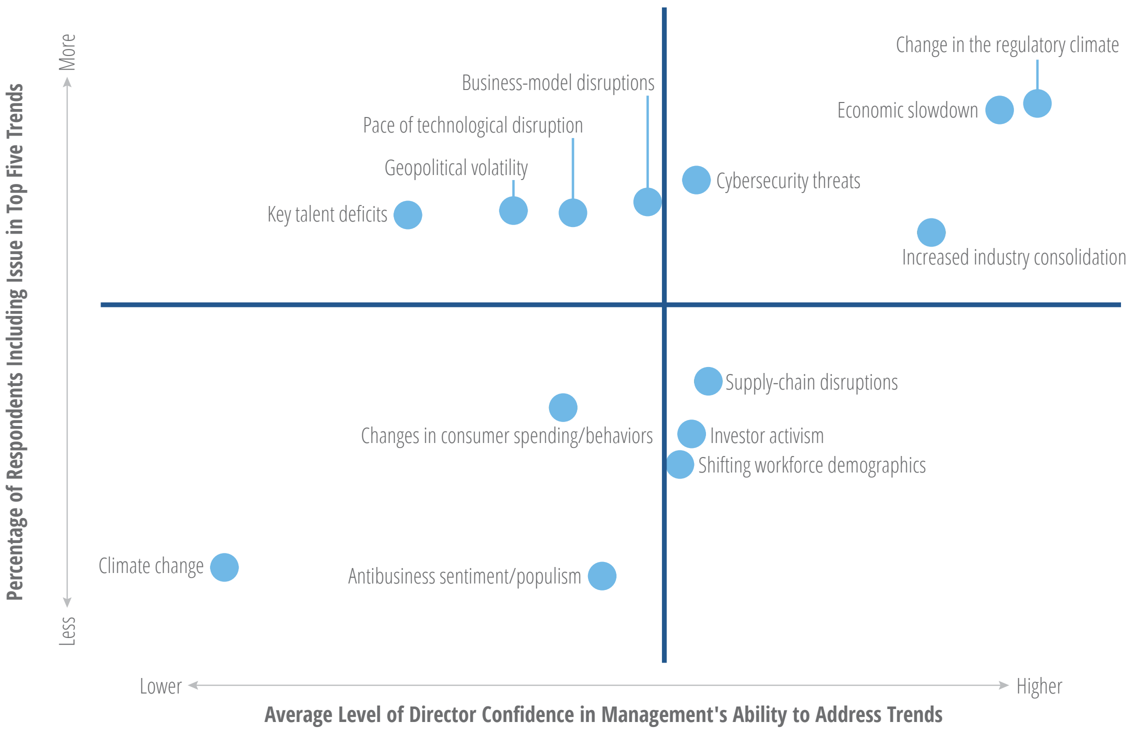
NACD Compensation Committee Chair and Risk Oversight Advisory Councils

Board Oversight of Human Capital Strategy and Risks

In this era of digital transformation, when technology and the skills needed to use it are evolving faster than ever before, providing oversight of human capital has become a top priority for boards of directors. According to the *2018–2019 NACD Public Company Governance Survey*, directors ranked the "pace of technology disruption" and "key talent deficits" in the top half of trends likely to impact their organizations; however, directors had low confidence in management's ability to address these trends, with their confidence in these areas ranking in the bottom half when compared to other trends.[1]

Major Trends vs. Confidence in Management to Address Trends



Boards are particularly concerned with finding qualified senior talent to drive the future of the organization. "*We're finding that evolving strategy requires more and more digital experience, especially at the senior level*," said one director. "*Our company has a median age in the 50s or late 40s—just under 65; however, those who are steeped in technology are in their 30s*

[1] NACD, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 12.

or early 40s."[2] As boards become more engaged in oversight of corporate culture, they are pushing management to create a culture that attracts and retains talent capable of carrying out a long-term strategy that incorporates a strong digital element.

To address these challenges NACD, Farient Advisors, PwC, and Sidley Austin LLP cohosted a meeting of the NACD Compensation Committee Chair and Risk Oversight Advisory Councils on October 30, 2018. The discussion with compensation, risk, and audit committee chairs from Fortune 500 companies focused on the board's oversight of human-capital strategy and risks, and produced the following three key takeaways:

- The combination of major shifts in the workforce and the rise of emerging technologies will have a transformative impact on companies of all sizes and sectors.
- Boards need to elevate the discussion on human-capital strategy and risk, and clarify oversight responsibilities at the full-board and committee levels.
- Directors should set expectations for management regarding human-capital objectives, and use appropriate metrics to measure success.

