Free Cash Flow (28%) • Revenue (7%)
15% Operational Scorecard	• Customer Experience • Product Churn • Platform Growth • Organizational Collaboration
15% Stakeholder and Sustainability Initiatives	• Bridging the Digital Divide • Diversity, Equity and Inclusion • Environmental Sustainability • Culture

15% weighted Stakeholder and Sustainability scorecard. Discretionary component that measures four specific areas including providing digital access to underserved communities, DE&I, sustainability/emissions, and workplace culture.

Implementing ESG and HCM measures into incentive plan performance measurement can come with much complexity, especially regarding goal setting. When thoughtfully designed, the flexibility built into a scorecard structure may be particularly valuable for newer companies in their journey of ESG and HCM within incentives.

In light of recent SEC news, companies may also consider adding ESG and HCM measures to their pay versus performance disclosure, providing another avenue for companies to feature ESG and HCM priorities more prominently. ■

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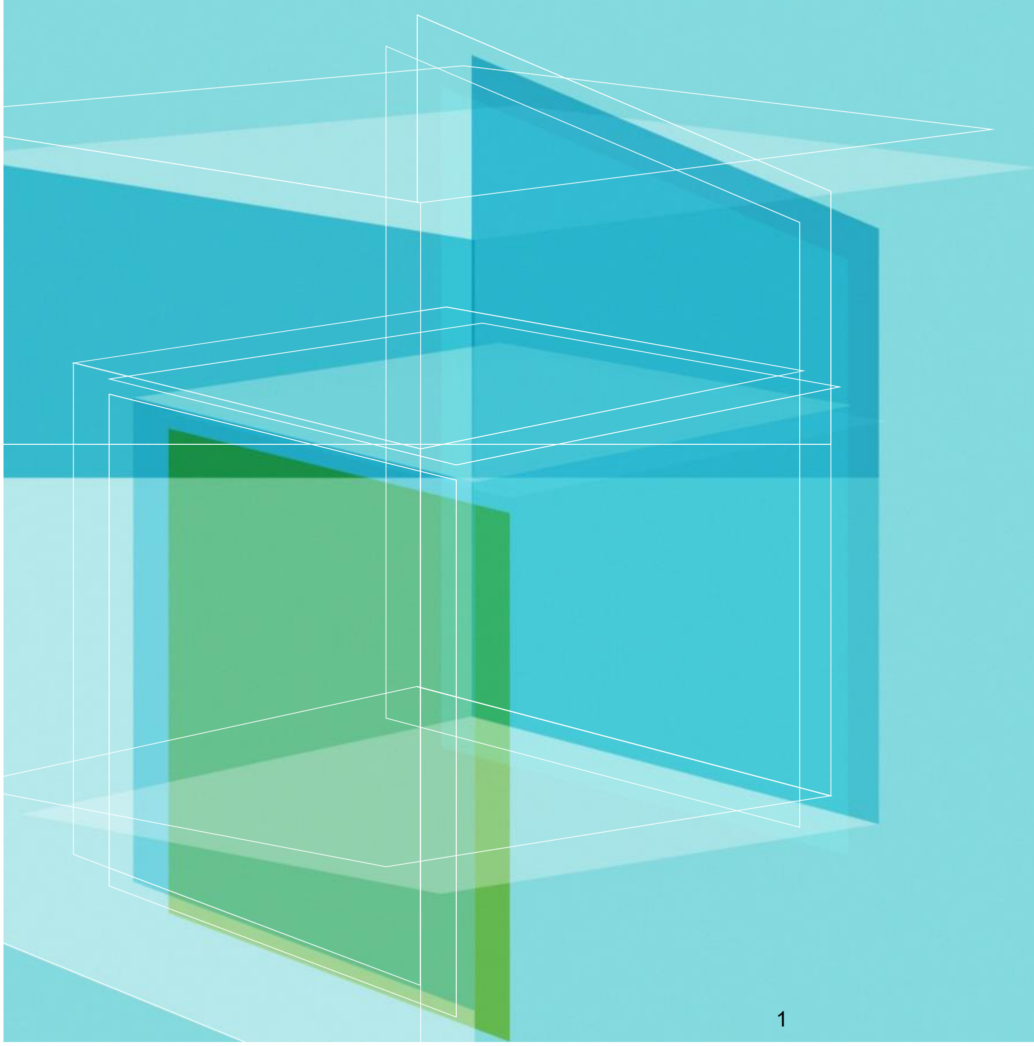
ESG+INCENTIVES

S&P 500

2022 REPORT

IN THIS ISSUE



INDUSTRY ASSESSMENT

As external pressures to adopt ESG metrics strengthen, it remains imperative that ESG metrics in incentive plans reinforce material business priorities. We continue to urge caution in adopting measures for incentives in response to external pressures that do not align with key business opportunities and risks. Our second ESG + Incentives Report of the year finds that ESG metric prevalence varies by industry and generally aligns with our expectations of key industry priorities.

SUMMARY OF SAMPLE

- S&P 500 COMPANIES
- $29B MEDIAN MARKET CAP

ESG IN COMPENSATION – TOP INDUSTRIES BY PREVALENCE

Energy: 100%

Utilities: 96%

Materials/Real Estate: 86%

KEY TAKEAWAYS

Our ESG + Incentives Report finds that ESG metrics by Industry are often aligned with key business priorities. Findings are largely consistent with our Industry report last year, and include:

- Energy, Utilities, Materials, and Real Estate companies have the highest prevalence of ESG metrics in incentives. They are the top four industries that incorporate environmental metrics and among the top five industries that have adopted HCM metrics
- Diversity & Inclusion metrics rank as a top 3 metric by prevalence in 10 out of 11 industries
- Carbon Footprint is the only environmental metric represented in all 11 industries (increase from 9 industries last year)

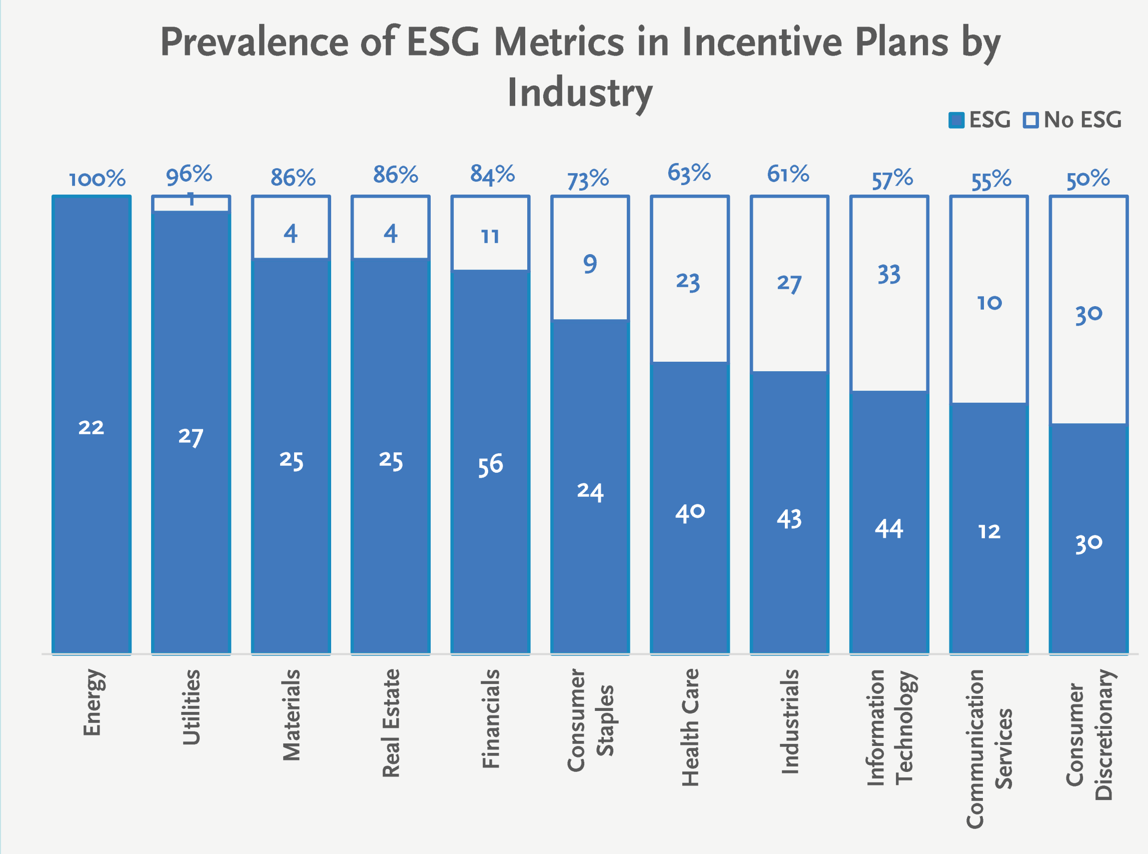
Three of the four industries with the highest percent prevalence of ESG metrics are "heavy industries" with significant environmental footprint and employee safety challenges relevant to their business plans. Although Safety is not the only human capital-related metric for these industries, it is the most prominent. These findings are consistent with last years' industry report.

