EXECUTIVE REMUNERATION PERSPECTIVE
FOR BETTER OR FOR WORSE: SAY ON PAY COMES TO CANADA

CANADA
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Although a shareholder advisory vote on executive compensation, or "say on pay" (SOP), is not mandatory in Canada, many Canadian companies have voluntarily adopted SOP policies. An advisory vote does not bind a company to take action but allows shareholders to provide input on the executive compensation program as set forth in the company's proxy circular. Interest in SOP has grown significantly as Canadians watch how the Dodd-Frank Act's SOP mandate for US public companies has played out over the past three years. The advent of SOP in Canada is not only placing more power in the hands of shareholders but also increasing the influence of the already-powerful proxy advisory firms to influence pay program design and governance practices.

IN THIS ISSUE, ANSWERS TO:

How have Canadian companies responded to the push for say on pay?

What are the proxy advisory firms' voting policies on say-on-pay proposals?

How could the proxy advisors enhance their say-on-pay voting guidelines?

What is the impact of say on pay on plan design and pay decisions?

STATUS OF SOP IN CANADA

SOP has significant momentum in Canada. Over the past few years, 80% of TSX-60 companies have adopted SOP policies. Overall, at least 127 mostly large Canadian companies have adopted SOP and 120 held SOP votes in 2013, with support averaging about 90%. Only three companies failed to receive majority support for their pay programs in 2013, up from one in 2012. One company with a failed vote was "forced" to make changes to its pay programs because of SOP, which is an example of the impact SOP can have on a company's compensation approach.

Some companies have decided to voluntarily adopt SOP in response to the recommendations of the Canadian Coalition for Good Governance (CCGG), which views voluntary SOP as a good governance practice. The CCGG believes an advisory vote fosters improved clarity of proxy disclosure and encourages companies to engage shareholders. The group recommends that Canadian companies adopting SOP and securities regulators use its model resolution to provide clarity for investors and comparability among companies.

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There has been discussion of a mandatory vote in Canada, but many companies do not think that approach is necessary given the substantial amount of support for voluntary adoption. Voluntary adoption has been, in part, a reaction to the US mandate and pressure from shareholders, corporate governance groups, and proxy advisors. In 2010, the Dodd-Frank Act mandated that all US public companies hold nonbinding shareholder votes to approve executive compensation as disclosed in the proxy statement's Compensation Discussion & Analysis and related tables at least once every three years. In addition, shareholders must have an opportunity to vote at least once every six years on whether SOP voting should occur annually, biennially, or triennially.

Although many US pay and governance initiatives eventually travel north, many believe Canada may not require mandatory SOP. In 2011, as part of a review of shareholder rights and corporate governance, the Ontario Securities Commission (OSC) asked for feedback on requiring a SOP vote on executive compensation for all of its reporting companies. Despite asking for input, the OSC has not followed up on this initiative, much to the chagrin of some investor groups.

Institutional investors and investor groups, such as the Shareholder Association for Research and Education and Meritas, typically support SOP and have been pressuring companies to adopt a policy. However, there is at least one notable exception. The Ontario Teachers' Pension Plan believes it is not the responsibility of shareholders to advise the board on compensation decisions and that a majority-vote standard combined with individual director elections eliminates the need for a mandatory advisory vote on pay.

PROXY ADVISORS ON SOP

The two major proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis & Co., typically support adoption of SOP policies and have developed guidelines to determine vote recommendations for SOP proposals. Under these policies, they may recommend shareholders vote against a SOP proposal and, in some cases, withhold votes from board nominees when a company has poor pay-for-performance alignment or problematic pay practices.

GLASS LEWIS

Glass Lewis takes a case-by-case "highly nuanced" approach to analyzing SOP proposals in Canada. The proxy advisor supports an annual SOP vote and, in analyzing SOP proposals, it focuses on four areas: overall design and structure of pay programs; quality and content of disclosure; amounts paid to executives; and the pay and performance link. Companies are considered within the context of industry, size, financial condition, historical pay-for-performance practices, and other mitigating factors. Examples of problematic pay and disclosure practices that could lead to a negative vote recommendation include insufficient disclosure; excessive incentives or severance payments; guaranteed bonuses; high pay compared to company performance; and inappropriate benchmarking. Companies that maintain poor pay policies year after year may also receive recommendations against compensation committee members.

