Compensation Committee Leadership Network

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CCLN

VIEWPOINTS

Oversight of human capital

The workforce is changing, as is the nature of work. Hiring, training, and retaining the right people, as well as developing a strong corporate culture, are central to success. Additionally, companies must weigh and respond to investor perspectives on people and pay. In this environment, many compensation committees are expanding their mandates and working more closely with their chief human resources officer (CHRO) on talent strategy.

On June 25–26, members of the Compensation Committee Leadership Network (CCLN) were joined by human resources executives for a series of discussions about improving human-capital oversight. Members of Tapestry Networks' Lead Director Network joined CCLN members for a dinner discussion with Carmine Di Sibio, global chairman and CEO of EY. Ken Bertsch, executive director of the Council of Institutional Investors (CII), also joined participants for a session. This *ViewPoints* synthesizes these discussions.[1]

The evolving roles of HR and the compensation committee

CCLN members and HR executives discussed the elevated role of the CHRO, the compensation committee's mandate for human-capital oversight, the CHRO's role in onboarding new directors, and the relationship between the compensation chair and CHRO.

HR leaders have become strategic business advisers

A recent *Forbes* article declared that the CHRO is one of a company's most strategic roles,[2] and the nature of the role is expanding at many companies. CHROs work closely with CEOs on talent, culture, corporate reputation, and operations.[3] One compensation chair said, *"They have to think about talent, diversity, succession, and the culture. They are a peer to all the top executives."*

Given HR's rise in stature, it is necessary but no longer sufficient for HR leaders to have an excellent command of the subject matter in areas such as payroll, benefits, recruiting, and performance management. Increasingly, the trait that determines success as a CHRO is an intimate knowledge of the business.[4]

Several CCLN members' companies have moved executives from operating roles into HR leadership. One member described a shift in the last decade: *"There is a greater willingness now to appoint a CHRO with a business background or an HR background. It would be a mistake to say one is better than the other—you just need someone strategic and business savvy."* Another concurred, adding, *"The role has certainly transitioned to be on the front end of strategic discussions in terms of talent development and compensation topics. We now look* *for a confidante and strategic team member to engage in conversations with, as opposed to someone who can manage the process."*

CHROs weighed in on the evolution they have seen in their roles and the importance of having clout in the organization. One summed it up well: *"We've gone from being a support function to being leaders of the transformation of the company."* Another discussed changes in the external environment that have led to this shift in stature: *"Our environment is changing, and more quickly than ever. There is a changed expectation of what HR is bringing to the table and a push to think about HR more holistically. Pay equity, #MeToo, and the media have brought HR along as a different type of adviser and business partner. We are no longer just a process adviser but a people adviser."*

Talent oversight is becoming part of the compensation committee mandate

While oversight of human-capital strategy is ultimately the responsibility of the full board, specific responsibilities are typically allocated to committees, as appropriate.[5] In recent years, compensation committees' remits have continued to expand, as broader human resource issues are seen as a critical area for potential differentiation and value creation.[6]

Some boards are debating whether the compensation committee should be responsible for talent oversight. In some cases, committees have changed their names and charters to reflect a broadening agenda; in others, expanded responsibilities are not formally defined. One compensation chair was concerned about delegating too much of such a fundamental board responsibility to a committee: *"The board does not want to fully delegate, but how do we get enough time and focus without overwhelming the board?"* One compensation chair noted a connection to the expanding mandate of the CHRO: *"We freelance on HR issues because of our relationship with the CHRO."*

The CHRO plays a role in director onboarding

According to the recently published *CHRO's Guide to Compensation Committee Chair and Director Onboarding*, a well-executed compensation committee onboarding program will increase the odds that a director will make meaningful contributions sooner.[7] The guide offers a range of practical tips on the materials to provide new committee members, the internal meetings to schedule, and techniques to accelerate their learning.

