HUGESSEN CONSULTING

BRIEFING *UPDATE*

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Integrating E&S considerations into company strategy, board structure and oversight, and executive compensation programs

This article is an updated version of the briefing titled "Environmental and Social Issues: Growing Expectations on Boards and Implications on Executive Pay" published by Hugessen Consulting in November 2017

The shareholder community has turned its attention to "ESG" (Environment, Social and Governance). While the Governance component has been effectively addressed by Canadian boards, the topic of "E&S" or more broadly "sustainability" is growing in importance within boardrooms. Conversations between Hugessen and the institutional shareholder community across North America reveal a growing recognition that E&S factors represent risks and opportunities that should be managed like any others. Numerous studies on E&S have identified a correlation between a well-executed E&S policy and long-term investment outperformance, stronger earnings, and lower operational costs. Such policies go beyond the traditional way of thinking about E&S, from short-term and operational measures of safety and the environment, to longer-term measures that can impact strategy.

Yet directors continue to scratch their heads over which E&S factors are relevant to their business and should be given airtime – amidst already busy board agendas – and how to manage these opportunities and risks. This article aims to provide directors with a practical guide to developing and enhancing a more robust approach for integrating E&S considerations into company strategy, board structure and oversight, and executive compensation programs.

In 2019, RBC Global Asset Management ("RBC GAM") published the 2019 Responsible Investment Survey, which found that 80% of Canadian Institutional Investors surveyed considered ESG principles when they made investments.

E&S Integration into Board Oversight

Stakeholders are increasingly advocating for inclusion of E&S considerations in a company's strategy, as effective board oversight cannot be accomplished by merely allocating E&S as a standalone agenda item. Yet, it is important to keep in mind that responsibility for executing E&S priorities have been largely in the domain of management, not the board. With this in mind, Hugessen offers the following framework to help directors ensure the effective integration of E&S into an organization's strategy and the board's oversight process.

Integration into strategy:

- Have management determine which E&S priorities need to be managed by the organization.
- Get informed on the material E&S risks which are relevant to your organization – not the catalogue of issues. During this process, subject matter experts within and outside the company may be needed. You may also wish to ensure management has reached out to the Board, as appropriate.
- Review the identified priorities and how management proposes to address them in the strategy; ensure they adequately address issues raised by the company's top shareholders and key stakeholder groups.

In May 2018, the Canadian Coalition for Good Governance ("CCGG") published The Directors E&S Guidebook outlining practical insights and recommendations for effective board oversight and company disclosure of environment and social ("E&S") matters.

Consider board composition and structure:

- Ensure you and your fellow directors have the appropriate knowledge to actively oversee E&S areas; E&S expertise may become a recruiting priority.
- Integrate E&S education into director education programs and board policy documents.
- Create a sustainability committee or assign oversight of E&S priorities to existing committee(s).

Integration into board oversight:

- Have management devise a plan for reporting, measuring, and responding to E&S factors.
- Establish a process for board oversight to track progress and compliance. The board should regularly monitor and oversee progress on the organization's performance against E&S goals, objectives, and targets within the corporate strategy.
- Evaluate management on execution of E&S targets. E&S priorities should be incorporated into executive job descriptions, performance evaluations, and compensation schemes.
- Ensure management discloses material E&S issues, risk assessment and performance against E&S metrics in annual reporting.
- Disclose the role the board plays in overseeing sustainability.
- Evaluate board performance on sustainability oversight within the annual board assessment.

It is important to note that E&S oversight is not "one size fits all;" the approach taken will differ by industry and company. For a more detailed guide, we recommend Ceres' Lead from the Top: Building Sustainability Competence on Corporate Boards.