ISS

ISS adopted a new Canadian pay-for-performance policy in 2013, similar to the US policy, for determining its vote recommendations on SOP. The analysis compares CEO pay to absolute and relative total shareholder return (TSR) over a period of up to five years using three different quantitative tests. ISS will generally recommend (i) against management SOP proposals, (ii) against or withhold votes on compensation committee members (or, in rare cases, the full board — including the CEO), or (iii) against equity plans if there is "significant long-term misalignment" between CEO pay and company performance.

The pay-for-performance analysis includes three quantitative tests for assessing pay and performance alignment. Two are relative peer group tests and one measures absolute alignment:

- Relative degree of misalignment — the difference between the company's TSR rank and its CEO's total pay rank within the peer group of 11–24 companies over a three-year period. (The "relative degree of alignment" test was modified for 2014 to consider a three-year period only, instead of both one- and three-year periods.)

- Multiple of median — the total compensation in the last reported financial year relative to the median compensation of the peer group.

- CEO pay-to-TSR alignment — the difference between absolute pay changes and TSR changes during the prior five-year period.

ISS establishes its own peer groups for determining relative pay and performance under these tests. The peer groups are based on companies that (i) had revenue (assets for financial services companies) between one-quarter and four times the subject company's size, (ii) were in the closest Global Industry Classification Standard (GICS) industry group (eight-, six-, four-, or two-digit) to the company's GICS category, and (ii) had market capitalization between one-quarter and four times the company's market value, using four market cap "buckets." For very large or small companies, a customized peer group may be used.

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Companies flagged as having potential pay-for-performance misalignment under the quantitative tests receive a qualitative assessment, considering, among other things:

- The ratio of performance-to time-based equity grants and the overall mix of performance-based compensation relative to total compensation.

- The quality of disclosures and appropriateness of the performance measures and goals.

- The trend in other financial metrics, including growth in revenue, earnings, and return measures, such as return on equity, return on assets, and return on invested capital.

- The trend relative to prior years' pay-for-performance concern.

- Extraordinary situations due to the hiring of a new CEO.

CONCERNS RAISED BY ISS POLICIES

SOP has placed a significant amount of power in the hands of the proxy advisory firms to influence pay plan design and governance practices. Companies have raised concerns about the one-size-fits-all approach to SOP voting recommendations and lack of transparency in the vote recommendation process. Glass Lewis takes a black-box approach to determining its voting recommendations, so it is difficult to understand what factors are considered. However, since the ISS process is more transparent, it is easier to identify areas that may be different from how a company views its pay/performance relationship. Concerns have been raised about the ISS peer group selection process, overreliance on short-term TSR, and its failure to consider realizable pay in Canada.

PEER GROUP SELECTION

A critical aspect of any pay-for-performance review is to ensure that pay comparisons are made to an appropriate group of competitor organizations. Peer group development requires more analysis than simply comparing revenue size, market capitalization, and GICS codes. The ISS methodology for selecting peer companies may not accurately reflect a company's actual competitors for talent, performance, and investor dollars.

In response to concerns raised by US companies regarding the 2012 peer selection process, ISS changed its US policies to consider a company's self-selected peer group and the GICS industry groups represented by the company's self-selected peers. The process is designed to select peers that are closest to the company in terms of revenue or assets and industry and market cap, prioritizing those that keep the company near the median of the peer group, are in the company's own selected peer group, and have chosen the company as a peer. However, this change was not included in the 2014 policy updates for Canada. Incorporating this change into the Canadian policy would result in a more appropriate peer group and provide investors with a better understanding of how the company's compensation committee evaluated relative pay-for-performance when determining the CEO's pay package.

ISS does not include US companies when selecting peers for Canadian companies, which may produce fewer than the desired 11–24 companies. For example, one Canadian company tried to replicate a peer group applying the ISS model, but only eight companies resulted from the simulation — two of which were not in the company's line of business. Many Canadian companies have significant operations in the US and compete with US companies for talent. And similar to the issue raised earlier, using only Canadian companies for the peer assessment could exclude true competitors and produce too few peers. Several large Canadian companies have a significant presence in the US and few similar companies of like-size in Canada.

RELIANCE ON TSR

Although ISS's new three-year period for analyzing TSR and CEO rank that will be used in 2014 gives more weight to the longer term than its prior one-year and three-year test, it still places significant focus on the starting point of the three-year period. ISS believes the change makes the test simpler, provides a better view of long-term pay-and-performance alignment, and avoids skewed results from periods of volatility. With the elimination of the one-year period, companies whose relative performance improved over the three years will likely do worse under the new test than the old one and vice versa. Also, since many companies' pay plans are tied to measures other than relative TSR over a three-year period, it is only one view of the pay-for-performance relationship and may not measure the metrics most important to a company's business success and the long-term interests of shareholders.

