HUGESSEN CONSULTING

Briefing

June 2014

Pay Benchmarking and CEO Transition – Select Shareholder Perspectives

Introduction

With the 2014 proxy season now behind us, compensation committees may be feeling the pressure to respond to below-par Say-on-Pay results and/or director support levels and other criticism received from shareholders and their advisors. Adding to this pressure is the lack of a clear process for gathering the views of the shareholder community in order to inform the board's review and decision-making process.

As part of an increased focus on shareholder engagement, Hugessen initiated 12 conversations in early 2014 with large institutional shareholders (n=8, pension funds and asset managers representing total assets under management of $2 trillion), associations (n=2), and advisors (n=2). Our aim was to understand the compensation concerns that are currently top of mind for the shareholder community in light of:

- Continuing interest among some shareholders for reducing the reliance on traditional "horizontal" benchmarking and exploring alternative approaches (i.e., "vertical" benchmarking) when determining executive compensation levels
- Recent academic research[1] that suggests the transferability of CEO skills and the risk of losing CEOs may be overstated, and
- The expected limited usefulness to shareholders of the SEC's proposal to mandate disclosure of a CEO pay ratio in the U.S.

This briefing broadly summarizes participants' perspectives on these matters. For clients who are interested in our detailed findings – including a series of survey-based questions gauging participants' urgency on these and other matters, please contact Michelle Tan or Erin Poeta at Hugessen. Hugessen offers tailored guidance to boards for engaging with shareholders, associations and proxy advisors, as well as insights on specific issues raised by these stakeholder groups.

[1] Executive Superstars, Peer Groups and Over-Compensation – Cause, Effect and Solution, Charles Elson and Craig Ferrere, John L. Weinberg Centre for Corporate Governance, University of Delaware (2012)

Synopsis of Shareholder Perspectives

The continuing increases in pay levels in certain sectors has led shareholders to begin considering, for the first time, absolute quantum of CEO pay in their compensation reviews. There was broad consensus among the participants on a number of the factors contributing to this perceived "ratcheting up of pay levels", most notably, weak succession planning and overreliance on traditional ("horizontal") benchmarking.

Shareholder Perspectives: Process for Setting Pay

- Institutions do not want to be prescriptive in determining how or how much CEOs are paid, although most participants have general principles that they believe should be followed
    - Participants are willing to deviate from these principles if circumstances and board decisions are clearly explained and make sense to them
    - On what constitutes excessive pay, many participants apply the "you know it when you see it" approach, while a few participants have developed their own "bright line test" (e.g., the CEO is paid more than 4x the next-highest paid executive)

- Traditional Benchmarking: almost all participants agreed that despite its potential shortcomings, horizontal benchmarking is a reasonable place to start in determining target pay levels for executives, but should not be the sole consideration
    - There is interest from some participants to have the board look at additional factors, namely vertical benchmarking, and internal pay equity considerations

- Vertical Benchmarking**:** all participants take a positive view of companies that practice and disclose vertical benchmarking considerations. The majority prefer to monitor the level of CEO pay relative to other senior executives, rather than the ratio of CEO pay to non-management employee pay (the SEC's proposed internal pay ratio ("CEO pay ratio") is believed to have numerous challenges providing little value in terms of making final voting decisions)
    - However, many participants noted that CEO pay ratio disclosure could be used to create a "target list" of companies for further review

Shareholder Perspectives: CEO Transitions, Retention, and Succession Planning

- All participants believe that the transferability of CEO skills, and the risk of losing a CEO, has been overstated by executives, boards and advisors
- Participants listed numerous concerns arising from the absence of a well thought-out succession plan, including the perception that boards may be hastily providing sign-on and/or retention awards

- Participants' views on the degree to which an incoming external hire should be "made-whole" in regards to their incentive equity awards from their prior employer vary widely and are at odds with the widely-held view among issuers that such replacement is essential to hire proven talent
    - Just over half of the participants held the view that nothing should be replaced, regardless whether the award had already been earned/vested
    - A significant number of participants held the view that awards earned/vested should be partially replaced under certain circumstances
    - None of the participants held the view that unearned/unvested awards should be partially or fully replaced, particularly for the CEO

Shareholder Perspectives: Other "Burning Issues" for 2014 and Beyond

- Top two areas of focus for shareholders in the near term are:
    - Performance metrics selected by the board to determine incentive payouts and how they reinforce corporate strategy
    - Succession planning

For further information on the contents of this briefing, or to obtain access to Hugessen's more comprehensive report on the perspectives and priorities among shareholder and their associations and advisors, please contact one of the following professionals:

Toronto:	Michelle Tan	416-868-4421	mtan@hugessen.com
Calgary:	Erin Poeta	403-441-6294	epoeta@hugessen.com

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 and Calgary, 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.