Real Estate and Financials also have a high prevalence of companies with ESG metrics, with Financials being the industry with the largest number of companies using ESG metrics across our sample. This reflects the importance placed on talent in these industries, with prominent measures related to talent development and employee satisfaction.

The largest year-over-year increase in ESG metrics occurred in the Consumer Discretionary industry (+74%); however, this industry continues to have the lowest overall prevalence, consistent with last year. We expect that this increase in prevalence may have been driven by investor and stakeholder pressures for companies within this industry to keep pace with the broader S&P 500.

Prevalence of ESG Metrics in Incentive Plans by Industry Sector
(N=500)

Number of all S&P 500 who have vs. have not adopted ESG metrics by Industry Sector



65%

PREVALENCE OF S&P 500 COMPANIES WITH HCM METRICS

– Company Culture
– Diversity & Inclusion (D&I)
– Employee Satisfaction
– Talent Development
– Turnover/Retention
– Safety

Consistent with last year's report, we see specific metric types show up more frequently in industries where these metrics align with the business dynamics of each industry. We delve into these patterns below, with full details on prevalence within each industry provided on the final pages of the report.

HUMAN CAPITAL MANAGEMENT (HCM) METRICS

At least half of all companies in each industry include an HCM metric in their incentives. **Diversity and Inclusion (D&I)** remains the most prevalent metric across industries, ranking as the first or second most prevalent ESG metric across nearly all industry sectors.

Strong competition for talent over the last few years has led to HCM challenges across all industries. We expected to see the most talent-dependent and service-oriented industries leading prevalence statistics for HCM metrics (excluding safety) because companies within these intellectual capital-oriented industries have been the most severely impacted by HCM challenges.

This hypothesis held true for the **Financials and Real Estate industries**, which both saw large year-over-year increases and are currently leading in prevalence for most HCM metrics. However, this trend did not carry through to **Information Technology**, where metrics related to talent were found at only slightly more than half of the companies in the industry. We expect that this may be driven, at least in part, by the diverse nature of Information Technology companies within the S&P 500. This group includes both mature technology companies and early-stage, high-growth companies. Past experience has shown that these younger companies have more of a 'start up' culture and tend to focus less on ESG in incentives, and sometimes even ESG more broadly, at this stage in their lifecycles.

The low relative prevalence of HCM metrics in **Consumer Discretionary** seems harder to explain but may reflect a high proportion of consumer services (e.g., retail, restaurants, and hotels) in this sector, which may place a lower emphasis on HCM given higher relative turnover.

Finally, we expected to see the highest prevalence of **Safety** metrics in the natural resource-oriented industries as these industries generally have the highest concentration of jobs with higher operational risks. This finding held true for **Energy, Utilities, and Materials** continuing with the trends we saw last year.

23%

PREVALENCE OF S&P 500 COMPANIES WITH ENVIRONMENTAL METRICS

– Carbon Footprint
– Emissions/Chemical Containment
– Energy Efficiency
– Sustainable Sourcing
– Waste Reduction
– Water Consumption

ENVIRONMENTAL METRICS

Energy, Utilities, and Materials are the three industries with the highest prevalence of environmental metrics in incentives, which intuitively tracks with historical external focus on environmental impacts of fossil fuels, oil/chemical spills, etc. Over 50% of the companies in the Energy and Utilities industries (and nearly 50% of Materials) include environmental metrics, which stands in stark contrast to HCM metrics, which are represented in over 50% of companies across all industries. Conversely, environmental metrics are the least common in the **Information Technology** and **Consumer Discretionary** industries and continue to have relatively low prevalence in other industries, despite environmental impact (e.g., waste reduction, single-use plastic, etc.) emerging as an area of concern across industries. The limited use of such metrics in incentive plans for these other industries may reflect a sense that there is less of a direct link between business performance or risk for these companies than there is for companies with a more direct impact on the environment.

Carbon Footprint is the most prevalent environmental metric and is included as a compensation metric among over half of **Energy** companies and over 15% of **Utilities, Materials, Communication Services, and Real Estate** companies. This is a significant jump compared to last year, when Energy was the only industry with Carbon Footprint at >15% prevalence. Carbon Footprint is widening its scope of importance across industries, as shown by its inclusion in metrics across all 11 industries (no other environmental metric is represented across all industries).

Emissions/Chemical Containment is a frequent metric within the **Energy, Utilities, and Materials** industries. Among these industries, spills and similar hazards are more common and can lead to hefty fines from regulators. Beyond these industries, chemical containment is not a frequent business risk, so we do not expect this metric to spread dramatically to other industries in the future.

The **Utilities** industry has the highest prevalence of energy efficiency metrics, given the demand for renewable energy and efficient energy practices in the industry as the world shifts towards a more sustainable, energy-focused future. This metric likely will gain prominence in industries with "softer" environmental footprints such as **Information Technology,** where business operations use significant energy resources, but direct carbon footprint and pollution levels are relatively low.

41%

PREVALENCE OF S&P 500 COMPANIES WITH OTHER ESG-RELATED METRICS

– Community Engagement
– Customer Satisfaction
– Cybersecurity
– Product Quality

OTHER ESG METRICS

"Other" ESG metrics are largely operational in focus and are somewhat prevalent across many industries, although most prominently found in the **Utilities, Financials, and Real Estate industries**.

Customer Satisfaction is the most prominent "Other" ESG metric across most industries, consistent with last year. **Utilities, Financial Services, Information Technology, and Industrials** all have a fairly high prevalence for Customer Satisfaction. For Utilities the prevalence is nearly universal (93%), likely driven by their regulated operating environment and need to demonstrate that they are maintaining effective levels of service. **Community Engagement** is often the second most prevalent "Other" ESG metric, with the highest prevalence among **Financial Services**, likely due to regulatory oversight and social pressures to provide benefits to communities in which they invest.

Information Technology companies have the highest prevalence of **Product Quality** metrics, which may reflect the need to monitor quality in an industry with fast development cycles.

"Other" ESG Metrics are least prominent in the **Energy, Consumer Discretionary, and Communication Services** industries.

CONCLUSION

There are clear tied between the metrics each industry incorporates most frequently in incentives and those most strategically significant. Most ESG metrics align largely with the strategic drivers of success or risk factors within each industry.

The most enduring ESG metrics will likely be material from both a business and stakeholder lens. We continue to urge a degree of caution in adopting incentive plan metrics purely due to pressure from investors or peer practices. Boards should ensure management commitment and adequate infrastructure to support progress on the chosen metrics such that the metrics are durable and can be reliably measured over time.

