A Director's Guide to
EXECUTIVE COMPENSATION

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Updates from Industry Stakeholders

There are an increasing number of interested stakeholders, practitioners and service providers in the executive compensation sphere. This results in an increasingly sophisticated collective knowledge and expertise in executive compensation. As the knowledge and expertise of these groups continues to grow, so too does their expectation of good compensation practices. Consequently, executive compensation continues to be an ever evolving practice area.

Keeping current on what the executive compensation experts have to say can help companies stay at the forefront of the best practices in executive compensation and the benefits associated therewith, such as stable management, stable share prices, positive press and good reputations. This newsletter provides an overview of the recent publications released by various executive compensation stakeholders.

CCGG

The Canadian Coalition for Good Governance (CCGG), a pre-eminent organization representing the interests of institutional investors, published its 2013 Executive Compensation Principles, as an update to its original 2009 publication.[1] These principles are noteworthy and warrant summarizing, along with some of the key commentary on the principles.

1. A significant component of compensation should be 'at risk' and based on performance.
2. Performance should be based on key business metrics aligned with corporate strategy and the period in which the risks are assumed. The business metrics should include single and multi-year financial measures, as well as non-financial measures, such as environmental, social, governance and corporate sustainability measures. Boards should avoid an overreliance on relative total compensation against industry peers, which can lead to ever increasing compensation levels. Instead, compensation should be justified primarily based on performance within the context of the organization. Consideration should be given to the realized value of past compensation awards and the current value of awards in comparison to the value stated in the proxy circular.
3. Executives should build equity in the company to align their interests with the long-term interests of shareholders.

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

This issue reviews some of the recent publications released by executive compensation experts and industry stakeholder, including CCGG, ISS, Glass Lewis & Co., MEDAC, CPPIB and Equilar. Understanding where industry experts are focusing their attention on executive compensation matters can, in turn, help organizations focus their attention on areas where their executive compensation practices may be deficient. Consequently, this enables organizations to make the necessary corrections to establish and maintain good compensation practices before falling under negative public scrutiny.

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— *Nadine Côté LL.B.*

4. Companies that offer pensions, benefits, severance and change-of-control entitlements should ensure those entitlements are not excessive. With respect to supplementary executive retirement plans (SERPs), boards should impose annual limits on the SERP payments to ensure the benefit is reasonable and does not amount to additional non-performance linked compensation.
5. The compensation structure should be simple and easily understood by management, boards and shareholders.
6. Boards and shareholders should actively engage with one another other.

ISS

Institutional Shareholder Services Inc. (ISS), a leading provider of corporate governance solutions, released its 2013 Canadian Corporate Governance Policy Update.[2] The policy provides insightful comments on how ISS recommends shareholders of TSX and TSXV companies vote on various governance matters, such as:

- Board composition, including the need for majority independent boards and committees.
- Compensation, including management say-on-pay resolutions, voting for compensation committee members or equity-based compensation plans when there is a disconnect between CEO pay and company stock performance.
- Shareholder rights and defences, including proposals requiring shareholders to provide 30 to 65 days of notice prior to the annual shareholder meeting of any directors they intend to nominate.
- Social and environmental issues, including labour standards and human rights.

ISS also released its 2013 Canadian Pay for Performance Methodology–Frequently Asked Questions.[3] ISS notes how the Canadian market as reflected by the S&P/TSX Composite Index has struggled to regain its pre-financial crisis levels, whereas executive compensation levels bounced back much faster and have surpassed the pre-crisis levels at many companies. ISS notes how executive compensation practices and the link to company performance and shareholder value remain a key concern to investors. The report explains the Pay for Performance methodology used by ISS to help evaluate the alignment of an executive's pay and a company's performance. The report provides detailed explanations of various aspects of compensation, such as how peer groups are determined.

Glass Lewis & Co

Glass Lewis & Co., a leading, independent governance analysis and proxy voting firm, released its Proxy Paper Guidelines for the 2013 Proxy Season for Canada.[4] The Guidelines include a non-exhaustive list of practices that may be indicative of poor compensation governance, which could lead to a recommendation to vote against a company in its shareholder say-on-pay vote. These practices include:

- Egregious bonuses.

- Executive pay that is comparably high and not reinforced by outstanding company performance.
- Inadequate discussion of the company's approach to risk management, including the absence of features such as clawback mechanisms, anti-hedging policies or executive share ownership guidelines.
- The granting of extra or 'bonus' years of unworked service to determine the benefits to be provided under supplemental executive retirement plans (SERPs).
- Inappropriate peer group or benchmarking issues.
- No disclosed target or maximum variable compensation.

MEDAC

Le Movement d'éducation et de defense des actionnaires (MEDAC), the shareholder advocacy and education movement, filed a shareholder proposal with Canada's banks titled "Fairness of Treatment with Respect to Pension Plans". The shareholder proposal asked the banks to offer pension plans to all employees on the same terms, including the same type of pension and calculation of credited service, the consistent use of salary only to calculate benefits and a fixed age at which benefits become payable.