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The PwC report *Workforce of the future: The competing forces shaping 2030* outlines five megatrends that will impact the future of the workforce: technological breakthroughs, demographic shifts, rapid urbanization, shifts in global economic power, and resource scarcity and climate change.[3] As advances in areas such as robotics, artificial intelligence (AI), and automation increase productivity, they will also require an agile, reskilled, and likely smaller workforce. To attract and retain younger talent with desirable technical skill sets, organizations are highlighting workplace flexibility and mission-driven culture. "Millennials have

[2] This document reflects NACD's use of a modified version of the Chatham House Rule in which the names and institutional affiliations of participants are published, but their comments (rendered in italics) are made anonymously. See page 12 for a list of participants.

[3] PwC, *Workforce of the future: The competing forces shaping 2030* (2018), p. 7.

BY THE NUMBERS

A PwC survey of more than 10 thousand people in the United States, China, India, Germany, and the United Kingdom found the following about the general population in these countries:

- ***37%*** *are worried about automation putting jobs at risk—up from 33% in 2014.*
- ***60%*** *think "few people will have stable, long-term employment in the future."*
- ***25%*** *say their ideal employer is an organization with values matching their own.*
- ***74%*** *are ready to learn new skills or completely retrain in order to remain employable in the future.*
- ***74%*** *believe it's their own responsibility to update their skills rather than relying on any employer.*

Source: PwC, *Workforce of the future: The competing forces shaping 2030* (quotes taken from p. 8, p. 13, p. 25, p. 31, and p. 35) blurred lines about what you get from your employer, your family, and the world," said Comcast executive vice president of human resources (HR) William J. T. Strahan. "To be a good employer, you have to help them create a good life."

Council meeting participants reported that the impact of these trends is already beginning to be felt at their companies. "Customer demands and the way we interact and serve customers is changing. We took 16 million fewer phone calls last year than the year before. If you go back five years, that's 100 million fewer calls. Something you did 100 million fewer times than five years ago is a dramatic change," said Strahan. "*On my boards we're finding that every strategy has to have a digital component, regardless of the industry we're in*," said one director.

PwC partner and Workforce of the Future leader Carrie Duarte said, "Management teams and boards have to ask themselves, how well is the organization prepared to cope with rapid change at scale? As we're increasing productivity with technology, does management have a view on how much time that will save three to five years from now? Do you need to slow down recruiting in certain areas expected to be impacted by automation? How many people do you need to train, versus who might self-select out that is reticent to change?" A director observed, "*We sent executives to Silicon Valley to get a crash course on AI to see how it will affect jobs in the future—are senior leaders getting in the way or are they embracing change? [We need management to] envision what changes are coming and where culture needs to go.*"

In addition, investors are placing an increased emphasis on human-capital strategy—part of an overall focus on environmental, social, and governance (ESG) issues. Meeting participants observed that boards need to consider whether they are providing adequate disclosures about how they are approaching these changes in workforce trends. "How talent factors into the company's overall strategy, and how the board oversees talent strategy, are topics that are very interesting to investors these days," said Farient Advisors founder and CEO Robin Ferracone. Executives and compensation committees are asking, 'What should we disclose, and what do we want to disclose, to investors? How much might we be obligated to disclose in the future?'"

Another director framed the issue this way, "*On our compensation committee we've moved from the belief that our shareholders only want to know about the top five officers, to the realization that shareholders are interested in how the board views talent companywide. We can use this as an opportunity to speak to investors about how the board monitors the connections between our culture, strategy, and talent beyond simply the named executives.*"

Appendix A on page 9 contains recent statements about human-capital strategy by BlackRock, the Council of Institutional Investors, and the Human Capital Management Coalition, a group of 25 leading investors. It also includes examples of workforce-related metrics from the Sustainability Accounting Standards Board.

Boards need to elevate the discussion on human-capital strategy and risk, and clarify oversight responsibilities at the full-board and committee levels.

