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CLIENT ALERT
Shareholder Engagement:
Why, When, Who and How

Shareholder Engagement: An expected part of the HR Committee Chair's Role?

Engagement with shareholders on executive compensation has changed in the last several years, driven by two important shifts:

- Both proxy advisors expect a robust level of engagement (and disclosure of this engagement) when say on pay support is below 80% (a higher standard than the historical 70%).
- Institutional investor policies on executive compensation are diverging both from other institutional investors and from the proxy advisors, increasing the likelihood that at least some institutional investors will be critical of compensation programs

Based on our experience assisting our clients with shareholder engagement, this update provides guidance on the following questions:

- **Why** has shareholder engagement on executive compensation become so prevalent and important?
- **When** in the fiscal year cycle should engagement occur?
- **Who** should participate in this engagement (management or the Board) and **who** should the engagement be with (which shareholders and proxy advisors)?
- **How** to maximize the benefits of engagement with shareholders?

Why Should Directors Engage with Shareholders on Executive Compensation?

Both ISS and Glass Lewis have policies that use their say on pay vote recommendations to penalize companies if directors do not engage with shareholders following a vote that is less than 80% in favour of say on pay.

ISS Policy

ISS's policy for Canadian TSX listed companies is that, in making its voting recommendations on executive pay related items, it will consider:

> "*Board's responsiveness to investor input and engagement on compensation issues, including …Failure to respond to the company's previous say-on-pay proposal that received support of less than 80 percent of the votes cast taking into account the ownership structure of the company.*"

ISS suggests that this responsiveness should include:

- Disclosure of engagement efforts
- Specific actions taken to address the issues that contributed to low say on pay
- Increased disclosure of the rationale for pay practices

Failure to meet ISS' expectations materially increases the risk of a recommendation against say on pay which, in turn, increases the risk of a failed or low say on pay vote outcome. Based on Meridian's research an ISS recommendation against say on pay is likely to depress the vote outcome by ~30%.

Glass Lewis Policy

Glass Lewis' policy for Canadian companies is that, if less than 80% of shareholders support say on pay:

> *"…the board should demonstrate a commensurate level of engagement and responsiveness to the concerns behind the disapproval, with a particular focus on responding to shareholder feedback"*

Glass Lewis suggests that this include:

- Engaging with dissenting shareholders to identify their concerns
- Where reasonable, making changes or commitments that that address the concerns with the compensation program

When Should Companies Engage with Shareholders

Boards typically engage with shareholders on executive compensation at three points in time:

- After a negative proxy advisor recommendation: In the short window between receipt of an ISS or Glass Lewis report and the date of the Annual Meeting, in response to a recommendation against say on pay:
  - Shareholders may be reluctant to engage during this short window (due primarily to volume of meetings), so it is generally an engagement time of last resort—it is preferable to anticipate the negative vote recommendation and engage with shareholders earlier in the year
  - The key goal of this engagement is to persuade shareholders to vote with the company, rather than follow the proxy advisor recommendations. A good proxy solicitation firm can help access those individuals at the company's investors who make the voting decisions
- **After the Annual Meeting at which the Company received less than 80% support:** Several months following the Annual Meeting in any year in which the company received less than 80% say on pay support. The goals of this engagement are to:
  - Hear shareholders' questions or concerns with executive compensation
  - Understand why shareholders did or did not support the say on pay vote
  - Receive input into potential changes to compensation programs
  - Provide a foundation for the disclosure of engagement expected by both proxy advisors
- **After the initial round of engagement and before the next Annual Meeting:** Several months prior to the next Annual Meeting following the company receiving less than 80% say on pay support at the prior Annual Meeting. The goals of this engagement are to:
  - Discuss potential responses to address investor concerns from the first engagement
  - Support strong disclosure respecting engagement and changes made to compensation resulting from the prior engagement and low say on pay vote support

- Increasingly, we are also seeing Boards engage with shareholders annually even when no say on pay issues are anticipated. The primary purpose for this engagement is to understand investors' perspectives on compensation programs and to maintain open communication in case there are future say on pay issues.

Who Should Participate in the Engagement?

Who at the Company Should Participate?

