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Regulatory and investor demands to use ESG performance metrics in executive compensation: right instrument, wrong method

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ABSTRACT
The growing acknowledgment of the need to transition to sustainability in corporate governance has led to the scrutiny of and the infusion of non-financial environmental, social, and governance (ESG) goals into the traditional incentive-based executive remuneration frameworks. The swift adoption of ESG metrics in executive compensation by global corporations and their endorsement by influential institutional investors and various regulatory bodies highlight this trend. This article challenges the effectiveness and necessity of universally applying standard ESG metrics in compensation structures and aims to construct a framework for a more contextual and nuanced application of ESG-linked executive compensation. The analysis highlights the limitations of ESG objectives unrelated to shareholder value and demonstrates the limited circumstances where some company specific ESG objectives can drive rapid changes in targeted performance by drawing attention to these objectives. These findings question the evolving practice of a uniform integration of ESG metrics in compensation plan design of all companies and urge regulators, institutional investors, and corporate boards to adopt a more tailored, focused, and selective strategy in integrating ESG metrics into executive pay.

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KEYWORDS Corporate governance; investor stewardship; institutional investors; executive pay; say-on-pay; environmental, social and governance (ESG)

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1. Introduction

The use of environmental, social, and governance (ESG) targets in executive compensation plans is becoming an increasingly prominent topic in the ongoing discussions on responsible capitalism and emerging regulatory debates on sustainable corporate governance. Executive compensation, also known as executive pay or remuneration, has long been a prominent corporate governance tool for influencing the behaviour of managers through incentives created by the design of compensation plans.[1] This design has been evolving over time in search of an optimal structure and in response to the changing corporate governance models. In a classic shareholder value approach, executive remuneration is structured in a way to maximise the value for shareholders. The growing consensus on the need for more responsible corporations that are accountable for their environmental, social, and economic impact poses serious questions regarding the desirability of linking executive compensation solely with financial performance metrics that account for shareholder interests only. The concept of 'sustainable corporate governance,' which is explicitly endorsed by the European Union,[2] has brought about fundamental discussions on the structure of executive compensation and the merits of the incorporation of ESG metrics. The integration of non-financial ESG targets into the design of executive pay can, seemingly, have an impact on the incentives and actions of corporate executives, thereby transforming corporate behaviour. While compensation is traditionally associated with both the short-term and long-term performance dimensions, ESG linked pay is a vital component of this time-horizon discussion, but it extends much further to encompass the complex nature of ESG multidimensionality in the compensation.

The rise of responsible capitalism has thus prompted changes in both the theoretical and practical approaches to corporate governance. The practice of linking executive pay with ESG metrics, although relatively recent, has gained prominence rapidly, with many large corporations in different parts of the world embracing this idea in recent years. The compensation committees of corporate boards and their pay consultants have been actively adding ESG targets into the design of executive compensation plans. Indeed, in a series of pioneering reports examining the use of ESG targets in executive pay, experts from PwC, a consulting and audit firm, and London Business School document the quick

[1] M.C. Jensen and W.H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *J Fin Econ* 305, 323; M.C. Jensen and K.J. Murphy, 'CEO Incentives – It's Not How Much You Pay, But How' (1990, May-June) *Harvard Business Rev* 138, 139. Jennifer Hill & Charles Yablon, 'Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict' (2002) 25 *UNSW Law Journal* 294, 295.

[2] European Commission, 'Sustainable Corporate Governance', https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance_en. The sustainable corporate governance initiative was listed among the deliverables announced in the Action Plan on a Circular Economy, the Biodiversity and Farm to Fork strategies and would be part of the renewed Strategy on Financing Sustainable Growth.

proliferation of ESG metrics among the companies included in the FTSE 100 index, which comprises the largest companies listed in the United Kingdom.[3] The percentage of the FTSE 100 companies incorporating any form of ESG target into their pay structures increased from a very low base to 45 per cent in 2019[4] and further to 86 per cent in 2021.[5] Similarly, many S&P 100 companies, which are the largest listed companies in the US and account for half of the country's market capitalisation, have adopted ESG targets.[6] This practice is also widespread in other developed countries and among private companies as well.[7] Experts believe that the growing use of ESG metrics in executive compensation will continue and that we will 'start to see more of it over time.'[8]

An increasing number of powerful institutional investors has reinforced this trend by demanding that corporate boards adopt ESG targets to link executive compensation with non-financial corporate performance. Two influential European institutional investors, Cevian Capital, a leading European activist investment firm, and Allianz Global Investors, one of Europe's largest asset managers, have committed to vote against pay proposals of large UK and European companies without ESG targets starting from the 2022 and 2023 voting seasons, respectively.[9] They are also urging other institutional investors to follow suit.[10] Some other large UK and European fund managers, such as Amundi Asset Management, AXA Investment Managers, DWS Investments, Legal & General Investment Management, and Sarasin & Partners, made this move earlier.[11]

But can the use of ESG metrics in executive remuneration be effective in changing the behavioural incentives of executive directors? Can a standard best practice approach work in every company? Or does the effectiveness of pay related ESG metrics depend on specific circumstances, such as the overall design of compensation related incentives, the company's core

[3]T. Gosling et al., 'Paying Well by Paying for Good' Joint Report by London Business School Centre for Corporate Governance and PricewaterhouseCoopers (2021), at https://www.pwc.co.uk/human-resource-services/assets/pdfs/environmental-social-governance-exec-pay-report.pdf (hereinafter Gosling et al., 'Paying Well'); T. Gosling et al., 'Paying for Good for All' Joint Report by London Business School Leadership Institute and PricewaterhouseCoopers (2022), at https://www.pwc.com/gx/en/services/paying-for-good-for-all/Paying-for-good-for-all.pdf (hereinafter Gosling et al., 'Paying for Good'); T. Gosling et al., 'Paying for Net Zero' Joint Report by London Business School Leadership Institute and PricewaterhouseCoopers (2023), at https://www.pwc.co.uk/human-resource-services/pdf/paying-for-net-zero-using-incentives-to-create-accountability-for-climate-goals.pdf (hereinafter Gosling et al., 'Paying for Net Zero').

[4]Gosling et al., 'Paying Well,' n 3 above, 14.

[5]Gosling et al., 'Paying for Good,' n 3 above, 2.

[6]n 43 below.

[7]Gosling et al., 'Paying for Good,' n 3 above, 14.

[8]E. Glazer and T. Francis, 'CEO Pay is Tied to Diversity Progress' *Wall Street Journal* (3 June 2021) B1, B2.

[9]A. Mooney, 'Cevian Warns Boards to Include ESG Metrics in Bosses' Pay' *Financial Times* (3 March 2021) 10; A. Klasa, 'AllianzGI to Vote Against Pay Deals with No ESG Links' *Financial Times* (23 February 2022) 13; H. Agnew, 'AllianzGi and Cevian Raise Pressure Over Linking Pay to Climate Goals' *Financial Times* (28 February 2022), at https://www.ft.com/content/025d0de8-4e5c-4eaa-be10-858fb2843206.

[10]H. Agnew and D. Thomas, 'War and ESG Take Centre Stage for Meetings Season' *Fin Times* (28 March 2022) 11.

[11]S. Gomtsian, 'Executive Compensation: Investor Preferences During Say-on-Pay Votes and the Role of Proxy Voting Advisors' (2024) 44 *Legal Studies* 140, 160.

business, its business model, and internal governance? In the latter case, ESG metrics need to be used sparingly and not every company needs them. Related to this, and moving towards a normative perspective, should regulatory rules, industry best practice norms, and investor voting and engagement policies promote blanket demands for the inclusion of ESG metrics in the structure of executive compensation for all companies? These are questions at the very centre of the ongoing debate on the use of ESG metrics in executive remuneration. A recent discussion paper issued by the Financial Conduct Authority (FCA), the UK's financial regulatory body, aims to encourage an industry-wide dialogue on sustainability-related governance, incentives, and competencies in companies, including the definition of the future regulatory approach that the FCA should adopt.[12]

The objective of this article is to contribute to this dialogue by developing a framework for assessing the pros and cons of linking executive pay with ESG metrics and identifying the pitfalls of a standard approach toward the use of ESG targets in compensation. With the increasing popularity of pay-related ESG metrics in the deliberations of board remuneration committees, the emerging investor stewardship norm of using ESG metrics in every executive compensation plan, and the possibility of regulatory action – whether through hard law or soft law best practice guidance – it is essential to establish a solid framework for the use of ESG metrics in pay. This will assist the actors with the power to influence the design of executive compensation plans in adopting a regulatory or industry-led approach to the use of ESG metrics in compensation. This approach should not be driven by a fashionable trend but should be carefully thought through and focused on value creation in each company where such metrics are used.

The analysis leads to several important conclusions. First, Section 3 reviews various challenges that the use of ESG measures in compensation face to show that an ESG measure is effective for achieving quick and meaningful improvements in targeted performance. However, the attainment of this short-term goal does not necessarily translate into better overall financial performance or more responsible corporate behaviour in the long-term. As a further extension of this conclusion, aggregate ESG measures must be avoided because they fail to highlight specific areas that require immediate improvements and encourage reflective behaviour aimed at maximising the score of the aggregate measure. Second, we develop a framework for assessing the impact of pay-linked ESG metrics in Section 4 to show that the conditions for the effective use of ESG metrics in executive compensation are narrow. In addition to the need to overcome the challenges of measuring ESG goals, the selected ESG measure must align and not compete with the core financial

[12]Financial Conduct Authority, *Finance for Positive Sustainable Change: Governance, Incentives and Competence in Regulated Firms*, Discussion Paper DP23/1 (London: FCA, 2023) paras 1.7-1.8, 5.3.

incentives included in the executive compensation plan. By contrast, ESG targets related to corporate externalities are likely to fail unless the entire compensation plan is reformed so that the reduction of externalities – not financial performance – becomes its core focus. Accordingly, ESG measures can be used to improve performance on a material aspect of corporate strategy where a company needs a significant and visible change in a short timeframe. Third, a key implication of our framework is that pay-linked ESG measures are not a universal solution for every company. ESG metrics that can work effectively may be irrelevant for some companies; adding others for the sake of having ESG metrics in pay may lead to waste and inefficiencies like any poor corporate governance arrangement. Moreover, the widespread adoption of ESG metrics and the need to oversee their use can dilute shareholder resources and direct attention away from companies that need those metrics the most. This means that a standard approach to the use of ESG metrics in pay must be avoided.

Overall, these conclusions indicate that the approach to the use of ESG metrics in executive compensation must be selective and focused both at the stage of deciding whether the attainment of an ESG goal needs to be rewarded and, in case of a positive decision, at the stage of selecting and designing the appropriate metric for rewarding the selected ESG goal. The application of these findings to the evolving practices of institutional investors and regulatory proposals in Section 5 highlights obvious shortcomings. The trend towards a blanket use of ESG measures in executive compensation by every company overlooks the limited role of these measures and the individual needs of each company. Consequently, both regulators and the industry, whether it is corporate boards and their consultants incorporating ESG metrics into pay to stay ahead of the curve or investors demanding companies to use ESG metrics, need to develop a more careful and nuanced approach to the use of ESG metrics in executive compensation.

This article contributes to the literature on incentive-based executive remuneration, and more specifically, the use of sustainability-related targets in the variable component of executive remuneration. The article aids in gaining a better understanding of the role of ESG metrics in pay and demonstrates their limited effectiveness in achieving sustainability-related objectives that are not aligned with shareholder value creation. This finding holds important implications for the emerging shareholder stewardship approaches of large institutional investors during say-on-pay votes and potential regulatory interventions on the best practice design of incentives in executive compensation plans.