E&S Integration into Executive Pay Programs

We have observed increasing prevalence of companies incorporating non-financial measures into incentive pay programs, many of which include E&S-related items. Coro Strandberg of Strandberg Consulting, a firm that provides strategic advice to organizations seeking to integrate E&S into their core business model, notes: *"unless companies begin to connect compensation to sustainable environmental and social performance, they will continue to sacrifice long-term value creation and competitiveness for short-term, unsustainable gains."* In 2013, Strandberg Consulting reviewed the adoption rate of sustainability factors[1] in executive compensation plans among TSX 60 constituents. Hugessen replicated the study in 2020 and compared the results:

"Qualitative, non-financial assessments should have a direct impact on compensation and are important when it comes to aligning pay with the risk an organization face." - *Financial Stability Board*

	Consideration Given to Sustainability Metrics	# of Constituents that Assign Weighting[2]	Average Weighting of Sustainability Metrics in incentives
Strandberg 2013 Study (2012 data)	57%	40%	20% (STIP)
Hugessen 2020 Study (2019 data)	67%	60%	19% (STIP; n=33) 29% (LTIP; n=3)

[1] The report defined "sustainability" metrics broadly to include: health & safety, employee engagement, stakeholder relations, environment, corporate social responsibility, and customer loyalty (Hugessen followed the same methodology)

[2] Represents the amount of TSX60 companies that disclose the use of pre-determined sustainability metrics, targets and/or weightings

As shown, there has been a 18% increase in adoption of sustainability-related metrics among the TSX 60 over the past seven years. Health & safety remains the dominant sustainability category (n=19), with environmental (n=17) as a close second, followed by employees/corporate culture (n=10). The number of constituents among the TSX 60 that assigned specific weights to sustainability-related metrics has increased 50% over the past seven years.

Metrics continue to be largely backward-looking (e.g., incident-based) and/or focused on risk mitigation (e.g., compliance based), rather than focused on forward-looking sustainability measures or the opportunity of long-term value creation. However, the emergence of community and stakeholder relations metrics (n=4) may signal a shift. Interestingly, the number of TSX 60 issuers considering some measure of sustainability in their long-term incentive plan has increased from 1 to 3 companies since our original publication.

There is no consensus amongst ESG practitioners if customer-related metrics (e.g. net promoter scores) should be included in the ESG category. For our study, we have qualified customer related metrics as ESG metrics, as we believe these metrics are related to the "social" element of ESG. We note of 14 instances of companies in the TSX60 disclosing customer-related metrics in their incentive plans this year – mostly financial institutions, telecom companies and grocery chains.

Interesting ESG Metrics Observations (2020 proxy season)

Cameco Corporation:

Metric: Supportive Communities (15% STIP weight)

- In light of the local economic environment in Western Canada, the company includes a metric related to their ability to source services from Northern Saskatchewan vendors.

TELUS Corporation:

Metric: Corporate Sustainability Index (3% STIP weight)

- The company includes an internally-generated index that measures TELUS' commitment to the community, overall brand perception and progress toward reducing greenhouse gas emissions.

Hugessen suggests the following guidelines for incorporating E&S goals into incentive programs:

- Consider metrics that are both backward and forward-looking.
- Some categories and metrics should be long-term and strategy-focused to avoid consequences of short-sighted decision-making.
- Assign specific targets (quantitative or qualitative) that are simple and measurable and allocate an appropriate weighting so executives understand their importance to the long-term success of the company – as your E&S component of you incentive program matures, we encourage it to evolve to a non-discretionary component.
- Choose the most relevant E&S metrics for your organization or industry and avoid including the gamut of potential E&S risks in an incentive program.
- Disclose the rationale for the metrics selected, specifically describing how the E&S concerns impact financial and operational goals and addressing the tension that can exist between short-term financial goals and E&S metrics.

Useful ESG Resources Links:

- SASB Materiality Map
- The Book of Jargon - Environmental, Social & Governance
- WEF ESG Ecosystem Map
- UN Sustainable Development Goals (SDGs)

Conclusion

Most organizations and boards are already addressing E&S risks and opportunities to some extent, perhaps without a formal agenda. As noted in Ceres' 2017 report *Lead from the Top: Building Sustainability Competence on Corporate Boards,* formalizing this process *"helps to capitalize on market opportunity created by tackling sustainability challenges,"* Once your board has developed appropriate oversight processes, it can begin to reward executives for executing on these priorities, which in turn should align with how your organization thinks about its overall performance. At maturity, E&S may become so integrated into strategy and operations that a dedicated management and committee devoted to sustainability may not be needed. As Shona McGlashan, Chief of Governance at MEC, articulates: "*Ultimately, sustainability should become a mindset, not a process*."

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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 medium and large companies in Canada, the U.S., and the U.K.