Rich Floersch, a senior strategic adviser to the HR Policy Association and the Center on Executive Compensation, which published the guide, said at the meeting, *"This is an opportunity for CHROs to be proactive and to start to build trust. They can provide good information on compensation committee history and philosophy and share things that, in retrospect, didn't work well."* Participants shared their experiences with director onboarding programs. One said, *"We have a routine onboarding process for the compensation committee for any new member that joins. It's a major process, with a briefing book that covers a lot. We* *also encourage new board members who are not assigned to the compensation committee to avail themselves of the information; it's not mandatory, but four out of five times they do it."*

Mr. Floersch suggested CHROs conduct a page-by-page review of the proxy statement with new compensation committee chairs: *"If you dive into it and let the new committee chair ask the CHRO questions, it will reveal a lot."* One CHRO noticed a trend in director onboarding sessions: *"After onboarding the last few directors and reviewing the proxy and other documents, the conversation always turns to tone, culture, and how much time is spent on compensation versus talent issues in the committee. It's been a trend in the last few years to have talent be the greater focus of board members, and it may mean we weigh the materials differently in our next onboarding session."*

CCLN members and CHROs also discussed what exposure to compensation issues and the HR staff looked like for other parts of the organization, including directors who were not on the compensation committee. One CHRO said, *"We do a very comprehensive talent review with the full board once a year. I also have lots of informal interaction with every board member outside of the formal talent cycle. Our high-potential candidates are in front of the board during strategy day and various diversity and inclusion events. Involving the board members in these events paints a nice picture to the younger members of the organization that the board cares about more than just stats."*

Compensation committees are forming a closer bond with CHROs

In many cases, the CHRO plays a key role in supporting the compensation committee's work. CCLN members said that it is essential to develop a strong working relationship with the CHRO. Compensation chairs and CHROs discussed how they work together to develop the committee's agenda. One shared a detailed account: *"It should not come as a surprise that this process requires heavy lifting. We conscientiously map out the agenda for the next year to 18 months. We get input from our CEO, our compensation consultants, our head of HR, and our investor relations team so we ensure we are staying attuned to issues that arise that should be included in our agenda. It all comes from the master plan that the board drives."*

Compensation chairs and CHROs noted the value of collaborative preparation meetings and streamlined advanced reading. One CHRO said, *"My compensation chair makes sure all questions are addressed in advance of the meeting so that I have no surprises going into it. It's a lot of work ahead of time, but it helps us stay on track."* Another CHRO discussed relying on the compensation chair to help navigate difficult situations: *"The compensation chair helps me understand the motivations of the various board members. If we can find a common thread, it helps us present nuanced ideas in a way that people can understand and support."*

While the CHRO is a regular participant in compensation committee meetings, the other members of management who participate vary both by board and by a specific meeting's agenda. One CHRO said, *"Our CEO, chief accounting officer, and general counsel also attend. Our culture is to have very few other staff in committee meetings. To be frank, I think our head* *of compensation and total rewards should get airtime with the board, but having one of my direct reports present might suggest that I was not prepared to have that conversation."* One compensation chair discussed a change in approach: *"We moved from a small room to a big room, which reflects that our mission has grown, along with our participants. Along with the CHRO, we have head of compensation, general counsel, corporate secretary, CEO, and compensation consultant. The chairs of other committees also attend when we discuss setting targets because we want robust discussions on that topic."* Participants noted that they try to strike the right balance between ensuring the appropriate people are included in the conversation and protecting the intimacy that allows for candor.

Linking strategy, talent, and culture

In a study of the top risks facing their companies, more than 800 executives and directors rated "succession challenges and the inability to attract and retain talent" in the top five.[8] For CCLN members, this human resourcing challenge goes beyond just senior management; competition for talent at all levels of the organization has become a major issue demanding board attention. As new technology transforms how employees work and what skills they need, directors and managers are focused on ensuring their organizations are prepared to adapt.

