EXECUTIVE COMPENSATION

A Board's Guide to Navigating Pay Equity Issues

By Rosie Newman and Justin Peters

Compensation committees are increasingly considering the social aspects of environmental, social, and governance (ESG) programs, expanding their traditional focus on executive compensation into oversight of broader workforce topics such as human capital management and diversity, equity, and inclusion (DE&I) initiatives. Governance over broad workforce management, development, and retention strategies has brought to the forefront questions about pay equity and pay parity, including how to effectively communicate compensation matters. In light of the attention on ESG and workforce considerations, we recommend that compensation committees consider the following when developing and communicating compensation programs.

- **Review pay positioning.** Companies need not have the same pay philosophy at all levels (e.g., for senior executives, there is more focus on at-risk, performance-based pay), but the program should cascade appropriately throughout the organization. In particular, it is important to be mindful of how pay positioning is communicated. If there are differences in where senior executives are positioned (e.g., the executive team is at the 60th percentile versus market while broader-based employees are at the 50th percentile), communication of these targets, especially without justification, can cause concerns.

- **Conduct a pay equity study.** Many companies are conducting or commissioning pay equity studies to understand the influence of age, race, or gender on pay practices. This data can help a company recognize any issues and move toward more equitable and transparent pay programs, where differences are driven by job duties, responsibilities, and company and individual performance.

- **Consider discrepancies in bonus payouts.** The proxy statement should clearly disclose bonus payouts for the named executive officers. However, this may create an internal communication challenge if the executive team payout (as a percentage of target) varies from that of the broader employee population. In some cases, companies exercised discretion to reduce executive team payouts to be in line with or provide for additional bonus funds for the broader employee population. If communicated effectively, these discretionary adjustments can help resolve equity concerns. But if this becomes an ongoing issue, boards should consider whether there should be consistency in metrics and goal setting to drive a "one company" mentality.

- **Incorporate ESG metrics.** Companies are increasingly designing incentives that not only emphasize financial and operational performance, but also demonstrate awareness and action on ESG dimensions. Meridian found that 56 percent of large companies include a social metric in their annual incentives. Of these companies, more than 60 percent included DE&I metrics (e.g., percentage of underrepresented groups in leadership positions), and 42 percent included a human capital, culture, and labor metric (e.g., tied to employee well-being, training and development, turnover and retention, culture, or employee engagement). All of these metrics can help demonstrate executive commitment to workforce matters and clarify the company's philosophy, tone, and culture.

- **Tell a compelling story in the proxy and other key disclosures.** The proxy statement remains the most important public disclosure for telling the story about compensation programs and pay-for-performance alignment for the executive team. Increasingly, companies are also telling the story about their pay programs for broader-based employees. Meridian found that 62 percent of companies disclosed information related to total rewards policies or initiatives in human capital management in Form 10-K. Total rewards disclosures typically include information on compensation and benefits packages, both financial and nonfinancial, provided to specific segments of the employee population (e.g., cash, equity, health or life insurance, or retirement contributions). While a minority practice, 23 percent of companies also disclosed information related to pay equity policies or initiatives.

As the responsibilities of compensation committees continue to expand, it will become a necessity to maintain an arsenal of effective, company-specific tools to identify, address, and communicate pay equity and other workforce issues. D

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