REALIZABLE PAY ANALYSIS

ISS should consider including realizable pay as one of its "key factors" in its qualitative analysis under the Canadian policies, and including realizable pay in its research reports, as it does for large US companies (S&P 1500). Focusing on the total compensation figure included in the proxy circular's summary compensation table, which values equity awards at their grant date fair value, fails to take into account that those amounts may never actually be received or realized by the executives. For example, if stock price declines, options may become underwater and equity compensation may lose a portion of its value — which demonstrates pay-for-performance alignment. Providing institutional investors with realizable pay figures would help them determine whether companies are truly paying for performance.

"COMPANIES THAT HAVE ADOPTED SOP SHOULD EXPLAIN IN THEIR PROXY CIRCULARS HOW THEY RESPONDED TO SOP RESULTS EACH YEAR, INCLUDING ANY CHANGES MADE TO PAY PROGRAMS, DISCLOSURE ENHANCEMENTS, AND SHAREHOLDER ENGAGEMENT."

DISCLOSING SOP RESULTS AND SHAREHOLDER ENGAGEMENT

Companies that have adopted SOP should explain in their proxy circulars how they responded to SOP results each year, including any changes made to pay programs, disclosure enhancements, and shareholder engagement. In the US, SEC rules require companies to describe in their proxy statements how the results of previous SOP votes factored into pay decisions. In Canada, in a new ISS voting policy for 2014, the proxy advisor will consider a company's failure to respond to previous SOP proposals that received less than 70% support when it evaluates ballot items related to executive pay (as in the US). Examples of an appropriate board response include disclosure of engagement efforts on the issues that contributed to the low levels of support, specific actions taken to address these issues, and greater rationale for pay practices.

IMPACT OF SOP

Although SOP is not required in Canada, it is still possible to see trends and potential long-term ramifications among voluntary adopters and to extrapolate from the experience in the US. There is clearly greater accountability for pay and governance decisions and incremental changes in pay practices resulting from SOP. But some changes may have unintended effects that could ultimately have negative consequences if companies simply fall into line with proxy advisor policies without tailoring their pay and governance practices to their own needs and circumstances. For example:

- Companies are eliminating problematic pay practices, such as tax gross-ups and excessive perquisites, to respond to shareholder and proxy advisor concerns. However, in some cases, companies may be replacing these takeaways with higher salary or larger bonuses, potentially leading to higher pay.

- Companies may be adopting clawback and hedging policies, stock ownership guidelines, and other shareholder-friendly policies without fully understanding how they will be implemented.

- Companies may feel pressure to add relative TSR to their long-term incentive plans, or to adopt it as the primary metric, largely because TSR drives ISS pay-for-performance test results. However, this may not be the best metric for each company and could result in incentivizing executive behavior contrary to a company's primary business objectives.

- Companies are continuing to replace stock options with other equity vehicles, in part because ISS does not consider stock options with service-based vesting to be performance based. This move may be inappropriate for some companies, particularly high-growth start-ups.

Concerns about pay levels and pay and governance practices will likely be raised again in 2014, and leading this push are institutional investors and proxy advisors, whose influence is apt to increase as more companies adopt SOP. As the impact of the proxy advisors' policies is felt in Canada, more questions about potential conflicts of interest, data accuracy, and lack of transparency at these firms are also crossing the border.

"CONCERNS ABOUT PAY LEVELS AND PAY AND GOVERNANCE PRACTICES WILL LIKELY BE RAISED AGAIN IN 2014, AND LEADING THIS PUSH ARE INSTITUTIONAL INVESTORS AND PROXY ADVISORS, WHOSE INFLUENCE IS APT TO INCREASE AS MORE COMPANIES ADOPT SOP."

ADDITIONAL RESOURCES

To learn more about some of the topics discussed in this article, see our prior US *Perspective* issues:

- Proxy Season 2014: Moving Beyond The Mandates (January 2014).
- Proposed Pay Ratio Rule: Mercer Recommendations Would Reduce Costs, Improve Consistency (January 2014).
- The Role of Realized and Realizable Pay in Disclosure, Performance Measurement, and Compensation Planning (December 2013).

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