2. The rise of ESG-linked executive compensation

Executive compensation has traditionally served as a corporate governance tool for aligning the incentives of corporate managers with the interests of shareholders.[13] The line in the famous title of the *Harvard Business Review* article, 'it's not *how much* you pay, but *how,*' underscores the attention given to the structure of executive compensation during 1980s and 1990s in strengthening the links between CEO pay and shareholder returns.[14] To achieve this, executive compensation plans have evolved to include large components of short – and long-term incentive-based reward payments that are tied to the achievement of corporate financial performance targets.[15] Executive directors receive these reward payments when the company meets target performance objectives. Various accounting and share-price based metrics, such as sales, earnings per share, and share price performance, are typically used to set these performance measures.[16] Additionally, executive directors receive company shares that further align the interests of shareholders and managers.[17]

The growing support for the sustainability transition in corporate governance has once again placed the structure of executive compensation plans in the spotlight. The attention this time is on the incorporation of ESG considerations into the already intricate design of executive pay.[18] The argument for linking executive pay with ESG performance suggests that it creates incentives for managers to make decisions that are sustainable environmentally, socially, and economically.[19] Calls to link executive pay to ESG performance are coming from all corners: prominent compensation consultants, investors, financial regulators, and academics. Notably, Willis Towers Watson, a global professional services company, advocates using executive compensation to align the interests of executives with employees and other stakeholders.[20] PwC, a consulting and audit firm, goes even further, advocating the use of ESG metrics not only in the pay of executive directors but for other employees as well.[21] Investor pressure is also on the rise. The joint 2021 report by London Business School and PwC notes that 'in almost every shareholder engagement in the last 12 months the question of ESG in pay has arisen.'[22] Several prominent institutional investors have begun voting against pay

[13] Jensen and Meckling, n 1 above, 323; Jensen and Murphy, n 1 above, 139.
[14] Jensen and Murphy, n 1 above, 138 (emphasis added).
[15] A. Edmans, X. Gabaix, and D. Jenter, 'Executive Compensation: A Survey of Theory and Evidence' in B.E. Hermalin and M.S. Weisbach (eds) *The Handbook of the Economics of Corporate Governance* (2017) 398-399.
[16] K. J. Murphy, 'Performance Standards in Incentive Contracts' (2001) 30 *J Accounting & Economics* 245, 250-51; Edmans et al., n 15 above, 418-419.
[17] Edmans et al., n 15 above, 398-399.
[18] L. Lu, 'ESG-Based Remuneration in the Wave of Sustainability' (2023) 23 *J Corp L Stud* 297, 297-298.
[19] European Commission, 'Study on Directors' Duties and Sustainable Corporate Governance – Final report' (2020) 109, 119-120, at https://data.europa.eu/doi/10.2838/472901.
[20] S. Ganu and D. Delves, 'Responsible Executive Compensation during Times of Crisis' Willis Towers Watson (22 April 2020), at https://www.wtwco.com/en-ZA/insights/2020/04/responsible-executive-compensation-during-times-of-crisis.
[21] Gosling et al., 'Paying for Good,' n 3 above, 11.
[22] Gosling et al., 'Paying Well,' n 3 above, 11.

proposals lacking ESG links.[23] They believe that corporations can add much-needed credibility to their ambitious emission reduction commitments by linking executive pay with ESG targets.[24] Data on mutual funds with ESG objectives show that they are significantly more likely than non-ESG funds to vote in favour of shareholder proposals related to executive compensation, especially where these proposals are related to aligning executive compensation with environmental and social objectives.[25]

A similar approach is emerging on the regulatory side. For instance, one of the proposals in the climate change framework of the Basel Committee on Banking Supervision encourages banks to review their pay and bonus structures to make sure that they are consistent with long-term goals on dealing with the climate change.[26] Likewise, arrangements to align remuneration and incentive structures with environmental and net zero goals are very prominent in the transition plans led by the UK government.[27] The UK's FCA expects firms to be accountable for their sustainability-related claims and commitments by linking the stated objectives and incentive structures.[28] According to the FCA, 'remuneration is a crucial tool to help align corporate outcomes with long-term sustainability aims.'[29] The FCA thus proposes linking remuneration and incentive plans to sustainability-related metrics.[30] In the United States, SEC Commissioner Crenshaw highlighted the importance for the SEC to know 'how ESG measures are utilised in executive pay packages', 'whether there is sufficient insight into the methodologies behind the measures on which ESG compensation targets are based', 'about the use of targets based on measures of performance with qualitative or discretionary inputs', for the purposes of (re)calibrating pay and performance disclosures.[31] The SEC eventually amended its 'pay versus performance' requirements, and required all registrants to disclose the relationship

[23]A. Mooney, 'Cevian Warns Boards to Include ESG Metrics in Bosses' Pay' *Fin Times* (3 March 2021) 10; A. Klasa, 'AllianzGI to Vote Against Pay Deals with No ESG Links' *Fin Times* (23 February 2022) 13; Gomtsian, n 11 above, 159-161.

[24]A. Stobbe and H. Zimmerman, 'Ahead of the Curve: Tie Executive Pay to Climate Targets' *IPE Magazine* (June 2022), at https://www.ipe.com/esg/ahead-of-the-curve-tie-executive-pay-to-climate-targets/10060184.article.

[25]S. S. Dikolli et al., 'ESG Mutual Fund Voting on Executive Compensation Shareholder Proposals' (2023) 35:3 *Journal of Management Accounting Research* 51, 62-64.

[26]Basel Committee on Banking Supervision, 'Principles for the Effective Management and Supervision of Climate-Related Financial Risks' (June 2022) para 13, at https://www.bis.org/bcbs/publ/d532.pdf.

[27]Transition Plan Taskforce, *The Transition Plan Taskforce Disclosure Framework*, Consultation (London: TPT, 2022) 25.

[28]FCA, n 12 above, paras 1.15, 3.59.

[29]*ibid*, para 1.16.

[30]*ibid*, para 3.66.

[31]C.A. Crenshaw, 'Statement on the Reopening of Pay vs. Performance' (January 2022), at https://www.sec.gov/news/statement/crenshaw-statement-pvp-012722.

between executive compensation and financial performance with an emphasis on ESG compensation.[32]

The growing expectations of integrating ESG considerations into executive pay is not only the result of external push; there is also a substantial pull from corporate boards and their pay consultants who aim to stay ahead of the curve and showcase the sustainability credentials of their companies. Interestingly, consultants are playing a crucial role for the establishment of ESG-based executive compensation, consistent with what occurred in the 1930s, when McKinsey conducted the first studies on executive compensation contributing to its exponential increase.[33] A survey of senior corporate executives reveals that most view ESG targets in pay as a means for long-term value creation and, perhaps more importantly, as a credible signal that communicates the company's values and its commitment to those values both internally to employees and externally to various stakeholders.[34]

All these forces and factors have significantly influenced the modern design of executive compensation plans. ESG-linked executive compensation has experienced rapid growth worldwide in recent years and is becoming an increasingly prevalent common practice in large business organisations.[35] In the UK, almost half (45 per cent) of the FTSE 100 companies, the largest 100 companies listed on the London Stock Exchange by market capitalisation, included an ESG target in the variable component of their 2019 executive compensation packages, as reported in a joint study by PwC and London Business School.[36] This figure rose even further to 86 percent in 2021.[37] ESG measures were most commonly incorporated into annual bonus, with 37 per cent of the FTSE 100 companies having an ESG target.[38] Furthermore, some companies included ESG targets in the long-term incentive plans (LTIPs) of the executive compensation, either in addition to or as an alternative to annual bonuses. In total, 19 per cent of the FTSE 100 companies linked LTIPs to ESG performance.[39] ESG-linked executive pay is common among mid-cap companies in the

[32]See generally SEC, 'SEC Final Rule: Pay Versus Performance Disclosure Rules' (2022), at https://www.sec.gov/files/rules/final/2022/34-95607.pdf. As Morgan Lewis, a law firm, suggested this might trigger consequences for corporations as they might have to 'explain why ESG goals are included as part of the executive compensation program, how they comport with the company's fiduciary responsibilities, and how they will move the needle on the company's performance' (Morgan Lewis, 'Proxies, Pay, and the Brave New World of ESG' (February 2023), at https://www.morganlewis.com/pubs/2023/02/proxies-pay-and-the-brave-new-world-of-esg).

[33]W. Bogdanich and M. Forsythe, *When McKinsey Comes to Town* (2022).

[34]Gosling et al., 'Paying for Good,' n 3 above, 18-20, 36. See also Shearman & Sterling, 'Corporate Governance and Executive Compensation Survey 2021' (November 2021) 23, at https://digital.shearman.com/i/1425392-corporate-governance-and-exec-compensation-2021/0?_ga=2.85084955.364132651.1683014484-945938603.1683014484.

[35]S. Cohen et al., 'Executive Compensation Tied to ESG Performance: International Evidence' (2023) 61 *Journal of Accounting Research* 805, 809, 814-815.

[36]Gosling et al., 'Paying Well,' n 3 above, 14.

[37]Gosling et al., 'Paying for Good,' n 3 above, 2.

[38]*ibid.*

[39]*ibid.*

broader FTSE 350 index as well.[40] A recent study of pay practices in Euro Stoxx 50 companies, Eurozone blue-chip companies considered leaders in their respective sectors, documents a similar rise of ESG considerations in the rest of Europe.[41] This trend is also common across the Atlantic. The first study to explore the integration of environmental and social criteria in executive compensation found that only 12.1 per cent of the S&P 500 companies had adopted such criteria in 2004.[42] The rates of adopting ESG metrics in the executive compensation plans of US corporations are very different nowadays. Just over half (52.6 percent) of the S&P 100 companies, the largest listed companies in the United States, included some ESG metrics in their 2020 CEO compensation packages.[43] In most of these cases, ESG metrics were used to determine the amount of the annual bonus.[44] Two other studies found that 57 percent of companies in the S&P 500 incorporated at least one ESG metric in their executive compensation plans as of March 2021.[45] According to the latest data for 2023, 73 per cent of S&P 500 companies linked a portion of executive incentive compensation to the achievement of ESG metrics.[46] However, for now, this trend is primarily concentrated among large-cap companies, as less than 10 per cent of companies in the Russell 3000 (excluding S&P 500 companies) are including ESG metrics in executive compensation.[47]

3. Challenges of using ESG metrics in executive compensation

The use of ESG metrics in the design of executive compensation is not without problems. Several studies point to these problems to strongly discourage linking pay with ESG performance[48] or to advocate for a cautious approach when including ESG metrics in the design of pay.[49] In this section we take the first step in developing a framework for incorporating ESG

[40] Lu, n 18 above, 310.

[41] M. Dell'Erba and G. Ferrarini, 'ESG Remuneration in Europe' (2024) 25 European Business Organisation Law Review (forthcoming).

[42] C. Flammer, B. Hong, and D. Minor, 'Corporate Governance and the Rise of Integrating Corporate Social Responsibility Criteria in Executive Compensation: Effectiveness and Implications for Firm Outcomes' (2019) 40 *Strategic Management Journal* 1097, 1109.

[43] L.A. Bebchuk and R. Tallarita, 'The Perils and Questionable Promise of ESG-Based Compensation' (2022) 48 *J Corp L* 37, 52.

[44] *ibid.*

[45] M. Castañón Moats and C. Hamilton, 'Purpose Driven Leadership: The Evolving Role of ESG Metrics in Executive Compensation Plans' PwC (March 2022) 2, at https://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-esg-metrics-in-executive-compensation-plans.pdf; Semler Brossy, *ESG+Incentives: 2021 Report* (13 September 2021) 3, at https://semlerbrossy.com/insights/2021-esg-incentives-report/.

[46] Meridian Compensation Partners, 'ESG Incentive Practices at S&P 500 Companies' (June 2023) 3, at https://d2jsype5crt5mk.cloudfront.net/wp-content/uploads/2023/06/2023-Meridian-ESG-Study-in-SP-500-CEO-Incentives.pdf.

[47] Castañón Moats and Hamilton, n 45 above, 4.

[48] Bebchuk and Tallarita, n 43 above, 74-75.

[49] Gosling et al., 'Paying Well,' n 3 above, 12; D.I. Walker, 'The Economic (In)significance of Executive Pay ESG Incentives' (2022) 27 *Stanford Journal of Law, Business & Finance* 318, 349.

metrics into executive compensation plans by identifying and discussing the main challenges for their use in executive compensation.

