A Director's Guide to
EXECUTIVE COMPENSATION

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Executive Compensation under the Spotlight

USA Updates

David Johnson and Ana Fluke, Ernst & Young LLP

In 2010, the United States Congress and regulatory bodies continued to shine the spotlight on executive compensation. This has resulted in new Securities and Exchange Commission (SEC) disclosure requirements related to compensation risk management, and a variety of legislative initiatives, including the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). This article provides a brief overview of some of the key aspects of U.S. legislative and regulatory activities and some of the activities or focus points for most publicly-traded companies.

SEC Final Rule

The SEC adopted enhanced proxy disclosure rules (Final Rule), effective February 28, 2010, which require revisions to the Summary Compensation Table, as well as disclosures regarding risk, compensation and corporate governance in proxy materials. The Final Rule generally requires or influences disclosures in proxy information statements regarding:

- Overall compensation policies and their effect on risk taking
- Director and nominee qualifications and legal proceedings
- The consideration of diversity in director nominations
- Company leadership structure
- The board's role in the risk management process
- Potential conflicts of interest of the company's compensation consultants

The Final Rule, in effect, requires a company to perform an analysis of its broader compensation policies and actual compensation practices for all employees, including non-executive officers to determine if risks arising from those compensation policies or practices are "reasonably likely to have a material adverse effect on the company." A summary of this analysis, as well as findings, may be disclosed in the company's annual proxy filing (actual disclosures and requirements should be addressed with legal counsel).

The Final Rule also lists examples of situations that may create material risks to a company that might not otherwise be readily apparent. For example, com-

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.

Nadine Côté is an employment and executive compensation lawyer at Davis LLP. She is also the author of *Executive Compensation: A Director's Guide*, the first book in Canada on executive compensation.

General Editor & Author
ncote@bell.blackberry.net

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From the Editor

I am excited to present this edition's lead article on compensation updates in the U.S. by U.S. compensation experts, David Johnson and Ana Fluke of Ernst and Young LLP. David and Ana provide a practical overview of the changes in compensation disclosure adopted by the SEC and under the Dodd-Frank Act. This edition also includes a commentary from Michael Bowen of CIBC Wood Gundy outlining the advantages of instituting automatic share disposition plans. — *Nadine Côté LL.B.*

pensation policies and practices at a business unit of a company that represent a significant portion of the company's risk profile, or compensation policies and practices at a business unit that is more profitable than other company business units. It is the responsibility of the company to consider its unique organizational structure, business activities and associated risks which have the potential to materially impact the organization.

In addition, the Final Rule requires additional disclosure about the board's role in the company's risk management process. For example, such disclosure might address whether the individuals responsible for overseeing risk management report directly to the board as a whole or to a committee, and whether and how the board or committee monitors risk.

Dodd-Frank Act

On July 21, 2010, the Dodd-Frank Act was signed into law. Although the portion of the Dodd-Frank Act relating to executive compensation is relatively minimal compared to the entire Dodd- Frank Act, the new requirements make meaningful changes to the overall governance, structure and disclosure of executive compensation. Considering that many of the concepts set forth in the Dodd-Frank Act are new to U.S. stock exchange-listed companies, understanding the practical considerations of the legislation is the key to mapping out a path to compliance.

The Dodd-Frank Act contains an array of executive compensation and corporate governance related rules including, but not limited to, the following:

- Say-on-Pay – Executive compensation and golden parachute advisory vote
- Compensation Committee independence
- Power to hire advisors
- Enhanced executive compensation disclosures
- Clawbacks of incentive compensation

Automatic Share Disposition Plans Insiders Effectively Disposing of Company Shares

Executives often receive a considerable portion of their compensation in the form of stock options and share-based grants. Over the years, a significant amount of their personal wealth may be concentrated in the shares of a single company. Automatic share disposition plans (ASDPs) can assist executives in disposing of the company shares they hold in an organized manner. Also, executives may be able to dispose of the company shares without the constraints of insider trading restrictions and the negative connotation perceived by the broader market when an insider disposes of company shares.

The United States Securities and Exchange Commission (SEC) first introduced rules to govern ASDPs in 2000 by enacting SEC Rule 10b5-1. Pursuant to this rule, trading plans could be established when insiders were not in possession of material, non-public information so they could transact in company stock even if they later became aware of material, non-public information. In essence, a contract with standing instructions could be established that would provide insiders with the future ability to transact the company shares at predetermined prices and volumes. Depending on a company's insider trading policies, this could enable insiders to conduct these transactions during black-out periods.

In 2006, I and other market participants brought this development to the attention of the Ontario Securities Commission (OSC). Subsequently, the OSC released Staff Notice 55-701 – *Automatic Securities Disposition Plans and Automatic Securities Purchase Plans*. The OSC notice sets out various requirements for the establishment of ASDPs by insiders or issuers.

