

April 2009

# Say on Pay in Canada

## *Implementation and Implications*

### Introduction

Seemingly overnight, “Say on Pay” is becoming a part of the corporate governance landscape for a number of major Canadian companies and their shareholders. Within the month of March (2009), proposals to give shareholders an annual, non-binding vote on executive compensation were adopted by ten prominent Canadian companies, including each of the six largest chartered banks. After receiving strong but below majority support from shareholders in 2008, Say on Pay proposals have yet to be defeated at the targeted organizations this year, with voting still to come at several companies.

Given that Say on Pay (SOP) proposals for 2009 only targeted 15 Canadian companies, it remains to be seen how broadly SOP will be adopted next year, although support among the shareholder community, and increasingly the director community, appears to be more and more widespread. Notably, as the momentum for Say on Pay grew, the Canadian Coalition for Good Governance (CCGG) publicly changed its position on March 26 to now “[recommend] that all boards follow this best practice”. Meanwhile, a growing number of directors, regardless of their position on Say on Pay, feel it is only a matter of time before it becomes pervasive, at least among larger issuers.

While the move to SOP was not completely unexpected, the speed and breadth of its adoption is creating some uncertainty, and in many cases, apprehension, among boards and shareholders alike. Even for those large issuers and major shareholders who have maintained an ongoing dialogue on governance and compensation issues in recent years, SOP promises to bring about a new paradigm, not to mention for issuers and shareholders who have had little or no history of engagement. Directors and investors

alike are working to assess what it really means, and to contemplate what, if anything, should be done or changed to prepare for the new SOP environment in Canada.

The purpose of this article is not to debate the merits of Say on Pay, but to examine what SOP means for directors and for shareholders in the immediate future (that is, preparing for the first such vote in 2010), and the possible longer term ramifications it may have on corporate governance and compensation practices in Canada.

## **Central Questions: What Will Shareholders Vote On and How to Decide How to Vote?**

### **What to Vote On**

Although Say on Pay appears to be a singular initiative, there were in fact two separate proposals submitted by two separate activist shareholders, Meritas/SHARE and MÉDAC. The two proposals differ in terms of what is being subjected to a shareholder vote: the MÉDAC proposal asks that “the executive compensation policy be subject to an advisory vote”; the Meritas proposal seeks to “ratify the report of the Human Resources Committee set forth in the proxy statement”. While the wording of the proposals differs, the end result, with respect to what shareholders will be asked to vote on, may ultimately be the same, if the experience of other countries that have adopted Say of Pay is any indication.

The United Kingdom provides a long-established example of Say on Pay, with government legislation bringing shareholder advisory votes on executive compensation into effect in 2003. All publicly traded corporations in the U.K. (except for those on the Alternative Investment Market) must comply. What U.K. shareholders vote on is the Directors’ Remuneration Report, a document similar to the Compensation Discussion and Analysis found in the proxy circulars of North American companies. An essential difference is that the report is authored exclusively by the board, rather than by management. At the annual general meeting, each company is required to put forward a resolution seeking shareholders’ approval of the Directors’ Remuneration Report. A

resolution typically states nothing more than simply “to approve the directors’ remuneration report for the year”.<sup>1</sup>

While its experience with Say on Pay is still evolving, the U.S. provides another, perhaps more relevant, reference point for Canada. As is the case in Canada, Say on Pay was a shareholders-driven initiative rather than a universal requirement mandated by the government. In the first year of Say on Pay in 2008, six U.S. companies held advisory votes. That number will increase dramatically in the current 2009 proxy season as several hundred companies will hold Say on Pay votes, mostly as a requirement for receiving financial assistance under the Troubled Asset Relief Program (TARP).

A scan of the 2009 proxies of this new group of Say on Pay adoptees shows that most of them are using common language found in the proxies of early adopters such as AFLAC and H&R Block. Shareholders are typically asked to approve one general resolution, with such wording as “resolved, that the shareholders approve the overall executive pay-for-performance compensation policies and procedures employed by the Company, as described in the Compensation Discussion and Analysis and the tabular disclosure regarding named executive officer compensation”.

Based on the U.K. and U.S. experience, we expect that shareholders will likely end up voting on a compensation report similar to the CD&A and its accompanying tabular compensation disclosure, since that is the information made available to them in the proxy. As for the specific language of the approval resolution, since any shareholder can propose “say on pay” voting language, institutional shareholders may want to take the lead in defining a standard form for Say on Pay votes. Indeed, the CCGG has stated that it intends to “publish a model form of shareholder resolution (after consulting with legal experts and leading companies) for boards to consider using for their next annual meetings”.

