COMPENSATION COMMITTEE PRIORITIES FOR 2022

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As we begin 2022, talent shortages continue to plague business leaders, business priorities like environmental, social and governance (ESG) issues increase in importance, and reporting requirements continue to shift.

In the year ahead, compensation committees may want to ensure that these evolving factors are kept in mind when making decisions and communicating with stakeholders in 2022. There are five key areas that should be top of mind for compensation committees in the coming year.

1 Evolving Roles and Responsibilities

Compensation committees are navigating a variety of challenges from traditional roles and responsibilities in addition to taking on emerging areas of focus. As compensations considerations become more complicated, a higher level of commitment, responsibility, time and expertise is expected. Leading directors are pursuing continuing education to ensure they can properly carry out their duties.

Compensation committees are also being tasked with board-level oversight of broader human capital responsibilities. While traditionally focused on executive team compensation arrangements and exercising fiduciary duties in applying the business judgment rule and duties of care and loyalty, the topics of people and performance are broadening in compensation committee discussions to cover a more expansive employee population.

As ESG issues come to the forefront, compensation committees are concentrating on the "S," collaborating with corporate HR departments and **expanding their charters** to focus on human capital management (HCM), diversity, equity and inclusion (DEI) and other social concerns. Succession and leadership pipeline planning, talent development, employee health and safety and oversight of DEI metrics are all on the agenda as boards look to ensure their organizations have the right talent mix — and incentives to draw in and retain top performers — that will set the organization up for long-term success.

Creating a baseline is key to successfully guiding the human capital conversation. For companies just starting the conversation, it can be helpful to take a step back and define what HCM means for the organization and help the board understand what management is already doing — and not doing — in this area. Considering an array of HCM strategies to align operational, functional and board oversight responsibilities is a good starting point. It is also important to recognize that each company is unique, and the HCM conversations and strategies may vary from one company to another.

DEI metrics and practices most often fall under the HCM responsibilities. Many companies made DEI commitments in the past 18 months, and employees and other stakeholders are keeping a careful eye to ensure that promises made by executives are kept. Diversity in the board and C-suite have long been under the microscope, but employees are now looking to commitments made about recruiting a diverse pool of candidates for rank-and-file positions. Pay equity is also top of mind, both among various identity groups but also between employees and senior leadership. Compensation committees should carefully consider the metrics they are putting in place to track executive action in these areas. On top of that, there are disclosure approaches to consider. Currently, the majority of DEI disclosure is voluntary, but employees increasingly require transparent executive action to feel confident that leadership is making good on promises.

As responsibilities expand, so does the scope of stakeholders the board is beholden to. The **Business Roundtable** has provided impetus for a focused and prioritized plan that outlines how to satisfy the needs of various **stakeholder groups**. Institutional investors' growing focus on ESG is reverberating through incentive discussions as companies evaluate the use of ESG goals or metrics in their annual bonus and performance share unit plans. This comes alongside continued external stakeholder focus on executive compensation, pressuring the compensation committee to consider these sometimes conflicting priorities. Outside parties such as proxy advisory firms ISS and Glass Lewis will provide their own analyses of stakeholder priorities, but it is critical that the company takes control of the narrative and informs stakeholders of the risks and opportunities directly.

Though compensation committees have increasingly taken on these additional roles, at the end of the day, they serve as advisors to the full board on determining matters of compensation. Communication with the full board, management and stakeholders, together with clear documentation of roles and responsibilities within the charter, are imperative to long-term success and accountability.

Compensation and Proxy Advisor Focus in 2022

Annually, proxy advisors **Glass Lewis** and **ISS** issue updates to their voting policies and guidelines. In 2021, ISS has further indicated within its **FAQs** that the "surprise" element of the COVID-19 pandemic is no longer applicable. Accordingly, ISS has indicated, *"as in pre-pandemic years, any mid-year changes to metrics, performance targets and/or measurement periods, or programs that heavily emphasize discretionary or subjective criteria will generally be viewed negatively. This will be of particular focus for companies that exhibit a quantitative pay-for-performance misalignment."* Companies who decided to make such changes need to be prepared to disclose their specific reasoning to aid investors in their evaluation of such changes.

2 Understanding the Impact of Organizational Culture and Wellness

As part of the board's role in mitigating organizational risk and providing strategic oversight of management, it must consider the implications that corporate culture has on an organization's agility and ability to sustainably scale.