SUSTAINABILITY VS. OPERATIONAL METRICS

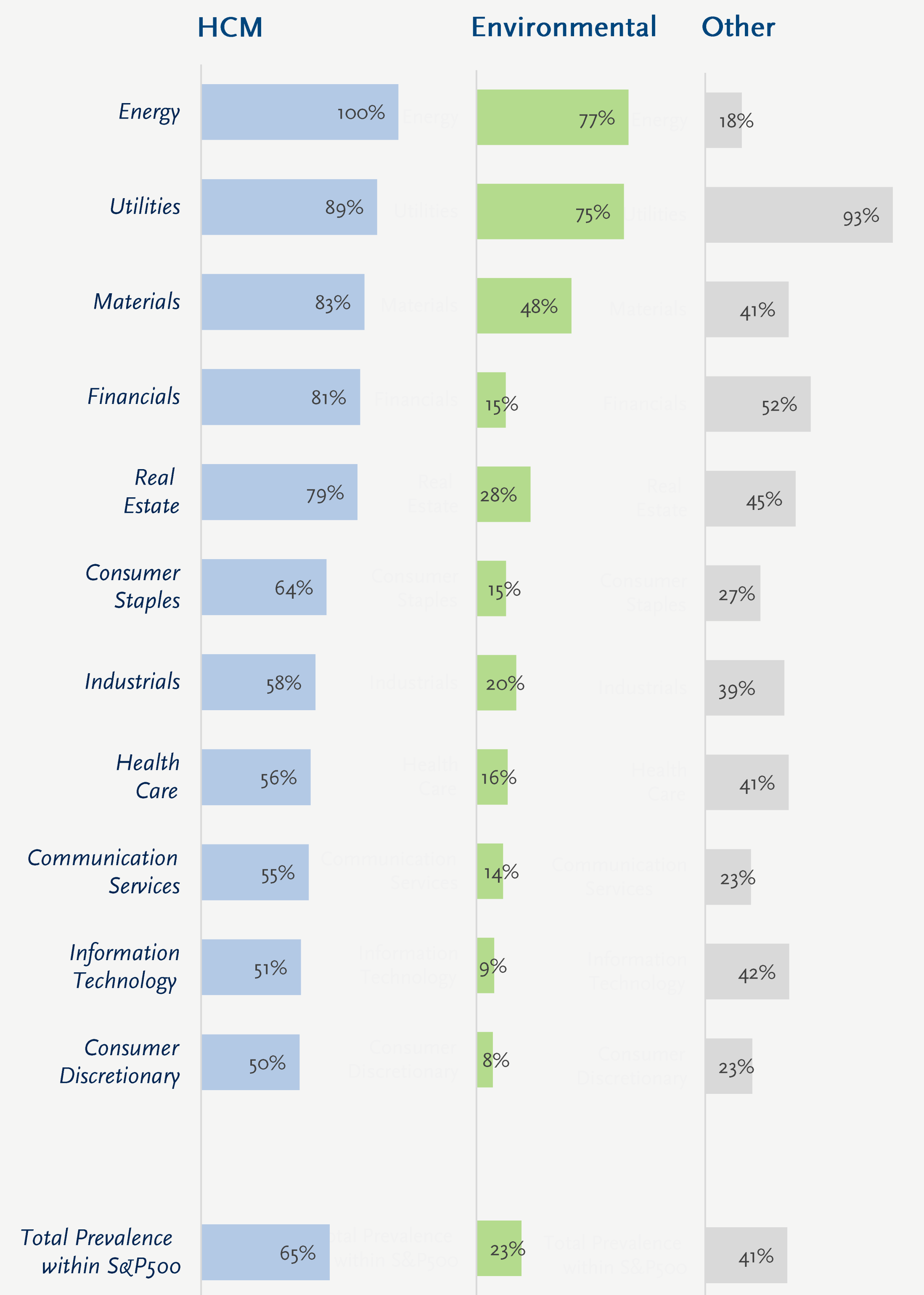
For the purpose of evaluating evolving trends in ESG, we have divided metrics into three separate categories. HCM and Environmental metrics focus on the broader social and environmental impact of companies and are frequently the focus of large institutional shareholders. Other ESG metrics here reflect issues important to various stakeholders, but are more engrained in the day-to-day success of the business:

HCM ESG METRICS	ENVIRONMENTAL METRICS	OTHER ESG METRICS
– Company Culture – Diversity & Inclusion (D&I) – Employee Satisfaction – Talent Development – Turnover/ Retention – Safety	– Carbon Footprint – Emissions/ Chemical Containment – Energy Efficiency – Sustainable Sourcing – Waste Reduction – Water Consumption	– Community Engagement – Customer Satisfaction – Cybersecurity – Product Quality

Prevalence of ESG Metric Type by Industry Sector (N=500)

% of S&P500 companies in each industry using each measurement type

(see page 7 for definitions)



Metric Prevalence Among the Energy Industry

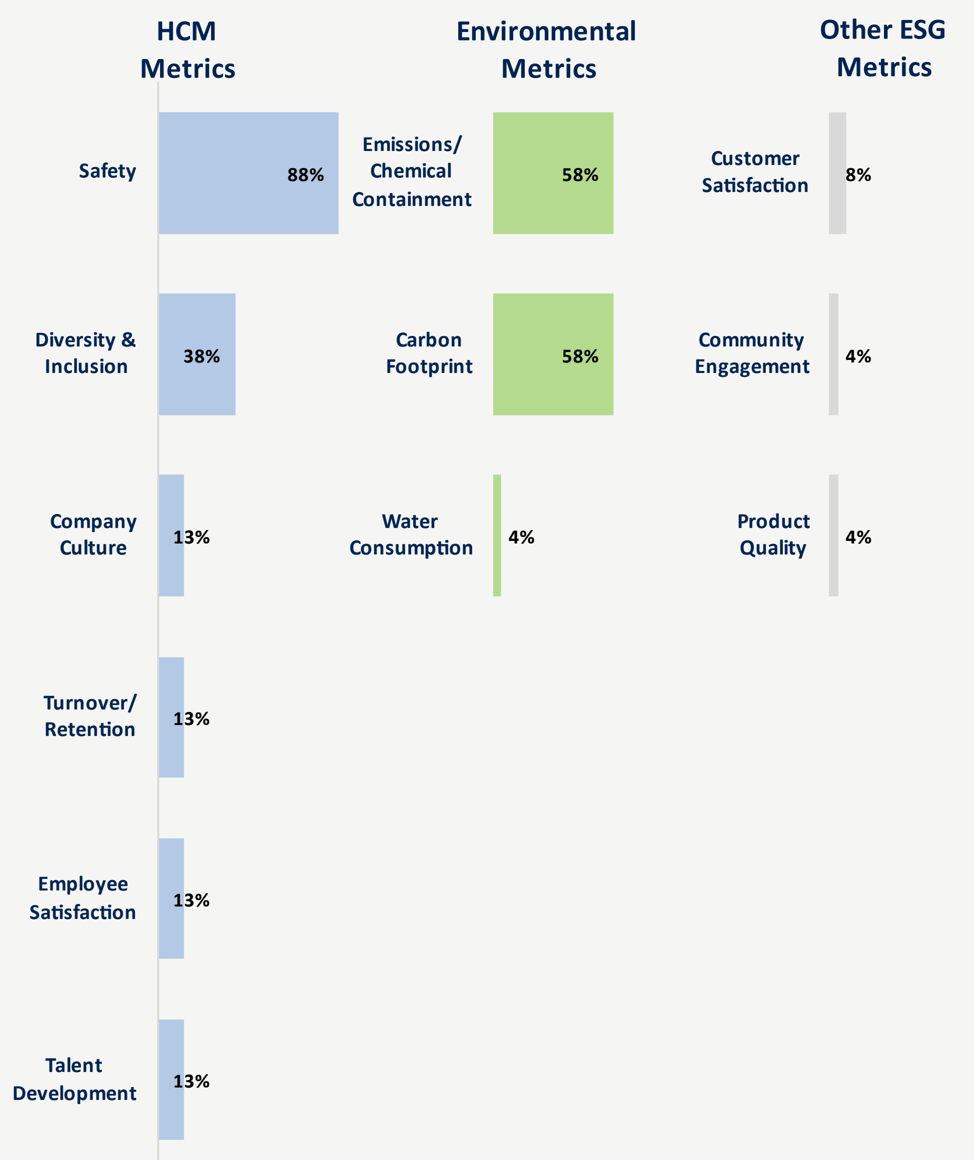
Industry Examples

Energy

— Chevron
— Exxon Mobil
— Marathon Petroleum
— Phillips 66
— Valero Energy

Energy

(n=22)



