XI. Is Executive Compensation The Proper Vehicle for ESG Integration into Corporate Operations? And, If So, Why Is the Explicit Conditioning of Executive Pay on ESG Initiatives Not Yet Widespread?

A. Introduction

ESG refers to the Environmental, Social, and Corporate Governance factors that weigh into measuring the sustainability and societal impact of an organization. Because executives have a fiduciary duty to maximize value for shareholders of the corporation, executive compensation incentives have historically been tied to the overall financial success of the company. Debate subsists over whether the maximization of stockholder value should be the sole objective of a corporation, or whether directors and officers could properly have other goals. However, there is increasing favor for the opinion that corporate executives have a duty to consider relevant ESG factors. Moreover, over the past fifteen years, thinking around ESG factors has shifted and, today, many investors, executives, and consumers alike view commitment to ESG issues as a sign of long-term corporate well-being. Still, while scholars and commentators have called for a stronger link between ESG and executive compensation, the adoption of this compensation strategy has yet to become widespread.

This article examines the recent revelations leading to shifting views around ESG and their impact on corporate value. It analyzes the efficacy of integrating ESG initiatives into executive compensation schemes and evaluates several promulgated guidelines for doing so. Additionally, it compares actions taken by the U.S. government relating to corporate governance those taken by other countries. Finally, this article seeks to identify the current roadblocks stifling widespread adoption of ESG conditioned executive pay and proposes several recommendations that corporations should take into account when instituting ESG into an executive incentive plan.

B. Shifting Viewpoints on the Value of Corporate ESG Initiatives

ESG factors cover a wide spectrum of issues including climate change, renewable energy use, pollution, labor standards, access to health care, diversity, shareholder rights, board structure, and so on.

While these factors sit outside of the traditional analysis of a company's financial success, recent studies show that they do, indeed, have financial relevance.[1] A 2005 report from The Global Impact asserted that that embedding ESG factors in capital markets is prudent business, encourages more sustainable markets, and leads to better societal outcomes.[2] In October of 2005, a second report was published, this time by the United Nations Environment Programme Finance Initiative (UNEP FI), which reaffirmed the relevance of ESG issues in financial valuation.[3] These reports were the impetus behind the launch of the UN-backed Principles for Responsible Investment (PRI), which seeks to advance the integration of ESG into analysis and decision-making through thought leadership and the creation of tools, guidance and engagement.[4] Today PRI has over 3,000 signatories and represents over $100 trillion in assets.[5]

As ESG's relevance in financial valuation came to be understood, the perspective of sophisticated investors on corporate integration of ESG initiatives began to shift.[6] Today, investors look at a corporation's commitment to ESG issues as an indicator of long-term

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[1] George Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/?Sh=3525c7561695 ("ESG factors cover a wide spectrum of issues that tradetionally are not part of financial analysis yet may have financial relevance").

[2] IVO KNOEPFEL, WHO CARES WINS: CONNECTING FINANCIAL MARKETS TO A CHANGING WORLD 9–10 (The Global Impact 2005) (providing business-centric support for the implementation of ESG principles).

[3] UNITED NATIONS ENVIRONMENT PROGRAMME FINANCE INITIATIVE, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT (2005) (highlighting the germaneness of ESG factors when evaluating the financial position of organizations).

[4] Kell, *supra* note 1 (explaining the background that developed later into the more formalized guidance in the PRI); UNITED NATIONS ENVIRONMENT PROGRAMME FINANCE INITIATIVE, *supra* note 3 (discussing the relevance of ESG issues to financial valuation).

[5] PRI, *About the PRI* (last visited Feb. 18, 2021) https://www.unpri.org/pri/about-the-pri. (highlighting the growth of the PRI over a relatively modest period of time).

