IN-DEPTH: LINKING COMPENSATION TO SUSTAINABILITY

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Executive compensation has been the most controversial issue facing companies in recent years. From regulation requiring U.S. companies to provide investors with advisory votes on executive compensation, "two strike" rules for executive compensation in Australia and binding resolutions on compensation policies in the UK, the influence of shareholders on executive compensation matters has dramatically increased on a global basis.[1] With increased advisory power, many investors are focusing on the concept that properly designed executive remuneration programs should incentivize management to focus on long-term, sustainable corporate growth, rather than rewarding the short-termism that was likely a significant contributing factor in the most recent global financial crisis.

In an effort to encourage sustainable, long-term growth, Glass Lewis has observed a trend among companies to incorporate metrics associated with sustainability into long-term and short-term incentive plans. Likewise, investors have also become more vocal in encouraging the use of such metrics. For example, in June 2012, the United Nations Principles for Responsible Investment ("UNPRI") released guidance for the integration of environmental, social and governance issues in executive pay.[2] This guidance, which was established through discussion with investors and issuers, addresses the three key areas of constructing compensation packages that successfully utilize sustainability metrics: (i) identifying appropriate ESG metrics for each company; (ii) linking these metrics to executive pay packages; and (iii) providing high-quality disclosure on sustainability-linked compensation plans.

The movement toward the integration of sustainability-related compensation metrics into executive remuneration plans stems from the belief that companies that promote sustainable business practices often outperform those that do not. This belief has recently been further reinforced as companies such as Tokyo Electric Power Company, Walmart, BP and Massey Energy have suffered massive blows to shareholder wealth as a result of significant environmental, social and/or governance-related issues. These issues highlighted the considerable implications of these companies' failures to appropriately identify, manage and mitigate their exposure to environmental, social and ethical risks. Not only do companies who improperly manage these issues face significant risks, but companies who embrace a sustainability-focused strategy could reap significant rewards. For example, 2013 research from the Carbon Disclosure Project and Sustainable Insight Capital Management found that companies who took industry leadership positions with respect to climate change had better performance with respect to return on equity, cash flow stability and dividend growth than their peers.[3] Given the potentially significant impacts (both positive and negative) from sustainability-related issues, it is unsurprising that sustainability factors have been gradually making their way into an evolving definition of corporate performance. Complementing their traditional analysis of performance metrics, such as stock price movement and EPS, many mainstream investors- and a growing number of companies- are now embracing the importance of including a corporation's operational impacts on the environment and society in discussions of aggregate corporate performance.

While the practice of companies integrating sustainability metrics into compensation plans is relatively new, the idea of evaluating performance on the basis of sustainability metrics is not. In 1951, Ralph Cordiner, the CEO of General Electric, commissioned

1 Under Australia's "two strike" rule, if 25% of shareholders vote against a company's remuneration report at two consecutive annual meetings, shareholders vote on whether the entire board will stand for reelection within 90 days following the annual meeting.

2 United Nations Principles for Responsible Investment, United Nations Global Compact LEAD. "Integrating ESG Issues into Executive Pay: Guidance for Investors and Companies." June, 2012.

3 "Linking Climate Engagement to Financial Performance: An Investor's Perspective." Sustainable Insight Capital Management, Carbon Disclosure Project. September 2013.

a task force to identify key performance metrics, which were determined to be: profitability, market share, productivity, employee attitudes, public responsibility and the balance between short- and long-term goals.[4] The recent translation of these performance metrics into compensation packages has resulted in a growing consensus of the importance of responsible corporate performance that has been supported by a mounting body of research showing that firms that operate in a more responsible manner may perform better financially. For example, a 2010 study found that analysts are more likely to recommend a stock "buy" for companies that have strong corporate responsibility strategies. Because other studies have shown that analysts' perceptions are a good proxy for overall investor expectations and perceptions of the long-term earnings potential of a firm, the study's authors argue that their findings could therefore encourage the linking of strong company-level corporate social responsibility strategies to more value creation in public equity markets.[5]