Some observers say that to stay relevant, companies need to hire talented individuals who can constantly learn new skills, some of which may not even exist yet.[9] Research from McKinsey found that 82% of executives at large organizations "believe retraining and reskilling must be at least half of the answer to addressing their skills gap," with 27% calling it a top-five priority.[10] Executive recruiters share this view: in another survey, 74% of them said reskilling workers represented an effective strategy to combat talent shortages.[11]

Participants discussed a few of the factors driving this conversation:

- **Dealing with technological innovation.** According to the 2018–2019 National Association of Corporate Directors (NACD) Public Company Governance Survey, directors ranked the "pace of technology disruption" and "key talent deficits" as high among trends likely to impact their organizations; however, directors had low confidence in management's ability to address these trends.[12]Artificial intelligence, machine learning, and the associated automation of increasingly advanced tasks are changing the nature of some jobs and the skills needed to keep pace. A participant noted how technology has complicated decision-making: *"When you re-envision the workforce and its tools, you see that the complexity in the space has increased dramatically. Do you build, buy, bot, or bend?"*
- **Developing new skills.** Participants stressed the importance of change management and digital skills in the next generation of leadership. One participant said, *"The talent pool we need has changed dramatically as we've implemented a digital strategy. It required a shift in attitudes and behavior. We've placed a much greater emphasis on collaboration."* Some

said their companies have launched massive reskilling programs or created unique events to familiarize employees with new strategic initiatives. The changing work environment also requires new management styles. A CHRO said, *"Some people can be technical leaders but not people managers. We are doing work on defining what is a quality manager."* Another concurred: *"We are moving the metrics on managerial effectiveness into the performance evaluation dashboard. A track record of building a strong team is critical."*

- **Changing employee expectations.** New workers desire factors such as workplace flexibility and a mission-driven culture.[13] An executive participant in a recent NACD advisory council meeting said, "Millennials have blurred lines about what you get from your employer, your family, and the world. To be a good employer, you have to help them create a good life."[14] One compensation chair said, *"It's not that millennials want to work less—they just want more flexibility. And they want respect. Today, people just won't suffer anymore, and I think it's a wonderful thing for the future."* Technology helps provide solutions such as remote working, role sharing, and freelancing. Yet accessibility can create new challenges. One participant said, *"People don't want to be on call with 24/7 availability. It might not have much to do with our overall strategy, but jobs have to change; otherwise, people aren't going to want to do them."* Elements besides pay are increasingly important to today's workforce. One participant said, *"Pay is table stakes—but then you have to differentiate based on the individual. For some, it's a pension; for others, it's free pet insurance or an extra vacation week."* Participants said that employee engagement surveys have proved to be a useful tool for understanding what employees value and for assessing organizational morale.
- **Recruiting diverse talent.** Some participants discussed the continued struggle to attract a more diverse talent pool. One said, *"We have trained our recruiters on unconscious bias and still have to send recruitment lists back to them. We refuse recommendations until we have some diverse candidates."* Participants brought up the challenge of recruiting across different countries and different levels, and the importance of a tailored approach. One CHRO said, *"We have very different strategies for recruiting in India versus going on campus to recruit MBAs. We have to be thoughtful about how we meet talent depending on our location."* The war for talent continues, so companies must devote more time and attention to creating an attractive work environment and demonstrating that to prospective employees. One participant said, *"In our industry, we are competing for talent with Google, Amazon, and other big Silicon Valley companies. We can never come close on pay, so we have had to focus on the quality of the work experience and what you will learn, who you will work with."*
- **Aligning corporate culture with strategy.** Over dinner, Mr. Di Sibio emphasized the tie between strategy and culture: *"About 20 years back, we started building our strategy around teaming, within EY and with our clients. We wanted to tell our clients, 'We are an organization that works with you, not for you.' That also required a culture focused on*

teaming and collaboration to embed the right behaviors in our business. We had little tolerance for partners who didn't drive this new culture." Change requires signals large and small. One participant said, *"Big shifts take years, but there are symbols in the organization that show something is changing. It can be as small as a new CEO doing a town hall without wearing a tie."* Participants added that fostering a culture of diversity and inclusion and providing ample opportunities for employee feedback is critical for attracting the next generation of the workforce.