Metric Prevalence Among the Utilities Industry

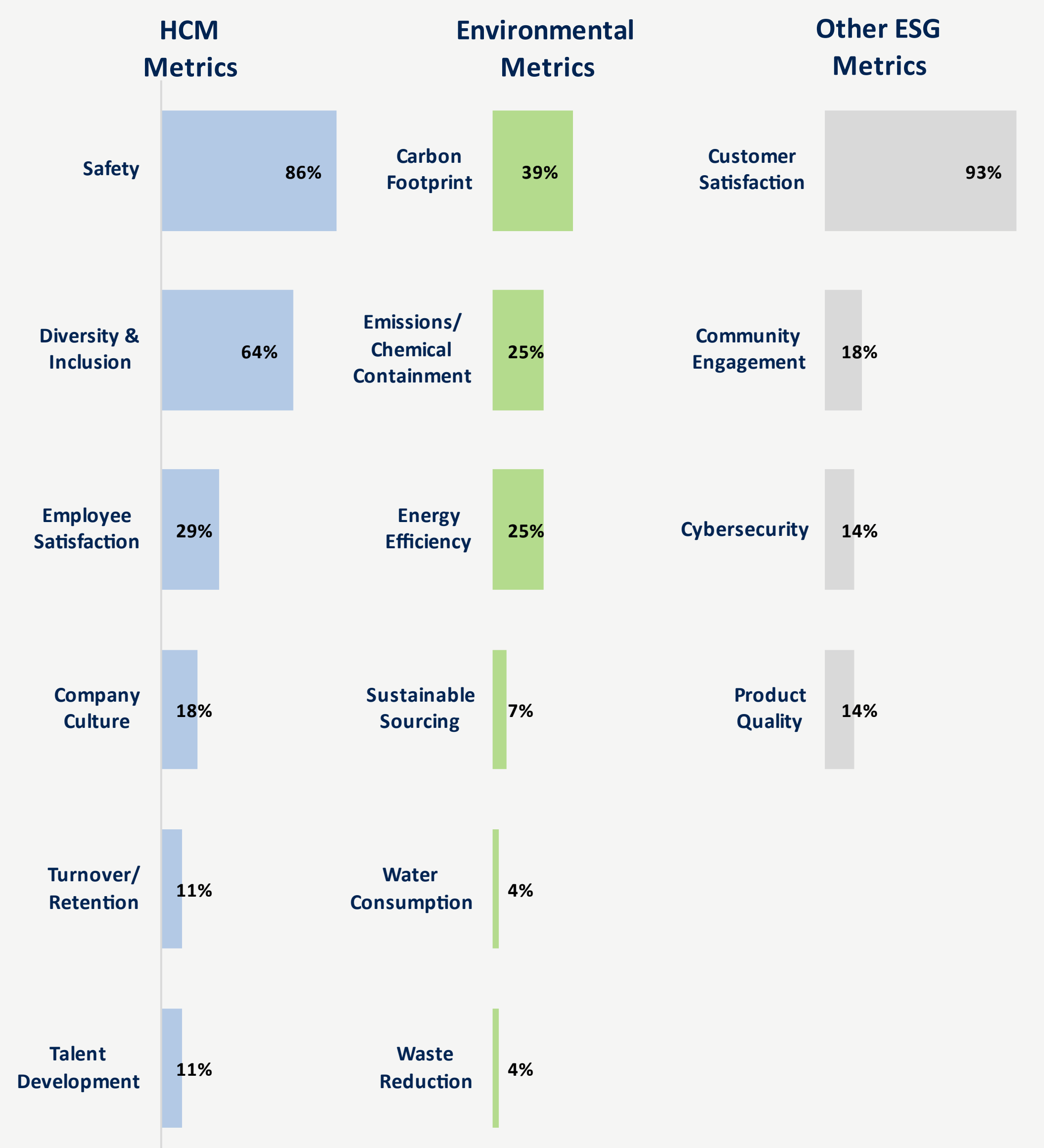
Industry Examples

Utilities

- American Electric Power
- Duke Energy
- Exelon
- NRG Energy
- Southern Co.

Utilities

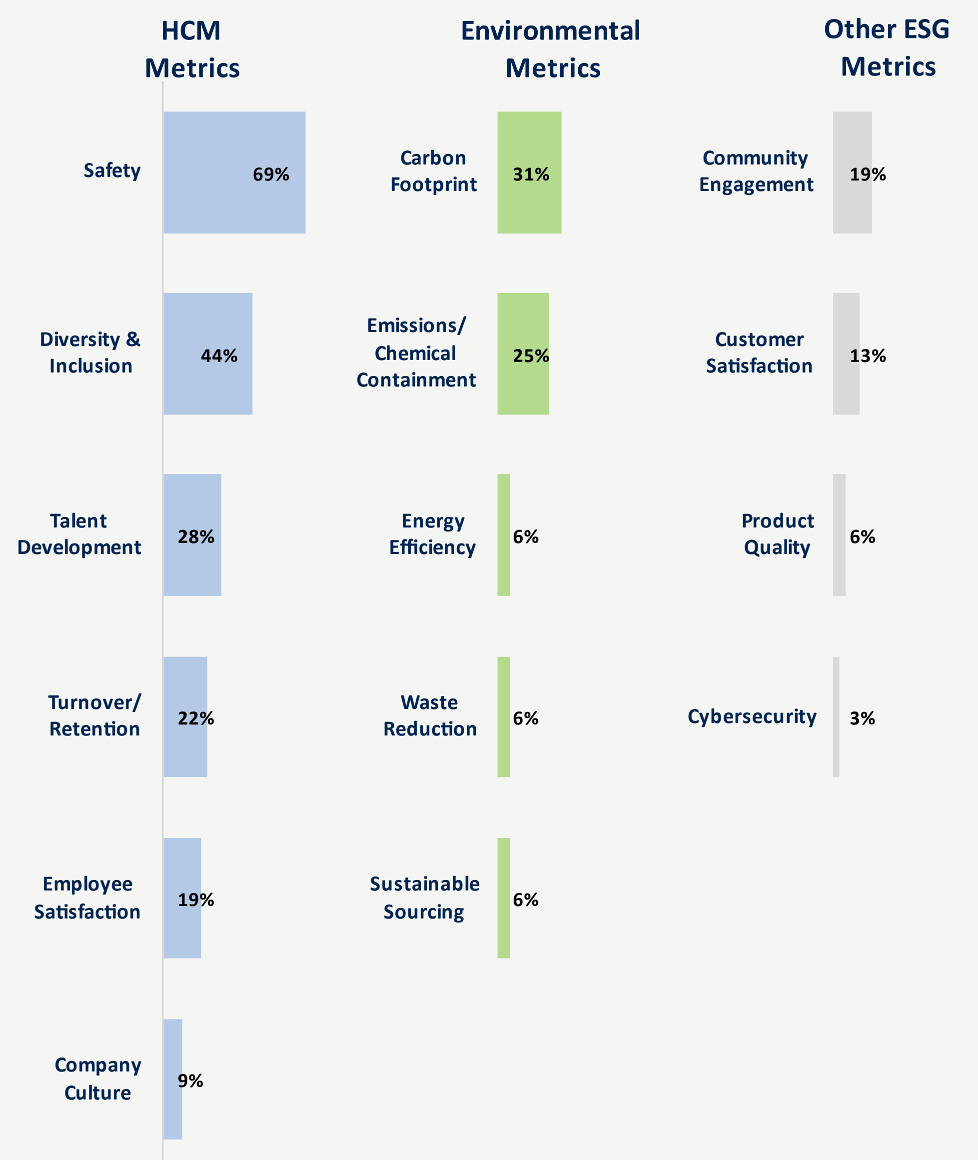
(n=28)



