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Briefing

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CSA Proposed Changes to Executive Compensation Disclosure

Introduction

On November 19, 2010 the Canadian Securities Administrators (CSA) issued proposals to amend the current executive compensation disclosure rules. The proposals are open for comment until February 17, 2011, with the changes intended to become effective for the 2012 proxy season. In this briefing we discuss the key proposed changes and their implications for compensation committees if adopted.

Implication of Proposed Changes

If enacted, the proposals should not involve significant changes for companies that have already focused on the issues covered by the proposals. For others, certain of the proposals, discussed below, may call for some changes and will require the direct attention of the compensation committee. Challenging decisions may have to be made with respect to both disclosure and the practices that will be the subject of that disclosure.

Perhaps the biggest challenge for companies will be the proposed risk related disclosure. The practice of explicitly incorporating risk considerations into compensation is still in its infancy, with the exception perhaps of financial institutions. To avoid boilerplate and hence meaningless disclosure, boards will have to start now to take a hard look at this difficult area and begin to put processes in place to make the incorporation of risk into compensation decisions a reality.

While it is too early to anticipate the final form of the proposals that will follow the comment process (reaction to date has been muted), it is likely that most of the proposals will survive in some form. Given that the changes will not be in place until 2012, companies should have sufficient lead time to consider the issues and take appropriate steps to prepare regardless of the outcome. We outline those steps below.

Summary of Key Proposed Changes

While there are many changes being proposed, the substantive changes that we believe will be of most interest are:

- Clarification of use of "seriously prejudice" exemption for disclosure of performance targets
- Disclosure of risk management in relation to compensation practices
- Compensation governance
    - disclosure of relevant skills and experience of compensation committee members
    - expanded disclosure of compensation consultants' services and fees

The additional proposed changes are described in the attached appendix.

Review of Key Proposed Changes

Exemptions from Disclosure of Performance Targets

The requirement to disclose performance targets unless "serious prejudice" can be shown is one of the most contentious aspects of the current executive compensation disclosure rules that were introduced at the end of 2008 and it continues to cause some consternation among some issuers. Many companies choose not to disclose specific targets, often without explicitly relying on the exemption, an option which would appear to no longer be available if the proposed changes become effective.

The proposed changes would make clear that the use of broad corporate-level financial performance metrics such as EPS, revenue growth and EBITDA will not in itself be sufficient to qualify for the exemption. Over the past two proxy seasons, many companies have taken the position that the disclosure of such targets, even if disclosed "after the fact", would in itself cause competitive harm without explaining how this harm would come about. For compensation committees that continue to grapple with the issue of whether or not to disclose performance targets, and which ones, adoption of the changes would provide guidance, welcome or otherwise, and help to end the inconsistent application of the current rules.

Compensation committees will want to prepare by reviewing their company's practices with respect to the disclosure of performance targets in order to determine whether changes would be required in the event the provisions are adopted as proposed. This could be time sensitive for performance goal setting in respect of fiscal 2011 given the CSA's clarification of its expectations for more complete disclosure of such performance goals in 2012.

Disclosure of Compensation Related Risk Management

Under the proposed changes, companies must disclose whether the board considered the implications of the risks associated with the company's compensation policies and practices and, if so, further disclosure is required concerning the board's oversight role and the practices in place to monitor compensation related risk.

The proposals are the CSA's response to the increasing focus in the last two years on the need to integrate risk oversight into executive compensation practices. While this focus was originally on financial institutions and the concern that some of their compensation practices encourage excessive risk taking, we now see expectations emerging on the part of shareholders and some regulators that all companies should be incorporating more explicitly a consideration of risk when structuring compensation, so as to avoid promoting inappropriate risk taking. Most commonly, this is expressed as the need to align payout under compensation plans with the actual time horizon of risks undertaken by management in the achievement of strategic goals (see for example, the 2009 SEC executive compensation disclosure changes as well as the CCGG's Principles of Executive Compensation). Accordingly, we are seeing the increased use of deferred incentives, along with the wider adoption of clawbacks and forfeiture provisions to back up the long-term focus.

The CSA has provided examples of the sorts of practices that it believes could lead to inappropriate or excessive risk taking, such as the use of performance goals that are heavily weighted to short-term rather than long-term objectives. While the examples are helpful, they do not assist boards with the difficult task of determining how to incorporate risk management into performance goals themselves, which will of course vary from company to company and industry to industry and which, even within the financial services industry, is proving challenging. Some of the more straightforward examples we have seen include resource companies incorporating environmental and safety metrics into performance goals.

Note that the proposed risk provisions extend beyond compensation related to named executive officers, to include compensation for any "individual at a principal business unit or division". The proposed changes would see the discussion of risk as it relates to compensation included in the CD&A, currently restricted to a discussion of named executive officers. This differs from the US, where the SEC ultimately decided not to include mandated risk discussion in the CD&A.

Clearly, the proposal to adopt this rule, supported by the existence of similar rules in the US, should strongly motivate boards to establish or review oversight practices that identify and mitigate risks associated with compensation policies and practices. Boards will want to avoid having to disclose that there are less than robust processes in place in the event the proposal becomes a reality.

There are several practical steps compensation committees can take to prepare that make sense, given the current focus on risk and compensation, regardless of whether the proposals are ultimately adopted as drafted.

- Establish or review *processes* for monitoring the incorporation of risk into compensation practices, e.g. regular dialogue between the risk committee and the compensation committee
- Review the need for *mechanisms* to link time horizon of risk with payouts, e.g. clawbacks and deferred compensation
- Ensure proper mix of variable and fixed compensation to avoid encouraging a focus on 'the big win'
- Ensure incentives are appropriately weighted between short term and long term objectives to avoid focus on short term goals at the expense of long term shareholder interests
- Forward-looking testing of compensation plans to assess possible results under different scenarios
- Historical lookbacks to understand how plans have performed to date

Compensation Governance – Compensation Committee Expertise

The proposed changes would require disclosure of the levels of relevant expertise and experience of the compensation committee, similar to the sorts of information that the SEC began to require about directors more generally in the SEC rules enacted in December 2009.