Given the importance of talent strategy, some CCLN members questioned whether their boards and committees were devoting sufficient time to the relevant issues. Most agreed that a talent strategy discussion once a year is not enough to dig into these issues. One said, *"We have a thorough succession conversation where we go through the whole top team in conjunction with a broader view on talent strategy. We discuss, What is the talent we are looking for, where will it come from, and what is the mix? But the core conversation is once a year—an overall view of where talent is embedded into other strategic business issues."* Several noted the importance of incorporating more discussions on talent at each compensation committee or full board meeting, understanding how the company is implementing training and development programs and spending time with high-potential employees.

Investors' expectations on people and pay

CII's Mr. Bertsch joined participants to discuss human-capital management disclosures, non-GAAP pay metric disclosures, and changes to performance-based pay.

Founded in 1985, CII is a nonprofit, nonpartisan association of corporate, public, and union employee benefit funds and endowments with a focused policy mission: to be the leading voice for effective corporate governance practices for US companies and for strong shareholder rights and protections. CII has more than 120 general members with combined assets that exceed $3 trillion.[15] Mr. Bertsch was named executive director in March 2016 and brings over 30 years of experience across a variety of corporate governance roles.

Human-capital management disclosures

On March 28, 2019, the Investor Advisory Committee of the Securities and Exchange Commission (SEC) voted to recommend that the SEC consider imposing human-capital management disclosure requirements[16] in response to a petition from the Human Capital Management Coalition.[17] The coalition contended that investors are unable to fully understand a company's long-term business, risks, and prospects without more information about its people, and it proposed that with consistent, mandatory disclosures, it would be easier for investors to collect and analyze information and more efficiently direct capital to its highest-value use.[18]

Mr. Bertsch elaborated on what CII's members are looking for: *"Our membership is diverse and some investors want different things, but there is broad consensus on a desire for disclosures on talent development, recruitment, retention, and morale. Current accounting rules make it hard to get at the value of intangibles, including human capital, so making that better is the basic impulse here."*

In a speech in March 2019, Bill Hinman, director of the SEC's Division of Corporation Finance, discussed the possibility of additional disclosure requirements in this area:

> Principles-based disclosure requirements articulate an objective and look to management to exercise judgment in satisfying that objective by providing appropriate disclosure when necessary. Management's Discussion and Analysis (MD&A) and Risk Factors are examples of such disclosure requirements and are well-suited to elicit disclosure about complex and evolving areas. Ideally, MD&A allows investors to see a company's results and prospects through the eyes of management. A well written MD&A allows investors to understand how management is positioning the company in the face of uncertainties, like those associated with rapidly evolving topics.[19]

Participants said that their companies make disclosures about their workforces in a range of places, including proxy statements, sustainability reports, and the MD&A portion of SEC filings. The lack of a single standard makes it difficult for investors to make comparisons. *"I believe that the Sustainability Accounting Standards Board has the best opportunity to move this along, but some CII members would prefer that the Financial Accounting Standards Board and the SEC create a required regime,"* said Mr. Bertsch.

Participants were concerned about the imperfect and subjective nature of quantitative human-capital metrics. One said, *"It's tough to pick a metric to disclose, and once you do, investors will look for it year over year. Take turnover, for example—high turnover in the brokerage industry is bad, but it's to be expected in the tech industry. Everything gets blended into one number and it's not comparable."* Another added, *"Some have taken to the pay ratio to better explain the workforce. It's not terribly useful or comparable."*

Mr. Bertsch noted that while CII's members would favor a consistent set of quantifiable metrics, investors also value qualitative descriptions of companies' human-capital management practices. He shared an example of one company to look to for a good qualitative disclosure: *"Regions Financial has excellent disclosures in their proxy about corporate culture, fair treatment of employees, etcetera. It's the best I've seen and it has gone a long way with their investors."*[20] CCLN members and CHROs shared their experiences engaging on these issues. One participant said, *"We put most of this information in our annual sustainability report—not as much in the CD&A [compensation discussion and analysis] and MD&A. We have found that there is more expectation in the dialogue with investors every year, though. There are more* *questions on culture, diversity, and pay equity and it's going to push us to do more in the broader proxy statement as well."*