Metric Prevalence Among the Materials Industry

Materials

(n=30)



Industry Examples

Materials

- DOW Inc.
- Freeport-McMoRan
- Linde
- LyondellBasell Industries
- Sherwin-WIlliams

Metric Prevalence Among the Financials Industry

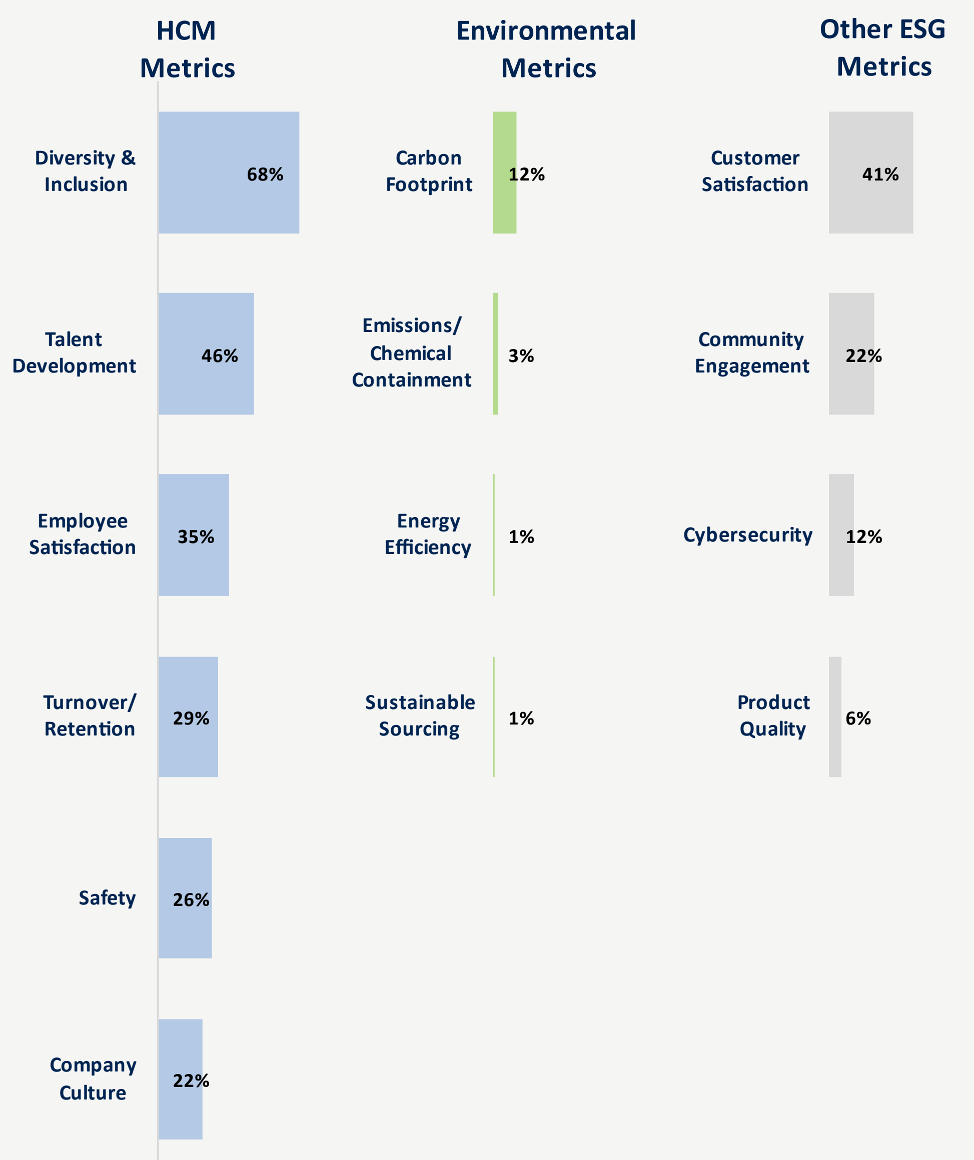
Industry Examples

Financials

— Bank of America
— JPMorgan Chase & Co.
— MetLife
— Prudential
— Wells Fargo & Co.

Financials

(n=67)



Metric Prevalence Among the Real Estate Industry

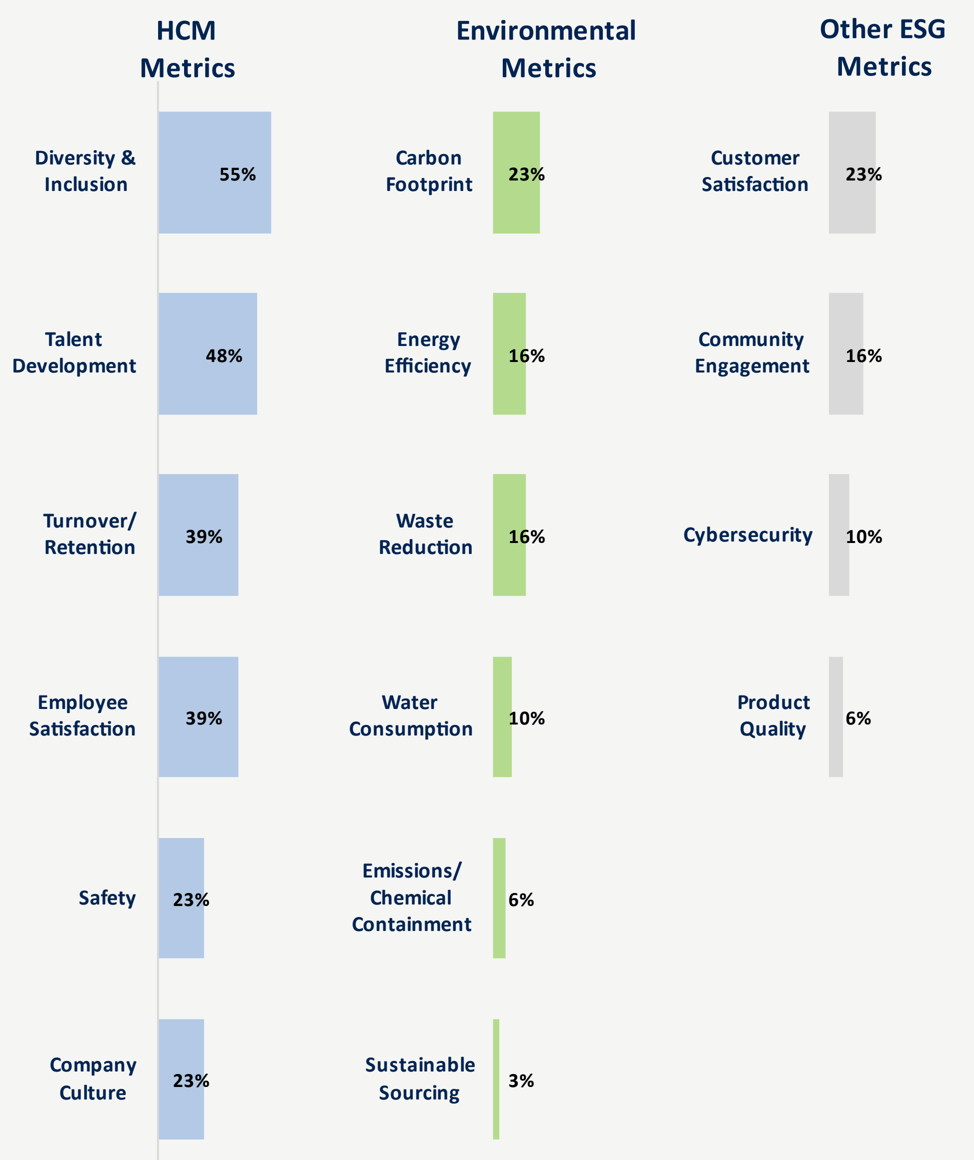
Industry Examples

Real Estate

— CBRE
— American Tower
— Prologis
— Welltower
— Weyerhaeuser

Real Estate

(n=28)