3.1. The insignificant weight of ESG-linked pay in the total executive compensation

The major difficulty of creating an effectively functioning ESG-linked pay design is the overly limited impact of ESG metrics on the incentives of managers because of the insignificant weight of the ESG component in the overall compensation. The above-mentioned joint study by PwC and London Business School shows that the average weighting of ESG measures in the FTSE 100 companies that had such measures was 15 per cent in the bonus and 16 per cent in the LTIP in 2019.[50] Similarly, many companies in the broader FTSE 350 index allocate low weights to ESG incentives in executive compensation, thereby making ESG-based remuneration 'more symbolic than substantive.'[51] US companies using ESG metrics in pay allocate even smaller weights to those metrics. In most S&P 100 companies that disclosed information, ESG metrics accounted for only 1.5-3 per cent of the total compensation in 2020.[52] According to the estimates by Glass, Lewis & Co., a major proxy advisory services company, nearly 8.6 per cent of rewards paid to CEOs of companies in S&P 500 in 2021 were based on environmental and social performance.[53] Looking more globally, the weighting of ESG targets varies across studies, depending on the composition of the sample. One study finds that, on a global scale, ESG targets typically have a weighting of 10 percent in the total compensation.[54] Another study finds that the average weight of ESG metrics is approximately 13 per cent in the short-term annual bonus and just below 16 percent in the long-term variable component of executive compensation contracts.[55]

However, a more careful analysis shows that even those modest numbers significantly overstate the real-life impact of pay related ESG metrics.[56] When accounting for the total share and stock option award components of executive compensation, including share and stock options previously granted but still outstanding, the significance of pay-related ESG metrics becomes negligible. An examination of CEO compensation in a sample of US corporations shows that the median weight of the ESG component in the variable

[50]Gosling et al., 'Paying Well,' n 3 above, 18.
[51]Lu, n 18 above, 317-318.
[52]Bebchuk and Tallarita, n 43 above, 52.
[53]E. Shostal and K. Shah, 'E&S Metrics and Executive Compensation' Harvard Law School Forum on Corporate Governance (23 March 2022), at https://corpgov.law.harvard.edu/2022/03/23/es-metrics-and-executive-compensation/.
[54]Gosling et al., 'Paying for Good,' n 3 above, 15.
[55]Cohen et al., n 35 above, 822, 823.
[56]Walker, n 49 above, 321.

executive compensation was only 0.2 per cent in 2020.[57] This limited impact may be further diluted by potential conflicts between non-financial and financial performance metrics.[58] Share awards under compensation plans, constituting the largest element of executive incentive pay,[59] reinforce the interest of executive directors in maximising shareholder value. Unlike most diversified investors, who are concerned with portfolio value maximisation and may thus take into account global challenges that could affect overall portfolio value,[60] executive directors are undiversified shareholders with an investing time horizon typically tied to the vesting period of share awards.[61] Furthermore, a substantial body of survey literature shows that corporate managers, especially in large public companies, describe themselves as earnings-per-share (EPS) maximisers.[62] For chief financial officers of large public companies, EPS is considered 'the single most critical performance metric.'[63] As noted earlier, executive compensation is typically linked to the achievement of EPS targets.[64] This implies that managers are unlikely to pursue an action that conflicts with the goal of company-specific shareholder value creation in general, and EPS maximisation in particular. The primary incentive for executive directors is to overlook such actions. Certainly, some ESG metrics, such as employee health and safety or workplace diversity, are often aligned with and are complementary to shareholder value creation and are unlikely to pose a threat to shareholder interests. Executive directors, if rewarded based on such metrics, can easily combine the achievement of those targets with their primary interest of increasing shareholder value. But others, such as a commitment to significantly cut carbon emissions or continuously increase employee pay or job security, are certainly at odds with EPS maximisation and often also with shareholder value creation, especially at critical junctures of corporate takeovers and restructurings.[65]

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57 *ibid*, 339.

58 *ibid*, 338.

59 The average long-term incentives plan in the FTSE 100 companies constituted 44.75 per cent of the overall compensation package during 2018-2021, according to High Pay Centre, a think tank (High Pay Centre, 'Analysis of UK CEO Pay in 2021' (August 2022) 7, at https://highpaycentre.org/wp-content/uploads/2022/11/CEO-pay-report-2022-1.pdf.

60 L. Enriques and A. Romano, 'Rewiring Corporate Law for an Interconnected World' (2022) 64 *Arizona Law Review* 51, 60, 65.

61 The vesting period for share awards is currently five years or more under the revised best practice guidelines in the United Kingdom (Financial Reporting Council, *The UK Corporate Governance Code* (July 2018) Part 5, Provision 36, at https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf) and usually three years elsewhere (Edmans et al., n 15 above, 416).

62 I. Ben-David and A. M. Chinco, 'Modelling Managers as EPS Maximisers' NBER Working Paper 31125 (April 2023) 6-8, at http://www.nber.org/papers/w31125.

63 *ibid*, 6.

64 n 16 above.

65 L.A. Bebchuk, K. Kastiel, and A. Toniolo, 'How Twitter Pushed Stakeholders Under the Bus' (2023) 28 *Stanford Journal of Law, Business & Finance* 307.

ESG metrics would need to constitute a substantial portion of overall executive compensation to have an impact on managerial incentives. The limited weight of the ESG component in executive pay also undermines the use of ESG metrics as a tool to signal the importance of stakeholder interests for companies. If the signal is directed towards external stakeholders, it lacks credibility due to the negligible influence of ESG-related incentives. But, if the signal is intended to establish and emphasise priorities for executives, then the inclusion of ESG targets in a corporate strategy document would accomplish a similar goal without unnecessarily complicating the structure of executive compensation. A cynic may argue that companies could employ ESG metrics for signalling purposes regardless of their impact on incentives. Indeed, some companies may intentionally adopt a design of ESG metrics that ostensibly reinforces the credibility of the company's ESG commitments in the eyes of various external stakeholders, while actually having minimal real impact on the incentives of executive directors.[66] Signalling through mere 'window-dressing' can be effective in shaping external perceptions because information asymmetries between the board and outsiders increase the costs of stakeholders in assessing the adequacy of the ESG component of pay.[67] Needless to say that the use of ESG metrics in this manner contradicts the intended purpose of linking executive compensation to ESG metrics and contributes to greenwashing, thereby distorting the accuracy of information in the markets.

3.2. The increased complexity of executive compensation plans

Introducing ESG targets to the already complex and multi-dimensional design of compensation further compounds this complexity and can lead to unintended negative consequences. As explained by a leading pay consultant, 'space for new metrics [in executive compensation plans] is limited.'[68] Maintaining simplicity in the structure of pay 'keeps the organisation's main priorities front and centre, and makes expectations clear.'[69] In contrast, a complex compensation structure generates confusion and diminishes the clarity and the value of input factors for executives, thereby diluting the impact of incentives incorporated in the compensation design. Not surprisingly, some institutional investors oppose the increasing complexity of pay structures because of its diluting impact on incentives.[70] Investor resistance to pay complexity is exacerbated by the challenges in overseeing compensation arrangements with overly complex structure.

[66] Cohen et al., n 35 above, 812.
[67] *ibid.*
[68] Castañón Moats and Hamilton, n 45 above, 3.
[69] *ibid.*
[70] Gomtsian, n 11 above, 159.

Complex pay structures with incentive-based performance targets distort managerial decision-making by diverting the manager's focus among their various responsibilities.[71] Executive compensation with multiple performance targets tends to guide executives towards those performance targets that present the most obvious and the highest reward opportunities, especially where the different targets are substitutes.[72] The minimal weight of ESG targets in compensation and the vague connection between the achievement of target performance on certain metrics and share price performance (consider, for example, metrics improving well-being, trust and credibility in local communities, or fostering environmental sustainability) imply that financial targets are likely to be the priority. This situation worsens when the goals of the selected ESG targets collide with short – to medium-term shareholder value creation. Furthermore, when confronted with multiple tasks, managers tend to prioritise the performance targets at the expense of other factors not integrated into the compensation design.[73] In other words, incentive targets get priority over non-targeted dimensions.[74] For instance, there is the potential risk of diverting management attention away from aspects like product quality or, even worse, safety when managers are rewarded for the company's environmental impact.[75] The distorting effect of incentive-based performance targets is particularly strong in situations where the competing non-targeted tasks are challenging to measure and cannot be readily monitored.[76]

The concern about excessive complexity is particularly acute when companies are expected to address every possible ESG issue, leaving no stakeholder interest unaddressed. Many different aspects of corporate performance included in aggregate ESG ratings create an unmanageable list of actions that executives must prioritise. Given the limited weight of each aspect within the aggregate rating, none is likely to receive sufficient attention even in the best-case scenario. The result is an executive compensation plan that lacks motivational impact in terms of ESG measures. A likelier response (and more damaging for stakeholder interests) from executive directors to the use of aggregated ESG ratings as a pay-for-performance target is tailoring corporate decisions to align with the methodology of the selected rating to improve the company's standing in the rating.[77]

[71] B. Holmström and P. Milgrom, 'Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design' (1991) 7 *Journal of Law, Economics, and Organization* 24, 25.
[72] Holmström and Milgrom, n 71 above, 32-33.
[73] *ibid*, 34-35.
[74] A. Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit* (Cambridge: Cambridge University Press, 2020) 115.
[75] Gosling et al., 'Paying for Good,' n 3 above, 25.
[76] Holmström and Milgrom, n 71 above, 26, 34-35.
[77] There is rich literature showing how various indices encourage behaviour that improves the narrow aspects constituting the elements of the index without meaningful changes (W. N. Espeland and M. Sauder, 'Rankings and Reactivity: How Public Measures Recreate Social Worlds' (2007) 113 *American*

3.3. The difficulty to capture accurately ESG goals in simple numerical metrics

The choice of performance measures is the foremost crucial element of an effective executive compensation plan.[78] Executive directors react to compensation-related incentives by giving priority to actions that, in their subjective judgement, enhance the measured performance, resulting in higher pay. Poorly chosen performance measures could thus promote managerial actions that have a weak correlation with the intended outcome. The choice of proper performance measures for rewarding executive directors is a challenging task in general[79] but it may get even more complicated when dealing with some ESG goals. Translating ESG goals into measurable, quantifiable metrics often requires a degree of simplification which can result in a prioritisation of form over function. Most ESG metrics employed for executive compensation purposes gauge a narrow, quantifiable aspect of an ESG goal, while some other metrics serve as proxies for measuring frequently non-quantifiable complex ESG goals. The rationale for a simplification of ESG performance goals is obvious: corporate boards and shareholders require objective and quantifiable standards by which to measure the performance of executive directors and reward them. However, the reduction of ESG goals into measurable metrics leads to the risk of 'only counting what can be counted.'[80] The problem with compensation plans that incorporate simple, yet incomplete incentive metrics is that they are prone to causing goal displacement, especially when applied to complex aspects of organisational performance.[81] Simple, objective standards for measuring performance tend to excessively focus attention on the performance measure being rewarded and encourage executives to employ any permissible means for achieving the performance target, even if the actual outcome diverges from the intended outcome or the spirit of the incentive.[82] When performance measures poorly align with the underlying goal, managers can reach the target performance through various methods, some of which contradict the goal's essence and fail to

Journal of Sociology, 1, 6-7, 24-33; D. Bush and J. Peterson, 'Jukin' the Stats: The Gaming of Law School Rankings and How to Stop It' (2013) 45 *Connecticut Law Review* 1235, 1250-1257; M. Osterloh and B. S. Frey, 'Ranking Games' (2015) 39 *Evaluation Review* 102, 109-113). Especially controversial was the World Bank's Doing Business index which was discontinued in 2021 after an investigation concluded that manipulations had taken place to improve country rankings (J. Zumbrun, 'World Bank Cancels Report After Investigation' *Wall Street Journal* (17 September 2021) A1, A10).

[78] K. J. Murphy, 'Executive Compensation: Where We Are, and How We Got There' in G. Constantinides et al. (eds) *The Handbook of the Economics of Finance, vol. 2, Part A* (2013) 242.