The Role of the Full Board

NACD recommends that oversight of human-capital strategy should be the responsibility of the full board, with specific responsibilities allocated to committees as appropriate.[4] The full board must receive adequate information, however, from the chief human resources officer (CHRO), as well as business and functional leaders, in order to fulfill its duties in this area. Council participants provided examples of how their boards receive information from management about the organization's human-capital strategy, including these:

- "*We ask each division head to talk individually to the full board about the human-capital strategy in his or her respective division. This gives the board the chance to hear the perspective on succession from down within the organization. This also gives us the chance to ask questions and hear a point of view aside from the head of HR, even though that role is very strong.*"
- "*On my board we do a fairly deep dive on human capital once a year with the chief people officer. There is a scorecard with a number of human-resource-related metrics, such as turnover, and whether it's voluntary, and diversity.*"
- "*One challenge of oversight is getting the unvarnished truth and getting information from outside of the narrow channel from the CEO. Having access to people farther down the line is key. Consider mentorships or employee lunches to get this point of view.*"

NACD recommends that oversight of human-capital strategy should be the responsibility of the full board, with specific responsibilities allocated to committees as appropriate.

[4] NACD, *Report of the NACD Blue Ribbon Commission on Talent Development: A Boardroom Imperative* (Washington, DC: NACD, 2013), p. 9.

The Role of Committees

Many directors at the meeting indicated that their compensation committees are taking a more active role in oversight of talent strategy and its implications, including holding management accountable for goals related to employee engagement, recruitment, and incentives. One compensation committee chair observed, "*Human capital has a special place in the compensation committee. You're looking at performance measures and incentives, and short- and long-term investment of shareholder resources into the talent base. You are reading employee engagement surveys and discussing changes to incentives."* Another director reported, "*Our compensation committee did a review of mission-critical jobs in the company and created a list of jobs we needed to keep an eye on, since talent in the 75th percentile can be hard to find.*"

Audit and risk committees also come into play by overseeing management's approach to mitigating risks stemming from the human-capital strategy, including risks related to compliance, culture, and controls. At the meeting, directors shared several approaches used by these committees, including the following:

- *"To understand risks related to incentives, we bring the audit and compensation committees together and spend time kicking the tires before anything is shared with management."*
- *"Our incentive metrics are tested by internal audit and also reviewed by the chief risk officer before any payout decisions are finalized."*
- *"We have the risk committee meet with the head of HR and the finance committee to discuss unintended consequences of compensation. New metrics may be picked so quickly in order to drive transformation—how do you know that you're not incorporating risks into that?"*
- *"When my company made an acquisition, we had to ask what talent we had to run the new business line. We used the compensation and risk committees to do a deep dive on talent during the due diligence process, and also for new business launches."*

Regardless of where talent oversight responsibilities are assigned, Council attendees affirmed these responsibilities should be clearly defined in charters to avoid confusion. See Appendix B on page 11 for examples of committee charters that include human-capital oversight.

Additional Board Collaboration Practices

In addition to specific roles for the full board and key committees, directors also shared more general practices to increase board communication on talent oversight:

- Use cross-committee membership, or committee membership rotation, to increase collaboration across the board. "*Cross-fertilization among committees is incredibly helpful to stay on top of potential risks, including talent and incentive issues,*" one director said.
- Organize a meeting with all the committee chairs prior to the full board meeting to decide what should be reported out to the full board.
- "Establish an escalation process for if there is a talent-management crisis—who will be involved in the investigation and when should it be elevated to the full board, similar to having an incident-response plan for a cyberattack," said PwC partner Paula Loop.

Directors should set expectations for management regarding human-capital objectives and use appropriate metrics to measure success.

Council participants discussed how to work with management to set human-capital objectives, as well as how to measure management's achievement of those objectives. Human-capital strategy should be treated as a cross-departmental and enterprise-wide issue, with the CEO or CHRO leading the charge. According to Loop, "Companies need a strong CHRO or CEO focused on talent management. Without that it's hard for the board to get in deep." The board should then set the expectation with the CEO or CHRO that HR is collaborating on the human-capital strategy with leaders from other functions, such as information technology, internal audit, and other business units. "Today it is important to look at what is coming down the pike," said Farient Advisors partner and chief operating officer John Trentacoste. "ESG has become a significant topic for investors, and we anticipate that this will become 'ESG&T'—with aspects of technology, cyber, and overall risk playing an important role in most companies' human-capital strategy."