[6] Jessica Strine et al., *The Age of ESG*, HARV. L. SCH. F. ON CORPORATE GOV. (Mar. 9, 2020) https://corpgov.law.harvard.edu/2020/03/09/the-age-of-esg/ ("many investors now expect ESG factors to be integrated into a company's strategy and disclosed in public reports.").

corporate well-being.[7] Moreover, while the traditional view was that the predominant fiduciary duty was maximizing value for a company's shareholders, ESG integration has been increasingly acknowledged as part of an institutional investor's fiduciary duty.[8]

In this new era of ESG, it has become common practice for shareholders to look beyond the traditional financial statements and evaluate companies based on their stewardship of stakeholder resources.[9] One driver of this phenomenon is index-based investors, now the largest shareholders of most public companies in the United States.[10] These funds do not have the flexibility to alter their positions in response to slight variations in stock price, thus they place strong importance on indicators of long-term performance.[11] Since ESG factors have become a recognized factor in long-term corporate success, these investors have increased their scrutiny of corporate efforts in that area.[12] As of 2018, ESG investing was estimated at over $20 trillion in AUM or about a quarter of all professionally managed assets around the world.[13] Moreover, world of Sustainable and ESG Consideration Funds has grown significantly over the past several years.[14]

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[7] *Id.* ("Investors recognize that ESG factors can influence long-term business performance").

[8] Kell, *supra* note 1 ("In many important markets, including the U.S. and EU, ESG integration is increasingly seen as part of fiduciary duty.").

[9] Strine, *supra* note 6 ("[I]t is now common practice for shareholders to look beyond the traditional bottom line and evaluate how companies are performing in their stewardship of stakeholder resources, attention to environmental and social risks, and disclosure of sustainability strategies.").

[10] *Id.* (discussing the impact of index-based investors on rising importance of ESG factors to corporate shareholders).

[11] *Id*. (discussing the rationale for focusing on ESG as part of long-term indicators of performance.).

[12] *Id*. (explaining the level of attention ESG factors attained after adopting them as long-term evaluative factors).

[13] Todd Zeranski, *"Responsible" ESG investments hit $20tn, a quarter of the world's professionally managed tota*l, ENERGY POST (Apr. 9, 2019) https://energypost.eu/responsible-esg-investments-hit-20tn-a-quarter-of-the-worlds-professionally-managed-total/#:~:text=Environmental%2C%20social%2C%20and%20governance%20(,one%2Dquarter%20of%20all%20professionally (illustrating the scrutiny and the effects of that scrutiny on ESG advancement efforts in the corporate world).

[14] Jon Hale, *The ESG Fund Universe Is Rapidly Expanding* (Mar. 9, 2020) https://www.morningstar.com/articles/972860/the-esg-fund-universe-is-rapidly-expanding (finding number of Sustainable Funds has grown from 100

The growing importance of ESG factors to investors has led to an increased acknowledgement from corporate leaders that ESG initiatives should be integrated into their governance and operations. In 2017, Pearl Meyer Survey conducted a survey and found that 60 percent of companies reported ESG issues to be a top concern.[15] Moreover, the Pearl Meyer survey showed that of 100 directors and executives surveyed, 85 percent personally feel ESG issues should be formally addressed within a company, almost 60 percent believe that ESG issues are important to customers, and more than 75 percent say they are currently important to investors or may be in the future.[16] Reporting of ESG initiatives has also risen, with 81 percent of the S&P 500 publishing corporate reports on their ESG positions in 2015, up from under 20 percent in 2011.[17] This uptick in reporting illustrates the level of importance corporations now place on setting strategies, measuring, and managing ESG issues in response to growing stakeholder and shareholder expectations, as well as information requests from major customers.[18]

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to 303 since 2009, and the number of ESG Consideration Funds has grown from 81 to 564 since 2018).

[15] *Pearl Meyer Quick Poll: Environmental and Social Governance (ESG) and its Potential Link to Incentives*, PEARL MEYER 4 (Mar. 2017) https://www.pearlmeyer.com/pearl-meyer-quick-poll-environmental-and-social-governance-esg-and-its-potential-link-incentives.pdf ("ESG is a top company concern among 60% of survey respondents.").

[16] *Id.* at 4, 14 (finding 85 percent of respondents feel ESG issues should be formally addressed within the company, 58 percent of respondents believe customers are interested now, and 77 percent of investors are interested now or may be in the future).

[17] *Flash Report: 81% of the S&P 500 Index Companies Published Corporate Sustainability Reports in 2015*, Governance & Accountability Institute (Mar. 15, 2016) https://www.globenewswire.com/news-release/2016/03/15/819994/0/en/FLASH-REPORT-81-of-the-S-P-500-Index-Companies-Published-Corporate-Sustainability-Reports-in-2015.html ("sustainability reporting rose from just 20% of the companies reporting in 2011 to 81% in 2015.").