[79] E. Micheler, *Company Law: A Real Entity Theory* (2021) 169; Murphy, n 78 above, 245.

[80] T Gosling, 'Using Pay to Create Accountability for ESG Goals,' in Financial Conduct Authority, *Finance for Positive Sustainable Change: Governance, Incentives and Competence in Regulated Firms*, Discussion Paper DP23/1 (London: FCA, 2023) 42.

[81] S. Kerr, 'On the Folly of Rewarding A, While Hoping for B' (1975) 18 *Academy of Management Journal* 769, 779-780.

[82] Edmans, n 74 above, 109.

generate true value.[83] As a result, objective pay measures often backfire, leading companies to reward behaviour that differs from what the compensation plan originally intended to incentivise and reward.

Incentive reward practices, including those in corporations, are abundant with examples of how wrongly selected incentive measures can undermine the intended outcomes, often resulting in serious unintended negative side effects.[84] Companies may hope for one outcome but end up rewarding different behaviours, sometimes behaviours that totally undermine the desired outcome. Consider, for example, targets that reward a reduction in corporate emissions. Companies can reduce emissions (without any positive societal impact) and meet pay-linked emission targets by divesting heavily polluting business segments. Examples of divestitures driven by emission reduction goals in highly polluting sectors have become increasingly common in recent years.[85] The use of carbon targets in pay may also deter business acquisitions that could potentially increase the company's carbon emissions, even if the company plans to transform the acquired business and reduce its carbon emissions in the long-term.[86]

The second key element of a well-functioning executive compensation plan is the relation between pay and the selected performance measures.[87] This relation largely depends on how targets for the chosen performance measures are set. ESG performance measures employ discrete targets that do not result in payment until a minimum performance threshold is achieved (for instance, achieving a specific minimum quota of employment diversity or reducing carbon emissions by a specific minimum percentage). This creates another problem for using ESG metrics in pay because executive directors can influence target-related performance through their control over the company's day-to-day operations.

Examples of performance management related to pay can vary from relatively harmless actions that increase pay without any substantial change in performance to more serious situations that have significant negative consequences for the company and its stakeholders. Bengt Holmström provided some examples of gaming performance targets in his 2016 Nobel Prize lecture: an executive who is far from achieving the sales target at the end of the review period might try to postpone potential sales into the next year to gain an early advantage toward next year's bonus.[88] Similarly, if the executive has already met the sales target, they might shift all additional

[83]B. Holmström, 'Pay for Performance and Beyond' (2017) 107 *American Economic Review* 1753, 1767.
[84]Kerr, n 81 above, 769; Holmström, n 83 above, 1767-1768; Murphy, n 78 above, 245.
[85]S. Gomtsian, 'Debtholder Stewardship' (2023) 86 *Modern Law Review* 395, 411-412; A.A. Gözlügöl and W.-G. Ringe, 'Net-Zero Transition and Divestments of Carbon-Intensive Assets' (2023) 56 *UC Davis Law Review* 1963.
[86]Gosling et al., 'Paying for Net Zero,' n 3 above, 15.
[87]Murphy, n 78 above, 242.
[88]Holmström, n 83 above, 1763.

sales to the following year.[89] Potentially even worse are scenarios in which executives struggle to meet the target performance. They might either give up completely if the target threshold is too far or do whatever it takes to achieve the minimum performance threshold, even if it involves reducing investments in research and development to cut expenses or engaging in accounting fraud.[90] These examples can be readily adapted to the use of ESG metrics in executive compensation. Importantly, these are not hypothetical scenarios. Existing empirical evidence is consistent with the hypothesis that executives manipulate reported accounting performance to achieve compensation targets. When there is a significant increase in executive pay upon reaching a performance target, and if actual performance is expected to fall just short of this target, executives tend to take actions that enhance the reported performance to meet or surpass the pre-established compensation plan target.[91] Performance management may be motivated not only by the prospect of higher pay outcomes, but also by the fear of an executive being dismissed for performance falling short of the target or the expectation that better performance exceeding targets by a considerable margin will result in more challenging performance targets in future.[92]

This evidence, while primarily associated with accounting and financial performance goals, highlights the drawbacks of linking executive compensation to performance targets, including ESG targets, particularly when executives have influence over the reported performance. Because many ESG targets serve as proxies that do not perfectly capture the underlying goals, the perverse incentives of executive directors to manipulate reported performance become even more pronounced compared to the use of financial targets. As a result of such performance management, individuals being rewarded may meet the target and increase their payoffs without any meaningful improvements in the underlying goals, at best. Moreover, there could be negative long-term consequences for the company and its stakeholders.

Some ESG goals, such as collegiality and supportive working environment, are non-quantifiable and require qualitative judgement. Instances where companies rely on qualitative judgement instead of attempting to reduce complex ESG goals to simple numerical measures, are widespread in practice.[93] This introduces an additional problem of using vague and abstractly defined performance standards that grant too much discretion to the

[89] *ibid.*
[90] Murphy, n 78 above, 243.
[91] B. Bennett, J.C. Bettis, R. Gopalan, and T. Milbourn, 'Compensation Goals and Firm Performance' (2017) 124 *Journal of Financial Economics* 307, 314-317 (finding evidence that a disproportionately large number of firms clusters just above performance targets as compared to the number of firms that fail to meet the performance target by a small amount).
[92] *ibid*, 322-325.
[93] Bebchuk and Tallarita, n 43 above, 71; Gosling et al., 'Paying for Good,' n 3 above, 26.

board of directors and executives in determining final compensation and weaken external oversight of pay.[94] Besides, information asymmetries between corporate insiders and shareholders make it hard for shareholders to define the stretch of company specific ESG targets and oversee their implementation, especially in situations requiring qualitative judgement, as opposed to financial targets. As a consequence, experts raise reasonable concerns that the use of ESG targets in pay risks creating vague, opaque, and easy-to-manipulate compensation components that can be exploited by self-interested CEOs.[95] The same problems also weaken external oversight and scrutiny of executive compensation by shareholders and other interested parties.[96] The likely outcome are failure to design effective incentives for executive directors[97] and further increase in the level of executive pay.[98] Emerging evidence supports this concern: a recent study of the 50 largest European listed companies shows that payments on carbon targets included in pay averaged at 86 per cent of the maximum award opportunity in 2022, with more than half of the companies paying out at 100 per cent.[99] By contrast, the typical average payments on other pay targets reach only 75 per cent of the maximum award opportunity.[100]

The challenges of measuring non-financial ESG goals via numerical metrics do not mean that the efforts to incorporate ESG metrics in executive compensation must be abandoned completely. There are, for example, well established occupational health and safety key performance indicators that have become commonplace in many business organisations.[101] The argument rather is that some ESG metrics are a bad measure for promoting the underlying goal, can be prone to manipulation by those whose performance they are supposed to influence, and can be hard to verify and monitor externally. Ongoing efforts to improve the use of other non-financial indicators will broaden the range of metrics that can be used in executive compensation. Consider, for example, the SBT Initiative, a coalition formed to promote the use of independently verified 'science-based targets' (SBTs) by companies for reducing their greenhouse gas emissions and reporting on them using a specific format.[102] These independently verified goals serve as a defense against greenwashing and facilitate meaningful comparisons across

[94]Bebchuk and Tallarita, n 43 above, 40; Walker, n 49 above, 348-349.
[95]Bebchuk and Tallarita, n 43 above, 74.
[96]*ibid*, 74-75.
[97]Micheler, n 79 above, 127.
[98]Gosling et al., 'Paying Well,' n 3 above, 30; Bebchuk and Tallarita, n 43 above, xx.
[99]Gosling et al., 'Paying for Net Zero,' n 3 above, 11.
[100]*ibid*.
[101]L. S. Robson et al., 'The Effectiveness of Occupational Health and Safety Management System Interventions: A Systematic Review' (2007) 45 *Safety Science* 329, 331; S. Sinelnikov, J. Inouye, and S. Kerper, 'Using Leading Indicators to Measure Occupational Health and Safety Performance' (2015) 72 *Safety Science* 240, 243.
[102]Science Based Targets, 'SBTi Monitoring Report' (Aug. 2023), 4.

companies.[103] Therefore, they play a pivotal role in establishing a higher level of scrutiny and holding companies accountable for 'the actual mechanics of sustainability-linked performance pay.'[104] Of course, SBTs, despite the expectation of being ostensibly more objective metrics directly influenced by science, remain subjective in design and prone to wide interpretation. Also, disagreements might emerge over which emissions to include, which reduction methods to prioritise, and how to interpret scientific recommendations, ultimately leading to potential disagreements regarding the validity and achievability of the set targets. Nevertheless, the development of SBTs for corporate emission reductions and similar attempts to improve the measurability and reliability of other ESG metrics are needed to avoid 'streetlight bias' in the use of ESG-linked pay when corporate boards respond to the sustainability demand by giving priority to a narrow set of established non-financial targets at the expense of other important but hard-to-measure ESG goals.

* * *

Combined, these challenges increase the risks of creating perverse incentives and increasing the level of pay by integrating ESG metrics into the structure of executive compensation plans. The costs associated with those risks often outweigh the benefits of adding ESG targets into executive compensation plans. The case for integrating ESG metrics into pay becomes even weaker considering that integrating those goals into the company's strategy document can have a similar impact. Financial rewards are important, but declaring specific goals and failing to meet them also has important negative reputational implications for the company and its managers and thus can create incentives to implement the goal similar to the inclusion of metrics into pay.

The analysis above explains why some institutional investors, although open to the idea of using ESG metrics in pay in principle, have valid concerns over their use by companies. Investor comments during shareholder say-on-pay votes highlight the risks of using ESG metrics in pay: opaque qualitative targets can be manipulated to increase the level of pay, thus weakening investor oversight.[105] 'It is hard to judge whether the targets are stretching or not,' according to a leading UK-based investor.[106] Institutional investors prefer incentive awards that are based (only or predominantly) on financial targets because financial targets are 'tangible,' 'quantifiable,' and offer 'a high level of transparency.'[107] These comments indicate that for securing broad investor support for the use of ESG metrics non-financial performance

[103]Planet Tracker, 'Plastics Executive Compensation' (Sep. 2023), 1.
[104]*ibid*.
[105]Gomtsian, n 11 above, 160.
[106]*ibid*, 160-161.
[107]*ibid*, 160.

targets must be clearly defined, quantifiable, objectively measurable, transparent, and must not allow scope for discretion by boards.[108] Transparency is the easiest of the five criteria. The other four are going to be problematic for many ESG goals.

4. The narrow path: when and how ESG tied executive compensation can work

The broad use of ESG metrics in pay leads to the challenges identified in the previous section. Not every executive compensation plan then needs ESG metrics: these metrics may be valuable in some companies and contexts and destroy value in others. Accordingly, the path towards the integration of ESG metrics into the structure of executive compensation is narrow. This section provides a framework for incorporating ESG metrics into executive compensation plans. In doing so, this section relies on the economic models of incentive problems of multitasking agents developed by Bengt Holmström and Paul Milgrom[109] and on the challenges of using ESG metrics in executive compensation plans identified above. We argue that the use of pay-related ESG metrics can be effective in solving specific problems of a company's business associated with the interests of a specific stakeholder group in a quick way. But ESG targets cannot be counted on as a universal solution that can encourage managers to give priority to the interests of a non-shareholder stakeholder group at the expense of shareholder value.[110] We also explain when and how ESG metrics can be used in executive compensation.

This framework can serve as guidance for regulatory and investor initiatives aimed at encouraging the integration of ESG metrics into executive compensation. The analysis leads to the conclusion that ESG metrics in pay have a limited impact as an incentive mechanism. They work well in specific conditions but are likely to fail if applied broadly and indiscreetly. Most importantly, there is no one standard model that can be abstracted and universally applied across all companies, as each company's approach varies depending on the overall design of its executive compensation plan, the company's core business, business strategy, ESG strategy, and other factors. All these elements should contribute to a divergence in the

[108]Marsh, n 148 above; Stobbe and Zimmerman, n 24 above.

