Make room, and make ready

Directors need to acknowledge the increasingly active role of shareholders and their advisers in executive compensation decision making—and then engage shareholders directly to hold sway over the agenda

By Ken Hugessen

Today, it would be hard for a director of a mid-size or large public issuer to miss the increasing involvement of shareholders and proxy advisers (e.g. ISS and Glass Lewis) when dealing with executive and director pay and related performance and governance issues. Until recently however, many directors have been reluctant to participate directly in the shareholder engagement process, leaving many in the shareholder community almost completely reliant on the proxy advisers for an explanation and evaluation of an issuer's compensation plans and practices.

Directors have increasingly expressed concern about proxy advisers' "checkbox" compliance approaches, as well as the accuracy of their reports and their own policy-development processes. In response, advisers have more recently sought input from the shareholder and issuer community as part of their policy-making processes. They have also begun to apply more judgement when evaluating compensation programs. Yet, many directors would argue this process remains arbitrary and opaque.

So what can the directors do?

The most obvious step is to develop relationships directly with their largest shareholders to balance the influence on shareholders of the proxy adviser. Based on our firm's ongoing discussions with the shareholder community, we know the shareholders are more than willing to speak directly with boards. A subsequent second step might see a group of senior corporate directors, representing a range of well-known issuers, work together to develop common views on key issues, to counterbalance the advisers' disproportionate influence.

The pressure on directors to act continues to mount given the Toronto Stock Exchange's new listing requirement mandating majority voting policies. Say-on-pay has already focused boards on their role in overseeing compensation programs, providing a simplistic tool for gauging overall shareholder support. What more directors must now recognize is that say-on-pay is a conversation starter, even where support levels are high.

Based on our discussions with shareholders and senior directors, the ideal engagement process includes the following:

- Engage early and often, prior to the busy "proxy season"—not only will shareholders have more time to discuss, issuers won't be under the extra pressure to influence shareholder voting decisions. Getting shareholder thoughts early can prevent last-minute pre-AGM surprises.
- Engage with the investment decision makers as well as the governance/responsible investment department. While the latter has accountability for the voting process for the institution, the former may have a different perspective, and can influence voting decisions.
- Engage on compensation-related issues without management present, providing for a more frank and candid conversation.

In early 2014, our firm conducted 12 conversations with many of the large institutional shareholders, associations and advisers. Among other topics, we discussed some shareholders' interest in reducing the focus on traditional pay benchmarking and exploring other perspectives in determining executive compensation levels. While these initiatives enable us as advisers to convey shareholders' views to boards, there is no substitute for directors to hear it directly.

Boards that engage with shareholders will find different perspectives and focus areas from more typical investor relations engagements. For example, best practice standards and sound principles relating to good compensation governance are continually evolving. Yet these changes rarely happen overnight; rather they percolate over time, slowly gaining acceptance among the shareholder community. Directors should be a part of this conversation.

Directors need to develop relationships directly with their largest shareholders. Based on our firm's ongoing discussions on compensation practices with that community, we know shareholders are more than willing to speak directly with boards.

Boards and directors who have not already done so, may want to consider adding shareholder engagement activities to their annual work plan and begin building relationships directly with their largest shareholders. Furthermore, and as engagement becomes increasingly commonplace, a representative group of well-established directors may want to consider working together to promote common interests, rather than to leave the proxy advisers to develop policy unchallenged.

Ken Hugessen is founder and president of Hugessen Consulting Inc. E-mail: khugessen@hugessen.com.

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