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Director-Shareholder Roundtable

June 2016, Calgary, Alberta

On June 1, 2016, Hugessen Consulting hosted a Director-Shareholder Roundtable in Calgary, Alberta. This session brought together experienced corporate directors and representatives from large CND and US institutional shareholders for a day of interactive dialogue on **board leadership on compensation and related governance.**

The discussions that took place were open and engaging, with participants freely sharing their views and experiences on a wide range of compensation and governance matters. There was consistency among directors across a range of topics, which in part may reflect the concentration of energy sector directors in the room. Some of the areas of agreement between directors and shareholders included:

- Benefit for both issuers and shareholders of ongoing director-shareholder engagement and recognition that the relationship and credibility is built over time (and not in one proxy season)
- A rethink of the approach to pay (both quantum and structure) within the resource sector may be worthwhile to reflect the current economic realities and to ensure the long-term competitiveness of the industry
- The importance of board discretion in pay decisions to support the alignment of pay and performance, while maintaining the credibility of the pay programs
- Greater focus of compensation and on the long-term and corporate strategy; however, broad sentiment that this first requires acceptance by capital markets of “long-termism”

We summarize below the key themes coming out of this discussion (note: we have not included our point of view).

Shareholder Engagement

Shareholders have found that the volume of engagement requests coming from companies have increased significantly over the last few years. In the case of one shareholder, 20% of recent engagements included a director, and they expect that to rise. As a result, proxy season is becoming less busy, while "off season" is picking up pace. And as one shareholder put it, this is the way it should be, *"proxy season is for proxy voting – not addressing governance matters"*.

Many people in the room echoed the notion that relationships between boards and shareholders should be built over time; it's likely too late to engage with shareholders when advisors have already recommended against proposals. Some participants look forward to the day when outreach becomes more informal, through ad hoc correspondence to get shareholders' views on potentially contentious matters.

Directors discussed the need to address two, often distinct, groups of stakeholders: portfolio managers and the governance proxy voting team. Shareholders acknowledge that they need to address the sometimes diverging views between the two departments.

Directors also noted the importance of understanding each stakeholder's investment approach: short versus long-term. Shareholders that effectively *"invest in perpetuity"* (e.g., index funds, pension funds, sovereign funds, etc.) noted their interest in discussing the link between strategy and pay, a practice one shareholder noted European oil & gas issuers do well. However, directors are doubtful about their ability to influence short-term shareholders. In response to this concern, a few shareholders in the room suggested prioritizing the company's top 20 shareholders (often representing ~50%+ ownership) who tend to acknowledge their stake in a company's future (and are interested and willing to engage).

Yet, not all directors consider shareholder engagement as part of their role and are concerned it may interfere with director independence. One shareholder in the room was quick to dispel this concern, *"directors should be independent from management – not shareholders; ultimately, directors work for shareholders"*.

One director proposed a possible evolution of the current director-shareholder engagement process: regularly-scheduled calls with the governance proxy voting department, much like investor calls or roadshows. Directors believe this concept could help address the scarce governance resources at many of these institutions, and support a consistent message from directors and management.

Acknowledging the criticisms of proxy advisors by directors, there was general agreement among the shareholders in the room that the proxy advisors play a valuable role in enabling shareholders to fulfil their fiduciary duty to vote the many proxies among their holdings. All of the shareholders in the room clarified that in addition to getting the "benchmark" proxy advisor reports, the advisors provide recommendations based on each institution's proprietary voting guidelines. Directors and shareholders agreed that direct engagement with key shareholders can mitigate the influence of the proxy advisors – making disclosure of such outreach efforts within a company's circular important.

Pay Decisions in Volatile Markets

Shareholders want to see board discretion applied to pay decisions in both the good times and the bad. A number of directors among oil and gas issuers applied negative discretion in 2016, and many people in the room expect this trend to increase in 2017. However, directors discussed the need to re-evaluate the construct of incentive plans if discretion continues to be necessary.

