On the 2024 compensation committee agenda

KPMG Board Leadership Center

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As companies reassess their talent strategies in the face of significant uncertainty, polarization, geopolitical and economic turmoil, regulatory changes, advances in emerging technologies, and a renewed focus on unionization and worker strikes, compensation committees will need to continue to evolve and expand their oversight of human capital issues in addition to their traditional responsibilities.

To guide management in developing a compensation and workforce strategy that drives a strong corporate culture and motivates executives and employees to achieve the company's short- and long-term goals requires effective committee governance practices.

Drawing on insights from our interactions with directors and business leaders, we highlight five issues to keep in mind as compensation committees consider and carry out their 2024 agendas:

Ensure the company's compensation strategy is optimal given the current environment and is responsive to shareholder concerns.

Reflect on the compensation committee's scope, responsibilities, and membership in light of increasing expectations for board oversight of human capital management (HCM).

Monitor regulatory developments and encourage thoughtful implementation of required changes.

Consider whether environmental and social measures should be included in incentive plans.

Maintain familiarity with the evolving expectations of shareholders.

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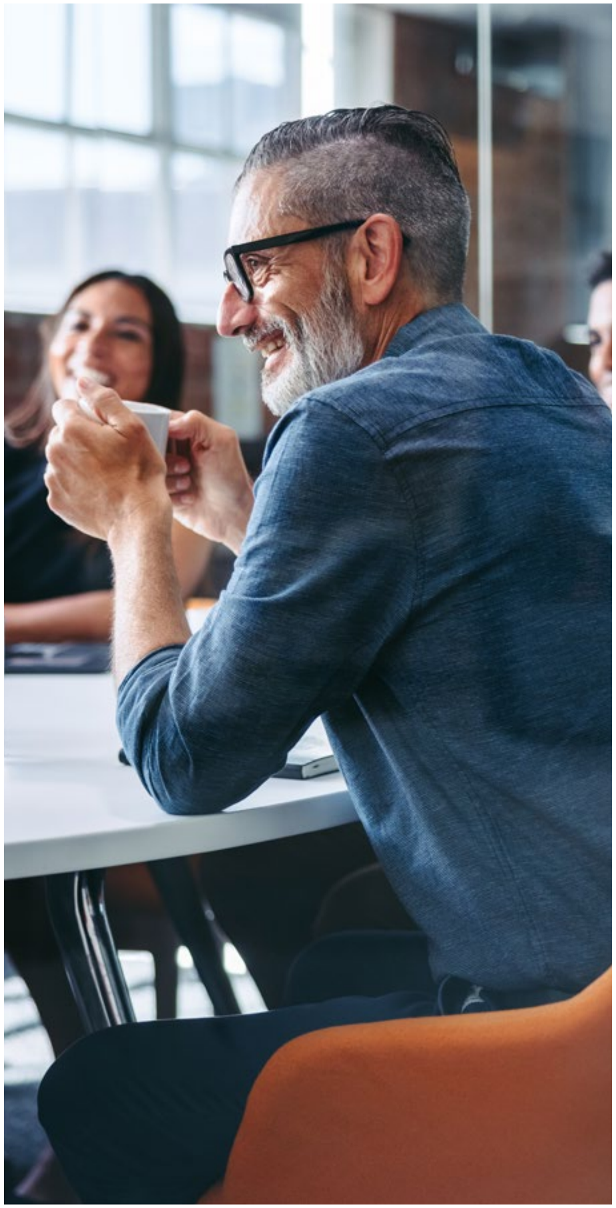

It is imperative that the committee stays focused on its fundamental purpose: to develop an effective CEO compensation plan that appropriately incentivizes execution on strategic goals to drive long-term sustainable value and to ensure the compensation strategy for other executives and employees is aligned. In addition, the committee must responsibly oversee the use of equity in incentive compensation to help ensure it is used to align the interests of executives to those of shareholders. Selecting the right performance measures and targets for the CEO and other executive incentive plans is challenging in the best of times—and even more so in these times of turmoil. Compensation committees should continue to seek outside expert advice and consider the concerns of shareholders and other stakeholders.

