2021 PROXY SEASON REVIEW: ESG & EXECUTIVE COMPENSATION

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October 2021

HUGESSEN CONSULTING

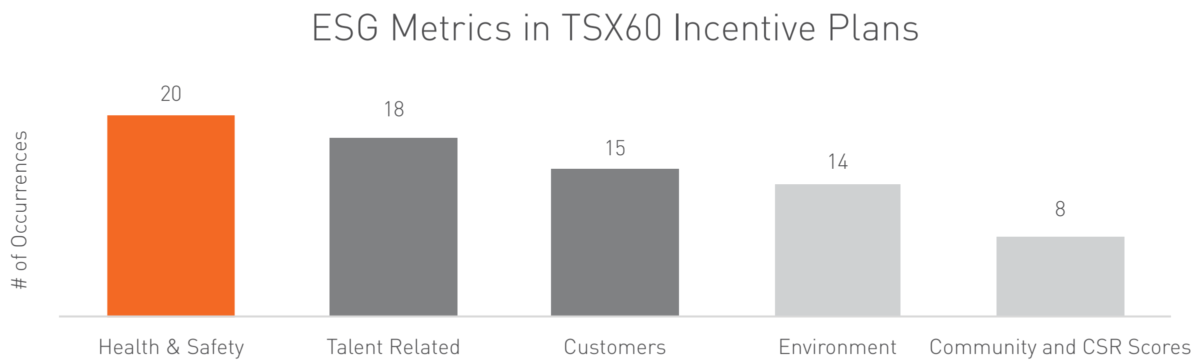
Every year, Hugessen Consulting conducts a review of the proxy circulars filed by the constituents of the S&P / TSX60 Index to report on trends in executive compensation and related governance practices among Canada's largest and most influential companies.

This year, we expanded our focus on TSX60 issuers' use of environmental, social and governance ("ESG") metrics in executive compensation. This article provides a summary of our findings.

A full recording of Hugessen's TSX60 Webinar on Emerging Trends in Executive Compensation and ESG can be found **here**.

Key Findings

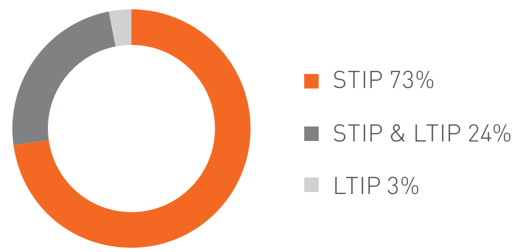
As of the 2021 proxy season, approximately two-thirds of TSX60 companies have incorporated ESG metrics into their short- or long-term incentive plans ("STIP" and "LTIP", respectively). Traditional health & safety metrics remain the most prevalent, followed by talent-related metrics (including diversity, equity and inclusion, or "DE&I"). Customer-focused metrics and environmental metrics were also observed.



The number of TSX60 companies using ESG metrics remained relatively steady year-over-year, despite the ever-growing interest and focus on ESG factors from stakeholders (which has only been amplified by the COVID-19 pandemic). However, the inclusion of ESG factors into compensation programs is not always a straightforward exercise. In general, the most effective measures will flow from a company's ESG strategy (which remains in the nascent phase for many organizations). Over the next few years, we expect to see increasing prevalence and more diverse examples of how issuers incorporate ESG considerations into compensation plans.

To date, ESG metrics have been incorporated primarily in the STIP: 73% of TSX60 companies that incorporate ESG metrics do so in just the STIP, and 24% have ESG metrics in both the STIP and LTIP. Where ESG metrics are used in the STIP, the average weighting in the scorecard is 20%. As companies' ESG strategies evolve, we expect to see an increased used of these metrics within LTIP given the longer-term nature of many of these metrics (i.e., especially those centered around environmental performance and DE&I initiatives).

Where are ESG metrics incorporated?



	Environmental	Social	
	Climate and/or Environmental Metrics	Operational Metrics	Talent-Related Metrics
STIP	▪ Emissions intensity ▪ Sustainability ▪ Environmental incidents ▪ Compliance/reporting practices	▪ Customer satisfaction ▪ Client loyalty ▪ Client growth ▪ Community outreach ▪ Safety (accident ratios, injury ratios)	▪ Culture/colleague experience ▪ Employee engagement ▪ Diversity, equity, & inclusion
LTIP	▪ "Environment" ▪ Disclosure & compliance	▪ Customer satisfaction ▪ Customer connections ▪ Client loyalty ▪ Community outreach	▪ Employee engagement ▪ Diversity, equity, & inclusion

Examples of ESG metrics in TSX60 incentive plans

Disclosure surrounding the specific measures and objectives underlying these ESG metrics tends to be lean. As companies explore the incorporation of ESG into incentives, some organizations are understandably allowing themselves leeway to fine-tune the program as their processes mature. Focus and growing interest are observed in the social (i.e., human capital) and environmental categories, which are further explored below.

Human Capital Factors

We observed 18 instances of TSX60 companies including talent or human capital related metrics within executive compensation programs, making them the second most common ESG metrics, after health & safety measures. The majority of talent-related measures are focused on employee engagement or investing in people. There are also 4 instances of TSX60 companies including DE&I measures in compensation plans.

Specific examples include:

RBC

30% "Risk and Strategic" bucket in the STIP, individualized for each executive. Some buckets include diversity and inclusion metrics.