Metric Prevalence Among the Consumer Staples Industry

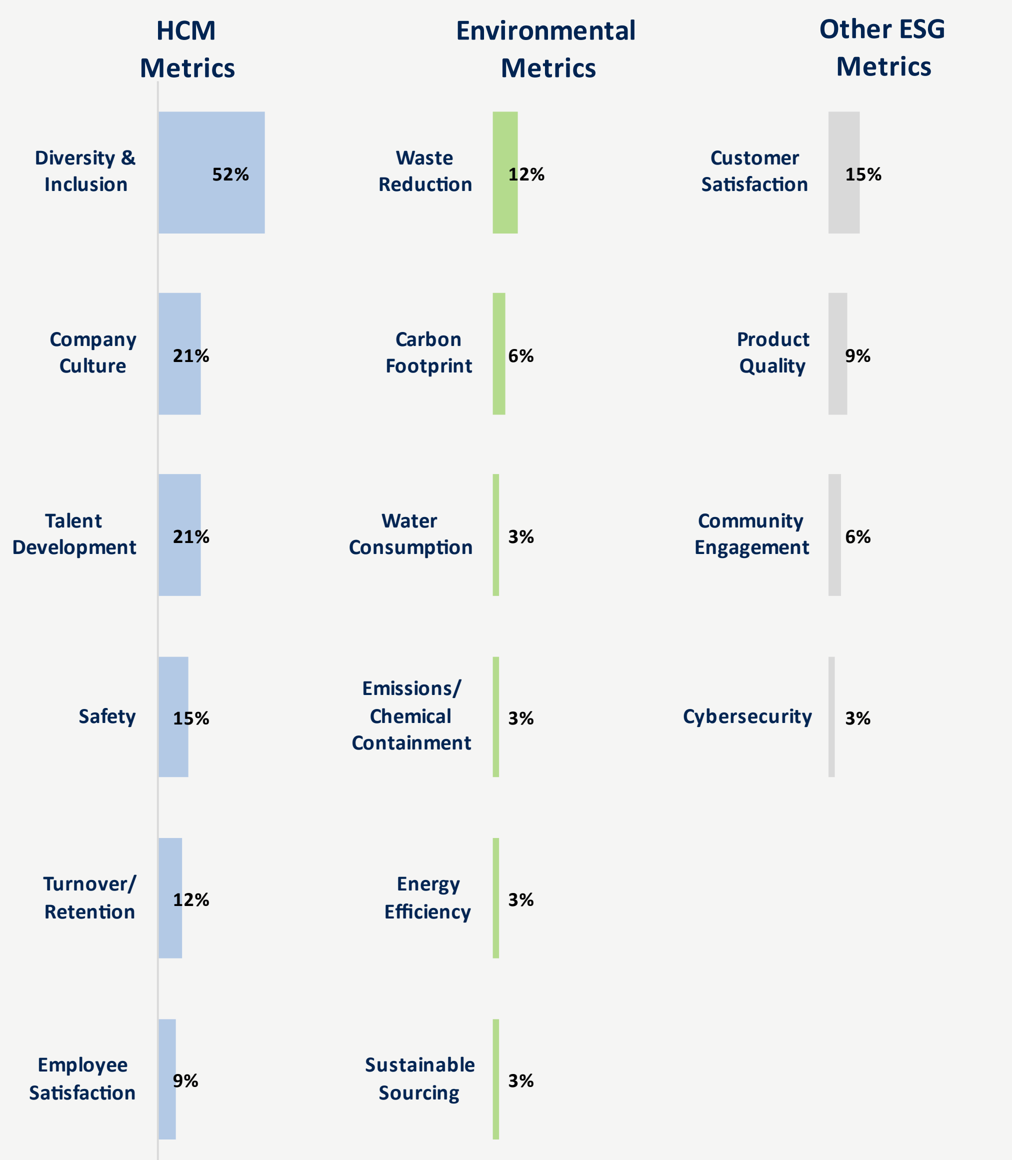
Industry Examples

Consumer Staples

- Archer-Daniels-Midland
- Kroger
- PepsiCo
- Walgreens
- Walmart

Consumer Staples

(n=33)



Metric Prevalence Among the Industrials Industry

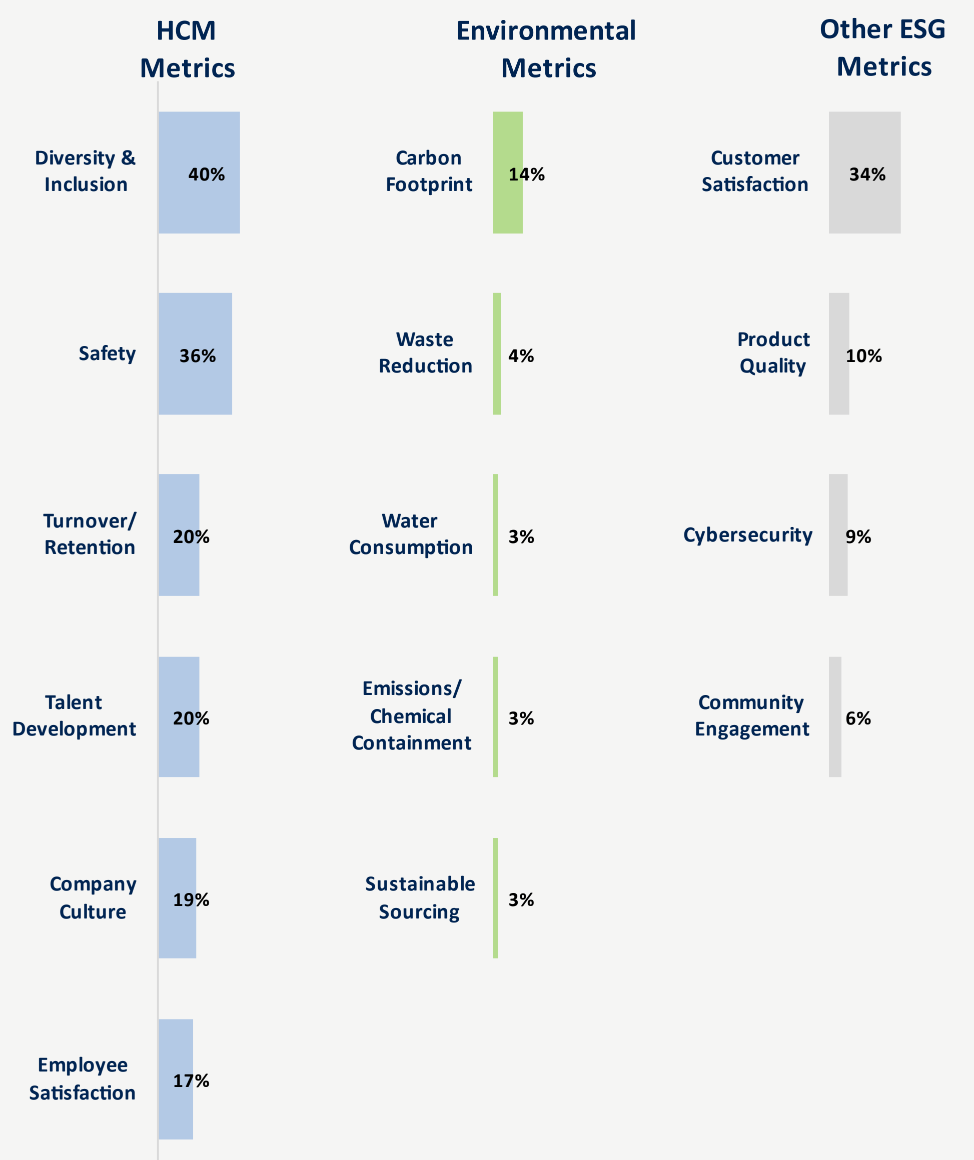
Industry Examples

Industrials

— Boeing
— FedEx
— Lockheed Martin
— Raytheon
— UPS

Industrials

(n=70)