Many committees have been faced with difficult decisions about awarding retention or one-time equity grants or considering repricing options or altering the terms of awards granted just prior to the market downturn. Many investors acknowledged these challenges during the pandemic years and were more lenient in the application of their voting policies, which generally disapprove of such measures. However, shareholders have returned to their previous stance of only supporting such practices under special circumstances. CEO-to-median-employee pay ratios are also under greater scrutiny, as average CEO total compensation remains high amid layoffs and stagnating employee pay.

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Reflect on the compensation committee's scope, responsibilities, and membership in light of increasing expectations for board oversight of HCM.

In addition to traditional executive and equity compensation responsibilities, expectations have increased for board oversight of broader human resources policies and practices affecting the entire workforce. Compensation committee chairs may ask the following questions as they reassess the scope and membership of their committees.

- Do we receive regular reports from the company's top human resources executive? Is the top human resources executive a member of the C-suite (i.e., CHRO) with an opportunity to participate in strategic discussions and capital allocation decisions? Do they have the right skills and experience to contribute at this level?
- Do the workforce metrics we receive provide a comprehensive understanding of how the company's resources are invested in the workforce (e.g., training and development programs) and whether those investments are generating the expected return?
- Do we feel comfortable that we understand employee engagement and satisfaction, as well as employee turnover at various levels in the company?
- Do we receive sufficient information on the diversity of the company's workforce—at all levels—to hold management accountable for hiring and developing the right talent?
- Have the company's DEI practices and incentive plan metrics related to DEI (if any) been reviewed by counsel in light of the Supreme Court's decisions on affirmative action and the potential for reputational and litigation risk?[1]
- Have we considered what portion of work is done by contingent or part-time employees and the potential impact on workforce engagement, productivity, and overall costs? Are we comfortable that management is considering the long-term implications of layoffs and increased use of technology to accomplish tasks currently done by people?
- Are we having regular discussions about the company's approach to where and how work is done (i.e., return to office/work from home) to ensure that management's approach is sufficiently responsive to evolving desires of current and future employees, competitive, and positions the company for cost-effective productivity over the long term?
- Do we review data on pay equity throughout the company and have oversight of any related internal and external disclosures? Do we have visibility into the company's compliance with pay transparency disclosures? Has management considered the potential implications such disclosures may have on employee satisfaction, corporate culture and hiring practices, etc.?

[1] H. Mark Adams and Emily Gauthier, "Practical Considerations for Corporate DEI Programs Following the Supreme Court's Affirmative Action Decision, " Jones Walker LLP, The National Law Review, July 10, 2023.

The SEC's proposed regulatory agenda listed a proposal to mandate enhanced HCM disclosure, although the timing is uncertain. While details of an SEC proposal remain to be seen, compensation committees may be interested in the September 2023 draft recommendation of the SEC Investor Advisory Committee's Investor-as-Owner Subcommittee (IAC Subcommittee).[2]

Given the importance of these issues and the increased expectations around board oversight of HCM, many boards have tasked the compensation committee with oversight of HCM matters including employee engagement and well-being, DEI, and workforce pay equity. As a result, many compensation committees have revised their charters and changed their names to reflect their expanded remits (e.g., human capital committee; people and compensation committee; etc.). For example, "49 percent of S&P 500 companies have a compensation committee name that expands beyond compensation, and 84 percent include at least one nontraditional compensation committee responsibility in their charter."[3]

Compensation committees should also carefully consider whether members have the appropriate expertise to oversee alignment of workforce strategy and corporate strategy, including members with human resources and workforce development and engagement experience. Directors with this background may most effectively guide the company's CHRO to maximize the company's investment in its workforce and may be best equipped to ask questions of management during reports to the board about the effectiveness of human resources policies and strategy. While the numbers are still small, corporate leadership data firm Equilar found that the percentage of new directors serving on Russell 3000 boards with CHRO experience more than doubled to 2.7% of directors in 2022, compared to 1.1% in 2020.[4]

Looking ahead: HCM disclosures

In addition to a narrative disclosure describing how the company's HCM practices align with its broader strategy, the IAC Subcommittee recommended the SEC require disclosure of the following quantitative metrics:

1. Total number of employees, broken down by full-time, part-time, and contingent workers
2. Workforce turnover
3. Workforce cost, broken down by key types of compensation
4. Workforce demographic data

Source: Recommendation of the SEC Investor Advisory Committee's Investor-as-Owner Subcommittee regarding Human Capital Management Disclosure, September 14, 2023.