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In addition to ensuring collaboration between business functions, Council delegates highlighted areas where boards should hold management responsible for implementing the human-capital strategy, emphasizing that directors should "*ask less about the process, and more about the outcomes*":

- *Determining the Company's Future Workforce*: Boards should ensure the talent strategy looks at least five years ahead, instead of only one year out. Boards should ask management to conduct a skills inventory and then share the results with the board. Duarte asked, "What talent is needed to fulfill future strategy, and where will the talent be coming from—inside or outside of the organization?" The skills inventory should evaluate the current workforce in light of the impact of automation and the changing nature of work, and determine if existing learning and development programs will be sufficient to reskill current employees. Additionally, management should review mission-critical roles below senior management and include information about those roles in reports to the board, specifically listing pipelines for replacement of those employees.
- *Building a Healthy Corporate Culture*: Boards should ask division leaders to conduct employee surveys and then bring the scores on talent and engagement to relevant discussions held in the compensation/organization committee, comparing the scores to the rest of the company and discussing reasons for discrepancies. At one director's board, internal audit is specifically asked to include culture in its reviews: "*In advance of every audit they do around the world, the team conducts a targeted employee survey via email, asking both about cultural risks and what's working well. That sets the internal audit team up so that during their visits they are able to not only conduct reviews about processes and controls but also have conversations with employees about the mood and atmosphere on the ground.*"
- *Promoting Diversity and Inclusion*: Several participants reported that their boards are emphasizing the importance of workforce diversity and asking how management is addressing unconscious bias and blind spots. "We are seeing clients implement training on blind spots and also doing 'neighborhood reviews,'" said Duarte. "This means looking at recruiting and other metrics within a single business division, and how those metrics

compare to other divisions. It's really about how diversity and inclusion are changing the way we work, beyond simply recruiting efforts. Promotion and career paths need to be inclusive, in order to get the most out of people investments in this talent-scarce environment."

At the meeting, directors discussed incorporating human-capital strategy as a component of executive compensation plans in order to place further emphasis on its importance. "*We have annual incentives that [are between] 5 and 10 percent of the total figure and focused around being a catalyst for transformation,"* one director said. *"It's a way to encourage people to use the new technology tools the company has put in place to improve self-service and the overall customer experience. We've seen great adoption of the tools, but beyond that, it's helped to inculcate an overall philosophy around [why technology skills are critical]—and it will pay off for the shareholders for years and years to come."*

Conclusion

Management teams in every industry are facing complex challenges not only in adopting new technologies to remain competitive but also in developing a workforce of the right size and skills to use those technologies and execute the chosen strategy in the face of transformative change. In parallel, directors are integrating human-capital oversight into board-level discussions and delegating deep dives on talent strategy to appropriate committees, informed by relevant data and reports from human resources and business leaders. Boards are also designing metrics and incentives to ensure that senior leaders are successfully carrying out the human-capital strategy and maintaining a healthy culture. For their part, investors view human capital as a key component of long-term sustainability and financial performance, and will be on the lookout for relevant disclosures from companies indicating that boards and management feel the same way. As Comcast's Strahan put it, "The need to retool the workforce is greater than ever, but the good news is that our abilities to make that change happen are better than ever as well."

For Further Reading

- Resource Center on CEO Succession and Talent Oversight (NACD)
- *Report of the NACD Blue Ribbon Commission on Talent Development: A Boardroom Imperative* (NACD)
- "ESG Shareholder Proposal Findings That Will Surprise You" (Farient Advisors)
- *Workforce of the Future: The Competing Forces Shaping 2030* (PwC)
- "Observations on the Future of the U.S. Workforce" (The Aspen Institute)
- "The Future of Human Work Is Imagination, Creativity, and Strategy" (*Harvard Business Review*)
- "Now Fighting for Top Tech Talent: Makers of Turbines, Tools and Toyotas" (*Wall Street Journal*)

Appendix A

Shareholder and Stakeholder Requests for Disclosures on Human-Capital Strategy

The following documents provide examples of shareholder and stakeholder requests for increased disclosure on how boards are overseeing human-capital strategies at their companies.

BlackRock Investment Stewardship's approach to engagement on human capital management
This March 2018 commentary released by BlackRock Inc. describes human capital as an engagement priority, describing why human-capital management is an issue for investors and the human-capital management topics BlackRock is likely to discuss with boards and management teams during engagements.

"$2.8 Trillion Investor Coalition Petitions U.S. SEC to Require Increased Disclosure of Human Capital Management Information"
The Human Capital Management Coalition (HCM Coalition), representing 25 institutional investors and more than $2.8 trillion in assets under management, issued this press release in July 2017 regarding their rulemaking petition, which requested that the US Securities and Exchange Commission (SEC) "require listed companies to disclose information on human capital management policies, practices, and performance." The HCM Coalition emphasizes in its press release that "better human capital management practices are associated with higher shareholder returns, profitability, and overall firm performance against benchmarks."

