HUGESSEN CONSULTING

Briefing

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Environmental and Social Issues: Growing Expectations on Boards and Implications on Executive Pay

The shareholder community has turned its attention to environmental and social concerns – commonly referred to as "E&S", or more broadly "sustainability" – so it's little wonder the topic has made its way into boardroom discussions on a regular basis. Conversations between Hugessen and the institutional shareholder community across North America reveal a growing recognition that E&S factors represent a risk that should be managed like any other risk within a company. 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[1]. 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 air time – amidst already busy board agendas – and how to manage these 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.

A 2016 Canadian investor survey conducted by SimpleLogic and RR Donnelley (24 CND institutional investment management firms, representing over $1.7T in AUM) revealed that "65% of investors often or always consider environmental and social issues, while 95% often or always consider governance issues".

[1] E.g., *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance,* Robert G. Eccles, Ioannis Louannou, and George Serafeim.

E&S Integration into Board Oversight

We hear stakeholders increasing pushing for E&S considerations to permeate a company's strategy – effective board oversight can't 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 lies with 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.

The Canadian Coalition for Good Governance ("CCGG") recently launched an E&S committee to develop guidelines for boards on oversight of E&S factors (e.g., materiality, controls, etc.), provide guidance to companies on expected E&S risk disclosure, and incorporate E&S into CCGG's board engagement.

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, as appropriate.
- Review the identified priorities and how management proposes to address them in the strategy; ensure they properly address issues raised by the company's top shareholders and key stakeholder groups.

Consider board composition and structure:

- Ensure you and your fellow directors have the appropriate knowledge to actively oversee E&S risks – specific 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 risks to an existing committee.

Integration into board oversight:

- Have management devise a plan for reporting, measuring and responding to E&S factors.
- Establish a plan for board oversight – a system 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 risks 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's important to note that E&S oversight is not a "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

> *"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

We have observed an increasing prevalence of companies incorporating non-financial measures in incentive pay programs, many of which relate to E&S concerns. Coro Strandberg of Strandberg Consulting, a firm providing strategy 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[2] in executive compensation plans among TSX 60 constituents. Hugessen replicated the study in 2016 and compared the results:

	Consideration to Sustainability Metrics	# of Constituents that Assign Weighting[3]	Average Weighting of Sustainability Metrics
Strandberg 2013 Study (2012 data)	57%	40%	20%
Hugessen 2017 Study (2016 data)	70%	50%	18%

[2] The Strandberg report defined "sustainability" metrics broadly to include: health & safety, employee engagement, stakeholder relations, environment, corporate social responsibility, and customer loyalty.
[3] Sustainability metrics were typically assigned a specific weighting on the corporate scorecard; however, companies' often chose to group multiple sustainability metrics together, assigning a weighting to the group.

As shown, there has been a 23% increase in adoption of sustainability-related metrics among the TSX 60 over the past three years, many of which are directly related to environmental and external social considerations. Health & safety remains the dominant sustainability category (n=20), with team member engagement and corporate culture (n=18) and the environment (n=14) as close seconds, while community and stakeholder engagement were less common (n=5). While metrics continue to be largely backward-looking (e.g., incident-based) and focused on risk mitigation (e.g., compliance-based) – rather than focused on the opportunity of long-term value creation – the continued use of community and stakeholder relations metrics and a significant increase in engagement and culture metrics may signal a shift. Interestingly, only one TSX 60 issuer considers some measure of sustainability in their long-term incentive plan.

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

- Consider metrics that are both backward and forward looking.
- Some goals 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 a material weighting so executives understand their importance to the long-term success of the company – don't make E&S metrics the discretionary component of an incentive program.
- Choose the most relevant E&S metrics – 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 permeate financial and operational goals, addressing the tension that can exist between short-term financial goals and E&S metrics.

The Sustainability Accounting Standards Board – "SASB" – is working on a universally accepted standard of reference for boards, senior executives and remuneration consultants to assess relevant E&S risks and opportunities.

Conclusion

Most organizations and boards are already tackling E&S risks 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 the appropriate oversight process, executives can begin to be rewarded for executing on these priorities, which in turn should align with how your organization thinks about its overall performance. Overtime, management teams and committees devoted to sustainability oversight may be dissolved, as E&S governance becomes ingrained into the company's mantra and the board's oversight functions. As Shona McGlashan, Chief of Governance at MEC, articulates: *Ultimately, sustainability should become a mindset – not a process*.

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