[2] Recommendation of the SEC Investor Advisory Committee's Investor-as-Owner Subcommittee regarding Human Capital Management Disclosure, September 14, 2023.

[3] NACD and Pearl Meyer, Future of the American Board: Compensation Committee Blueprint, 2023, p. 10.

[4] Equilar, "CHROs: The New Power Players in the Boardroom," September 20, 2023.

Monitor regulatory developments and encourage thoughtful implementation of required changes.

Compensation committees are often tasked with overseeing the implementation of evolving regulatory requirements and the last few years have been no exception. During the second half of 2022, the SEC issued new rules regarding pay versus performance disclosures, clawback policies and related disclosures, insider trading arrangements, and share repurchase disclosures. While compensation committees may not be responsible for overseeing all of the company programs discussed here, it is important for committee members to be aware of the impact the new rules will have on compensation practices.

Pay versus performance disclosure: The final rules required disclosure starting with the 2023 proxy statement. The SEC staff issued additional guidance in February, September, and November 2023. Compensation committee members should work with management and compensation consultants to review draft disclosures, particularly the company-selected measure, tabular list of financial performance measures, and narrative explaining the relationship between compensation actually paid and the related performance measures.

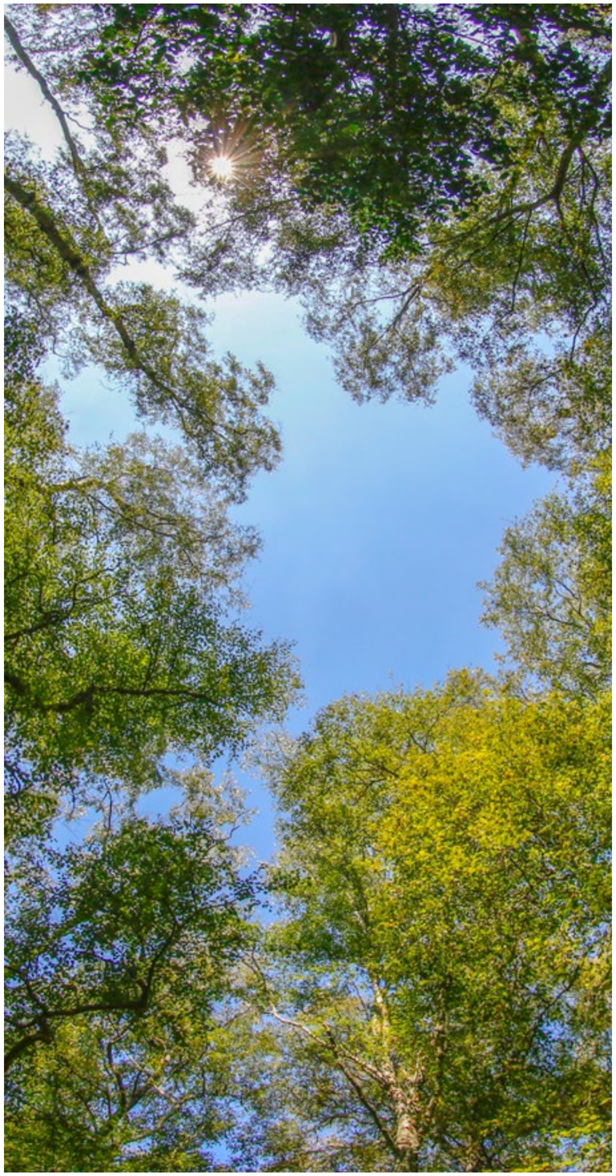
Clawback policy and related disclosure: The SEC's final Compensation Recovery Listing Standards and Disclosure Rules, the so-called "clawback rules," took effect for NYSE- and Nasdaq-listed companies on December 1, 2023. Companies must adopt and disclose policies requiring incentive compensation already paid to executives to be returned if the financial statements on which the incentive performance was measured are subject to either material ("Big R") or nonmaterial ("little r") restatements that could result in material misstatements. While reviewing their current clawback policies or adopting new ones, compensation committees should take into consideration the views of their investors, who may expect companies to include provisions beyond those required by the relevant listing exchange (e.g., the clawback of time-vested incentive awards).

Insider trading arrangements and related disclosure: Under updated SEC rules governing the structure and disclosure of the trading arrangements known as 10b5-1 plans, company insiders can no longer implement overlapping trading plans and are limited to one single-trade plan for each 12-month period. Companies must provide additional details on policies and procedures around these plans. Compensation committee members can work with their outside counsel or compensation consultants to ensure these plans are properly structured and disclosed.