To be successful, especially in the long term, culture must be foundational and driven from the top down. When employees see that leadership advocates for an organization's purpose, values and vision, they are more likely to feel connected to their work and less likely to leave for other opportunities. Onboarding and recruiting are expensive — currently, where companies are seeing employees exit for a whole host of reasons, the need to understand the specific triggers to enable the creation of an environment that allows employees to thrive becomes increasingly important. This includes conducting and being responsive to periodic employee pulse surveys and ensuring meaningful organization-wide participation that may impact decisions ranging from compensation/financial/health and wellness benefits to equity and inclusion, flexibility and other supportive means impactful to employees. It further includes carefully crafted, robust talent and skill development programs, transparent growth opportunities along with continual succession plans to ensure leadership at all levels are prepared to execute on longer term strategies of the business.

Amid the "Great Resignation" being experienced globally, employers are challenged to rethink traditional workplace norms and levels of transparency with both internal and external stakeholders. Many companies are reconsidering strategies for an optimal work life balance, opening opportunities for employees to pursue individual interests, be creative with how they craft their job role and career path, and even offering perks like sabbaticals to allow employees to pursue passions outside of everyday work.

The increased transparency required in external reporting may also influence corporate culture. Compensation ratios reported under the Dodd-Frank Act have been under fire in recent years, and COVID-19 increased scrutiny of excess pay, amplifying existing compensation issues and creating urgency for change from proxy advisory firms and other stakeholders. The CEO pay ratio for companies in the S&P 500 was up to 264:1 in 2019 and increased to 299:1 in 2020; while pay levels **increased** by 12.1% for CEOs and 10.1% for CFOs between April 2020 and March 2021. This increase is the largest of the last five years. These metrics will continue to be scrutinized, not only by stakeholders outside the company, but by those within and disparity will likely not support a unified culture. If leadership is seen as putting their compensation over the well-being of employees, confidence in management is bound to dry up rapidly and turnover will likely increase.

The compensation committee should consider whether or not corporate culture benchmarks should be included in their compensation packages. Focusing on hitting tangible metrics in areas such as staff retention, upskilling programs and DEI can help incentivize executives to focus on these areas as they focus on culture and the impact on long-term company performance. That said, any DEI metrics in an incentive plan should support the organization's overarching DEI or ESG strategy. Absent a defined plan and communications strategy, DEI metrics risk being counterproductive or viewed as disingenuous by stakeholders.

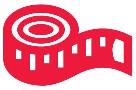
3 Aligning Compensation with Evolving Strategic Business Priorities

As priorities and strategies evolve, aligning performance goals with business strategy becomes more complicated for compensation committees. Our most recent **Board Pulse Survey** found that boards are aiming to take specific action to align executive compensation with business objectives and evolving stakeholder expectations. Their main focus areas are pay for performance and ESG. Tying compensation to value-driving goals can help compensation committees keep executives accountable and drive long-term benefits.

In the area of pay for performance, 63% of **directors surveyed** are aligning performance goals (thresholds/maximums) with the probability of achieving them. On top of that, 37% are shifting incentive compensation from a periodic bonus structure to longer-term equity grants, likely with the goal of pushing executives to think about business success long-term rather than simply making decisions to maximize their next bonus. COVID-19 caused some adjustments to be made to short-term executive compensation due to changes in annual cash flow, but most long-term incentives were not significantly impacted. Given the increased transparency and stakeholder interest in executive compensation, compensation committees should be considering what success metrics they are putting in place for the C-suite and how hitting those goals will further the organization's strategic vision and benefit shareholders.

When it comes to ESG success metrics, some boards have already begun weaving them into compensation agreements, even if a central framework on ESG disclosures has yet to be agreed upon. Based on a BDO **recent study** of 600 middle market public companies, about 14% mention using specific ESG metrics in their short-term incentive plans. BDO further found that 19% of public board members **indicate** that they are increasingly tying annual and/or long-term incentives to ESG metrics, 35% are enhancing communication and disclosures to key stakeholders about compensation and 33% are expanding the oversight role of the compensation committee. Ultimately, the end goal for most leadership is for ESG to become a natural fit within corporate strategy, though most companies are still working toward this. However, organizations shouldn't jump to using ESG metrics to gauge performance and evaluate compensation payouts until an organizational ESG strategy has been developed.

When designing an incentive plan that incorporates ESG factors, it is crucial to lay out the following strategic execution considerations:



What are you trying to measure? Agree on specific metrics and goals that align with your organization's values and vision. Without clear KPIs from the outset, measuring success over time will be more difficult in the long-term.