[18] *Id.* ("This body of corporate reporting underscores the importance of setting strategies, measuring and managing ESG issues in response to growing stakeholder and shareholder expectations—and in many cases, demands for such reporting, including information requests from major customers.").

C. Why Is the Explicit Conditioning of Executive Pay on ESG Initiatives Not Yet Widespread?

While it is clear that there has been growing pressure on corporations to integrate ESG factors into their operations, a surprisingly small number of companies have explicitly conditioned performance-based executive pay on ESG initiatives.[19] Executive pay is at the forefront of corporate governance discussions within both investor and academic communities. In 2019, the Harvard Law School Forum on Corporate Governance expressed its belief that executive compensation "can be a powerful tool for advancing business strategies, and incentives may be a useful catalyst for those boards looking to pursue a more meaningful emphasis on ESG issues."[20] PRI expressed a similar view, stating that "the inclusion of ESG issues within executive management goals and incentive schemes can be an important factor in the creation and protection of long-term shareholder value."[21] Perhaps sparked by recent global events such as the pandemic, the economic crisis, and racial injustice, even corporations themselves have begun to express intentions to change the way they use ESG factors in executive incentive plans in the coming years.[22]

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[19] Janice Koors & Pearl Meyer, *Executive Compensation and ESG*, HARV. L. SCH. F. ON CORP. GOV. (Sept. 10, 2019) https://corpgov.law.harvard.edu/2019/09/10/executive-compensation-and-esg/#3 ("Pearl Meyer's survey showed 11 percent of respondents indicating direct links between executive compensation and ESG."); *Gaining Ground: Corporate Progress on the Ceres Roadmap for Sustainability*, CERES (Apr. 29, 2014) https://www.ceres.org/resources/reports/gaining-ground-corporate-progress-ceres-roadmap-sustainability (finding 24% of the 613 largest, publicly traded U.S. companies link executive compensation to sustainability performance).

[20] Koors, *supra* note 19 ("[W]e believe executive compensation can be a powerful tool for advancing business and leadership strategies.")

[21] PRINCIPLES FOR RESPONSIBLE INVESTMENT, INTEGRATING ESG ISSUES INTO EXECUTIVE PAY: GUIDANCE FOR INVESTORS AND COMPANIES 1 (June 2012), https://www.unpri.org/download?ac=1878 ("[T]he inclusion of appropriate Environmental, Social and Governance (ESG) issues within executive management goals and incentive schemes can be an important factor in the creation and protection of long-term shareholder value.").

[22] *4 in 5 companies planning to change ESG measures in executive pay plans over next 3 years, Willis Towers Watson survey finds*, WILLIS TOWERS WATSON (Dec. 9, 2020) https://www.willistowerswatson.com/en-US/News/2020/12/4-in-5-companies-planning-to-change-esg-measures-in-executive-pay-plans-over-next-3-years-wtw-survey (finding global events are sparking companies to maintain or accelerate changes to ESG priorities and 78% of

1. *Is Executive Compensation The Proper Vehicle For ESG Integration Into Corporate Operations?*

When considering the options corporations have at hand to institute ESG initiatives into their governance practices, it is important to ask whether ESG factors warrant incentivizing through executive compensation. A simple way to determine whether that is the case is asking whether executing on ESG initiatives is a base role or responsibility of a corporate executive.[23] The traditional view is that an executive's primary responsibility is to maximize value for the corporation's shareholders.[24] This is reflected by the fact that the most common metrics currently used in executive incentive plans are profits and revenues.[25] Tying ESG initiatives to executive compensation has many clear benefits including increased accountability from corporate leaders, signaling corporate values to stakeholders, new dimensions of transparency (particularly for public companies), and of course a higher degree of commitment to addressing environmental issues as well as social inequities.[26] However, if ESG initiatives can be used to drive shareholder value, then the integration of such initiatives into

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respondents plan to change how the use ESG with their executive incentive plans over the next three years); *CEOs Welcome Alignment of Executive Pay to ESG Related Criteria*, WORLD ECON. F (Jan. 22, 2020) https://www.weforum.org/press/2020/01/ceos-welcome-alignment-of-executive-pay-to-esg-related-criteria/ ("Majority of CEOs at the International Business Council meeting in Davos indicate support for alignment").