Council of Institutional Investors, Re: Human Capital Management (HCM) Disclosures Rulemaking Petition, File 4-711 – 7/06/2017
In this October 2017 letter to the SEC, the Council of Institutional Investors (CII) responds to the above HCM Petition for increased human-capital management disclosures. CII is a nonprofit association representing institutional investors with more than $3 trillion in assets under management. CII agrees with many aspects of the HCM Petition and affirms that "[a]lthough human capital and talent development clearly is a key value driver and potentially a key competitive advantage for a company (and a critical risk if mismanaged), many of our members have concerns that public company disclosures in this area are not sufficiently robust."

The Sustainability Accounting Standard's Board—Human Capital Metrics

The Sustainability Accounting Standard's Board (SASB) provides sustainability and environmental, social, and governance (ESG) standards that aim to "[connect] businesses and investors on the financial impacts of sustainability." The SASB Materiality Map® links the human-capital issues of *Labor Practices*, *Employee Health & Safety*, and *Employee Engagement, Diversity & Inclusion* to corporate financial performance by industry. SASB also provides in-depth industry standards to assist companies in disclosing sustainability metrics.

Appendix B

Committee Charters Describing Human-Capital Oversight

The following committee charters provide examples of allocation of human-capital oversight activities at different companies. Responsibility for human-capital oversight is commonly paired with oversight of executive compensation, although committee naming conventions vary from company to company.

Humana Inc.'s Organization & Compensation Committee Charter

Humana's Organization & Compensation Committee administers the executive-officer-compensation programs, in addition to reviewing "management development planning status and policies, including succession planning."

BNY Mellon's Human Resources and Compensation Committee Charter

BNY Mellon's Human Resources and Compensation Committee oversees executive compensation and performs oversight of the following human resources functions: "employee compensation and benefit policies and programs," "management development and succession programs," and "programs for diversity and inclusion."

HCP Inc.'s Compensation and Human Capital Committee Charter

The HCP Compensation and Human Capital Committee oversees the company's executive-compensation plans and "human capital programs and policies, including with respect to management development, succession planning and diversity and inclusion initiatives." The committee may specifically review talent-development practices and "the [c]ompany's demographics, diversity and inclusion initiatives, employee retention, and employee compensation practices."

Unum Group's Human Capital Committee Charter

Unum's Human Capital Committee has responsibility for overseeing "compensation and benefits of the directors, executive officers and other employees." Additionally, the committee is charged with "evaluating and approving all compensation plans, benefit plans, workforce management, policies and programs of the [c]ompany as they affect the directors, executive officers and other employees of the [c]ompany."

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* This list includes delegates, partners, stakeholders, and guests who participated in all or part of the meeting on Oct. 30, 2018, and/or in related teleconferences on either Nov. 7, 2018, or Nov. 14, 2018.

About the Compensation Committee Chair Advisory Council

In support of a sustainable, profitable, and thriving corporate America, the National Association of Corporate Directors (NACD) created the Compensation Committee Chair Advisory Council. Since 2011, this council has brought experienced compensation committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general and the work of the compensation committee in particular. Farient Advisors LLC collaborates with NACD in convening and leading this council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for compensation practices, processes, and communications and to share observations and insights on the changing business and regulatory environment. The council's purpose is threefold:

- Improve communications and build trust between corporate America and its key stakeholders.
- Give directors engaged in the compensation arena a voice and a forum in which to exchange perspectives with regulators, standard setters, investors, and other important constituents on committee-related matters.
- Identify ways to take board leadership and compensation committee practices to the next level.

NACD believes that the open dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: to build a strong, vibrant capital market and business environment that will continue to earn the trust and confidence of all stakeholders.

About the Advisory Council on Risk Oversight

The National Association of Corporate Directors (NACD) created the Advisory Council on Risk Oversight with a focus on the common goal of a sustainable and profitable corporate America. Since 2012, this council has brought experienced risk and audit committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general—and risk oversight in particular. PwC and Sidley Austin LLP collaborate with NACD in convening and leading the council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for risk-governance practices, processes, and communications, and to share observations and insights on the changing business and regulatory environment. The goal of the council is threefold:

- Improve communications and build trust between corporate America and its key stakeholders.
- Give voice to directors engaged in risk oversight and related matters and improve the quality of the national dialogue on the board's role in risk governance.
- Identify ways to take risk-oversight practices to the next level.

NACD believes that the dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: a sustainable, profitable, and thriving corporate America.

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