Should it be over a long or short term? Consider how long it will take to show improvement for that area of focus. Some areas may be tackled quickly, while others are best measured over a longer time frame to truly capture the impact.

How much of an incentive should it be? Consider the importance of each factor and take that into account when building the plan. Will you weigh the performance measures based on priority level? Does a modifier make sense to include? This step requires that the ranking of priorities has already been determined.

With a still uncertain economy, compensation plans also need to be structured to ensure they are responsive to economic shifts, keeping executives accountable for long-term value creation without punishing them for unforeseeable circumstances that arise. These compensation committee challenges may be mitigated by strategies such as:

- Engaging with shareholders and other key stakeholders (e.g., employees, customers, etc.),
- Reviewing peer group data and making adjustments to ensure continued alignment with evolving business needs,
- Implementing relative performance measures if well-defined peers exist, and
- Expanding performance ranges or lengthening stock holding periods.

The above is not an all-inclusive list.

Any change, particularly actions that stand out relative to market expectations, should be well documented and disclosed so stakeholders understand how the compensation programs align with the company's needs. Overall, there is no one-size-fits-all solution to creating the perfect compensation package, and committee members need to consume available market data along with internal data in proposing compensation strategies and plans reflective of the business needs.

Mastering M&A: Considering Compensation Strategy

As merger and acquisition (M&A) transactions continue to trend higher, there are many considerations for the board to take into account. The most recent **BDO Board Pulse Survey** found that appetite for acquisition is high — 50% of directors are seeking or expanding an acquisition strategy. No matter the goal(s) for an acquisition — growth, gaining new market share, increasing innovation — contemplating compensation is a key step in the process both from the perspective of your existing employees and from integration of talent that will be acquired.

Whether engaging in a traditional acquisition or executing a SPAC transaction, there are a number of **compensation considerations** to keep in mind:

- **Defining talent strategy.** The company will need to establish a talent philosophy that inventories current skills, defines corporate needs, and creates a plan to address the gaps therein. The compensation committee should work collaboratively with the nominating and governance committee as necessary to execute the strategy.
- **Aligning compensation plans.** Evaluate the plans already in place on each end of the deal and consider the best way to ensure they are aligned. This may require going back to the drawing board and reevaluating organizational goals and priorities of the newly merged entity. Consider the historical incentives that have been offered — are they still relevant? This can be a delicate process so ensure the compensation team works closely with the broader board to consider all the potential complications.
- **Aligning human capital departments and policies.** Integration is a key step in any M&A process. When it comes to compensation planning, smoothly integrating the human capital aspects of the merging organizations is critical. Policies and procedures are important to examine, as are the less tangible aspects like culture and employee morale. Once again, carefully consider the goals for the company post-deal and ensure that you have plans in place to align your new human capital policies with those goals.

An acquisition also often brings a new range of stakeholders who need to be taken into consideration when evaluating compensation impact. For example:

- How may this impact **corporate tax** — e.g., deductions for highly compensated executives?
- Will the share price be affected, and if so, do we have a plan to communicate this to those whose compensation is tied to share price?
- If considering or already implementing a **remote workforce** post-deal, what are the tax and legal implications in the long-term and do we need to rethink our long-term incentive plans?

Ensure you have plans to address questions like these during the M&A process.

4 Looking Beyond Traditional Compensation Tools to Attract and Retain Talent

When it comes to attracting and retaining talent, and employees want more. While executive pay levels have been rising in recent years, companies and compensation committees need to look beyond pay to attract and retain talent.

In 2022, top talent will likely still be hard to come by and competition for qualified professionals will remain fierce. Sourcing labor is among directors' top three impediments to economic and operational success, as cited by 16% of directors.

To mitigate labor challenges, businesses are attracting and retaining talent by using some of the following strategies:

55%

are re-imagining flexibility and remote work

51%

are emphasizing DEI initiatives

46%

are upskilling the workforce

37%

are enhancing employee benefits

32%

are focusing on corporate social responsibility/philanthropy

Compensation committees are urged to consider broader labor strategies when crafting incentive plans as long as they are reflective of strategic shifts toward a more resilient and agile business model to sustain the organization's future.

We are also seeing new benefit trends emerge as organizations look to retain talent in a recovering environment. These may include monetary retention awards in addition to reviewing compensation philosophy and structure to remain competitive. Beyond salary, we expect to see more compensation packages include flexibility, mobility, improved benefits and the facilitation of growth and leadership opportunities.

