

A Director's Guide to EXECUTIVE COMPENSATION

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EVENTS

Say-on-pay

Will your pay practices survive the scrutiny?

Pay critics abound, with no end in sight to the number of those who have something to say on executive pay. The rising interest in executive pay can be attributed to several factors. Improved compensation disclosure rules applicable to public companies have provided, and will continue to provide, greater insight into, and greater opportunity for scrutiny of, executive pay practices. Further, executive pay levels have grown significantly in recent decades, magnifying the disparity in pay between the general workforce and top execu-

tives. Moreover, the mortgage crisis and the ensuing financial market meltdown, massive job cuts, government bailouts and losses in share value and retirement savings, occurred while the same highly paid executives held the reins. These events have left many workers, shareholders and governments angry and ready to speak out on executive pay.

Recently, shareholder "say-on-pay" proposals have gained traction in Canada. Typically, say-on-pay proposals can be described as proposals seeking a non-binding, advisory vote by sharehold-

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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From the Editor

The number of interested stakeholders providing their views on executive pay is rising. Government leaders around the world, such as, French President Nicolas Sarkozy and U.S. President Barack Obama have strongly criticized excessive executive pay and have taken measures to restrict it in companies seeking taxpayer bailout money. Workers around the world have held protests against excessive executive pay amidst soaring workforce layoffs. Examples of extreme cases include workers in France holding their bosses hostage in their offices for days for receiving bonuses while workers lose their jobs. The house of former CEO of the Royal Bank of Scotland was vandalized on reports he would be receiving an annual pension of \$1.2 million. In the U.S., AIG executives had personal security around their homes for protection from the rage over their receipt of excessive bonuses while the company received millions of dollars of taxpayer bailout money.¹ In Canada, though more moderate as is often the case, shareholders have exercised their voice through "say-on-pay" proposals. In this environment, it is more important than ever before that organizations adopt compensation practices that can withstand this high level of scrutiny from so many stakeholders.

This issue provides an update on say-on-pay proposals, good pay practices and certain regulatory changes in Canada. I am pleased to welcome comments from Bridgit Courey, Principal of Perrault Consulting, an independent boutique firm specializing in compensation at the board and management levels. I am also delighted to receive comments on the U.S. perspective from Sandra Cohen, a Partner and the U.S. Compensation and Benefits Practice Leader, at Osler, Hoskin & Harcourt LLP.

— Nadine Côté LL.B.

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ers on various aspects of executive compensation. In addition to shareholder advisory votes on compensation, institutional shareholders, shareholder service groups and even governments are commenting on executive pay practices. Understanding how these and other interested stakeholders perceive your organization's compensation practices is important. An organization's compensation practices are said to provide insight into the stewardship of the organization. As such, executive pay practices that are well perceived by interested stakeholders can contribute to an organization's overall success.

Shareholder Advisory Votes

CCGG

The Canadian Coalition for Good Governance (CCGG) recently released its policy on shareholder engagement and say-on-pay. CCGG supports say-on-pay shareholder advisory resolutions as a means of enabling share-

holders to communicate with boards of directors on a company's compensation plan and awards for the prior year. CCGG recommends that boards voluntarily add to their annual meeting agenda, an advisory shareholder resolution on the compensation committee, the compensation plan and the prior year's awards. CCGG recommends that shareholders consider say-on-pay resolutions on a case-by-case basis. CCGG has taken the position that institutional shareholders should have regular, constructive engagement with boards and compensation committees to explain their perspective on executive compensation and comment on the company's practices.²

RMG

Risk Metrics Group (RMG) recently released its Canadian policy on shareholder advisory votes. RMG indicated it will generally recommend voting for shareholder proposals requesting the adoption of a shareholder advisory vote

on the report of the compensation committee, taking into consideration certain factors. These factors are: the wording of the proposal, the timing for its adoption and the existing disclosure requirements and best practices. RMG also indicated it will generally recommend voting against a binding shareholder vote on compensation.³

CPPIB

CPP Investment Board (CPPIB) released its Proxy Voting Principles and Guidelines for 2009. CPPIB has indicated that due to the differences in the state and disclosure of executive compensation in Canada and the U.S., it is adopting different approaches to advisory votes. In Canada, CPPIB will generally not support shareholder proposals seeking an advisory vote on executive compensation. Rather, CPPIB will engage with selected issuers on executive compensation. If a company is unresponsive to CPPIB's concerns, it may then decide to support a shareholder proposal seeking

Perrault Consulting comments on say-on-pay

The emergence of shareholder "say-on-pay" proposals in Canada comes as no surprise, considering the weak link between some generous executive compensation packages and the related poor operational and stock price performance.