Each of the STIP and PSU scorecards are weighted 10% on Human Capital priorities, which include "building effective, industry-leading processes for attracting, developing, and retaining an effective multicultural, multigenerational workforce".

20% of the STIP scorecard is weighted on strategic measures, including diversity and inclusion metrics.

None of these examples clearly define their DE&I metrics; this may indicate that these metrics remain highly subjective, or that companies are choosing not to disclose the specific measurement methodology. In contrast, many high-profile US companies introduced or announced plans to include specific quantifiable DE&I objectives into incentive plans during the 2021 proxy season (e.g., In January 2021, Starbucks announced that a portion of executive's LTIP grant will be tied to a target of growing the chain's diversity in managerial ranks over three years).

Environmental Factors

Within the TSX60, 11 out of 14 observations of environmental metrics were at companies in the extractive industries (e.g., Materials and Energy). Interestingly, of these 11 occurrences, two are within LTIP performance frameworks. These metrics tend to be geared towards environmental risk: examples include disaster avoidance, compliance to environmental assessments or industry benchmarks, and greenhouse gas ("GHG") emissions reduction as a forward-looking metric.

Select examples include:

10% of STIP scorecard is attributed to environmental and health & safety performance metrics such as GHG emissions, pipeline leaks and injury frequency.

STIP and LTIP both use a comprehensive sustainability scorecard tracking CO2/tonne of ore processed, GHG emissions reduction, water use efficiency, and other metrics.

Looking forward: Algonquin Power & Utilities and Enbridge have disclosed plans to include sustainability plan targets and/or GHG emissions reduction in their 2021 incentive plans.

US Trends

*The following has been adapted from our US partner firm's (Semler Brossy Consulting Group) series on 2021 ESG & Incentives. For additional information, see their most recent report **here**.*

Semler Brossy found that 57% of companies in the S&P 500 include an ESG metric in either their annual or long-term incentive plan. DE&I is the most prevalent ESG metric ahead of more traditional metrics such as customer satisfaction and safety, with other human capital metrics (i.e., talent development and retention) also among the top five.

DE&I is at the intersection of two distinct trends: A growing focus on racial inequity brought to the forefront in 2020, and the increased attention on human capital management. DE&I prevalence in incentive programs among S&P 500 increased by 19% year-over-year for proxies filed between January and March of 2021 compared to 2020, as companies felt urgency to add DE&I metrics in response to the high degree of focus on racial inequity in the US.

Environmental measures continue to round out the bottom of the list, with 14% of companies including these metrics. These metrics' prevalence is expected to continue to grow as investors call for net zero GHG emissions targets and integration of ESG in compensation.

Year-over-year, the most commonly added metrics were safety, customer satisfaction, and DE&I. Nearly all COVID-related safety additions were incorporated into individual components, implying that Boards considered the treatment of employees during the pandemic (i.e., employee health and safety) in a retrospective assessment of executive performance. As a result, the increased use of safety measures is not expected to be permanent.

Why does ESG matter for Boards?

Oversight of ESG is now a core Board responsibility. Institutional investors want sustainable returns; employees and other stakeholders want ethical climate stewardship and actions on important social justice issues. Boards are expected to not simply "talk the talk," but to also "walk the walk" when it comes to ESG. Stakeholders are demanding concrete actions that reflect companies' public statements of support and commitments made, in the form of strategic plans, capital allocations, and meaningful change in Board and senior management composition.

High-performing Boards are taking action as they continue to navigate the changing ESG landscape. These are informed by our firm's work with Boards through our **Board Effectiveness practice**. Recommended activities include:

- **Education** about ESG issues and potential ways of addressing them – leveraging both management teams and outside resources
- **Drive a refresh of strategy** – ensure understanding of material climate related risks and opportunities and ensure capital is being invested ethically and in line with stated corporate purpose and values
- **Set robust goals with the CEO** – ensure there is Board and CEO alignment around what "great" performance looks like
- **Create meaningful linkages** between material ESG-related performance and executive compensation
- **Continue/hasten Board renewal** so that Board composition reflects both strategic imperatives and diversity commitments
- **Leverage feedback processes** (including Board evaluations, director peer feedback, and in camera sessions) to support the Board in continually raising the bar for itself
- **Ensure meaningful disclosure** around ESG strategies, goals, and progress towards achieving them – including via the compensation discussion and analysis section of the proxy circular

Conclusion – What's Next?

Hugessen's review of the TSX60 2021 proxy season sheds a light on the adoption of ESG into incentive plans. Moreover, we observe a refinement of metrics and increased disclosure of specific measurable objectives across ESG topics. TSX60 companies face ongoing shareholder pressure to incentivize ESG performance, particularly for those companies with significant exposure to climate-related risk. Moving forward, Boards must continue to monitor, manage, and oversee ESG. This will require identifying the specific issues most relevant to the organization, and establishing clear guidelines surrounding who "owns" ESG within the Board and its committees. Hugessen continues to work with Boards and management teams on the rapidly evolving topic of ESG strategy and its place in incentive plans.

For those with questions or who are interested in more in-depth or customized analysis, please visit our website at **www.hugessen.com** for more information.

Hugessen Consulting is an independent consulting firm dedicated to meeting the executive compensation consulting requirements of boards and their compensation committees. With offices in Toronto, Calgary and Montreal, the firm's mission is to be the leading provider of advice on executive compensation, performance measurement and assessment, and related governance to the compensation committees of companies in Canada, the U.S., and the U.K