When engagement is driven by say on pay issues, it is important that members of the Board and not the CEO engage with shareholders.

Typically, the Chair of the Human Resources or Compensation Committee will lead the engagement with shareholders, supported by the company's investor relations team and HR team, as they are the "expert" on a company's executive compensation plans and designs and can explain the programs and answer more technical questions.

If the shareholder has indicated that they are interested in multiple issues, it may be appropriate to include the Chair of the Board of Lead Director, or the Chairs of other committees.

While the company's compensation consultant does not typically participate in these meetings, they should be actively engaged in: preparing materials for the meeting; debriefing on the investor feedback; assisting with redesign of compensation plans in response to investor feedback; and reviewing disclosure of the engagement in the proxy.

Who at the Shareholder Should the Company Meet With?

Companies typically extend invitations to their largest 10 to 30 shareholders (depending on investor mix), informed by the proxy advisor each shareholder follows and shareholder voting history. The company's Investor Relations team and a good proxy solicitor can help identify the shareholders that it makes sense to reach out to, based on these criteria.

Typically, the Investor Relations team has contact with the portfolio manager, so this may be the easiest access point. However, say on pay voting decisions are generally made by the shareholder's governance team, rather than the portfolio management team . Accordingly, it is important to have the right players at the meeting. A good proxy solicitation firm can help with this and typically has contacts with the governance team at most institutional investors.

It can be helpful to include the i portfolio manager, particularly if they are a committed investor and supportive of the company's business strategy and execution.

Should the Company Engage with the Proxy Advisory Firms?

The short answer is "yes", but with reasonable expectations for these meetings. Generally, the goal of proxy advisor engagement is to ensure that they understand the company's business and any unique business factors that may support a qualitative overlay to their more formulaic approach to assessing the alignment of pay and performance.

Arguments that the methodology for assessing performance or peer group composition is flawed are not likely to change proxy advisor perspectives.

- Companies can effectively engage with the proxy advisory firms, ISS and Glass Lewis, in several ways:
  - The first form of engagement is one we think should always be followed—ensure that proxy disclosure specifically addresses issues that the company expects will be of concern to the proxy advisors in a way that makes it easy for them to get to the "right answer"
  - Following the issuance of an ISS or Glass Lewis report, engagement is more limited:
    - ISS will correct factual errors in its reports which are brought to its attention (but sometimes only if doing so will result in a change in ISS's vote recommendation). Any factual disagreement with ISS generally needs to be addressed through supplemental public disclosure
    - Glass Lewis allows those companies which have purchased its reports to provide a written response to the Glass Lewis report, which Glass Lewis distributes to those investors who received the original Glass

Lewis report. This is a low risk way of engaging with Glass Lewis and of reaching investors that follow Glass Lewis, without identifying to other shareholders that there is a potential say on pay issue

— Generally, neither proxy advisor will directly engage with companies during the primary (calendar year end company) proxy season, particularly in the short window between delivery of their report and the Annual Meeting.

- However, companies that have an off-season shareholder engagement campaign generally request both proxy advisors to engage with them.

How to Maximize the Benefits of Engagement?

Emergency Engagement

Short term or "emergency engagement" typically occurs in response to one or both proxy advisors recommending against say on pay. This requires engagement just prior to the Annual Meeting. The goal of this engagement is to positively influence say on pay voting. To do this, companies typically:

- Focus on 3 or 4 key points relevant to the links between pay, performance and strategy
- Identify fundamental flaws in the proxy advisor methodology, as it applies to the particular company—typically related to peer group selection: (i) companies in the proxy advisor selected peer group are smaller than the company, so don't provide a market perspective on pay; or (ii) proxy advisor selected peer companies are in industries differently impacted by macroeconomic factors, so don't provide a reasonable perspective on performance
- Use graphics and charts to make the key points clearly
- Where relevant information has not been previously publicly disclosed, file supplemental disclosure—typically 1 to 3 pages, addressing only the key issues

Post Annual Meeting Engagement

This engagement is more planful and typically involves two meetings:

- An initial meeting to understand shareholder's perspectives
- A second meeting to discuss potential changes to compensation, including changes to incentive metrics or vehicles, changes to the peer group, changes to the compensation philosophy, etc.

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