There is a danger that say-on-pay could also become the subject of the latest hotline after the hockey season is over. In sports, not everyone has the knowledge and information required to coach the winning team; similarly, few shareholders have the knowledge and information required to make the right compensation decisions. In any event, the current movement is a normal reaction, like the return of the pendulum, to practices that have become, in some rare instances, abusive. In those rare, yet highly publicized cases, some said: "Where were the directors?"

Shareholder say-on-pay combined with increased disclosure requirements with respect to the quantification of the cost of annual pension plan benefits and the incremental cost of termination benefits should focus directors' attention on the relevance and justification for these often expensive terms. In addition, if the UK experience is any indication of the results than can be expected in Canada, having shareholders officially express their opinion about compensation plans should help improve the link between compensation and "real" corporate performance. For example, incentives should only be paid or earned when the organization's operational performance (e.g. EBITDA / Sales or ROE) is adequate relative to a peer group of companies. Management should not be rewarded for performance resulting from volatile resource

prices on which they have absolutely no impact.

Despite the advantages of adopting say-on-pay votes, there is a risk of some unintended adverse consequences. For example, organizations with competitive, reasonable compensation practices may be "scared" into unduly constraining compensation, especially long-term incentive awards and, perhaps to a lesser extent, annual bonus opportunity and pension benefits. In fact, unintended consequences occurred with the introduction of the expensing of stock options for accounting purposes in the early part of this century following the crash of the high tech stocks. The change in the accounting of stock options resulted in many companies eliminating the use of options, rather than implementing more moderate measures, such as:

- Modifying their duration
- Introducing vesting conditions linked to operational performance
- Separating the exercise of an option from its vesting to reward sustained stock performance

Organizations that are too conservative and limit executive reward opportunities may be at risk of losing key executives, especially when the economy rebounds. Such a consequence would not be good news for shareholders who weathered the storm.

Thanks to Bridgit Cowrey, Principal of Perrault Consulting for her contribution to this newsletter.

Perrault Consulting is an independent boutique firm specializing in compensation at the board and management levels.

an advisory vote on executive compensation. In the U.S., CPPIB will assess shareholder proposals seeking an advisory vote on executive compensation on a case-by-case basis.⁴

Ontario Teachers' Pension Plan

The Ontario Teachers Pension Plan (Teachers) released its Corporate Governance Policies and Proxy Voting Guidelines for 2009. Teachers indicated it will generally not support shareholder proposals seeking an advisory vote on compensation. Teachers commented that it was preferable to allow shareholders to approach directors directly with concerns and, if dissatisfied with their response, to vote against them.⁵

Market Reaction

Say-on-pay proposals are winning shareholder votes in Canada. This year, shareholders voted in favour of say-on-pay proposals at some of Canada's major banks, including: Bank of Montreal, Bank of Nova Scotia, CIBC, Laurentian Bank and Royal Bank of Canada. Say-on-pay proposals were voluntarily adopted without the issue going to a shareholder vote at other banks, including: National Bank and TD. In addition, say-on-pay proposals have been voluntarily adopted at various companies, including: Sun Life Financial Inc., Potash Corporation of Saskatchewan Inc. and TMX Group Inc.⁶ Having won the right to have a say-on-pay, it should be interesting to see

U.S. say-on-pay from Sandra Cohen of Osler, Hoskin & Harcourt LLP

"In the United States, 'say-on-pay' is here to stay," says Sandra W. Cohen, Partner in Osler, Hoskin & Harcourt's New York office. "Banks receiving government bailout money were required to seek shareholder votes on pay this spring, so there were literally hundreds of say-on-pay votes in the U.S. in 2009. Further, new legislation is being proposed in Congress that would expand the requirement to seek a shareholder advisory vote on executive compensation beyond just financial institutions."

Cohen adds that "We advise employers to start preparing now as if an advisory vote will be required in 2010. Start talking to your investors: shareholder advisory votes are designed to improve communication. Consider whether the resolution will be narrow, such as a vote on the summary compensation table, or broad, such as a resolution with respect to the entire compensation philosophy."

Thanks to Sandra Cohen, Partner and the U.S. Compensation and Benefits Practice Leader at Osler, Hoskin & Harcourt LLP.

how shareholders will vote on these issues during next year's proxy season.

Good Pay Practices

With the increased attention being paid to executive compensation, organizations should endeavour to ensure they are meeting or exceeding the best pay practices, as commented upon by shareholder interest groups. This is particularly true for organizations whose pay practices will be subject to a shareholder advisory vote next year.

