

Shareholder Perspectives: Board Process for Setting and Evaluating Pay

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Introduction

In light of recent public scandals tied to executive compensation, Hugessen reached out to the shareholder community to discuss their expectations of directors when setting and evaluating performance-based pay decisions. Hugessen initiated conversations with select Canadian and U.S. institutional shareholders, including both pension funds and asset managers with assets under management aggregating CAD\$4T.

To guide the discussions, Hugessen asked shareholders what questions directors should ask themselves when:

- 1) Determining performance metrics, and
- 2) Adjudicating performance outcomes for determining pay decisions in respect of the prior year.

All of the shareholders we reached out to are engaging with boards on these (and other) matters.



Key Findings

- In general, shareholders continue to believe that boards and management have the best view of company performance and strategy and therefore do not want to micromanage the selection of metrics
- Shareholders are beginning to evolve their thinking around the board's ability to impact corporate culture in the context of setting performance metrics and developing incentive design structures
- Underlying shareholder' responses is the belief that these high profile cases come back to "culture" and the unintended consequences that were likely not considered when making these decisions
- Boards should be on the lookout for potential unintended consequences of pay programs and understand the message that the program sends to the entire company



Shareholder Views on Performance Metrics

- The right balance of performance measures should be struck, the interplay between the various measures should be considered, and all measures should be thought of holistically
 - ◊ A range of measures can provide a more complete view of performance
 - ◊ On the other hand, with a larger number of metrics, management could lose sight of what they are being incentivised for
- While senior management “sets the tone” through day-to-day interaction with employees, shareholders also expect boards to evaluate whether the metrics in place are incenting the right behaviours and how these metrics are influencing the corporate culture in the organization

“Strong Board culture will lead to a strong corporate culture”

- ◊ Boards should have the courage to push back on management, delve into the pros and cons of various metrics, and monitor the programs over the longer-term through thorough quantitative stress testing and qualitative discussions at the Board level

“Compensation programs can serve as a gate keeper to make sure the right behavior is being incented”

- Shareholders are looking for alignment between the metrics and the company’s long-term strategy, and for the achievement against mid-term milestones along the way
- It is the board’s prerogative to design programs that provide the ability for boards to exercise discretion and ensure there is clear and descriptive rationale behind any adjustments
- The rationale between the measures chosen should be carefully communicated
- Active managers typically make say-on-pay voting decisions alongside their investment teams
 - ◊ Active managers will have discussions with their investment teams regarding pay matters such as performance metrics and calibration, as a secondary source of information prior to engaging with a company

Views on ISS’ 2017 Change to its Pay-for-Performance test:

- Incorporating financial/operational metrics beyond TSR is a positive step
- Acknowledges the issues with TSR and the disproportionate focus on this metric
- Will give a more holistic picture of performance when evaluating say-on-pay proposals



Other Top of Mind Issues for Shareholders

- There is general concern regarding the overall quantum of executive pay. Pay in some industries is considered to be too high; although there is no bright line test that constitutes the “correct” amount, it is a topic that boards should keep in mind
- Shareholder concern regarding one-time awards has grown as the numbers trend substantially higher than last year. This issue is expected to weigh heavily into voting decisions over the coming year
- Shareholders have begun to ask whether clawbacks should include a broader trigger that considers violations of the code of ethics and reputational risk



Key Takeaways

- **Selecting measures:**
 - ◇ Boards need to do what is right for the company and their strategy while clearly articulating the rationale and meeting with shareholders to discuss
 - **Performance assessment:**
 - ◇ Outcomes need to pass the “sniff” test to make sure the board is comfortable – achieved through stress testing, etc.
 - ◇ Board should be comfortable to apply discretion, if there is a need
 - ◇ In circumstances where the Board applied discretion over multiple years, a review of programs may be warranted (e.g., metrics, shoulders etc.)
 - **Disclosure:**
 - ◇ At the year end meeting, in addition to assessing company performance, have a fulsome discussion of the board’s key messages to be communicated in the Compensation Discussion & Analysis section of the proxy
 - ◆ Share these notes with management (or whoever is responsible for the drafting) and review disclosure to ensure these messages are adequately expressed (especially in the letter to shareholders)
 - **Corporate Culture:**
 - ◇ Boards should be aware of the importance of the pay program incenting the right behaviour within the organization
 - ◇ Additionally, they should also remain cognisant that the disclosure will be read by both external shareholders and internal stakeholders
 - ◆ The broader employee population is potentially just as interested in the underlying rationale behind board decisions as they observe the behaviours executives are being incented for
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About Hugessen Consulting:

Hugessen Consulting helps Boards make the right decisions on executive compensation and its governance, within an environment of heightened complexity and scrutiny. Our people work with public and private company Boards who understand that experience and judgment, not just data, drive decision making. Since 2006, as a pioneering independent executive compensation advisory firm, our goal has been to create the deep and long-lasting relationships that result from the commitment we make to our clients and the value we deliver to them. Hugessen Consulting is an employee-owned firm with offices in Toronto, Calgary and Montréal, and affiliates in New York City (Steven Hall & Partners), London (MM&K), and Beijing (Taihe Consulting).

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