[109]Holmström and Milgrom, n 71 above, 33-35; Holmström, n 83 above, 1765-1769. This section thus develops further Professor David Walker's recent work on the use of ESG metrics in executive compensation plans who adopted the same analysis framework (Walker, n 49 above, 336, 343-347).

[110]The challenges of designing and using an aggregate ESG measure for executive compensation purposes (see text accompanying n 77 above) mean that compensation is a poor tool for promoting general sustainability in corporate governance. Encouraging the consideration of the interests of specific non-shareholder stakeholder groups through reward incentives is more feasible but only when the compensation plan is totally reframed to all but remove any metric aligned with shareholder interests.

identification of relevant stakeholders and their needs, which must be taken into account when defining the metrics. This is a key insight that regulators and institutional investors must keep in mind when developing best practice guidelines, shareholder voting, and engagement policies on the use of ESG metrics in compensation, as well as when applying those guidelines and policies in practice.

4.1. The incentive contracts of multitasking managers

The typical job of an executive manager consists of multiple tasks. Managers can allocate their time and effort among various tasks, including tasks that increase their private benefits. Attention to one task reduces the amount of attention that can be spent on other tasks.[111] The aim of performance-based compensation is to encourage executives to spend more time and effort on specific tasks. By rewarding those specific tasks, incentive contracts increase the opportunity cost of allocating attention to other tasks.[112] Viewed from this perspective, the traditional performance-based executive compensation contracts pursue the goal of maximising time and effort spent by executive directors on tasks that promote shareholder value creation. To achieve this goal, compensation contracts link rewards with improved financial performance of a company measured via various share price or accounting based performance metrics.[113] Additionally, executive directors receive shares awards which further strengthen their interest in allocating attention to tasks that increase shareholder value.[114]

The extension of this framework to the use of metrics associated with ESG goals reveals a basic factor that can predict the potential impact of ESG metrics on the incentives of managers: the relationship between the goal of a selected ESG metric and the dominant goal of the incentive contract. With the almost complete (if not absolute) dominance of the theme of shareholder interests in the traditional executive compensation contracts of for-profit companies, this factor can be reduced to the following question: how well is the direction of an ESG goal aligned with shareholder value creation? While ESG goals aligned with shareholder value creation can be incentivised through reward contracts, metrics associated with ESG goals that compete with shareholder value creation cannot lead to meaningful outcomes in the context of the traditional executive compensation contracts of for-profit companies.

[111] Holmström, n 83 above, 1766.
[112] *ibid.*
[113] n 16 above.
[114] n 17 above.

4.2. Rewarding ESG goals aligned with the dominant theme of managerial incentive contracts

Pursuing some ESG related tasks is perfectly consistent with increasing shareholder value. Moreover, the consideration of various ESG factors and their possible incorporation in corporate decisions is the duty of directors under the UK's enlightened shareholder value approach.[115] For example, corporate environmental and social initiatives contribute to identifying and reducing the downside risks of business, such as social risk and reputational damage, or the risk of unfavourable regulatory changes.[116] These risks, which arise when business decisions ignore or worsen major problems that are high on the agendas of large societal groups, may lead to significant negative consequences for a company. Hence, addressing them is in line with the business case of promoting the success of a company, in the interests of its shareholder, by protecting the company from downside risks.[117] The traditional incentive reward plans then, to the extent that they are aligned with shareholder value creation, create sufficient incentives for a rational manager to account for such ESG risks.

But in practice, even where ESG tasks are complementary to shareholder value creation, they may receive little attention from managers if their impact is relatively small. If compensation contracts include only financial performance targets, executive directors are discouraged from paying attention to other tasks that, while complementary to shareholder value creation, have limited immediate significance for shareholder value. As the model of incentive problems of multitasking managers demonstrates, secondary non-rewarded tasks have a high opportunity cost because time and effort spent on those tasks reduces the level of attention that can be allocated to the rewarded task of improving financial performance.[118] Accordingly, if corporate boards and shareholders want executive directors to pay attention to a task that cannot be achieved by exclusive focus on financial performance, they can design additional task-specific financial incentives. This will reduce the opportunity cost of time spent on the task.[119] The use of ESG metrics linked to additional tasks that are unlikely to be taken care about in the absence of a clear incentive can thus draw the attention of executive directors to those tasks and encourage them to allocate some time and effort towards their achievement. Empirical evidence is consistent with the theoretical prediction that the adoption of pay-linked ESG metrics helps direct managers' attention to stakeholders that are less salient but financially

[115]Companies Act 2006, s 172(1).
[116]S. Gadinis and A. Miazad, 'Corporate Law and Social Risk' (2020) 73 *Vanderbilt Law Review* 1401, 1410.
[117]*ibid*, 1411.
[118]Holmström, n 83 above, 1766.
[119]Holmström and Milgrom, n 71 above, 33; Holmström, n 83 above, 1766. See also Walker, n 49 above, 336, 343.

material to the company and contribute to value creation in the long-term perspective.[120]

Importantly, pay-linked ESG targets can achieve more than the inclusion of similar targets in a strategy document without a link to financial incentives. Motivation studies in business and cognitive psychology show that while committing to the so-called 'do your best' goals that are vaguely or abstractly defined does not guarantee goal achievement, the second act of setting specific targets for achieving the underlying goal leads to a higher level of performance.[121] Studies in applied psychology offer further support for the strong effect of simple but specific plans: goals that are accompanied by implementation intentions lead to higher rates of completion compared to goals without an action plan.[122] Specific goals guide through the actions that need to be taken for the goal attainment, just as if someone has an extensive behavioural practice.[123] But specific implementation intentions do not work perfectly in all situations.[124] In particular, while effective for one-time tasks, they do not work the same way with goals that require repeated effort.[125] It is clear then that supporting strategic goals with incentive linked ESG metrics can further strengthen goal attainment. ESG metrics included in pay not only make goals more specific, but also strengthen the commitment to those goals by making the goal public and financially relevant.

4.3. Rewarding ESG goals that compete with the dominant theme of managerial incentive contracts

Some tasks expected from executive managers, however, are substitutes and compete for their time and effort. Large scale workplace efforts to eliminate the gender pay gap, for example, do not fit within the limits of the efforts of managers to achieve corporate financial performance targets and benchmarks. Corporate transition plans to a greener economy offer another illustration of this dilemma. Consider an oil and gas company executive who needs to increase company returns and profits and, at the same time,

[120] Flammer et al., n 42 above, 1112-1114.

[121] E.A. Locke and G.P. Latham, *A Theory of Goal Setting and Task Performance* (1990) 29; H.J. Klein, E.M. Whitener, and D.R. Ilgen, 'The Role of Goal Specificity in the Goal-Setting Process' (1990) 14 *Motivation and Emotion* 179, 187-188.

[122] P.M. Gollwitzer and V. Brandstätter, 'Implementation Intentions and Effective Goal Pursuit' (1997) 73 *Journal of Personality and Social Psychology* 186, 189, 191-192; P.M. Gollwitzer and P. Sheeran, 'Implementation Intentions and Goal Achievement: A Meta-Analysis of Effects and Processes' (2006) 38 *Advances in Experimental Social Psychology* 69, 92.

[123] P.M. Gollwitzer, 'Implementation Intentions: Strong Effects of Simple Plans' (1999) 54 *American Psychologist* 493, 498-499.

[124] M. Carrera et al., 'The Limits of Simple Implementation Intentions: Evidence from a Field Experiment on Making Plans to Exercise' (2018) 62 *Journal of Health Economics* 95, 99-100.

[125] *ibid*, 101.

reduce substantially the company's carbon emissions. The second task, which requires cutting oil and gas production targets, conflicts with the first task of making more money from the company's operations in extracting, refining, and selling oil and gas products. It may be possible that the two tasks are not substitutes if the company can continue generating comparable shareholder returns by replacing oil and gas production with renewables. But if this shift to renewable energy production is not matched by the simultaneous transition of consumers to renewable energy sources, the company will lose its market share to competitors ready to supply the needed fossil fuels. Pursuing the second task in this scenario is likely to reduce shareholder value, at least in the short – to medium-term perspective.[126]

Where two tasks are substitutes, incentive contracts can encourage one task by increasing rewards for this task or decreasing rewards for the competing task.[127] If two tasks are perfect substitutes and both are important, then rewards for both tasks need to have equal strong incentives.[128] But the optimal design of rewards for competing tasks is challenging when the tasks differ in the degree of how easy they can be measured or when the available performance measures are incomplete.[129] The exact weight thus depends on two factors: the degree of the substitutability of the tasks and the ease of measuring the performance of the tasks. These factors differ in each specific case.

The extension of this conclusion to situations where corporate ESG and financial goals conflict makes clear the complexity of the task of incorporating ESG metrics in existing compensation contracts. This is not a matter of assigning an approximate substantial weight to the selected ESG target in the total reward to reallocate part of the efforts of managers away from actions that conflict with the underlying ESG goal. The weight of the ESG metric needs to be clearly defined to balance it against competing tasks. If an ESG goal is a perfect substitute for shareholder value, then financial performance metrics linked to shareholder value creation must be matched by similarly strong incentives for achieving the ESG goal. Yet, defining the extent to which various tasks are competing with each other for the attention of executive directors during the time horizon of the executive compensation plan is hard. Meanwhile, without accurate information on the substitutability of the

[126]To be clear, this example does not assume that climate risks do not affect shareholder value negatively. The example rather posits that the impact of climate risks on shareholder value may be negligible during the length of the manager's service contract and the vesting period of their share awards. From this limited time horizon perspective, actions directed at the reduction of carbon emissions can compete with the actions that increase shareholder value.
[127]Holmström and Milgrom, n 71 above, 33; Holmström, n 83 above, 1768.
[128]Holmström, n 83 above, 1766.
[129]*ibid*, 1765.

two pay linked goals, it is impossible to define the appropriate weights of the rewards for each goal.[130]

To complicate matters further, some tasks are hard to measure or may be linked to performance measures that are poorly aligned with the underlying goal. This means that incentives linked to hard-to-measure goals are necessarily imperfect and create risks associated with the manipulation of the performance targets.[131] Many ESG tasks, as shown above, are hard-to-measure tasks with measurement metrics that can be manipulated or create distortive incentives.[132] The cost of using incomplete performance metrics can be reduced by lowering or capping the weight of the reward for the hard-to-measure task.[133] Importantly, the reward for the competing easy-to-measure target must be lowered in parallel.[134] Otherwise the marginal cost of spending time on the hard-to-measure task would be too high and less time would be spent on that task than on the competing easy-to-measure task.[135] Alternatively, managers can be encouraged to allocate more attention to a hard-to-measure task by increasing the reward for this task, but this comes at the cost of a higher risk associated with the imperfections of measurement.[136]

The implication of this analysis is that the appropriate weights of ESG metrics in executive compensation plans depend heavily on company-specific circumstances. A simple addition of an ESG metric without a careful consideration of the appropriate weights of all metrics based on the degree of substitutability of the metrics and on the precision with which they can be measured cannot lead to an optimal outcome. Wrongly defined weights can lead to corporate waste by rewarding executive directors for worthless and sometimes even harmful performance.[137] Furthermore, they add more complexity to the structure of pay without much added value, if any, and with all possible negative consequences. Accordingly, in situations where neither corporate boards can define the appropriate weight of ESG metrics with accurate precision when setting the structure of executive compensation, nor shareholders – who face even stronger information asymmetries than boards – know the appropriate weights of each

[130] *ibid*, 1766.
[131] *ibid* at 1767-1768 (discussing recent high-profile examples of the manipulation of performance measures).
[132] *See* above Section 3.3.
[133] Holmström, n 83 above, 1766.
[134] One cannot easily assume that corporate boards responsible for setting the level of pay have enough bargaining power to accompany the introduction of ESG metrics not perfectly aligned with shareholder value with reductions in the level of rewards for financial performance and, most substantially, share awards.
[135] Holmström, n 83 above, 1766.
[136] *ibid.*
[137] *ibid*, 1767.

performance metric when overseeing executive compensation, companies should refrain from their use.