Non-GAAP pay metric disclosures

On April 29, 2019, CII submitted a petition to the SEC requesting clear disclosure on the use of non-GAAP financial metrics in the proxy statement's CD&A. CII asked that the SEC apply the same rules and guidance in that document as it does for earnings releases and other filings. This would require compensation metrics to be explained and placed in appropriate context, with reconciliation to GAAP figures.[21]

CII noted that its members are concerned that pay structures are too complex, making it difficult to understand the link between pay and performance.[22] According to CII, companies that use executive compensation targets based on non-GAAP financial measures are not required to adequately disclose how those measures relate to GAAP.[23]

Mr. Bertsch summarized the issue: *"We've heard dissatisfaction in certain quarters with how companies are presenting metrics in the CD&A. Some companies do it really well; they put it in context and have a reconciliation table when using adjusted GAAP targets. For others, you can't figure out whether the metrics used for pay are the same as the ones used in the earnings releases. If you don't specifically say what you are doing, it is not always clear."* While participants generally agreed on the merits of such reconciliation, some were concerned about adding regulatory requirements. One said, *"The CD&A is supposed to be our document. If you start to standardize the content, you get away from our ability to tell unique stories."*

Pay-for-performance alternatives

A recent *Wall Street Journal* article highlights disparities between CEO performance and compensation:

> For the fourth year straight, the biggest U.S. companies set CEO pay records in 2018 … even as a majority delivered negative stock-market returns to their shareholders—a sign of the often-weak relationship between pay and performance. Median compensation rose to $12.4 million for the bosses of S&P 500 companies last year, up 6.6% from 2017 and the highest since the 2008 recession … Yet the median shareholder return for the companies was minus 5.8%, the worst showing since the financial crisis. For 97 CEOs, last year's pay was a high-water mark even while their shareholder returns were in the bottom half of the group.[24]

At about 28% of S&P 500 companies, CEO pay grew faster than shareholder returns over five years.[25] These misalignments are causing some investors and other stakeholders to question performance-based pay. Mr. Bertsch explained, *"Some think the system has become dysfunctional and has worked to inflate executive pay. When more pay is at risk in complex plans, executives demand more to compensate for the uncertainty."* Participants pointed out, however, that pay reported in SEC filings can often be misleading, compared with actual values received. Some studies show that actual pay received correlates much more closely with performance.[26]

Some investors are also concerned that three-year plans do not do enough to encourage long-term decision-making. Some participants pushed back, arguing that various mechanisms, including stock holding requirements, incentivize executives to focus on the company's future. One CCLN member said, *"We largely pay in restricted stock that has long-term vesting and requirements to hold past retirement, so paying in stock and holding that stock has worked for us."* Participants asked whether there was a better alternative. Mr. Bertsch said, *"Some would argue that simplification is better. Calculate a market value for the executive and pay it in restricted stock with long holding requirements."*

When asked how to navigate pressure from proxy advisory firms, Mr. Bertsch encouraged direct engagement: *"Talk to your investors. If you can get through to your investors and bring them along to understand why you are paying executives the way you are, it is more powerful persuasion."*

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Employee expectations, combined with new technologies, have created a need for careful evaluation of human capital strategy. In addition, external stakeholders, including investors, are more focused on people and pay issues. In this environment, an effective relationship between the compensation committee and the CHRO is more valuable than ever. Board members and HR executives are working together to onboard new directors, improve recruitment and retention policies, communicate with external stakeholders, and sync talent strategy with corporate strategy.

About this document

The Compensation Committee Leadership Network (CCLN) brings together compensation committee leaders from North America's most prominent companies for private discussions about improving the performance of their corporations and earning the trust of their shareholders. *ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions.

The views expressed in this document represent those of the Compensation Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, or Tapestry Networks. Please consult your counselors for specific advice.

