STRAIGHT FROM THE SOURCE

A DAY OF DISCUSSION BETWEEN DIRECTORS AND INVESTORS

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EXECUTIVE COMPENSATION

In September 2016, Hugessen Consulting and Steven Hall & Partners hosted a Director and Shareholder Roundtable in Chicago, bringing together experienced directors and governance representatives from major institutional shareholders ($5.8 trillion in AUM) for a half day and dinner of unfiltered discussion on a variety of executive compensation and governance topics.

This event provided an opportunity for:

- Directors to hear first-hand about the key priorities of major institutional shareholders and their varied approaches to governance,
- Shareholders to hear directors' perspectives on board matters, including how they weigh business implications and market challenges, and
- Directors and shareholders to build connections across their respective communities

We summarize below select themes from the event:

Shareholder Engagement

- Some directors questioned the appropriateness of direct engagement between directors and shareholders
  - In any event, there was recognition that it is critical to have only designated "camera-ready" Board members engage in dialogue with major shareholders
- Shareholders confirmed that director participation in engagement meetings has increased and they expect this will continue
  - Interestingly, there were notable differences among shareholders as to the level of director participation in engagement—e.g., 20% of engagements by one shareholder included directors, where as it was closer to 50% for another
- Shareholders articulated their desire to build relationships with Boards and noted that, even if they are unable to engage when a request is made by an issuer, the request does not go unnoticed and opens the line of communication for the future (particularly useful if/when there is an issue down the line)
- Both shareholders and directors stressed the importance of advance preparation (on key topics/issues and an understanding of the shareholder's guidelines) and the development of a clear and specific agenda

- Both groups recognized that written materials (e.g. the proxy) only go so far in telling the story and that engagement can be instrumental in addressing contentious issues or in getting an early indication of how shareholders may react on various issues before decisions are made

- Shareholders stated that they engage with Boards to understand their oversight across a range of topics including: strategy, company culture, CEO and senior executive pay, performance and succession planning, disruptive technologies, cyber security, and ESG risk and opportunities
  - They are looking to understand the Board's process and level of active oversight (i.e., are directors asking the right questions of management?) and are not seeking selective disclosure of material undisclosed information

Executive Compensation Design

- Shareholders and directors agreed that there is both a science and a "whole lot of art" to designing executive compensation that drives the right behaviors to create shareholder value over the long-term, and that there is no such thing as perfect plan design

- Shareholders articulated that they are not looking to micromanage executive compensation, but want to understand rationale, ensure programs are aligned with shareholder value creation, and confirm that compensation committees are fully engaged with philosophy and objectives

- There was recognition across both groups that there is inconsistency between the long value creation cycle of some industries (e.g. 5 to 7 years), the typical 3-year term of many long-term incentive plans, and the often short-term investment strategy of some shareholders, making the development of incentive plans with appropriate time horizons a constant challenge

- Directors and shareholders discussed the sharing of value creation between the executives and investors:
  - One director expressed the view that a sharing ratio analysis could be helpful context for determining reasonableness of incentive payouts
  - Shareholders stated that there were no fixed guidelines on appropriate levels of sharing but articulated that they are seeking assurance that they are getting "a return on investment in human capital"

- Both groups agreed that having discretion on compensation outcomes is critical, with one shareholder going so far as stating that the Board's job description includes exercising well informed discretion

Executive Compensation Disclosure and Say-on-Pay

- Shareholders stressed the importance of robust disclosure to provide them with the information needed to understand the Board's rationale on executive compensation decisions (particularly when discretion has been exercised!)

- Shareholders emphasized that proxy advisor peer groups, analyses, and recommendations are simply a source of information, but that they make say-on-pay and other proxy voting decisions based on their own policies and judgement

- When asked by shareholders whether say-on-pay has helped directors to address pay levels, directors stated that it has certainly forced Board's to look at executive compensation with even greater diligence and proactivity, and to ensure clear articulation of the rationale for their pay decisions

Compensation and Risk

- There was significant discussion on the role of incentives in driving the right (or wrong) behaviors and company culture; both groups agreed on the importance of regularly evaluating compensation risk and monitoring incentive plan design against behavior outcomes across the organization, not just at the executive level
- Unanimous agreement that it is critical for directors to keep their "fingers on the pulse" through results of employee engagement surveys, whistle blower reports, etc.

Board Composition, Renewal, Diversity

- Shareholders articulated the need to ensure that Board composition and director skills reflect the diverse and evolving needs of companies, necessitating continuing director education, a rigorous Board evaluation process, and regular board renewal
- Shareholders were more focused on board renewal and development than on either term limits and/or fixed retirement ages, including some discussion of average tenure and policies allowing for limited exceptions to fixed term and/or age limits
- Directors shared their experiences with the difficulties of engaging in discussions on individual director performance and tenure to which one shareholder raised the concept of setting expectations for director tenure prior to appointment
- Both parties agreed that a strong independent Board chair or lead director is critical to an effective board and individual director assessment process, and that independent third parties could be very useful in facilitating these assessments

Split/Combined Chairman & CEO

- There were mixed views on the appropriateness of combined Chairman and CEO roles and several participants articulated their belief that it is highly dependent on the specific fact-set
- There was unanimous agreement that, where the Chairman and CEO roles are combined, a strong independent lead director is critical, and that there is a danger if directors (and particularly the lead director) feel they are serving at the pleasure of the Chairman & CEO
- The importance of regular executive or in-camera sessions (without any member of management, e.g., the CEO), with the lead director both setting the agenda and chairing the in camera session, was discussed and agreed

Conclusion

The day concluded with both shareholders and directors expressing strong support for more director- shareholder exchanges as an effective way to build understanding and mutual respect, and to improve the interaction between boards and shareholders when issues do arise