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Performance-Based Compensation and Corporate Responsibility

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While shareholders across different business sectors necessarily have diverse concerns, executive compensation is a topic that remains at the top of nearly all shareholders' lists of corporate governance priorities. Largely beginning with the implementation of "say-on-pay" votes under The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), companies have increased communications with shareholders and have begun more recently to proactively respond to shareholder concerns. A significant sea change in both evaluation and disclosure emerged over the last five years with respect to pay for performance. Not only did the Dodd-Frank Act address pay for performance clearly as a result of the financial crisis, but shareholders and their advisers have persistently pushed for it. And companies and their boards of directors have listened and continue to listen. By directly linking pay and performance, the connection between the interests of executives and shareholders is stronger than ever. A significant question, however, remains—how best to measure performance. This question is complicated and constantly evolving.

Currently, total shareholder return (TSR) is the gold standard in goal setting for performance-based compensation. If the goal of performance-based compensation is to align the interests of executives with those of shareholders, TSR does seem to offer a convenient bridge between the two shores. However, companies are finding that TSR should not be the end of the road or the only road. It can be argued that TSR often does not capture the full picture when it comes to investor interests, particularly in industries where environmental, social and governance (ESG) issues are becoming increasingly prominent priorities for investors.

Determining how to incentivize performance across a myriad of areas is not a new problem. Certainly, the most pervasive belief is that the performance of a company's stock is the ultimate proxy for performance across all other areas at the company. The thinking goes that if a company is able to sustain strong financial performance year-over-year, it must be doing well across the board. In addition, regardless of what other priorities he or she might have, an investor's first priority is said to be achieving a return on his or her investment. Though this belief is not illogical, it boils investment decisions down to their most basic form and does not account for the diversity of factors that actually goes into and affects various performance matrices of a company that ultimately influence its company stock price. Moreover, investors in today's economy are beginning to not only recognize these factors, but they are forcing companies to recognize them as well. While shareholders want to invest in companies that provide a return, they are also becoming more concerned with investing in corporations with long-term plans for sustained growth and stability. Investors are also increasingly looking for companies that are good corporate citizens. This is a shift away from a focus on short-term returns toward long-term sustainability. Companies are finding that if they can take a thoughtful approach toward incorporating sustainability goals into their overall assessment of corporate performance, they can address many shareholder concerns and improve shareholder engagement and support. Doing so, however, is no simple task.

Unlike TSR, which can be determined using a relatively simple mathematical formula, ESG performance can be difficult to measure. Appropriate metrics are unique to each individual company, and assessing the achievement of ESG performance goals is not always clear cut. Additionally, ESG performance metrics must accomplish the dual purposes of incentivizing the achievement of ESG goals while still maximizing shareholder value. Since there is often a wide range of opinions among shareholder constituencies about what it means to provide "shareholder value," it is easy to see why the incorporation of ESG metrics into performance-based compensation can be a vexing undertaking.

Despite the associated challenges, there are three key steps that companies can take to integrate ESG metrics into compensation packages. First, every company needs to determine which ESG metrics are appropriate for its unique circumstances. Though this can seem like a daunting task, determining the relevant ESG metrics is no different than the exercise a company must go through to determine the appropriate performance goals in any other context. Second, companies must link their determined metrics to executive pay packages. Again, this exercise is no different for ESG metrics than any other performance goal. This process requires a company to assess how best to balance ESG objectives among other performance goals that the company is trying to achieve. Once the appropriate metrics are identified, a company can determine where and how they best fit into its compensation policies and overall compensation structure. Finally, companies should provide high-quality disclosure regarding ESG performance metrics. As with all performance-based compensation, this final step is beneficial to both executives and shareholders. Clear disclosure helps executives understand the goals that they are trying to meet over an applicable performance period, and it also helps investors understand how shareholder and executive interests are aligned.

Although establishing and implementing ESG performance goals can seem daunting, companies often see a return on their investment in taking the time and effort to put these metrics into place. To the extent shareholders are pressuring companies to do so, companies can leverage the exercise of establishing and implementing ESG performance goals as they apply to overall company performance. Establishing ESG performance metrics shows that a company is thinking about, identifying and managing associated risks and opportunities as part of its overall, long-term strategy. Incorporating these metrics into performance-based compensation plans can have positive financial effects. Some research has demonstrated that companies that integrate a strategic approach to corporate responsibility may enjoy better financial performance than companies that do not.

As performance-based compensation continues to make up an increasing percentage of executive compensation packages, companies will need to maintain flexible criteria for measuring performance that is able to accommodate emerging areas of investor concern, as well as other stakeholder reactions. By keeping a pulse on the areas of potential risks and opportunities in which investors are most interested and identifying performance goals to mitigate those risks and take advantage of the opportunities, companies can create a meaningful link between executive and shareholder interests, thereby fostering a sound, long-term corporate strategy and preserving strong shareholder and stakeholder relations.

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