Companies do not face similar design challenges when rewarding executive directors for complementary goals. Because rewards for complimentary goals serve more as a signalling and commitment device, the level of precision in setting the weights of performance measure for each goal is a matter of secondary order. For example, executive compensation plans can easily link rewards to the implementation of corporate procedures that reduce compliance and regulatory failures, such as bribery scandals or regulatory fines, which may have significant reputational and financial impact on a company. Similarly, rewarding managers for strong health and safety standards is an imperative in resource extracting sectors, like mining and oil and gas, and in utility companies. The selection of these goals will differ across companies because their importance is business specific. But the risk of miscalculation of the reward size after the relevant goal(s) has been selected, due to the complementarity of this goal with shareholder value creation, is minimal. Accordingly, companies can adopt a standard reward size that will both create financial incentives for managers and serve as a strong signal that the company's board and shareholders consider the urgent attainment of the goal as a mission priority.

* * *

To conclude, ESG-linked executive pay can be effective within a narrow set of conditions. ESG metrics can be of good use when a company aims to (1) improve performance on one single major ESG aspect (2) that is complementary to shareholder value creation and does not contradict the broader aims of the executive compensation plan (3) but, at the same time, is also not explicitly reflected in these aims because its link to short – to medium-term share price performance is not obvious (note that variable instruments of executive compensation are linked to short-term financial performance targets through annual bonuses and to medium-term performance targets through LTIPs). The role of such ESG metrics is to highlight an urgent problem and draw the attention of executive directors towards the underlying ESG goal of addressing this problem quickly. The weight of the selected metric does not matter much as long as it is not trivial and is not overshadowed by many other performance targets. This implies that companies should select fewer ESG metrics that are aligned with the strategy of the company and have a meaningful, but not substantial, weight in the compensation. Furthermore, the need in adding ESG metrics to executive compensation plans and the way these metrics influence rewards vary across companies and time. The role of ESG targets that increase rewards when they are met is limited in time because these targets lose their relevance after the problem they target is solved. Gaps filled by emerging regulation and social norms also weaken the necessity of using certain ESG metrics.[138] Their continued use adds to the complexity of pay structures without the upside of addressing any problem in a meaningful way. The use of such targets should be discontinued or, at minimum, undergo a transition by reformulating the targets as minimum standards that can lead to reductions in pay if they are not met. Accordingly, companies do not need ESG targets in executive pay as a matter of best practice. Pay related ESG metrics can be useful for achieving specific narrow goals in a specific company at a certain point in time.

Conversely, the idea that rewarding performance by using metrics that are competing with shareholder value creation can make impact on the ground by, for example, addressing the problem of negative corporate externalities, is misconceived. ESG metrics that are incompatible with shareholder value creation could create powerful financial incentives only if the goals associated with these metrics replace shareholder value creation as the dominant purpose of an executive compensation plan.

5. Why the evolving stewardship practice of demanding the integration of ESG metrics in the design of executive compensation is wrong and how to fix it

The influence of incentive-based pay on the behaviour of executive directors makes ESG-linked executive compensation a powerful tool for strengthening the consideration of the interests of a broad range of stakeholder groups during corporate decision-making. But the framework developed above also shows that ESG metrics in pay should not be promoted as a standard practice. They work well under specific conditions that may be present in some companies and absent in others. While they can be valuable for some companies and in specific contexts, they may also be completely irrelevant or, in the worst cases, have the same detrimental effect as any improper corporate governance arrangement by contributing to value destruction. Besides, many ESG measures aim to improve an aspect of business – such as workforce diversity, health and safety, or equal pay and carbon emissions – where a company underperforms. Unlike financial performance measures that can be used repeatedly in executive compensation plans every year, re-using ESG measures offers executives easily attainable rewards for maintaining the standards that have been met. Here it is worth stressing the key difference between most ESG measures and typical financial performance measure used in compensation plans: companies start every financial year from scratch, and replicating the financial results of a particularly successful

[138]It is questionable, for instance, whether companies should reward executives for improving gender balance at the board or senior executive level where there is already pressure on companies to appoint more female directors and senior managers through soft law best practice corporate governance recommendations (Gosling et al., 'Paying for Net Zero,' n 3 above, 14).

year can be an achievement in and of itself. In contrast, most ESG goals involve ongoing progress and are not reset yearly (for example, a company that improved workplace diversity does not start each new year from the initial starting point). Accordingly, ESG measures that were effective for some companies in the past cannot be used again later. This section applies the framework developed above to analyse the evolving investor practices of demanding the use of ESG measures in executive compensation plans and the emerging regulatory efforts to support these practices. The analysis shows that both investors and regulators have, unfortunately, taken the wrong path that, perhaps inadvertently, encourages a box-ticking approach to the use of ESG metrics in executive pay. As a result, standardisation in the use of ESG metrics for executive compensation is becoming an increasingly common practice and we may end up in a situation where standard structures, as seen with the other elements of executive compensation, become the norm. Standard investor and regulatory demands for linking pay with ESG performance are thus a sub-optimal approach when using an otherwise potent tool. The evolving practices require an urgent re-assessment and reversal.

5.1. Institutional investor demands on using ESG measures in executive compensation plans

A growing list of institutional investors have been promoting the use of ESG measures in executive compensation plans as part of their shareholder stewardship efforts. Although an evolving practice, this is not a recent phenomenon. As early as 2013, institutional investors occasionally drew companies' attention to ESG shortcomings, often without explicitly using the term 'ESG,' during shareholder say-on-pay votes.[139] But this early-stage ESG engagement over pay was rare. A study of investor preferences during say-on-pay votes in FTSE 100 companies, the largest companies listed on the UK stock markets, reveals that instances where investors did mention non-financial considerations in the context of executive pay were mostly concentrated in industries like mining, extraction, and other sectors where hazardous working conditions posed health and safety risks to employees.[140] Institutional investors in mining companies Anglo American, Antofagasta, BHP Group, and EVRAZ, as well as in manufacturers such as GKN, Mondi, and Smurfit Kappa Group voted against remuneration reports. Investors were not satisfied that these companies did not adequately consider safety failures in the workplace resulting in fatalities and industrial accidents

[139] Evidence presented below, including direct quotes, are taken from vote explanations disclosed by institutional investors in relation to say-on-pay proposals voted on in the FTSE 100 companies during 2013-2021. The source of this information is Insightia One's Voting service.

[140] Gomtsian, n 11 above, 160.

when paying out generous rewards to their executive directors. Some of these companies included health and safety measures as a basis for bonus opportunity with the implication that compensation would be reduced in cases of health and safety lapses. But they made only insignificant deductions following workplace accidents. Thus, early-stage shareholder engagement on executive compensation, driven by ESG considerations, aimed to correct the board's oversight failures in the application of existing ESG measures to determine compensation levels. According to a major shareholder in one of the companies, the concern that large awards could 'send the wrong message regarding health and safety' drove shareholder decision to escalate the vote against the remuneration reports.

Institutional investors raised concerns about the disconnect between the level of awards and other ESG failures. Investors pointed to severe ESG controversies at BHP Group, which included the collapse of a dam, water pollution, failure to respect indigenous rights in different countries, accusations of tax evasion, and a failure to address the climate change impacts of its operations by building new coal-burning power plants and developing coal mines. Similarly, at Glencore, some investors repeatedly noted significant risks to shareholders stemming from severe ESG controversies, including water pollution, deforestation in the supply chain, child labour, failure to mitigate the company's climate change impact, respect union rights, health and safety conditions at workplace, and indigenous rights, as well as several investigations for bribery, tax evasion, and anti-competitive behaviour. The most famous example of shareholder opposition to executive compensation levels due to non-financial performance failures is, of course, payments made to the former CEO of Rio Tinto Group, one of the world's largest metals and mining corporations. In May 2021, at the annual shareholders' meeting of Rio Tinto Group, more than 60 per cent of votes, went against the company remuneration report.[141] Shareholders were outraged that the total annual remuneration of the company's former CEO, who had been forced to step down earlier after blasting ancient Juukan rock shelters in Australia to clear the way for a mining project, had increased despite the destruction of the sacred Aboriginal site and the ensuing reputational damage.[142] As BlackRock explained, the generous payments 'did not adequately reflect the severity of the destruction of the Juukan Gorge and the resulting damage to the environment, relevant communities, and the company's social license to operate.' Similarly, a large group of shareholders who voted based on the recommendations of ISS, the leading proxy advisory firm, expressed concerns that the former CEO retained a significant portion of

[141]N. Hume, 'Rio Tinto Suffers Big Investor Rebellion Amid Bruising Day for UK-Listed Groups' *Fin Times* (7 May 2021) 1.
[142]*ibid*.

his awards after leaving, even though the 'failures in risk oversight and governance at the Juukan site clearly constitute a 'catastrophic environment event' which has 'had a material effect on the reputation' of Rio Tinto.'

In addition to opposing executive pay levels in companies with ESG controversies, institutional investors sometimes exercised their voting rights to advocate for a stronger incorporation of ESG measures into the structure of executive compensation plans and to instruct companies on best practices in this regard. The following shareholder vote explanations described below illustrate these practices.

Some major shareholders encouraged Shell to 'introduce a sustainability component as an underpin to the LTIP, outlining minimum criteria that must be met for the award to vest.' In the case of BAE Systems, a defence contractor, several shareholders urged the company to reform the structure of executive compensation by not rewarding executives for positive performance on corporate responsibility metrics. Given the importance of business ethics and anticorruption in the company's operations, these shareholders recommended that ESG metrics be used as 'as risk underpins.' This would mean that failure to meet expected performance standards on ESG measures 'should be regarded as creating a business risk and have the result of impacting negatively bonus awards that are based on the achievement of strategic, operational and financial objectives.' At SSE, an energy supplier, at least one large shareholder complained about the stretch of a pay linked ESG metric, specifically customer service measure. For Barclays, shareholders voting based on ISS recommendations welcomed 'the consideration of culture and adherence to corporate values in remuneration decisions.' Royal London Asset Management, a large UK-based investment management company, called on the remuneration committee of Anglo American to apply a larger 'safety deductor' in the compensation structure to improve the company's health and safety practices. At National Grid, the same investment manager welcomed the introduction of stronger clawback measures to include a significant environmental, health or safety incident, or a failure of risk management. Following the Deepwater Horizon oil spill, shareholders at BP welcomed the introduction of a safety and environmental sustainability performance test for share awards and other long-term incentive payments to executive directors. Later, the same group of shareholders encouraged BP's remuneration committee 'to explore ways of bringing operational carbon reduction targets for business units into remuneration structures across the company.'

It is evident that institutional investors employed a company-specific approach to the incorporation of ESG measures into executive compensation plans prior to the Covid-19 lockdowns. Rather than insisting that every company link executive compensation to ESG metrics, investors focused on those companies that required these metrics the most. This focused stewardship strategy enabled major investors to develop a deep understanding of the ESG metrics used, including their effectiveness in achieving the underlying intended objectives and how to improve them. As a result, early say-on-pay votes motivated by the ESG considerations, while relatively uncommon, were tailored to the specific needs of each company. According to this approach, engagement on ESG measures was less frequent, as not every company needed them, but it was thorough and adapted to the needs of each targeted company.