Further, a recent study conducted at Harvard Business School found that companies that voluntarily adopted environmental and social policies exhibited fundamentally different characteristics from a matched sample of firms that had not adopted such policies. For example, the firms that adopted social and environmental policies were significantly more likely to outperform their counterparts over the long-term, both in terms of stock market and accounting performance. Moreover, these companies were also more likely to tie top executive incentives to sustainability metrics. The study's authors concluded that the observed financial outperformance was stronger in sectors where large firms significantly depended on the extraction of large amounts of natural resources and in instances where a firm's customers were individual consumers or where companies competed on the basis of brands and reputation.[6] However, this outperformance may come at the expense of short-term profitability. A 2013 study found that the benefits to society that are achieved through prioritizing environmental initiatives could come at a cost to the short-term profitability of a company. However, the study's authors note that having a proactive environmental strategy can have a positive impact on the long-term profitability of a company in terms of its relationship with various stakeholder groups and the resultant increase in the value of its brand.[7] Therefore, it seems prudent for companies to actively evaluate how sustainability most effectively can be managed within the context of their own unique operational environment. Over-enthusiastically committing to sustainability goals without an understanding of their ultimate ramifications on operations or strategy could be harmful to both companies and their shareholders. A 2013 article notes that, after a certain point, "greater sustainability from a societal point of view could come at a cost to shareholders," suggesting that there is indeed an 'optimal' degree of adoption of sustainability-related practices, beyond which they become value-destroying, at least in the short-term.[8]

Another study by researchers at Harvard Business School and the London Business School found that the better a firm's corporate social responsibility performance, the fewer capital restraints it would face. The study determined that better corporate social responsibility performance is the result of improved stakeholder engagement, which reduces the likelihood of opportunistic behavior and compels managers to adopt a more long-term strategy, which, in turn, introduces a more efficient form of

4 Robert G. Eccles. "The Performance Measurement Manifesto." *Harvard Business Review*. January, 1991.

5 Ioannis Ioannou, George Sarafeim. "The Impact of Corporate Social Responsibility on Investment Recommendations." Harvard Business School. August, 2010.

6 Robert G. Eccles, Ionnis Ioannou, George Serafeim. "The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance." Harvard Business School. May 9, 2012.

7 Surav K. Dutta, Raef A. Lawson, David Marcinko. "Alignment of Performance Measurement to Sustainability Objectives: A Variance-Based Framework." *Journal of Accounting and Public Policy*. May 22, 2013.

8 Robert G. Eccles, Ioannis Ioannou, George Serafeim. "Is There an Optimal Degree of Sustainability?" *Ethical Corporation*. February 2012.

contracting with key constituents. Finally, the study concluded that companies that employ positive corporate social responsibility practices are likely to report these practices, thus increasing their overall transparency, which can ease the fears of investors and make these companies more likely candidates for investment.[9]

The creation and disclosure of specific sustainability goals could also improve financial performance and relations with stakeholders and shareholders. A 2013 white paper by CH2MHill found that there is a link between tangible sustainability goals and improved environmental and financial performance. The paper also highlighted improvements in shareholder relations from communicating these goals, using shareholder proposals as a proxy for investor concerns regarding sustainability-related performance. The firm found that while 14% of companies with sustainability goals receive sustainability-related shareholder resolutions, such resolutions are filed at 44% of companies without sustainability-related goals.[10]

Perhaps unsurprisingly, a 2005 study found that companies with better environmental and social performance may also have different attitudes toward risk and compensation practices. This study, which examined companies in the Domini 400 Social Index, which selects companies using a socially responsible screen, compared with comparable companies outside of the index, found that the value of stock option grants is strongly related to stock return volatility for firms that are not socially responsible but not for firms that were categorized as performing in a socially responsible manner. The authors suggest that this means that an increase in the value of stock option grants does not influence the CEOs of socially responsible firms to take on more risk. Further, the study also found firms that are considered to be socially responsible pay their executives higher annual salaries, but that the CEOs of these firms receive significantly less non-traditional compensation, such as perquisites, debt forgiveness and other personal benefits, than do CEOs at the firms not deemed responsible.[11]

Given that, through academic research, it has been demonstrated that stronger corporate social responsibility performance can lead to fewer capital restraints, lower cash pay-performance sensitivity and increased transparency and engagement, it stands to reason that more and more companies would link these sustainability metrics to executive compensation, in efforts to incentivize executive behavior to pursue and achieve an exemplary level of financial and responsible corporate performance. Thus, it is not surprising that findings have shown that companies, on a year-over-year basis, are increasingly linking pay to sustainability. In fact, in 2013 it was reported that nearly all S&P 500 companies report some form of sustainability disclosure and that approximately 44% of S&P 500 companies are linking executive compensation to sustainability.[12]

Other research has found widely varying proportions of companies that link executive compensation to sustainability metrics. For example, according to Ceres, of the 613 largest, publicly-traded U.S. companies, 24% are linking executive compensation to sustainability performance, up from 15% in 2012.[13] Conversely, GMI Ratings found that 53.8% of S&P 500 companies provide a link between compensation and sustainability, though it notes that only 16% name specific metrics used to measure performance.[14] Further, a 2012 survey conducted by

9 Beiting Cheng, Ioannis Ioannou, George Serafeim. "Corporate Social Responsibility and Access to Finance." Harvard Business School. May 9, 2012.