RMG released its Canadian policy on poor pay practices. The policy identifies several pay practices considered to be

poor, such as egregious employment contracts, excessive severance provisions and excessive perks. Pursuant to the policy, if RMG determines a company has poor pay practices, it will generally recommend withholding votes from compensation committee members and the whole slate of directors if individual elections are not permitted. RMG will also generally recommend voting against an equity incentive plan if it is a vehicle for poor pay practices.⁷

CCGG issued a draft of its executive compensation principles. In its draft policy, CCGG indicated, among other things, that compensation should be simplified, payments should match

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Taking Canadian pensions to a new level-affordability

BY MELISSA WARELIN
New plan combines risk-sharing and flexibility

A pension plan without the employer risk of a defined benefit (DB) plan, but with all the accounting benefits of a defined contribution (DC), is the framework for the affordable defined benefit plan (ADB). This is a concept Ann's new whitepaper, Restoring Retirement Security, explores as a new Canadian pension plan possibility. This alternative is in line with changes wanted by plan sponsors. Approximately 65 per cent of survey respondents indicated they are interested in adopting alternative pension plan structures to the existing DB and DC-type plans. These plan sponsors reported a desire to achieve a risk-sharing intermediate between the current DB and DC structures, according to a 2007 survey of 81 nation-wide pension plan sponsors conducted by Ann Consulting.

In Canada there is an environment where you have DB and DC at the other end, said Barry Gies, vice president of Ann Consulting.

"With the tremendously high downturn in the economic conditions and financial market, we can't predict the future, so having the ability to make some alterations to your program part way through, which is what the ADB does allow you to do, introduces a greater level of fairness to all parties," he said.

The paper was released last month in Vancouver. The ADB plan is based on a model put in place by the University of British Columbia in 1972. The plan combines the best features of both a DB and DC plan on a neutral

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Pensions gone to the dogs in India

Secure retirement for pups

As an esteemed member of the Tamil Nadu police dog squad Oscar spent his career sniffing out bombs, investigating crime scenes and providing security to VIPs. After 10 years of faithful service, this hard-working canine got to a pension, reported the India Times.

When Oscar was slowed down by age, it was only natural that sub-inspector N Kothakkam, who has been with the dog squad for the past 30 years, recommended that he finally retire.

Retired dogs live in a separate kennel and receive a set amount of money per year to take care of food, vaccinations and grooming.

The pension and retirement rule was introduced in India in 2005 to give the pups the assurance of a comfortable retirement. Prior to the rule, the dogs were auctioned off to

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measurable achievements and underwater stock options should not be re-priced to a lower exercise price.⁸

U.S. CEO-to-worker Pay Disparity Grows

The increased scrutiny of executive pay has also brought the spotlight on the rising disparity between CEO and worker pay. The Economic Policy Institute has released certain chapters from “The State of Working America 2008/09”, including the chapter on executive pay. It reports that in 1965, U.S. CEOs in major companies earned 24 times more than a typical worker; this figure grew to 35 in 1978, 71 in 1989 and by 2007 it catapulted to 275. The ratio between the

median U.S. CEO pay and the typical worker in 2007 is somewhat less, but still high at 194-to-1. Other reports put these figures even higher.⁹

Regulatory Updates

OSC Adopts New Hearing Rules

On February 18, 2009, the Ontario Securities Commission (OSC) approved and adopted new *Rules of Procedure of the Ontario Securities Commission* (Rules), and repealed the former rules in their entirety. The new Rules are effective on April 1, 2009. The new Rules are intended to provide more complete and easily accessible guidance on the procedures required for proceedings before the OSC.¹⁰

BCSC Revises its Policies

On March 6, 2009, the British Columbia Securities Commission (BCSC) issued BCSC Notice 2009/03. Pursuant to the notice, BSCS revised BC Policy 15-601 Hearings. The changes were implemented to address inefficiencies in the hearing process, reflect current practice and consolidate the policy with BC Policy 15-602 *Electronic Hearings*. The notice also addressed changes to BC Policy 15-501 *Disclosure of Investigative Information* and the introduction of BC Instrument 15-501 *Disclosure of Investigative Information*. These changes clarify that a person obtaining information under the Instrument may use it only to answer allegations made against a person.¹¹

The following is provided for information purposes only and reflects the views of the author, unless otherwise stated. It does not constitute legal, tax, accounting, compensation consulting or other professional advice and cannot reasonably be relied upon as providing such professional advice. Your inquiries on these matters may be directed to the author.

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- ² Canadian Coalition for Good Governance, “Shareholder Engagement and “Say on Pay” Policy” (26 March 2009), online <http://www.ccg.ca/media/files/say-on-pay/CCGG%20Engagment%20and%20Say%20on%20Pay%20Policy%2026%2003%202009.pdf>.
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A comprehensive review of executive compensation in Canada is available in the regularly updated loose-leaf book published by Carswell, a Thomson Reuters business, titled “*Executive Compensation: A Director’s Guide*” by Nadine Côté.