[23] Ameena Majid et al., *Building an ESG Strategy: The Role of the Board and Executive Compensation [Part 4 or 4]*, JD SUPRA (Sept. 16, 2020) https://www.jdsupra.com/legalnews/building-an-esg-strategy-the-role-of-45996/#:~:text=The%20link%20between%20ESG%20and,role%20in%20a%20fragmented%20ecosystem (considering whether executing ESG factors is a base role and responsibility of corporate executives).

[24] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. 173, 174 (Sept. 1970) ("[I]n his capacity as a corporate executive, the manager is the agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them.").

[25] Boris Groysberg et al., *Compensation Packages That Actually Drive Performance*, HARV. BUS. REV. (Jan. 2021) https://hbr.org/2021/01/compensation-packages-that-actually-drive-performance ("The most common are profits (used by 91%) and revenues (used by 49%).").

[26] Majid, *supra* note 23 (discussing the benefits to linking ESG and executive compensation).

compensation incentives is not only a step in the right direction, but the logical next step from the traditional view on executive priorities.

Recent findings have shown that ESG factors are not only relevant to a corporation's financial valuation, but they are directly related to its financial success.[27] In a curation of studies done by the University of Oxford and Arabesque Partners "80% show that the stock price performance of companies is positively influenced by good sustainability practices;" "it is in the best interest of investors and corporate managers to incorporate sustainability considerations into their decision-making processes;" and "active ownership follows investors to influence corporate behavior and benefit from improvements in sustainable business practices."[28] Moreover, several global companies have "suffered massive blows to shareholder wealth as a result of significant environmental, social, and/or governance-related issues."[29]

Walmart serves as one example of a company implementing long-term sustainability measures to increase overall efficiency and operational performance. In 2005, Walmart committed to becoming totally supplied by renewable energy, having zero waste, and selling products that sustain people and the environment.[30] Their sustainability programs allowed the company to safeguard its low prices and achieve an advantage in operational efficiency over its competitors.[31] In 2012, Walmart saved approximately $231 million through efficient waste management and recycling.[32] The Walmart example illustrates how integrating ESG initiatives can allow corporations to realize cost savings through innovation, resource efficiency, and revenue enhancements through sustainable products, which should then lead to

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[27] GORDON L CLARK ET AL., FROM THE STOCKHOLDER TO THE STAKEHOLDER: HOW SUSTAINABILITY CAN DRIVE FINANCIAL PERFORMANCE (2015). (explaining relevance of ESG advancement to the success of a business).
[28] *Id.* at 9 (providing analytical data of the link between ESG factor and business success).
[29] GLASS LEWIS, IN-DEPTH LINKING COMPENSATION TO SUSTAINABILITY 1 (Mar. 2016) http://www.glasslewis.com/wp-content/uploads/2016/03/2016-In-Depth-Report-LINKING-COMPENSATION-TO-SUSTAINABILITY.pdf ("Tokyo Electric Power Company, BP and Massey Energy have suffered massive blows to shareholder wealth as a result of significant environmental, social and/or governance related issues.").
[30] CLARK, *supra* note 24, at 17 (detailing the Walmart case study).
[31] *Id*. (highlighting the benefits for Walmart in advancing ESG issues).
[32] *Id*. (providing financial data of the benefits Walmart obtain in its ESG efforts).

improvements in profit margin.[33] This points to a direct correlation between successful ESG initiatives and shareholder value, which strongly supports the efficacy of integrating such initiatives into executive compensation plans.

2. *What Obstacles Stand in the Way of Widespread Integration of ESG Issues into Executive Compensation?*

As it seems executive compensation is, in fact, an appropriate vehicle for the integration of ESG issues into corporate operations, it is important to ask what other obstacles are standing in the way of the widespread conditioning of executive pay on ESG success. As it stands, there are several factors that may be preventing U.S. companies from taking the leap and adopting an ESG focused incentive structure. First, changes in executive compensation generally only become widespread after a number of trailblazers have successfully adopted such changes.[34] Second, corporations have found it difficult to assign a weight to non-financially grounded metrics, which do lend themselves to easily verifying achievement.[35] Finally, while many countries are imposing regulations that promote bringing ESG issues to the forefront of corporate operations, the United States has been reluctant to do the same and may be moving in the opposite direction.[36]

The first obstacle to widespread adoption of ESG-focus incentives is the common practice among corporations of basing new compensation packages on those being offered by their peers. Often, the first step for a compensation committee in structuring an executive's compensation plan is the approval of a peer group.[37] This peer group is

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[33] *Id* at 18 (enumerating the means and ends of cost savings for Walmart in the context of ESG).