One shareholder observed an early decline in pay and performance within both the oil & gas and mining sectors, but noted a more recent plateau in pay levels while performance continues to decline, posing the question, *"At what point should an industry in turmoil reset pay levels?"* While most of the directors in the room anticipate the downturn in the energy sector to be long-lasting, "resetting" pay (e.g., lowering target levels) is a tough concept for boards to implement.

Shareholders do not have a bright line test when it comes to quantum of pay – as long as it's "reasonable" and considers the broader context – for example, cuts to capital expenditure budgets, layoff, etc. The shareholders in the room focus more so on the structure of pay (e.g., type of metrics within STIP v. LTIP, long-term vesting horizons, etc.).

One director asked, *"how do issuers in the energy sector transition away from providing high equity pay (on top of modest salaries), exposed to the significant volatility inherent in the sector?"* A discussion ensued about replacing stock options – a highly levered instrument which has done little to foster long-term ownership – with long-term performance-based restricted share units, dampening the impact of future volatility.

Shareholders in the room had mixed views on so-called "realizable pay" disclosure; some find this analysis useful, while others are only interested in pay as shown in the summary compensation table, as it demonstrates the value directors intended to award executives for target performance.

Pay in the Context of Long-termism

Directors and shareholders generally recognized the need to better align executive compensation time horizons with longer-term decision making – yet very few long-term incentives extend beyond three years (other than stock options). After discussing reasons why the market has been slow to evolve beyond three-year plans, hypotheses were drawn: tax constraints of cash plans, non-deductibility of treasury settled plans, and issuer concern over first mover disadvantage.

The shareholders in the room cited examples of long-term incentive plan features that, in practice, may drive short-term behaviours, such as the exclusive use of total shareholder return (TSR). Many view TSR as backward-looking *"outcome"* metric, often creating unintended consequences. So what drove the trend towards the use of TSR in PSU plans? Some participants in the room believe it was the proxy advisors, while others believe it's simply a *"safe harbour"*.

There is no one *"magic bullet"* long-term measure, as one shareholder put it, but two helpful suggestions were made:

1) TSR – absolute or relative – could be used as a modifier on operational metric(s) – not as the sole metric.
2) Adopt a multi-faceted approach, such as a balanced scorecard for LTIs.

However, certain participants argued that macro change is first required within the capital markets, shifting away from short-term thinking and gains, towards long-term planning, results, and rewards. While many shareholders in the room advocate for long-term value creation, this isn't always the case across all market participants. For example, new technology like high frequency trading – the antithesis of long-term – is a part of the investment portfolio of some investors.

So how might this transformation to long-term thinking occur? Some said that the change needs to be policy driven. As posed by one shareholder, the solution may actually be simpler than a systematic shift: *"engage with companies to understand the company's key long-term goals, and how these goals translate into actionable measures within incentive plans"*. Shareholders ultimately look to directors to determine which operational and financial measures are most appropriate for their business. From there, shareholders encourage companies to disclose a consistent strategy across all publicly disclosed documents.

Ultimately, influencing long-term thinking needs to be a shared responsibility between directors and shareholders to overcome any first mover disadvantage.

Other topics discussed:

- **Exit payments:** shareholders remain concerned with sizeable departure payments upon retirement. In the past, some boards have characterized underperformance or not-for-cause departures as "retirements". Such arrangements are also intended to preserve the dignity of the outgoing CEO and the reputation of the Board and Company.
    - A participant emphasized the importance of developing a well thought-out retirement agreement to avoid paying both severance and retirement payments – a less desirable but relatively common outcome.
- **One-time awards:** shareholders are not necessarily against one-time awards (e.g., at sign-on, promotion, etc.), rather, they evaluate them on a case-by-case basis and look for clear and compelling rationale to be provided. As one shareholders put it, "absence of a strong rationale may signal a weak Board".

Conclusion

The afternoon reinforced to both groups the need for more direct interaction between shareholders and directors, particularly during volatile markets or where there is a significant effort to align pay to long-term value creation.