Investor engagement in this area has become more common in recent years. A group of institutional investors has started referring to non-financial ESG considerations in say-on-pay vote explanations more frequently after the Covid-19 lockdowns.[143] Nevertheless, the topic remains relatively niche during the shareholder stewardship of executive compensation. The growing incidence of investor demands to integrate ESG targets into pay design is primarily driven by a small group of institutional investors with a policy of voting against pay proposals that lack ESG links.[144] Starting from 2020, but more significantly in 2021, Sarasin & Partners, one of the largest charity investment managers in the UK, called on companies to align their remuneration schemes with the Paris Agreement. The investment manager's ESG engagement targeted companies such as Barclays, BP, CRH, HSBC, Inter-Continental Hotels Group, Lloyds Banking Group, and Rio Tinto. In 2021, Amundi Asset Management and AXA Investment Managers of France, DWS Investment of Germany, and Trillium Asset Management of the USA followed suit, targeting companies including Avast, B&M European Value Retail, Berkeley Group Holdings, British American Tobacco, DS Smith, Experian, Ferguson, Flutter Entertainment, Halma, Hikma Pharmaceuticals, Informa, Intertek Group, Legal & General Group, London Stock Exchange Group, Next, Ocado Group, Pearson, SEGRO, and Whitbread. As noted earlier, Cevian Capital and Allianz Global Investors pledged to voting against pay proposals for companies with no link between executive compensation and ESG performance starting from the 2022 and 2023 voting seasons, respectively.[145]

The width of demands on the use of ESG metrics in pay naturally comes at the cost of the quality of shareholder voting engagement. Modern demands for linking executive compensation to ESG metrics are not specific and are targeting every company that lacks ESG metrics in the structure of its executive compensation plans at the date of the vote. In recent years, standardisation has thus replaced customised voting. Investors that vote against pay proposals without ESG measures do this without thorough consideration.[146] Investors have strong incentives to advocate for a standardised approach to

[143]Gomtsian, n 11 above, 160.
[144]*ibid*.
[145]n 9 above.
[146]Gomtsian, n 11 above, 160.

the use of ESG targets in the design of executive compensation. Diversified shareholders with investments in hundreds of companies often lack information about the appropriate weight of targets in each company. In a world of diversified holdings by many institutional investors, learning externalities associated with the standardisation of pay structures reduce investor monitoring and engagement costs. The extensive reliance on a limited number of proxy advisory firms for voting decisions on executive compensation further contributes to the standardisation of pay structures.[147]

Not surprisingly, institutional investors, promote a standard approach to the use of ESG metrics in executive compensation across the board. An increasing number of investors believe that every executive director compensation plan should incorporate an ESG metric.[148] However, rather than identifying the relevant ESG considerations for each company, investors expect every corporate board to propose specific ESG measures, design appropriate performance targets for these measures, and convince investors that these targets are appropriate for their company. Moreover, institutional investors adopt a standard approach not only to the need of using ESG measures in executive pay but also concerning how to use these measures. According to an annual survey of asset managers conducted by Georgeson, a proxy advisor, approximately eight out of ten respondents believe that a 20 per cent weight for ESG metrics in executive compensation is appropriate.[149] As one investor representative explained, '[s]omething like 20% is about right. Below 15% is probably not enough, and above 20% you start to worry that something else important is not getting done.'[150] This standard approach, although rational in terms of reducing voting and engagement costs of institutional investors, is wrong. The limited applicability of effectively functioning ESG metrics in compensation is incompatible with the standard policy of adding ESG metrics into the executive compensation plans of every single listed company. Not all companies need ESG targets in their compensation design; and for those that do, the need varies and is likely not permanent. Furthermore, if the weight of an ESG metric is chosen wrongly, it is unlikely to have a meaningful impact on the behaviour of executive directors because incentives created by the remaining targets will outweigh it. It is misconception to believe that a standard 20 per cent bonus linked to ESG metrics

[147]D. F. Larcker, A. L. McCall, and G. Ormazabal, 'Outsourcing Shareholder Voting to Proxy Advisory Firms' (2015) 58 *Journal of Law & Economics* 173, 200; F. Cabezon, 'Executive Compensation: The Trend toward One Size Fits All' (October 2021) 19-20, at https://ssrn.com/abstract=3727623; T. Jochem, G. Ormazabal, and A. Rajamani, 'Why Have CEO Pay Levels Become Less Diverse?' ECGI Finance Working Paper No. 707/2020 (April 2021) 10-11, at https://ssrn.com/abstract=3716765; Gomtsian, n 11 above, 152-153.

[148]nn 9-10 above. *See also* J. Marsh, 'ESG-Linked Pay: Investors Push for More Robust Targets' *Capital Monitor* (26 April 2022), at https://capitalmonitor.ai/institution/investment-managers/esg-linked-pay-investors-push-for-targets/.

[149]Marsh, n 148 above.

[150]*ibid.*

can influence the behaviour of an executive director if the rest of the compensation plan is based on financial performance targets, and pursuing the chosen ESG metric undermines the achievement of these financial targets.

This type of investor engagement is yet another example of a standard box-ticking approach where best practices are being promoted across firms without a thorough analysis of whether they can add or preserve value and how to adapt them to make them more relevant and valuable for the unique needs of an individual company.[151] Such engagement promotes certain practices across companies but fails to align these practices with the specific individual needs of each company. Moreover, reasonable minds may disagree on whether these are the best practices that should be promoted.[152] However, given the vast power of a limited number of asset managers[153] and the influence of a few proxy advisory firms,[154] the adoption of those practice by a select few may be enough to promote them across the market. Instead, investors need to focus on the targeted use of specific ESG targets in pay where those targets are most necessary and material for the company's business. Corporate boards and their pay consultants, even without investor pressure, already have strong incentives to adopt standard pay practices. Companies often copy well developed and easy to measure performance metrics from their peers, even where such metrics are not suitable for their specific circumstance, because 'no board wants to be first or last.'[155] Adding to this pressure through blanket investor demands for the use of ESG metrics, without considering whether a company actually needs such metrics and in what form, will further contribute to the promotion of suboptimal executive compensation plans.

5.2. The emerging regulatory approach towards the use of ESG measures in executive compensation plans

Let's turn now to the emerging regulatory efforts to support the use of ESG measures in executive compensation plans. Although no regulatory

[151] B. V. Reddy, 'Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code' (2019) 82 *Modern L Rev* 692, 698-699.

[152] D. S. Lund, 'The Case Against Passive Shareholder Voting' (2018) 43 *Journal of Corporation Law* 493, 516; Reddy, n 151 above, 702.

[153] L. Bebchuk and S. Hirst, 'Big Three Power, and Why It Matters' (2022) 102 *Boston University Law Review* 1547, 1556-1558 (documenting the power of the so-called 'Big Three' asset managers, BlackRock, Vanguard, and State Street, in the US); S. Gomtsian, 'Shareholder Engagement and Voting in the United Kingdom' in H. Kaur et al. (eds.) *The Cambridge Handbook of Shareholder Engagement and Voting* (2022) 436-437 (for similar evidence in the UK).

[154] Y. Ertimur, F. Ferri, and D. Oesch, 'Shareholder Votes and Proxy Advisors: Evidence from Say on Pay' (2013) 51 *Journal of Accounting Research* 951, 978-980 (presenting evidence on shareholder say-on-pay votes in the US companies); Gomtsian, n 11 above, 152-153 (presenting evidence on the impact of proxy advisory firms on shareholder say-on-pay votes in the UK).

[155] A. Taylor and B. Harward, 'Incentivising ESG: What Does It Really Take?' Sustainable Views (18 July 2022), at https://www.sustainableviews.com/incentivising-esg-what-does-it-really-take/.

mandates have been promulgated requiring the linking of executive compensation with ESG targets, ongoing discussions about implementing such rules are taking place. One of the first global initiatives in this field was a proposal by the Basel Committee on Banking Supervision encouraging banks to review their pay and bonus structures to ensure they align with long-term goals on dealing with the climate change.[156] The European Commission, meanwhile, has adopted an indirect disclosure-based approach for promoting the use of ESG metrics in executive pay. According to the European Sustainability Reporting Standards, which have been approved by the Commission and are applicable to large EU business organisations with over 500 employees, companies shall disclose 'whether and how climate-related considerations are factored into the remuneration of members of the administrative, management and supervisory bodies.'[157] This disclosure-based approach, although not demanding the use of ESG metrics in pay directly, adds pressure on companies to do so by implying that the inclusion of an ESG component in executive compensation design is a standard practice. In the UK, a recent discussion paper by the FCA proposes linking remuneration and incentive plans to sustainability-related metrics as a means for enhancing the credibility of corporate sustainability claims.[158] This proposal found its way into the draft revised UK Corporate Governance Code during the consultation period in 2023. The drafters of the code proposed to include a direct recommendation on the use of ESG metrics in the structure of executive compensation plans through a new best practice governance standard on executive pay: '[r]emuneration outcomes should be clearly aligned to company performance, purpose and values, and the successful delivery of the company's long-term strategy including environmental, social and governance objectives.'[159] That the UK Corporate Governance Code is a soft law tool and is formally not binding for companies makes little difference in terms of compliance rates in practice. Because many institutional investors and proxy advisors treat the Code's governance standards as a set of hard rules, companies have little room for flexibility, resulting in 'overcompliance' with the principles and provisions of the Code through box-ticking.[160] This proposal, as elaborated in more detail below, did not make into the final text of

[156] n 26 above.

[157] Commission Delegated Regulation (EU) 2023/2772 of 31 July 2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards, ESRS E1 Climate Change: s 13, OJ L 22.12.2023, 74/284.

[158] nn 28-30 above.

[159] Financial Reporting Council, *UK Corporate Governance Code: Consultation Document* (London: FRC, 2023) Principle P, at https://www.frc.org.uk/getattachment/a92c8f2d-d119-4c4b-b45f-660696af7a6c/Corporate-Governance-Code-consultation-document.pdf.

[160] Reddy, n 151 above, 694-698.

the latest edition of the UK Corporate Governance Code published in January 2024.

Such initiatives, if adopted in hard or soft law forms, are expected to broaden and give more legitimacy to investor support for standard ESG integration in executive compensation plans. But the FCA proposal also stands out by prescribing how companies should implement this requirement. According to the FCA, firms should not remunerate executive directors based on 'metrics that are easily achievable through normal business (e.g., health and safety related targets).'[161] This recommendation, which comes from a regulatory body and is likely to have a significant impact on the emerging investor approaches towards the use of ESG metrics in pay, is the opposite of the insights that follow from the framework developed above. The framework shows that ESG goals that are not 'normal business,' as described by the FCA, are likely to be substitutes to shareholder value creation and ignored if included in the structure of executive compensation plans with a heavy shareholder value component. By contrast, ESG goals that are normal business but tend to be overlooked because they, although important, are not a mission priority should be highlighted by using ESG metrics. These metrics can draw the attention of executive directors to important matters that require substantial improvements but tend to be overlooked because they are overshadowed by financial performance metrics. This is where pay related ESG metrics can create value. Unfortunately, the FCA's approach dismisses the use of ESG metrics that can make a difference in the context of the traditional shareholder value-focused remuneration structures and instead encourages a practice that is unlikely to create meaningful outcomes from using ESG metrics in executive compensation. This approach can do more harm by further complicating the structure of executive compensation plans, thereby weakening the effectiveness of internal and external oversight mechanisms for executive compensation by corporate boards, shareholders, and the business media.

The decision of the Financial Reporting Council (FRC), the government agency responsible for drafting the UK corporate governance code, to backtrack from its initial plans and not include a new best practice recommendation on the use of pay linked ESG metrics in the updated code published in January 2024 is a step in the right direction.[162] The consultation on the draft revised corporate governance code detected, somewhat unsurprisingly, 'caution and conservatism' of some corporate boards in deviating from the

[161]FCA, n 12 above, para 3.70.

[162]Financial Reporting Council, *The UK Corporate Governance Code* (January 2024), at https://media.frc.org.uk/documents/UK_Corporate_Governance_Code_2024_kRCm5ss.pdf [hereinafter the UK CG Code 2024].

code's best practice recommendations.[163] More specifically, there was a concern among the respondents to the consultation that the proposed amendments on the inclusion of ESG objectives in remuneration would mean that 'linking remuneration to such metrics would become mandatory.'[164] In response to this perceived inflexibility of best practice corporate governance standards and, perhaps more significantly, a change in the UK Government's policy on corporate governance, the FRC decided to withdraw over half of its original proposals on reforming the UK corporate governance code and proceed with a less ambitious and limited reform agenda.[165] The revised code not only highlights the flexibility of the comply or explain principle in giving companies freedom to adopt bespoke practices suitable for them,[166] but also avoids prescriptive best practice recommendations that effectively micromanage companies in matters of corporate governance. As our framework suggests, this is an approach that regulators elsewhere must adopt in relation to the structure and design of executive compensation to avoid influencing corporate behaviour in ways that are irrelevant and perhaps even value destroying for companies.