Engaging with employees — whether through town halls or pulse surveys — can provide companies with real time feedback as to what employees value and what changes may be appropriate. Striking the right mix of cash, equity, benefits, growth opportunities and more will be a process unique to each organization and each candidate.

5 Grappling with Increased Disclosure and Reporting Demands

Boards are dealing with ever-increasing disclosure and reporting demands as regulatory agencies reconsider what information is necessary for shareholders to make informed investment decisions. In late 2020, the SEC issued **new** HCM disclosure rules but left them largely principles-based, requiring reporting companies to include human capital measures that are *"material to an understanding of the registrant's business."* Although the SEC broadly identified the issues of attracting, developing, and retaining talent as examples considered important to stakeholders, it did not mandate the disclosure of these matters. Instead, the SEC recommended that each company disclose such details specific to its own business and circumstances. However, there is anticipation of additional and potentially more prescriptive HCM reporting requirements from the SEC expected in early 2022.

In August 2021, SEC Chairman Gary Gensler tweeted: *"Investors want to better understand one of the most critical assets of a company: its people. I've asked staff to propose recommendations for the Commission's consideration on human capital disclosure...This could include a number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety."*

Compensation committees must ask if their organization has the information and systems to collect such information readily available to address the potential additional disclosure requirements, as well as begin to understand what the disclosures will mean and how they might be interpreted by stakeholders. Directors should collaborate with the audit committee on reporting requirements, ensuring proper data controls are in place and disclosures are reviewed before filing.

The SEC also approved NASDAQ's board diversity compliance and **disclosure rules**. While compliance of such rules may fall under the purview of the nomination/governance committees, the compensation committee will need to work collaboratively with the board to support any enhanced recruiting and retention efforts that may result.

Though compliance is crucial, compensation committees must be mindful of where and how information is being disclosed to ensure there is a consistent and cohesive narrative for shareholders. An official disclosure in the 10-K or within the Compensation Discussion and Analysis (CD&A) is different than a disclosure in a standalone ESG report. While the new HCM disclosure requirements are specific to the 10-K, HCM disclosures in the proxy statement are also gaining popularity given the placement of the CD&A. The board needs to ensure that the company has appropriate mechanisms and controls in place to ensure information is reviewed and compared for consistency and accuracy, as these sources of information are being used by key stakeholders, including investors and regulators.

The increasing trend for companies to report on non-financial metrics has added complexities due to the subjectivity of the underlying qualitative and quantitative data. This causes difficulty when making a materiality assessment or trying to link to a trackable KPI. For example, boards have a range of plans to address ESG issues in the months and years ahead, with **nearly three-quarters of directors** (73%) focused on keeping up with evolving regulatory and reporting guidance for ESG in the near term. Board members also recognize this growing need for action and transparency, as the most important priorities coming out of shareholder meetings held during the 2021 proxy season included accountability for ESG/sustainability (13%) and DEI efforts (13%). Though ESG reporting remains largely voluntary in the U.S., we anticipate this to change significantly. For more on ESG, please refer to BDO's **ESG Center of Excellence.**

Controls are also critical to reporting and tracking comparatively over time; particularly as new non-financial metrics increase in frequency and prominence. The SEC has signaled that it is focusing heavily on comparability of data year over year. Any irregularities will be noted, and businesses will want to ensure controls are in place to explain variances and irregularities appropriately. Compensation committees should have a good understanding of the effectiveness of controls impacting compensation disclosures.

Overall, scrutiny continues to increase from a wide range of stakeholders and boards are being held to even higher standards. Any significant choices/changes made related to compensation are sure to be examined and dissected and committee members should take steps to ensure they feel comfortable responding to questions. Transparency is key, and carefully making and explaining strategic moves that drive long-term value will set organizations and board members up for success.

Next Steps

We encourage compensation committees to remain up to date on evolving compensation trends and work with your advisors on continuing education plans. For your convenience, here is a recent listing of resources that may be of interest to you from the BDO Center for Corporate Governance:

The BDO 600 2021 Compensation Studies

BDO In The Boardroom Podcast: Today's Compensation Committee: Impacts, Trends and Informed Decision-Making

Webinar: Executive Compensation Practices for Mid-Market Companies

2021 BDO Board Pulse Survey

Visit the BDO Center for Corporate Governance Compensation Committee hub page for more insights to support the evolving roles of the compensation committee.

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