Briefing: Shareholder Perspectives

2017 Proxy Season and Emerging Trends

HUGESSEN CONSULTING

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Introduction

As part of Hugessen's ongoing commitment to engaging with the shareholder community, we initiated conversations with select Canadian and U.S. institutional shareholders to discuss key topics coming out of the 2017 proxy season. Our engagement included discussions with shareholder representatives from both asset managers and pension funds with assets under management aggregating CAD$3.7T.

To guide the discussions, Hugessen asked shareholders their thoughts on the following topics:

- Key areas of focus in 2017
- One-time awards
- Boards oversight on environmental, social and governance ("ESG") factors
- Long-term incentive design and linkage to share ownership guidelines ("SOG")

Key Areas of Focus in 2017

- Overall, there was no big headline that defined the 2017 proxy season
- A number of issues continue to be of focus from last year – e.g. gender diversity, use of discretion, performance criteria, one-time awards
- Shareholders are refining their thinking around one-time awards – e.g. habitual use and uniform application across a management team raises questions as to whether incentive programs are broken
- Significant progress on adoption and integration of ESG factors into the investment process; however, broad acknowledgment that board oversight of ESG is lagging

One-Time Awards

What factors are considered when assessing the awards?

- Shareholders review and assess one-time awards on a company-by-company basis
  - Some recognition that one-time awards may be appropriate in unique situations
- Most one-time awards are viewed through a "lens of skepticism", with shareholders focusing their attention on the disclosure and rationale provided by the company
  - Consensus that disclosure around one-time awards needs to be enhanced
- There has been greater emphasis placed on habitual use of one-time awards and uniform granting of awards to the full management team
  - Raises the question of whether the incentive plans are broken and need to be changed

Are some one-time awards better than others (e.g. retention vs. promotion vs. special recognition / event driven?

- Greater focus on retention awards among many shareholders
    - What is the root cause of the flight risks?
- Select shareholders understand the rationale behind sign-on awards more than other types of one-time awards, given the need to compensate for lost value from previous employers
    - In contrast, other shareholders view make whole payments as the most problematic given that retention efforts failed, increasing the cost for the company acquiring the talent – the company is on the hook for the prior company's performance
- The structure of these awards is important – e.g., more acceptance for awards that are tied to performance versus cash
- Select shareholders noted that special recognition / event driven awards are unnecessary as duties such as executing transactions should be an inherent part of the role (for the CEO in particular)

Shareholder Expectations on Boards' Oversight of ESG Matters

How should the role of the board and management be differentiated?

- There is growing recognition amongst shareholders that ESG factors are a risk that the company should address like any other risk
- ESG factors vary by industry and the specific issues being faced within that industry
- Shareholders continue to believe that management has the best view of the business – the board is not in the position to manage these risks on a day-to-day basis

What initial steps should a board take to address ESG factors in their company?

- Given the breadth of ESG considerations, the board should have a process to become informed and educated on potential ESG risks facing their company
- Once company-specific ESG factors are identified, management should present to the board a plan for reporting, measuring and responding
    - From there, an oversight process should be established by the board
- The majority of shareholders noted the importance of having the right skill sets on the board to effectively oversee ESG risk
    - E.g., environmental management skills where climate change is a risk
- Select shareholders believe, as a final step, ESG risks need to be brought into the compensation program – *"what gets measured gets managed"*

Long-Term Incentives and SOG

Are enchancements to SOGs required to address evolution of longer-term equity compensation (e.g., less real ownership)?

- Questions concerning executive share ownership guidelines have been raised by a number of our clients; however, when asked, shareholders did not perceive this to be a significant issue, particularly in the US given the high levels of ownership commonly observed there (particularly among tenured CEOs)
- Canadian shareholders recognize the unintended consequence created by the increased use of cash-based restricted and performance share units – real ownership is diminished
    - However, counting phantom units towards achieving SOG is not necessarily on shareholders' radar, although real ownership would be preferred

Key Takeaways

Based on our conversations with the shareholder community, Hugessen offers the following guidance for boards:

- In the event a one-time award is deemed warranted (e.g., challenging company event), boards should carefully consider the structure of the award and selectively target recipients, while including detailed rationale in proxy disclosure. Where one-time grants are being provided to the full management team, or are being awarded consistently year-over-year, consider revaluating incentive frameworks.
- Boards should encourage their management team to determine ESG priorities; boards should then be informed on the potential risks, create a system of oversight, and determine what metrics should be linked to compensation programs.
- When a management team or board identifies a misalignment between a component of their compensation program – such as the executives' level of ownership – and operations / strategy (e.g. attracting, retaining, motivating), the company should advocate for making that change (while clearly disclosing the rationale in the proxy), despite the priorities of shareholders.

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