5.3. Suboptimal standardisation of executive pay as the likely consequences of the evolving regulatory and investor approaches to the use of ESG metrics in pay

When companies are faced with blanket demands to incorporate ESG metrics into their executive compensation plans, the board remuneration committees typically turn to their pay consultants to suggest suitable metrics. Pay consultants are likely to recommend the least controversial metrics that have been previously tested elsewhere and gained shareholder approval. The result is standardisation of the ESG metric usage in compensation plans across companies regardless of their actual impact on value creation in each specific case.

A general critique of the ESG economy relates to the difficulties in pursuing standardisation, as evident from the ongoing debate on ESG ratings and indexes.[167] Standardisation in securities markets and corporate governance offers various advantages, including the facilitation of consistency,

[163]Financial Reporting Council, *UK Corporate Governance Code 2024 Webinar* (23 January 2024), at https://www.frc.org.uk/news-and-events/videos-and-podcasts/uk-corporate-governance-code-2024-webinar/.

[164]Financial Reporting Council, *Feedback Statement: UK Corporate Governance Code* (January 2024) para 62, at https://media.frc.org.uk/documents/UK_Corporate_Governance_Code_Feedback_Statement.pdf.

[165]Financial Reporting Council, *Statement: FRC Policy Update* (7 November 2023), at https://www.frc.org.uk/news-and-events/news/2023/11/statement-frc-policy-update/.

[166]The UK CG Code 2024, n 162 above, at 4.

[167]See generally F. Berg, J. F Kölbel and R. Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings', (2022) 26 *Review of Finance* 1315. See also M. Dell'Erba and M. Doronzo, 'Sustainability Gatekeepers: ESG Ratings and Data Providers' (2023) 25 *U. Pa. J. Bus. L.* 355.

transparency, as well as more efficient analysis and comparability. However, in the context of ESG compensation, high levels of convergence might prove counterproductive and even counterintuitive. Standardisation in this area would fail to (i) contribute to the identification of the most relevant stakeholders and their specific dimensions for each company and (ii) on a broader scale, contribute to a more comprehensive portrayal of the complexity of sustainable corporate governance.

Indeed, empirical studies of the emerging practices of the use of ESG metrics in pay show remarkable convergence of the practices on the different sides of the Atlantic.[168] Companies tend to systematically build their metrics and targets converging on the same types of stakeholders (in particular employees, customers, and the environment), and selecting similar dimensions. Recurring dimensions are: (i) for **employees**, diversity (sometimes explicitly referring to the role of women in top positions) and inclusion, and their treatment, mostly health, safety, reduction of accidents, and well-being, with few references to training and talent development; (ii) for **customers**, satisfaction and experience; (iii) for the **environment**, metrics related to CO_2 emissions, decarbonisation, and sometimes more general references to sustainability and circular economy practices; (iv) for **communities**, metrics related to corporate social responsibility, and – given the historical circumstances – some very general references to human rights and ethics.[169]

Each company, even if operating in the same business sector, is characterised by specific business and financial strategies. Therefore, it would be reasonable to reflect these peculiarities at the level of stakeholders, considering their distinct needs and issues (as reflected in the metrics and targets), and how they are prioritised by executives' strategies. ESG-linked executive remuneration policies should ideally align with this approach. Despite ESG and sustainability objectives increasingly permeating corporate documents, including annual reports, ESG-linked remuneration policies should serve as the clearest signal regarding how ESG strategies are concretely prioritised and implemented in terms of managerial choices, forming an integral part of a unique corporate strategy.

Standardisation could potentially impede the pursuit of a more dynamic approach to ESG metrics and targets. As mentioned above, ESG priorities and objectives are likely to evolve over time, and ESG metrics and targets should adapt to these dynamic changes. These alterations are influenced by the emergence of new challenges and the achievement of specific short-term objectives. While standardisation may be more functional for

[168]Dell'Erba and Ferrarini, n 41 above; Bebchuk and Tallarita, n 36 above, 48-52. But see Cohen et al., n 30 above, 826 (arguing that the choice of metrics by different companies contains evidence of efficient contracting, like choice of metrics relevant for an industry or company size).
[169]Dell'Erba & Ferrarini, n 41 above, 13.

conventional financial approaches, where issues tend to remain relatively stable over time, ESG goals – reflected in ESG-linked pay targets and metrics – should be structured in a way that anticipates these potential changes. They should be functionally connected to concrete short-term problems to be addressed.

In the world of diversified global investing by large fund groups, company specific investor oversight remains an elusive goal. Standardisation, although not ideal, is a rational response that helps diversified investors and their consultants to engage with companies widely at a reasonable cost. The complexity of measuring ESG goals strengthens the case for some degree of standardisation because excessively company specific ESG-linked remuneration structures are likely to widen the information asymmetry gap between companies proposing the metric and investors supposedly overseeing the use of the metric. This tension between suboptimal standardisation and the use of pay structures that are unique but come with an increased risk of manipulation in the interests of insiders makes the use of ESG-linked pay challenging from the perspective of investor oversight. Regulatory and investor responses must then identify the aspects of ESG-linked pay that are acceptable to be standardised to ensure comparability and mechanisms to strengthen company specific investor oversight on those aspect that are not desirable to be standard.

Standardisation is highly desirable in creating reporting culture and frameworks on the use of ESG metrics in pay that offer proper contextualisation of metrics and targets adopted by companies and allow comparability across companies. Remuneration reports should provide clearer explanations of the precise impact of their choices in relation to the specific key characteristics of their business organisation, focusing on both business and corporate-governance specificities. This approach would enable companies to contribute to a better understanding of ESG-linked remuneration policies, addressing the complexity typically associated with remuneration policies, especially in the context of ESG considerations. Enhanced clarification on ESG-linked remuneration would further facilitate a better understanding of the overall ESG strategy pursued by companies. Currently, reading the remuneration reports focusing on ESG-related issues is often challenging due to fragmentary references to ESG through the documents, which hinder the emergence of a cohesive and unified vision on executive remuneration. In contrast to approaches promoting standardisation in the use of pay-linked ESG metrics, the alternative of consistently demanding more contextual information aligns with the opportunity to encourage experimentation and the development of best practices. Indeed, remuneration policies would not necessarily need standardisation if they effectively contributed to providing consistent contextual information. Such information would help justify the choices behind the identification and prioritisation of certain stakeholders, along with their related metrics and targets, even when these metrics and targets might inherently be somewhat vague, as is often the case.[170]

But a standard approach to adding ESG metrics in executive compensation plans is undesirable because the range of ESG metrics that can work effectively within corporate compensation plans is limited and not every company needs them. The challenge of the company specific approach is to equip institutional investors with resources for identifying the companies that need ESG metrics, the metrics needed, and the ways of implementing them. One strategy that regulatory and investor-led initiatives can pursue in achieving company-specific engagement is to leverage the expertise of local investors to promote and monitor the use of properly designed ESG-linked pay structures in companies that need them most. One of the reasons of the well-known tendency for home and local market bias in financial markets is the informational advantage of local investors: these investors often have local relationships and better access to private information,[171] better ability to process publicly available information,[172] and industry specialisation where domestic and local markets are dominated by specific industries.[173] The expertise of domestic investors can be leveraged by encouraging advance information sharing by the most actively engaging investors through the pre-declaration of voting intentions and voting reasons, as well as subsequent changes in these intentions. This information allows other investors to identify local investors with shared preferences and vote in line with their declared intentions. An alternative strategy is to improve the proxy advice process by imposing on proxy advisers an expectation of meaningful engagement with companies they cover. Many corporate boards, perhaps except for those in the largest companies, often have no access to influential proxy advisors to justify deviations from the 'market.' Proxy advisors, according to corporate directors, are inflexible and refuse to engage with companies on critical issues.[174] The expectation of meaningful engagement by proxy advisors can encourage more flexibility and diversity in the adoption of governance structures. Such engagement includes sharing in advance voting recommendations that diverge from management

[170]For examples of vague indicators, see Dell'Erba & Ferrarini, n 41 above, 36. Such indicators might include 'honesty and fairness' as an indicator of service quality for clients (Natwest Group), 'societal value' for community services (UCB Cap), and 'climate change' for environmental sustainability (Anglo American). Additionally, certain targets employ generic phrases like 'strategic objectives,' 'initiatives,' 'strategies,' 'roadmaps,' 'programs,' 'sustainable development objectives,' 'priorities,' 'plans,' and 'strategic aspirations.'

[171]J. D. Coval and T. J. Moskowitz 'Home Bias at Home: Local Equity Preference in Domestic Portfolios' (1999) 54 *Journal of Finance* 2045, 2046; Z. Ivković and S Weisbenner 'Local Does as Local Is: Information Content of the Geography of Individual Investors' Common Stock Investments' (2005) 60 *Journal of Finance* 267, 287–289.

[172]T.A. Dyer 'The Demand for Public Information by Local and Nonlocal Investors: Evidence from Investor-Level Data' (2021) 72 *Journal of Accounting & Economics* 101417, 12–13

[173]*ibid*, 4.

[174]Tulchan 'The State of Stewardship Report' (November 2022) p 18 (on file with the authors).

recommendations and the underlying analysis with companies, giving companies enough time to respond, and considering company responses when reviewing the original recommendation.

Avoiding suboptimal standardisation of executive pay could serve as a mechanism to encourage the market to develop suitable market-driven incentives within the framework of sustainable corporate governance. This approach would mitigate the immediate necessity to redesign or, at the very least, recalibrate fiduciary duties, expanding them to encompass broader sustainability considerations. When framing the relationship between fiduciary duties and sustainability, numerous questions arise, such as the potential for reforming fiduciary duties to broaden their scope to include stakeholders. There is also the possibility, as suggested by the 2020 'Study on directors' duties and sustainable corporate governance' prepared by EY for the European Commission, 'to strengthen the enforcement of the directors' duty to act in the interest of the company' by allowing stakeholders (other than shareholders) to file lawsuits in court for alleged violations of the duty of care and loyalty by directors.[175] A critical perspective might raise the question of whether there is a true need for the expansion of fiduciary duties as the basis for legal commitment. This perspective arises from the valid criticisms of an approach that seeks to bolster the enforcement of fiduciary duties,[176] including their extension to encompass stakeholders. While acknowledging the significance of fiduciary duties, it is also important to recognise the challenges associated with their potential reform and enforcement. Therefore, the focus on executive remuneration within the ESG framework assumes an even more significant role, as it can contribute to driving a shift toward the adoption of sustainable practices, becoming a market-based solution that by creating the appropriate incentives could potentially serve as a suitable alternative to any legislative or judicial reform of fiduciary duties.

6. Conclusion

This article develops a framework for assessing the question of whether and when ESG metrics should be included in the structure of executive remuneration plans. The conditions vary across companies. Pay-linked ESG metrics may be irrelevant for some companies and their standard use may lead to waste and inefficiencies like any poor corporate governance arrangement. Moreover, the widespread adoption of ESG metrics and the need to oversee their use can dilute shareholder resources and direct attention away from companies that need those metrics the most. This means that a standard

[175]European Commission, n 19 above, 59, 153.

[176]M. J. Roe, H. Spamann, J. M. Fried, and C. Wang, 'The Sustainable Corporate Governance Initiative in Europe' (2021) 38 *Yale Journal on Regulation Bulletin* 133, 152.

approach to the use of ESG metrics in pay should be avoided. Corporate boards should not be pushed in the direction of acting to legitimise remuneration decisions for external stakeholders by showing how the company's remuneration plan is aligned with best practices. Instead of promoting the use of pay related ESG metrics across the board, investors, and other market actors involved, such as pay consultants and proxy advisors, and both public and private regulators, should focus on the quality of ESG metrics when they are used, encouraging experimentation of meaningful, even diverging, if necessary, practices. Corporate boards should be encouraged to be more selective in the choice of ESG metrics for remuneration plans because their task is to design a plan that is aligned with the company's strategy and needs. As excellently put by Tom Gosling, a leading expert on the use of ESG metrics in pay, we should not 'let quantity be the enemy of quality.'[177]

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[177]Gosling, n 80 above, 46.