There are many benefits associated with ASDPs. ASDPs can enhance the liquidity of shares held by insiders, which otherwise may be quite limited. When the plans are disclosed to the public, they can enhance the transparency to the broader market participants and reduce negative misperceptions. It is important to keep in mind that there are various complexities and legal requirements that must be considered when implementing ASDPs and proper legal and financial advice should be obtained well in advance.

Michael Bowen is an Investment Advisor with CIBC Wood Gundy in Toronto. The views of Michael Bowen do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada.

- Disclosure of employee/director hedging
- Proxy access
- Broker voting restrictions

The full impact of these reforms will occur over an extended period, and regulatory agencies will need to undertake considerable post-enactment rule-making to clarify the practical impact of the statutory provisions. Companies have been taking steps to evaluate their compensation programs and develop an implementation roadmap to address the compensation-related requirements of the Dodd-Frank Act.

As a result of these regulatory and legislative changes, below is a brief summary of what management and compensation committees are focusing on now:

- **Shareholder "Say-on-Pay."** While the new shareholder "say-on-pay" requirement is generally a blunt instrument for addressing shareholder issues associated with executive compensation policies and programs, it will nevertheless foster a path of continuous reassessment for most companies in terms of compensation policies, transparency around compensation-related actions and increased communication with institutional investors and other key shareholders. The say-on-pay process will be a visible mechanism for investors to express concern with "irritants" in a company's compensation programs and policies.

To help promote improved shareholder understanding and endorsement of the company's compensation programs, in the upcoming proxy, many companies will be emphasizing themes such as:

1) Clearly telling the story of the compensation programs and the rationale for design (e.g., the decisions made, actions taken and why).
2) Discussing how pay is linked to performance and how the metrics utilized are linked to value received by shareholders.
3) Some companies may include an executive summary highlighting specific compensation practices, which further company objectives and are well aligned with shareholder interests. In addition, companies should con-

sider whether more proactive communications with large shareholders are appropriate when significant changes are being considered in executive compensation programs. Going forward, companies will need to disclose the results of the most recent vote and also what actions they have taken to respond to the vote, perhaps putting even more scrutiny on the compensation committee.

- **Incentive compensation risk analysis.** In light of increased scrutiny of executive compensation together with increased focus on risk and risk mitigation, companies are incorporating risk management activities into the organization's overall compensation strategy, not just for the protection of their business operations, but also to respond to investors and other stakeholders. The general public, shareholders, as well as lawmakers have expressed concern that the compensation practices utilized by some public companies for their employee populations (including executives) may subject companies to increased, and in some cases, undue risk.

As a result, many companies have devoted increased attention to compensation risk management and related risk mitigation techniques. In connection with these efforts, companies have begun linking their enterprise risk management efforts to compensation processes and enhancing risk mitigation features in their stock plans and other compensation agreements, such as clawbacks, deferral features, non-competition provisions, holding period requirements, discretion and other features.

- **Role of the compensation committee advisor.** With the enactment of the Dodd-Frank Act and as additional guidance is issued by the SEC, compensation committees may find themselves evaluating emerging governance trends and developing guiding principles in the use of outside consultants. For example, increasing focus on independence and objectivity may create a trend whereby compensation committees and management feel the need to retain separate advisors. While that may or may not be desirable, the ongoing monitoring of objectivity, independence and related protocols for the consultant may well be on future agendas.
- **Clawbacks of incentive compensation.** Under the Dodd-Frank Act, companies must adopt and implement a clawback policy to recover incentive-based compensation (including stock options) from current or former executives during a three-year look-back period. The policy must be applied if the company has to issue an accounting restatement based on erroneous data due to material non-compliance with any financial reporting requirement under the securities laws, regardless of whether the executive was involved in the misconduct that led to the restatement.

Clawback provisions are not a new concept. The clawback provision under the Dodd-Frank Act expands on a clawback provision included in the Sarbanes-Oxley Act (Section 304). Even more recently, under the Troubled Asset Relief Program, financial institutions that received taxpayer money from the Treasury Department were required to put in place a clawback provision that confirmed the company would recover any bonus, retention award or incentive compensation paid to the senior executive officers (e.g. CEO, CFO and three most highly compensated executive officers) and the next 20 highly compensated employees if the payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

What is new for many companies in the current landscape is the focus on how these different risk mitigation features and techniques, such as clawbacks, are evolving to become an integral part of the compensation strategy and risk management framework.

The U.S. legislative and regulatory landscape is continuing to develop relative to executive compensation. The information presented in this summary is intended to serve as an overview of general or emerging practices or themes for your consideration. As the SEC continues to promulgate rules around the Dodd-Frank Act and companies start to review say-on-pay votes in the 2011 proxy season, we are bound to see more executive compensation trends emerge and shine in the spotlight.

David G. Johnson, is the National Service Line Leader - Compensation Strategy & Design, Performance and Reward at Ernst & Young LLP. Ana M. Fluke is a Senior Manager in Performance and Reward at Ernst & Young LLP. Ernst & Young LLP is a global leader in assurance, tax, transaction and advisory services.

The views expressed herein are those of the authors and do not necessarily reflect the view of Ernst & Young, LLP.