It is foreseeable that such broad proposals may not be adopted in that specific form. However, the accrual of extra or bonus years of credited service under SERPs has already become a hot topic in executive compensation. Also, MEDAC's comment on the inclusion of compensation other than base salary in determining pension entitlements may get some traction. Often annual bonuses are included in determining executive benefits under SERPs. However, the purpose of annual bonuses is typically to reward executives for their short-term annual performance. The purpose of annual bonus plans is rarely viewed as part of the long-term retention or retirement compensation plans when the bonus plans are established or when bonuses are awarded. Also, it would be unusual for a proxy circular to describe a company's annual bonus plan also as a long-term retention or retirement compensation plan through its inclusion in the SERP calculation. Consequently, as organizations review their compensation practices, they may want to take into consideration the issues being monitored and raised by MEDAC.

CPPIB

The CPP Investment Board (CPPIB), the organization that is responsible for the investment of the assets in the Canada Pension Plan, released its Proxy Voting Principles and Guidelines for 2013. The compensation guidelines and principles include:

- ESPP: Support employee stock purchase plans, the terms of which align employee interests with creating value for shareholders.
- Say-on-Pay: Support shareholder proposals requesting an annual advisory vote on executive compensation.
- Clawbacks: Support shareholder proposals requesting that boards adopt a policy to recoup, for the

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benefit of the company, all performance-based compensation paid to any executive later determined to have engaged in fraud, negligence or willful misconduct that contributed to or resulted in a restatement of financial results.

- SERPs: Support reasonable executive pensions as a component of compensation, along with a reasonable cap to limit the annual amount received. However, do not support excessive SERP benefits.

Equilar

Equilar Inc., an executive compensation research firm, has released several interesting reports recently, including:

- Equilar – An Early Look at Realizable Pay of Some of the Highest Paid CEOs.[5]

This report notes how reviewing only the executive compensation values in the summary compensation table of a proxy circular may paint an incomplete picture of the compensation of the named executive officers. This report notes the importance of reviewing the realizable pay of the named executive officers, that is, the base salary, bonus payouts and the intrinsic value of equity grants, as well as, the values of the compensation awarded to the executives in the summary compensation table.

This report lists the CEOs in the S&P1500 with the highest realizable pay, pursuant to which the realizable pay of John Hammergren, the CEO of McKesson, ranked highest at over US$150 million versus his targeted pay of over US$75 million, while the three-year total shareholder return was 36.8%. The significance of the difference in pay measures is also illustrated by reviewing the realizable pay of Lawrence Ellison, the CEO of Oracle, who had the third highest realizable pay at over US$101 million versus his targeted pay of over US$240 million, while the three-year total shareholder return was 11.5%

- Equilar – Paying the New Boss: Compensation Analysis for Newly Hired CEOs[6]

This report examines the differences between CEOs hired internally versus externally from January 2010 to April 2013. The key findings of this report include:

- Externally hired CEOs received the highest median total compensation package, regardless of the S&P1500 index. The premium paid to externally hired CEOs is approximately 35%, with slight variations depending on whether the organization is a small, mid or large-cap company.
- Smaller companies tend to hire CEOs externally. Small-cap companies hired 40.7% of the total number of new CEOs hired externally, whereas large-cap companies hired only 20.8%.
- The best stepping stones to CEO for internal hires is serving as President and COO in the S&P1500 index and as a division executive in the S&P500.
- Lower performing companies tend to hire CEOs externally. In each of the three main segments of the S&P1500 index, companies that hired a CEO externally had a lower median three-year total shareholder return prior to hiring the new CEO, than companies that had an internally promoted CEO.

- Equilar – 2013 Equity Trends Report[7]

Key findings of this report include:

- Restricted stock grants are at an all-time high. From 2007 to 2012, the percentage of S&P1500 companies granting restricted stock to employees increased from 80% to over 92%.
- The median number of stock options granted by S&P1500 companies fell for the third year in a row.
- The number of S&P1500 companies granting performance based equity continues to rise.

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Endnotes:

1 Canadian Coalition for Good Governance, '2013 Executive Compensation Principles', online: http://www.ccgg.ca/site/ccgg/assets/pdf/ccgg_publication_-_2013_executive_compensation_principles.pdf.

2 Institutional Shareholder Services, '2013 Canadian Corporate Governance Policy Updates', online: http://www.issgovernance.com/files/2013CanadianPolicyUpdates.pdf.

3 Institutional Shareholder Services, '2013 FAQ' online: http://www.issgovernance.com/files/2013CanadianP4PMethodologyFAQ20130123.pdf.

4 Glass Lewis & Co., 'Proxy Paper Guidelines for the 2013 Proxy Season for Canada', online: http://www.glasslewis.com/assets/uploads/2012/02/Abridged_Guidelines_Canada_20131.pdf.

5 Equilar, 'An Early Look at Realizable Pay of some of the Highest Pay CEOs', online: http://www.equilar.com/knowledge-network/research-articles/2013/2013-Equilar-early-look-at-realizable-pay-article.php.

6 Equilar, 'Paying the New Boss: Compensation Analysis for Newly Hired CEOs', online: http://www.equilar.com/knowledge-network/research-articles/2013/pdfs/2013-equilar-ceo-new-hire-compensation.pdf.

7 Equilar, '2013 Equity Trends Report', online: http://www.equilar.com/knowledge-network/research-reports/2013-research-reports/2013-equity-trends-report.php.