[34] Groysberg, *supra* note 24 ("Most companies try to keep up with what their peers are offering … the market determines executive compensation levels.").

[35] Majid, *supra* note 23 (noting the challenges of ascribing weight to non-financially grounded metrics and verifying achievement of ESG-related incentives).

[36] Chris Macbeth et al., *Sustainable Finance: A Global Overview of ESG Regulatory Developments*, CLEARY GOTTLIEB 2–4 (Oct. 22, 2020) https://www.clearygottlieb.com/-/media/files/alert-memos-2020/sustainable-finance-a-global-overview-of-esg-regulatory-developments.pdf (analyzing trends in ESG regulatory development across various regions across the world).

[37] Steven Clifford, *How Companies Actually Decide What to Pay CEOs*, THE ATLANTIC (June 14, 2017) https://www.theatlantic.com/business/archive/

made up of companies that are identified as comparable in size and complexity to the committee's own company.[38] Companies then evaluate their self-selected peer groups to assess market practices, and the dominant short-term and long-term metrics within the group and application to their company.[39] Because a company wants to position itself positively amongst its peers and ensure it provides sufficient compensation to retain its talent, the compensation committee generally structures the package in a way that places itself just above the median in its peer group.[40] The problem with this being the common strategy is that it creates an endless cycle of corporations setting executive compensation just above the midpoint of their identified peers.[41] This creates a system that discourages innovation in executive compensation because it is easier to compare oneself to one's peer when the compensation package is structured in essentially the same way.[42] Integrating ESG-focused incentives into executive pay would require a significant departure from the norm.[43] Accordingly, it may be difficult for a corporation to hold itself out from its peers as a more attractive destination for executive candidates.[44] Thus, the adoption of ESG-focused incentives will likely start out slow and gain widespread popularity only once a critical mass of corporations, sufficient to develop peer groups for the majority of companies, have adopted such a compensation structure. This largely tracks what we have seen to this point. As of right now, a small number of trailblazers have taken the

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2017/06/how-companies-decide-ceo-pay/530127/ (explaining the common process for determining executive compensation).

[38] *Id*. (describing the composition of peer groups in compensation committees).

[39] *Id*. (describing the evaluation metrics of companies with regard to advancement of ESG).

[40] Groysberg, *supra* note 24 ("Most companies try to keep up with what their peers are offering, but as one director told us, "Obviously there is some balancing. If you want your CEO to stay, you'll probably err on the side of paying more); Clifford *supra* note 36 ("Benchmarking below the 50th percentile says, 'We are a lousy company and don't even aspire to be better'").

[41] Groysberg, *supra* note 24 ("'The problem is that everyone always says, "We want to be just above the midpoint in this"').

[42] Majid, *supra* note 23 ("The heavy emphasis on peer group data can operate to hold companies back from linking less financially driven ESG factors to incentives unless the company is willing to stand out").

[43] *Id*. (qualifying the proposal to tie executive pay to ESG).

[44] Groysberg, *supra* note 24; Clifford, *supra* note 36. (exemplifying the challenges in attracting executive talent acquisition).

leap, but if those few are successful, then ESG-focused incentives may become a desirable element in executive compensation packages moving forward.

Another primary issue with linking executive compensation to ESG issues is the quantifiable and verifiable measurements of performance.[45] Many ESG related issues do not naturally lend themselves to numerical measurement.[46] For this reason, health and safety, along with other environmental or climate focused metrics (e.g., reductions in emissions), have long been the dominant ESG metrics. Diversity and inclusion goals have been increasingly acknowledged as ESG metrics, however, the "S" in ESG has long been the most overlooked.[47] To overcome this challenge and take the first step toward developing quantifiable metrics for ESG incentives, companies should identify those long-standing activities already taking place in their organizations that fall into the ESG category.[48] Existing HR goals like hiring diversity, energy usage, and resource conservation can be easily reported as ESG-related metrics that drive compensation incentives.[49]

The final possible impediment to widespread integration of ESG initiatives into executive compensation is specific to the United States. While governments from other countries throughout the world have sought to develop regulations that promote corporate undertakings of ESG initiatives, the U.S. appears to be moving in the opposite direction.[50] First, Section 162(m) of the Internal Revenue Code

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[45] Majid, *supra* note 23 (noting the challenges of ascribing weight to non-financially grounded metrics and verifying achievement of ESG-related incentives).