Metric Prevalence Among the Health Care Industry

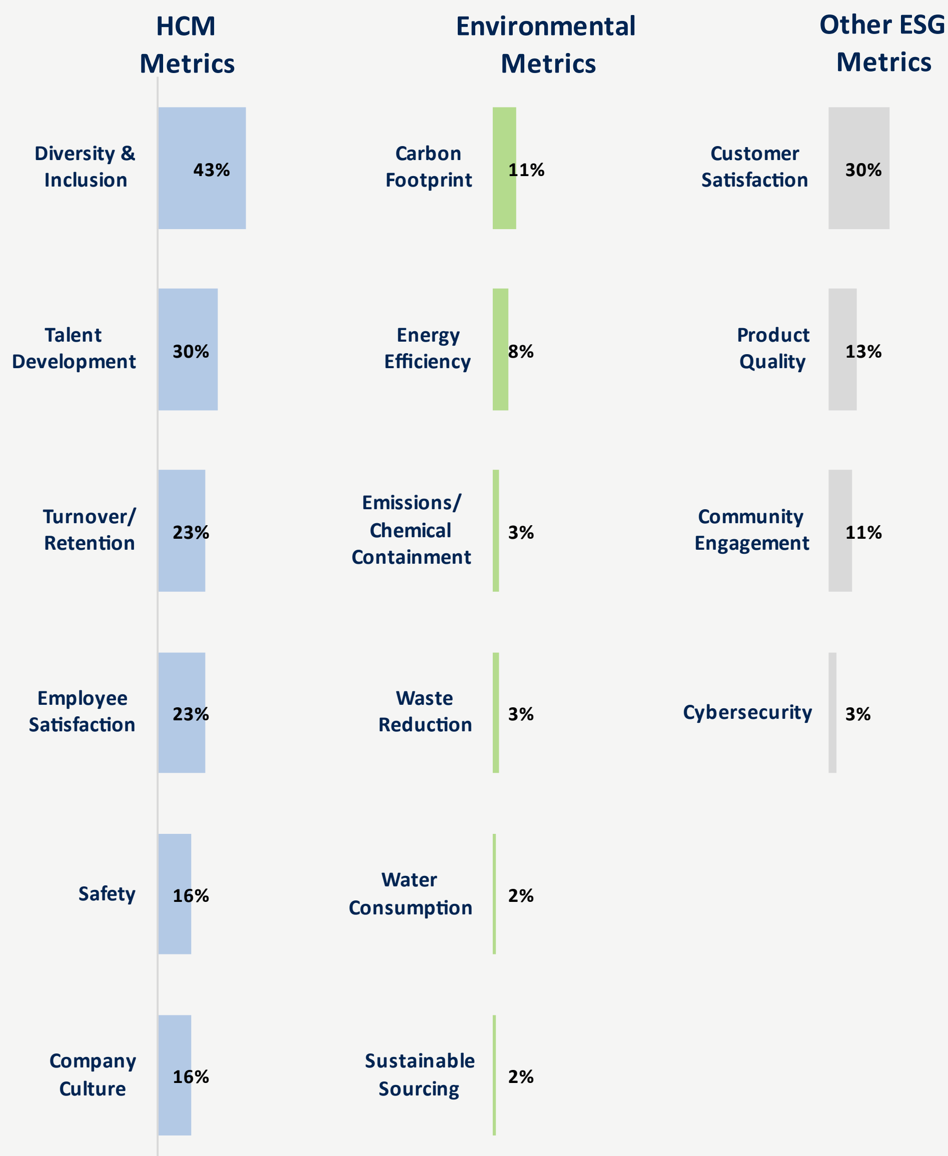
Industry Examples

Health Care

— Cigna
— CVS Health
— Cardinal Health
— Humana
— UnitedHealth Group

Health Care

(n=63)



Metric Prevalence Among the Communication Services Industry

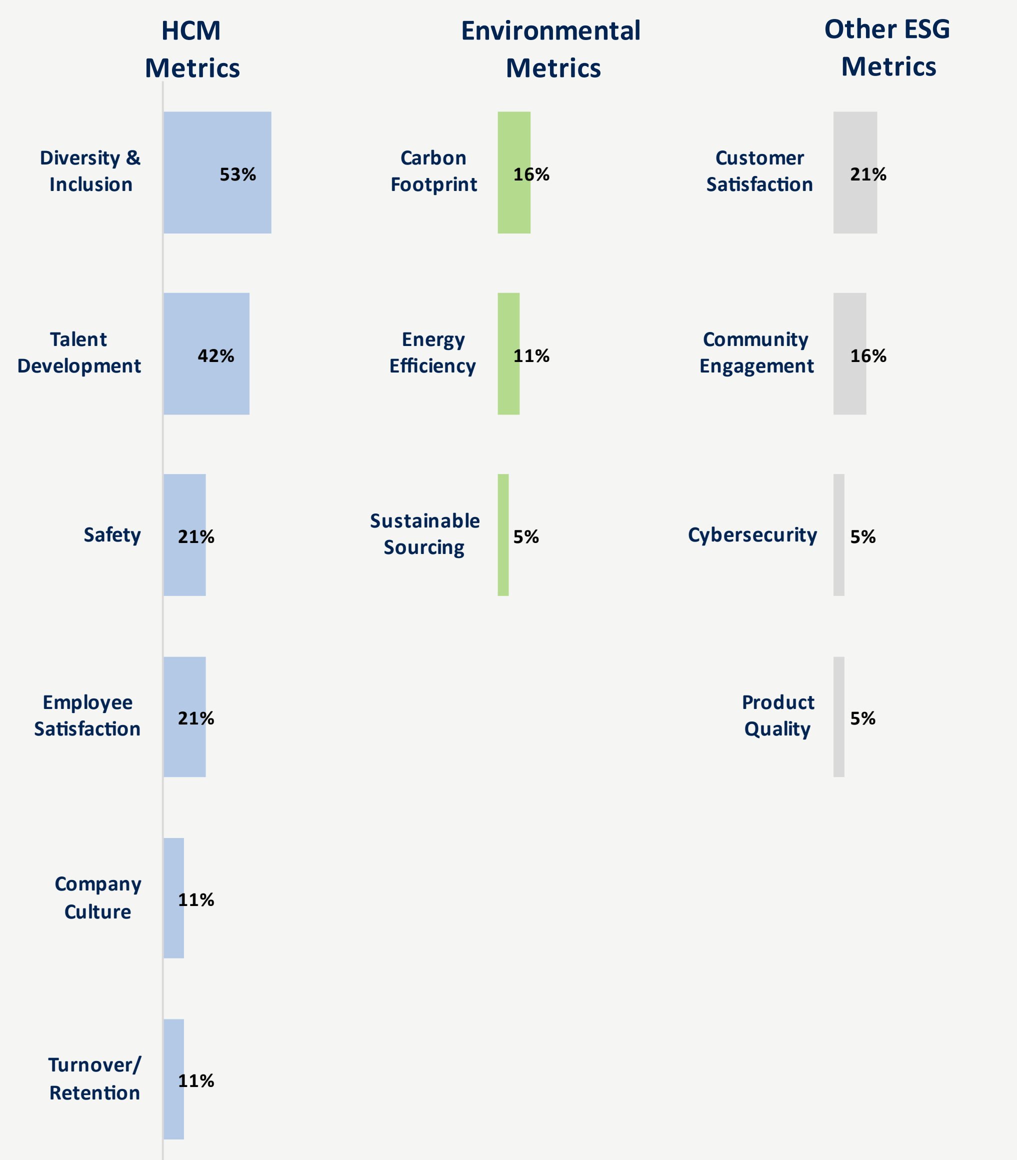
Industry Examples

Communication Services

- AT&T
- Comcast
- Disney
- Paramount Global
- Omnicom

Communication Services

(n=22)