Appendix: meeting participants

- Beth Cobert, Compensation Committee Chair, CBRE
- Erroll Davis, Compensation and Benefits Committee Chair, Union Pacific
- Rich Floersch, Senior Strategic Adviser to the Center on Executive Compensation and HR Policy Association
- Kate Gebo, Executive Vice President, Human Resources and Labor Relations, United Airlines
- Pattie Gould, Head of Compensation and Benefits, Morgan Stanley
- Melanie Hughes, Chief Human Resources Officer, Moody's
- Jim Kennedy, Compensation Committee Chair, United Airlines
- Bill Kerr, Compensation and Leadership Talent Committee Chair, IPG
- Annette Leckie, Partner, Meridian Compensation Partners
- Darcy MacKay, Chief Human Resources Officer, CBRE
- Mary McDowell, Compensation Committee Chair, Autodesk
- Susan Podlogar, EVP, Chief Human Resources Officer, MetLife
- Samme Thompson, Compensation Committee Chair, American Tower
- Marc Ullman, Partner, Meridian Compensation Partners
- Beth Whited, Executive Vice President and Chief Human Resources Officer, Union Pacific

Endnotes

[1] *PreView* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from conversations with network members and other participants in connection with the meeting.

[2] Kristy McCann, "Why the Chief Human Resources Officer Is the True Hand to the CEO," *Forbes Coaches Council* (blog), *Forbes*, September 5, 2018.

[3] Rick Delgado, "How 2018 Has Changed the Role of the CHRO," *Innovation Enterprise*, November 20, 2018.

[4] Michelle Vitus and Patty Woolcock, "HR Isn't Enough If You Want to Be a CHRO," *TLNT*, June 27, 2017.

[5] National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Talent Development: A Boardroom Imperative* (Washington, DC: NACD, 2013), 9.

[6] Ryan Resch and Don Delves, "What Steps Should Compensation Committees Take as HR Becomes Part of Their Expanding Responsibilities?" *Willis Towers Watson* (blog), November 13, 2018.

[7] Center on Executive Compensation, *The CHRO's Guide to Compensation Committee Chair and Director Onboarding* (Center on Executive Compensation), 1.

[8] North Carolina State University's Enterprise Risk Management Initiative and Protoviti, *Executive Perspectives on Top Risks 2019* (Protiviti, 2018), 3, 7.

[9] Fister Gale, "Reskilling: The New Trend in Recruiting," *Workforce*, February 27, 2019.

[10] Pablo Illanes et al., "Retraining and Reskilling Workers in the Age of Automation," McKinsey & Company, January 2018.

[11] Katie Tierny, "The Top Staffing and Recruiting Trends for 2019," Bullhorn, February 5, 2019.

[12] National Association of Corporate Directors, *Board Oversight of Human Capital Strategy and Risks* (Washington, DC: NACD, 2019), 1.

[13] National Association of Corporate Directors, *Board Oversight of Human Capital Strategy and Risks*, 2.

[14] National Association of Corporate Directors, *Board Oversight of Human Capital Strategy and Risks*, 2–3.

[15] "Council of Institutional Investors," About section, LinkedIn, accessed July 24, 2019.

[16] Investor Advisory Committee, *Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure* (Securities and Exchange Commission, 2019).

[17] Human Capital Management Coalition, petition to the Securities and Exchange Commission, July 6, 2017.

[18] Human Capital Management Coalition, petition to the Securities and Exchange Commission.

[19] William Hinman, "Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks" (speech, 18th Annual Institute on Securities Regulation in Europe, London, UK, March 15, 2019).

[20] See Regions Financial Corporation, *2019 Proxy Statement and Notice of Annual Meeting of Shareholders* (Regions Financial, 2019).

[21] Ken Bertsch and Jeffrey Mahoney, "Rulemaking Petition on Non-GAAP Financials in Proxy Statements," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), May 31, 2019.

[22] Ken Bertsch and Jeffrey Mahoney (Council of Institutional Investors), petition to Securities and Exchange Commission, April 29, 2019.

[23] Bertsch and Mahoney, petition to Securities and Exchange Commission.

[24] Theo Francis and Vanessa Fuhrmans, "Big Companies Pay CEOs for Good Performance—and Bad," *Wall Street Journal*, May 17, 2019.

[25] Francis and Fuhrmans, "Big Companies Pay CEOs for Good Performance—and Bad."

[26] Francis and Fuhrmans, "Big Companies Pay CEOs for Good Performance—and Bad."