[46] Jennifer Howard-Grenville, *ESG Impact Is Hard to Measure—But It's Not Impossible*, HARV. BUS. REV. (Jan. 22, 2021) https://hbr.org/2021/01/esg-impact-is-hard-to-measure-but-its-not-impossible (discussing the challenges of properly measuring the impact of ESG initiatives).

[47] *The rise of ESG engagement*, INT'L BAR ASSOC. (June 25, 2020) https://www.ibanet.org/Article/NewDetailPreview.aspx?ArticleUid=c28b0cee-ff4b-460a-b5c4-e96fa5bbeeb6 ("To date, the most overlooked 'bucket' within the umbrella term of ESG, has been the 'S.'").

[48] Koors, *supra* note 19 (discussing the integration of existing ESG goals into executive compensation).

[49] *Id*. (discussing traditional metric categories that are analogous and adaptable to ESG metrics).

[50] MACBETH, supra note 35 (analyzing trends in ESG regulatory development across various regions across the world).

was amended by the Tax Cuts and Jobs Act of 2017.[51] Prior to the passage of the TCJA, Section 162 (m), which imposes a $1 million cap on the deductibility of compensation paid to certain executives by publicly held corporations, included an exclusion for qualified performance-based compensation.[52] The amendments to the code eliminated this exception, which drastically weakens the motivation for publicly held corporations to institute performance-based compensation into executive payment structures, whether or not tied to ESG.[53] Additionally, "unlike in the EU and despite increasing pressure from large institutional investors, the U.S. Securities and Exchange Commission (SEC) has so far been reluctant to adopt ESG-specific guidelines and instead only requires that disclosure of ESG risks be made if they are "material", formally declining to publish any rule-making in the area of ESG in 2020."[54] Finally, in June 2020, the U.S. Department of Labor issued a proposed rule that would require pension plan investment fiduciaries to prioritize financial returns and not subordinate those to non-pecuniary benefits (which may include ESG factors).[55]

Conversely, government action by foreign nations has gone farther to encourage prioritization of ESG factors in corporate governance initiatives. The UK Stewardship Code sets standards for those investing money on behalf of UK savers and pensioners, and those that support them, and explicitly enumerates ESG integration under its "Principles for Asset Owners and Asset Managers."[56] An EU regula-

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[51] William H. Hoffman et al., *IRS issues proposed Section 162(m) regulations*, DLA PIPER PUBLICATIONS (Feb. 3, 2020) https://www.dlapiper.com/en/us/insights/publications/2020/02/irs-issues-proposed-section-162m-regulations/#:~:text=Section%20162(m)%20imposes%20a,by%20a%20publicly%20held%20corporation.&text=definition%20of%20publicly%20held%20corporation,subject%20to%20the%20deduction%20limitation (discussing the ramification from the proposed regulations implementing amendments made to Section 162(m)).

[52] *Id*. (contrasting the old and new statutory provision related to executive compensation).

[53] *Id*. (assessing the unintended incentives of removing performance-based compensation from statutory qualified exceptions).

[54] MACBETH, *supra* note 35 at 3 (contrasting executive compensation treatment in the EU and the US).

[55] *Id*. (discussing proposed regulatory reforms that would correct executive compensation tax-treatment issues).

[56] FINANCIAL REPORTING COUNCIL, UK STEWARDSHIP CODE 2020 15 (2020) https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf ("Signatories should

tion on sustainability-related disclosures in the financial services sector comes into effect in March 2021 and requires financial markets participants to integrate sustainability risks into their decision-making processes.[57] The EU is also working on a taxonomy regulation, which would introduce common criteria for defining what constitutes environmentally sustainable economic activities.[58] Finally, the Taiwan Stock Exchange requires listed companies to publish a corporate social responsibility report and the Tokyo Stock Exchange strongest suggests that companies do the same.[59] To promote the timely adoption of ESG-focused executive compensation incentives, the U.S. should seek to tailor future regulations in such a way that promotes corporate undertaking of ESG initiatives.