10 "Sustainability Goals that Make an Impact." CH2MHill. July 2013.

11 Melissa B. Frye, Edward Nelling, Elizabeth Webb. "Executive Compensation in Socially Responsible Firms." *Corporate Governance: An International Review*. Volume 14, Issue 5, pages 446-455. September, 2006.

12 Peter DeSimone, Jon Lukomnik. "Are Companies Connecting the Sustainability and Financial Disclosure Dots?" Harvard Law School Forum on Corporate Governance and Financial Regulation. May 19, 2013.

13 "Gaining Ground: Corporate Progress on the Ceres Roadmap for Sustainability." Ceres and Sustainalytics. 2014.

14 "Press Release: GMI Ratings' Study Finds That Only Ten Percent Of S&P 500 Companies Disclose Specific Sustainability Targets in Executive Compensation Plans." GMI Ratings. April 30, 2014.

GreenBiz Group and Ernst & Young of 282 executives and thought leaders from large-cap, mostly U.S.-based companies found that 21% of respondents stated that their leadership team's compensation was driven in part by sustainability performance.[15] Likely the cause of these figures is due to differing methodologies and definitions of "sustainability." However, while much of this difference could be explained by varied methodology, it highlights the struggle both for companies in creating and communicating sustainability-related metrics and for investors in understanding the extent to which companies are linking compensation to sustainability.

Despite this growing trend, the jury is still out regarding whether linking pay to sustainability metrics is ultimately beneficial to a company's bottom-line financial performance. Evidence that companies acting in a more responsible manner financially outperform their peers is nascent and somewhat ambiguous, as demonstrated in a 2009 study that found U.S. companies with an explicit policy linking compensation to environmental performance and that have board-level committees that oversee environmental issues do not tend to reward sound environmental strategies more than those without such structures, suggesting that these mechanisms play merely a symbolic role. However, the study did find that long-term pay could be an important incentive for pollution prevention and is an especially effective instrument for environmental mitigation for companies in highly-polluting industries, where emissions are of a greater concern and the environmental impact is more pronounced.[16] Additionally, a 2011 study of 490 global companies by S.B.M Rosendaal from the Erasmus School of economics found that incorporating sustainability targets in executive compensation schemes does contribute to sustainable development. Moreover, the study found that executives were not incentivized by either a higher percentage of sustainability-related targets or by a specific focus on short- or long-term rewards. Rather, the study found that simply including sustainability targets in remuneration packages was sufficient to encourage sustainable development.[17]

While it could be argued that some firms have incorporated corporate responsibility metrics into their remuneration packages simply to appease vocal or activist stakeholders, others insist that these companies have linked executive pay to sustainability measures and goals in order to drive executive behavior to effectively mitigate risk, increase efficiencies and to increase the long-term financial strength of the company. Irrespective of their true motives, there is no disputing that a growing number of domestic and foreign firms operating in disparate industries have chosen to link social and environmental performance to executive compensation.

However, it is important to note that further refinement is still necessary. Many observers have raised concerns regarding the efficacy of how companies are linking compensation to strategic objectives. For example, many cite inadequacies with the heavy focus on linking pay to safety and environmental issues, such as spills or accidents, as these issues may be too narrowly focused on mitigating risks, rather than creating value. Additionally, there have been criticisms that most metrics tend to focus on past performance, rather than focusing on metrics that reward executives for investing in improving future performance or efficiency or measures that demonstrate the overall quality of a sustainable management system.[18]

15 "2013 Six Growing Trends in Corporate Sustainability." Ernst and Young, GreenBiz Group. 2013.

16 Pascual Berrone, Luis R. Gomez-Mejia. "Environmental Performance and Executive Compensation: An Integrated Agency-Institutional Perspective." *Academy of Management Journal*, Vol. 52, No. 1, 103-126. 2009.

17 S.B.M. Rosendaal. "Sustainability Targets in Executive Remuneration: An Analysis of the Contribution of Sustainability Targets in Executive Remuneration to Sustainable Development." Erasmus School of Economics. August 11, 2011.

18 Coro Strandberg. "Sustainable Pay Should be Linked to Creating Value Not Just Protecting It." *The Guardian*. June 26, 2013.