These proposed disclosure requirements reflect the increasing importance and attention attached to compensation matters by both shareholders and regulators, as well as an acknowledgment of the complexity of the issues with which the compensation committee must deal. The same factors are reflected in the increased fees that are starting to be paid to compensation committee chairs and members, similar in scope to what is paid in relation to the audit committee.

In response to the proposed changes, boards will want to ensure that the compensation committee is composed of members that collectively have the required level of expertise and experience in compensation matters or that there are plans in place to bring the committee to that level. Note that the proposals do not require that all committee members have the same level of expertise; rather the concern is with the committee as a functioning entity.

In preparation for the possible adoption of the proposals, compensation committees should assess the combined skills and experience of compensation committee and the need for development of those skills, and perhaps the addition of new members who will bring the requisite levels of expertise and experience.

Compensation Governance - Compensation Consultants' Services and Fees

The proposed rules would require detailed disclosure which goes beyond that currently mandated whenever a compensation consultant is retained to assist the directors or compensation committee with executive or director compensation. Specifically, if additional non-executive compensation services have been provided by the consultant or any of its affiliates (for example, actuarial, pension administration, human resources support etc.), disclosure of:

- Whether the committee must pre-approve the other services the consultant, or any of its affiliates, performs for the company at the request of management
- The aggregate fees billed by the consultant, or any affiliates, for services related to executive or director compensation, and
- Under separate caption, the aggregate fees billed for all other services provided by the consultant, and any affiliates, along with a description of the nature of the services

Much of this disclosure is already best practice in Canada and is similar to what is now mandated by the SEC. For many companies however, adoption of the proposed rules will mean taking a look at the level of independence of compensation consultants used by the board and the practices set up to ensure that independence.

The proposed rule differs from the US rule in that in the US there is no requirement to disclose fees at all unless the consultant has also provided non-executive compensation services exceeding $150,000. Under the proposed rules, fees must be disclosed whenever the board or compensation committee has retained a compensation consultant.

Conclusion

Regardless of whether the proposals are ultimately adopted, in their current form or otherwise, directors and compensation committee members will want to take the time now to consider the issues raised and formulate their position with respect to those issues. In the event that those positions are at odds with the proposals in their current form, committees should consider submitting a comment letter to the CSA expressing their views by the February 17, 2011 deadline.

Appendix

Additional Proposed Changes to Executive Compensation Disclosure

1. Disclose whether or not an NEO or director can hedge equity securities of the company granted as compensation or held directly or indirectly
2. Disclose whether directors can exercise discretion to award compensation when performance goals are not attained or to reduce or increase the size of an award and whether, and in relation to which named executive officers, such discretion was exercised
3. Disclose future significant changes to compensation policies planned for the next year
4. The language in the current rules that speaks of the purpose of the disclosure being to communicate what the "board of directors *intended* the company to pay, make payable..." etc., has been removed and replaced simply with what "the company paid, made payable..." etc.
5. Disclose market value of vested share-based awards that have not yet been paid (in new column added to outstanding equity-based awards table)
6. Disclose methodology used to determine grant date fair value regardless of whether it differs from accounting fair value
7. Additional columns may not be added to the Summary Compensation Table, although additional tables may be added
8. Plain language requirement: information must be clear, concise and presented in such a way that "a reasonable person, applying reasonable effort" can understand:
    - how compensation decisions are made, and
    - how specific compensation relates to the overall stewardship and governance of the company
9. A formula is provided for purposes of quantifying annual lifetime pension benefits for the defined benefits plan table
10. Clarification that incremental payments on termination may be disclosed in a table
11. Any RRSP contribution made by the company and not reported in the defined contribution plans table must be disclosed as "other" in the Summary Compensation Table
12. Amounts must be disclosed either in Canadian currency or in the same currency that the company uses for its financial statements
13. Disclose all compensation paid to an NEO or director by an external management company for services provided to the company, its parent or a subsidiary.

What should Boards and Compensation Committees Do?

The following practical steps can be taken by boards and compensation committees in order to prepare for the changes coming in 2012:

- Review practice with respect to disclosure of performance targets to determine whether changes will be required
- Clarify practice with respect to the exercise of discretion with respect to performance targets and/or payouts
- Establish or review processes for monitoring the incorporation of risk into compensation practices, e.g., regular dialogue between the risk committee and the compensation committee
- Review need for mechanisms to link time horizon of risk with payouts, e.g., clawbacks and deferred compensation
- Ensure proper mix of variable and fixed compensation to avoid encouraging a focus on 'the big win'
- Ensure incentives appropriately weighted between short term and long term objectives to avoid focus on short term at the expense of long term shareholder interests
- Forward-looking testing of compensation plans to assess possible results under different scenarios
- Historical lookbacks to understand how plans have performed to date
- Assess combined skills and experience of compensation committee and the need for development of those skills and perhaps the addition of new members who will bring requisite levels of expertise and experience
- Review independence of compensation consultants and procedures in place for ensuring independence and be prepared to disclose all fees.

For further information or to schedule a discussion about this topic, please contact any one of the following consultants:

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Hugessen Consulting is an independent consulting firm dedicated to meeting the executive compensation consulting requirements of boards and their compensation committees. With offices in Toronto and Calgary, the firm's mission is to be the leading provider of advice on executive compensation, performance measurement and assessment, and related governance to the compensation committees of medium and large companies in Canada, the U.S., and the U.K.

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