Share repurchase disclosure: In May 2023, the SEC amended its rules regulating disclosures of share repurchases (i.e., "buybacks"). However, following a legal challenge to the rule, on December 1, 2023, the SEC informed the Fifth Circuit Court of Appeals that the SEC was "unable to correct the defects of the rule," so the rule will not apply to the upcoming annual reporting season. The SEC can "either appeal the decision or attempt to promulgate a new share repurchase proposal to address the defects identified by the Fifth Circuit … Companies should continue to follow the current rules to report quarterly repurchases in their upcoming Form 10-Ks and 10-Qs." [5] Compensation committee members may take this opportunity to review their processes for considering the impacts buybacks have on incentive measures and equity plans.

[5] Heath D. Linksy et al., "SEC Unable to Correct Defects of Share Repurchase Disclosure Modernization Rule," Troutman Pepper, December 4, 2023.

Consider whether environmental and social measures should be included in incentive plans.



Many companies include environmental and social metrics (sometimes referred to as "ESG metrics") in their incentive compensation plans. According to compensation consulting firm Semler Brossy, the percentage of S&P 500 companies that included ESG metrics in incentive plans increased from 57% in March 2021 to 72% in March 2023. Performance measures that fall in the broad category of HCM were the most prevalent, while the metrics in the environmental category saw the largest increase in usage, with carbon footprint being the most common in this category—used by one quarter of S&P 500 companies.[6]

Measures related to diversity were the most common type within the HCM category, with 55% of S&P 500 companies including a diversity measure in their incentive plans in 2023. When incentive plans include any measures related to diversity, compensation committees should ensure that they are reviewed carefully by counsel given the increased potential for litigation after the Supreme Court's decisions related to affirmative action.[7]

Compensation committees should review any metrics to ensure they reward executives for environmental and social targets that are material to the business and that have a clear link to the company's strategy. Since investor focus on these issues has not waned, it is important for compensation committees to help ensure that the company communicates its ESG strategy consistently and clearly and explains the link to the use of these measures in incentive plans.

[6] Semler Brossy, "ESG+Incentives 2023 Report," August 14, 2023, pp. 2–5.

[7] Sanjay Shirodkar et al., "Linking executive compensation to D&I metrics in the wake of SFFA: Action steps for public companies to consider," DLA Piper, September 26, 2023.

Maintain familiarity with the evolving expectations of shareholders.

In addition to a robust and proactive shareholder engagement strategy and director participation in engagement meetings as appropriate, boards can also gain insight into investors' concerns by reviewing the outcomes of annual say-on-pay votes and any concerns raised by investors and proxy advisory firms. In an analysis of the outcomes of the 2022 and 2023 votes, law firm Sullivan & Cromwell found that the average level of support for say-on-pay proposals generally remained steady at about 90%. The main issues triggering an "against" recommendation from ISS were pay-for-performance disconnect, compensation committee communication and responsiveness, severance/change-in-control arrangements, and nonperformance-based pay elements.[8] The main issues prompting against recommendations from Glass Lewis were pay-for-performance disconnect, structural concerns, excessive grants, other concerning pay practices, and insufficient response to shareholders.[9]

It can also be helpful to review trends in shareholder proposal submissions, even if the company is not typically a recipient of such proposals. For those companies that receive shareholder proposals, the compensation committee should be involved in reviewing any that are relevant to workforce and compensation matters.

Sullivan & Cromwell's annual review of shareholder proposals found that 65% of the shareholder proposals submitted during the 2023 proxy season at S&P 1500 companies related to environmental and social/political topics, which is similar to last year.[10] The proposals most relevant for the compensation committee that received the highest average shareholder support related to HCM such as workforce DEI, collective bargaining and employee health and safety.

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[8] Sullivan & Cromwell, "2023 Proxy Season Review Part 2 – Compensation and Current Developments," September 5, 2023, pp. 2–4.

[9] Glass Lewis, "2023 U.S. and ESG Proxy Season Review Webinar," October 5, 2023, p. 15.

[10] Sullivan & Cromwell, "2023 Proxy Season Review Part 1 – Rule 14a-8 Shareholder Proposals," August 11, 2023.

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