Metric Prevalence Among the Information Technology Industry

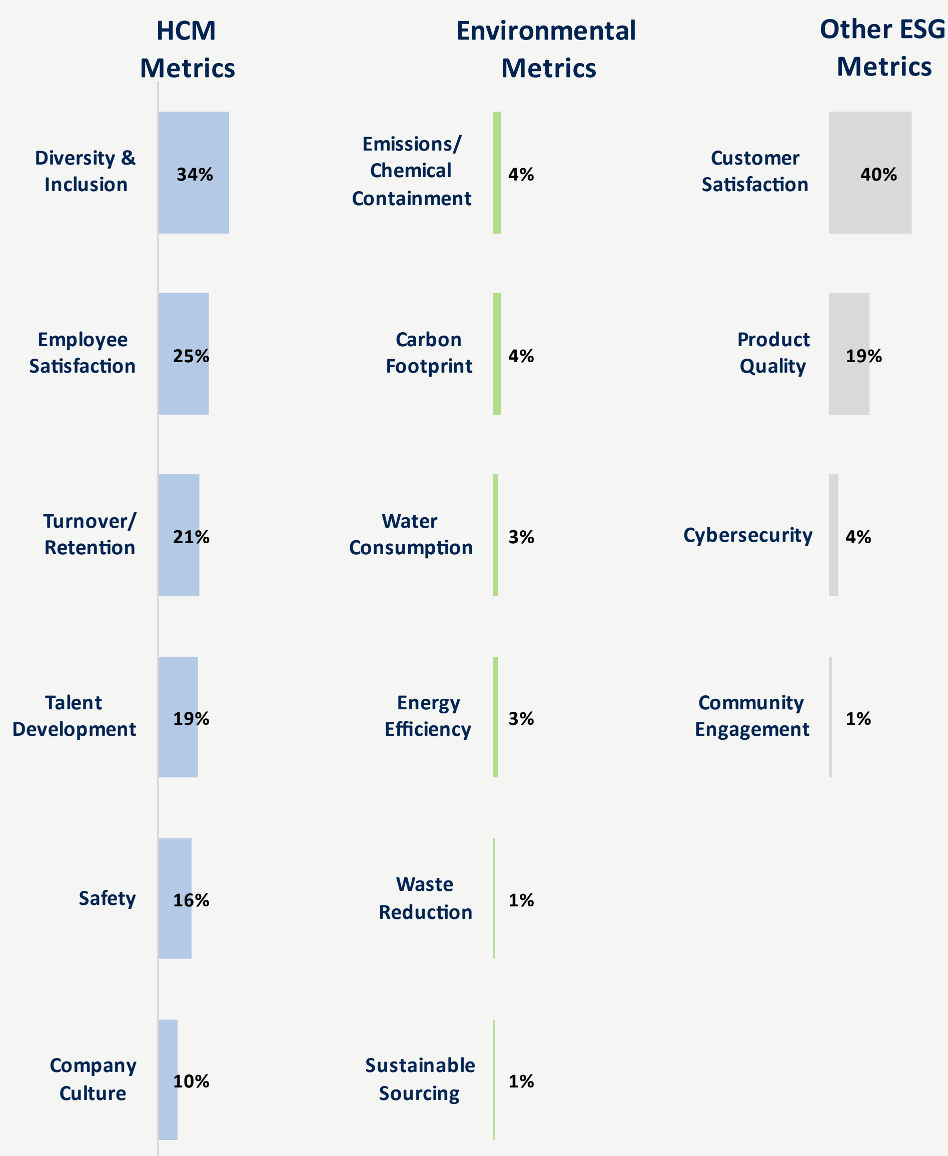
Industry Examples

Information Technology

— Apple
— Cisco
— Microsoft
— Micron Technology
— QUALCOMM

Information Technology

(n=77)



Metric Prevalence Among the Consumer Discretionary Industry

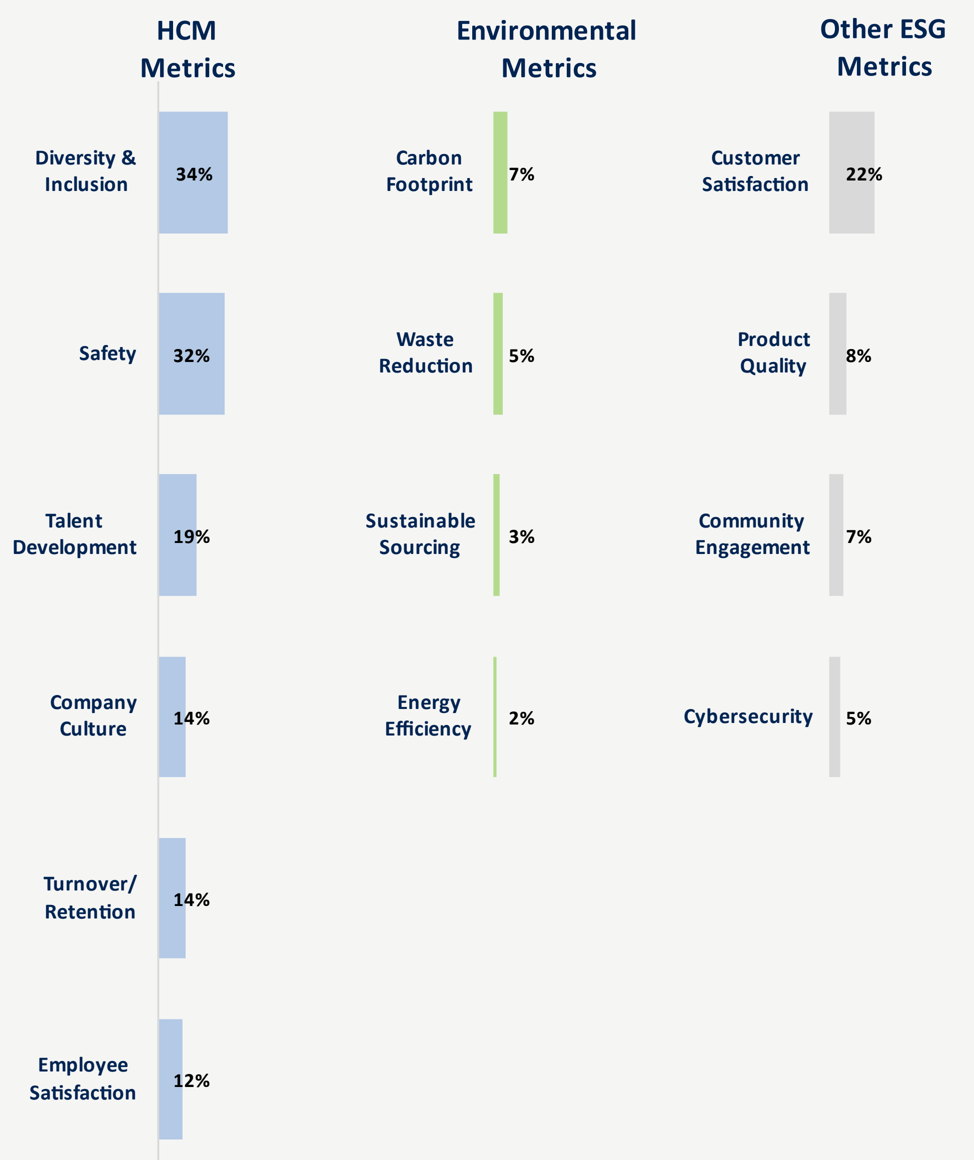
Industry Examples

Consumer Discretionary

— Best Buy
— General Motors
— Lennar
— Starbucks
— TJX Companies

Consumer Discretionary

(n=60)



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