D. Recommendations for Integrating ESG Initiatives into Executive Compensation

Both the Harvard Law School Forum on Corporate Governance and the PRI have issued guidance on developing quantifiable ESG performance indicators for integration into executive compensation. The Harvard Law School Forum on Corporate Governance encourages organizations approach ESG in the way that is best for its specific business model and culture, beginning by evaluating a standard set of ESG factors and determining which are most linked to the organization's business strategy.[60] Similarly, PRI advises organizations to identify ESG metrics with a clear link to the optimization of shareholder value and which are aligned with the company's long-term business strategy.[61] As stated above, it is important for ESG-focused incentives to not deviate from the executive's role as a fiduciary for the corporation's shareholders. By integrating ESG factors into executive compensation plans in a way that also maximizes shareholder value and linking the initiatives to the organization's business strategy,

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disclose the issues they have prioritized for assessing investments, prior to holding, monitoring through holding and exiting. This should include ESG issues.").

[57] *The rise of ESG engagement*, *supra* note 46 (explaining regulatory developments in the EU related to risk mitigation in EU jurisdictions).

[58] *Id*. (explaining additional proposed regulatory developments in the EU).

[59] Koors, *supra* note 19 ("discussing foreign ESG regulations").

[60] *Id.* (discussing recommendations for linking ESG to financial results).

[61] PRINCIPLES FOR RESPONSIBLE INVESTMENT, *supra* note 21, at 6 (recommending ESG metrics that are quantifiable or tangential).

corporations can ensure that this new executive compensation structure (1) is not radically different from those in their "peer group" and (2) does not ask executives to choose between their compensation and their shareholders.

Moreover, corporations should use the same thoughtful methodology to determine the nonfinancial metrics linked to ESG as when choosing financial performance.[62] Just like setting goals tied to financial metrics, setting ESG goals will be an intensive exercise and will require careful thought and analysis to be truly effective.[63] Finally, PRI suggests that there be clear disclosure of the rationale in identifying ESG metrics linked to executive compensation and evidence of alignment with business strategy and shareholder value.[64] Such disclosures will give investors access to meaningful and clear information on how ESG metrics have been identified and considered.[65] This will inspire investor confidence that the chosen compensation incentive are truly drivers of ESG performance, as well as shareholder value, and not merely a nominal means of increasing executive compensation.[66] To ensure disclosures adequately inform investors, corporations should include information about any compensation awards earned by executives during the previous payment period, along with the actual ESG benefits derived from the executive's achievement.[67]

E. Conclusion

Over the past two decades investors have come to view commitment to ESG initiatives as an important aspect of their evaluation of a corporation's long-term value. This shift in investor thinking has led to the acknowledgement from a majority of corporate

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[62] Koors, *supra* note 19 ("Balance the leading and lagging metrics that matter, using the same thoughtful methodology to determine nonfinancial metrics linked to ESG as you do when choosing financial performance.").

[63] *Id.* ("As is the case with financial results, setting ESG goals and measurements in this way will be an intensive exercise, requiring careful thought and analysis to be effective.").

[64] PRINCIPLES FOR RESPONSIBLE INVESTMENT, *supra* note 21, at 22 (recommending that the rule purposes be clearly espoused in support gathering effort).

[65] *Id*. (providing guidelines on significant ESG metrics).

[66] *Id*. (assessing ESG metrics to boost confidence to proper executive compensation).

[67] *Id*. (promoting transparent disclosure on executive compensation arrangements).

executives of the need to integrate ESG initiatives into their governance practices. However, integration of ESG factors into executive compensation incentives has yet to become a widespread practice. This lag in adoption is likely due the traditional use of peer groups to develop executive compensation packages as well as challenges with quantifying certain ESG elements. To properly implement ESG factors into executive compensation, corporations should (1) use those ESG factors which are most linked to their business strategy and the optimization of shareholder value,[68] (2) use the same thoughtful methodology to determine the ESG metrics as they do when choosing financial performance indicators,[69] and (3) provide clear disclosures to investors of the factors selected for integration into executive compensation, as well as the ultimate results of such incentives.[70]

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[68] Koors, *supra* note 19; PRINCIPLES FOR RESPONSIBLE INVESTMENT, *supra* note 21, at 6 (explaining that ESG metrics can optimize business and shareholder valuation).

[69] Koors, *supra* note 19 (comparing financial indicators and ESG metrics).

[70] PRINCIPLES FOR RESPONSIBLE INVESTMENT, *supra* note 21, at 22 (discussing transparent disclosures in the criteria selected when evaluating executive compensation).

[71] Student, Boston University School of Law (J.D. 2022).