Thus, effective incorporation of incentives that promote sustainability objectives may require a significant organizational shift in how companies view these issues. In order to ensure that sustainability is sufficiently embedded with an organization, some studies have suggested that companies integrate sustainable business practices in operational decision making, which would mandate the incorporation of sustainability metrics in performance measurement and compensation schemes. In fact, studies have found a positive relationship between environmental strategy and the use of environmental performance measures for decision-influencing purposes operated indirectly through systems focused on financially quantified environmental information.[19] This sentiment was echoed by another study that found the success of an environmental strategy implementation depended on providing information related to corporate environmental impacts to various managers within a company and making the development of clear, quantitative performance measures critical in achieving sustainability-related objectives. However, while many companies include sustainability as part of their strategic objectives, studies have found the associated measurement systems to not be well developed.[20] As such, while we have witnessed the growing trend in companies incorporating sustainability into executive compensation schemes, it appears that there could be significant room for growth in how these plans are constructed in order to obtain optimal efficacy in driving sustainable corporate performance. The most important facet of a compensation plan is that it is properly linked to long-term, sustainable corporate performance. To this end, many companies may find the use of sustainability-related compensation metrics to be beneficial in driving the behaviors that ensure a focus on long-term performance. Companies should employ strategies and incentivize behaviors that leverage their own unique strengths and competitive advantages. It is important that companies assess sustainable opportunities through the lens of long-term growth and shareholder returns, because unless companies are profitable and remain in business, they will cease to benefit shareholders and wider groups of stakeholders.

There is still much room for improvement in companies disclosing links between sustainability and compensation, but linking compensation to sustainability continues to be an evolving practice. We believe that as companies progress in this area they should be held to a higher standard of accountability for their practices by both compensation committees and investors. Several companies have clearly demonstrated that construction of a link between compensation and sustainability can be beneficial to organizations as well as their shareholder and stakeholders. The progress made by these companies in constructing a link between compensation and sustainability is important and could easily be furthered by the construction and inclusion of stronger, more specific and value creating goals. It is likely that, as shareholders push for more information on how companies link compensation to sustainability and as companies are required to disclose more and better information regarding compensation packages and associated performance metrics, this link will continue to grow stronger.

While the incorporation of sustainability metrics in corporate performance is clearly a growing trend that many companies have adopted, there is still much improvement to be made in the actual construction of the link between compensation and sustainability. For example, a 2012 review found that there is a general agreement about key corporate sustainability issues, but not necessarily on the specific form and number of metrics used to measure them. However, these metrics largely tend to approach ESG issues from a risk mitigation perspective, rather than a

19 Surav K. Dutta, Raef A. Lawson, David Marcinko. "Alignment of Performance Measurement to Sustainability Objectives: A Variance-Based Framework." *Journal of Accounting and Public Policy*. May 22, 2013.

20 Surav K. Dutta, Raef A. Lawson, David Marcinko. "Alignment of Performance Measurement to Sustainability Objectives: A Variance-Based Framework." *Journal of Accounting and Public Policy*. May 22, 2013.

value creation perspective.[21] As such, now that companies have established metrics that measure sustainability issues, it may be important for them to begin to focus on the upside rather than just the downside of these issues. For example, as has been the case for a number of years, the majority of firms that provide a link between compensation and sustainability did so under the category of "safety" performance. This, perhaps is due to the fact that this metric is the most visible and easily measured. Additionally, this metric can be easily tied to shareholder value through lower fines, reduced accidents and mitigation of environmental risks, among other factors. Furthermore, we found, unsurprisingly, that there are more firms that link compensation to sustainability metrics (often using "safety" as a key metric) in the more production-intensive sectors, such as Utilities, Materials or Energy. However, while it is extremely important for these companies to continue to focus on ensuring safe operations, it may be time for them to construct sustainability-related goals that are more opportunistic and forward looking.

Investors, too, seem to be demonstrating a growing interest in companies linking compensation to sustainability. In a 2013 report by Ernst & Young and GreenBiz Group, 30% of corporate respondents stated that they had received inquiries from shareholders regarding their practices in tying executive compensation to sustainability metrics. In addition, 21% of respondents stated that their leadership teams' compensation was driven in part by sustainability performance, while 11% responded that those responsible for sustainability had no impact on strategy or governance.[22] As such, it is likely that investors with a focus on ensuring that executives are awarded for long-term, sustainable corporate performance are driving part of this growth in the prevalence of companies adopting a link between compensation and sustainability.

Ultimately, sustainability is a moving target. There are no easy answers to what is the best way to incentivize behaviors that will drive performance, benefit shareholders and the environment, and eventually lead to shareholder returns. Whether it is tying specific environmental or social metrics to executive compensation or developing a board-level committee to review sustainability issues, it is critical that companies seriously consider the risks that are presented by various environmental and social issues.

21 Peter A. Soyka, Mark E. Bateman. "Finding Common Ground on the Metrics that Matter." IIRC Institute. February, 2012.
22 "Six Growing Trends in Corporate Sustainability." Ernst & Young, GreenBiz Group. 2013.

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