### **Deciding How to Vote**

To date, Canadian shareholders have generally not had to opine on compensation committee reports. With no standards in place and no agreed criteria on which to base SOP decisions, what follows are some thoughts on actions that Canadian institutional

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<sup>1</sup> Stephen Davis, *Does ‘Say On Pay’ Work? Lessons on Making CEO Compensation Accountable*

shareholders and SOP issuers will likely have to consider over the next year, the first year for SOP in Canada.

## **Implications for Institutional Shareholders**

### **Issues and Concerns**

While much of the initial debate was over the impact of Say on Pay on Canada's larger public issuers, there may actually be greater implications for institutional shareholders. Until now, the CCGG and its members have confined their issuer-specific comments on compensation to disclosure (via a scoring system) and a relatively few high profile interventions where they felt performance and pay were clearly misaligned. With SOP, however, every institutional shareholder will need to decide "yes" or "no" vote for every issuer with SOP, or risk appearing derelict in their duties as shareholders.

Shareholders are thus faced with the prospect of having to evaluate at first (in 2010) a dozen or so, and then perhaps hundreds of, individual compensation policies. For even the largest institutional shareholders, there is limited capacity to carry out such a task.

Beyond the issue of manpower, there is also the issue of costs. For institutions that currently engage a select number of issuers on compensation issues, the aggregate cost of engagement is substantial but undefined. If instead a shared capability is developed and funded, the cost will become explicit. If the U.K. experience is anything to go by, the cost will be substantially more than what is currently expended on the CCGG.

### **What Might Shareholders Do?**

In order for SOP to work well, we believe shareholders will likely need to seek agreement on what to vote on and on what basis to make these decisions. The first step is to achieve consensus and develop a uniform approach amongst themselves, and with issuers and boards. To that end, and as noted above, the CCGG has stated it intends to publish a model form of shareholder resolution and board Say on Pay policy.

The CCGG's response seems to bear out our view that, since SOP is a shareholder initiative, the onus is on shareholders to set the ground rules, both in terms of process and policy. On process, there is a need to define procedures for communication and engagement – who will be involved, when and how often, and what method will be used. Will each issuer discuss compensation issues with one major shareholder at a time or

with a consortium of shareholders? Which individuals, from management, the board, and the shareholders, will be represented? Will the discussion take place before the Say on Pay vote, or only after an unsatisfactory voting result? Will the discussion be in the form of in-person meetings, written statements or surveys, or some other method?

On policy, there is a need to establish which principles and practices should be supported, and which ones opposed. To see what direction Canadian institutional shareholders may take on this critical issue, it is perhaps instructive to examine the scenario in the U.K. and the emerging developments in the U.S. In the more compliance-driven environment in the U.K., standards of good practice in executive compensation are documented by the regulators (the Financial Reporting Council, in its Combined Code on Corporate Governance) and by major institutional shareholders (the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) both issue influential guidelines on remuneration). In addition, both the ABI and the NAPF provide closely watched voting recommendations on directors' remuneration report through the voting services they are affiliated with (the IVIS for ABI and RREV for NAPF).

In the U.S., government and the regulators have generally refrained from prescribing code of standards for compensation practices and policies, although that appears to be changing. In the meantime, amongst institutional shareholders and proxy advisors, RiskMetrics published a policy paper, "Evaluating U.S. Company Management Say on Pay Proposals" in March, while various organizations such as TIAA-CREF and Glass Lewis have put forward guidelines for evaluating CD&As. It remains to be seen whether any organization will become the standard bearer in the U.S. as the ABI, NAPF, and their guidelines have become in the U.K. The same question can be asked in Canada, with the CCGG and its Principles for Executive Compensation as perhaps the most likely candidate.

To meet the responsibility that comes with Say on Pay, individual shareholders in Canada will need to decide how best to perform the necessary functions of engaging and communicating with issuers, setting criteria for voting, and reading and analyzing proxies. Their major alternatives include:

- Building in-house expertise
- Combining resources with other institutional shareholders, perhaps under the auspices of an organization such as CCGG
- Relying on third-party advisors (e.g. Risk Metrics and Glass Lewis)
- Some combination of the above

In making the decision, each shareholder will likely be weighing the tradeoffs between having control of the process versus costs, and can be expected to choose to act according to the importance they place on executive compensation and their Say on Pay vote.

### How Much Work Is Say on Pay?

Canadian shareholders can once again look to the U.K. to get a sense of the scope involved in implementing universal Say on Pay. The ABI's IVIS voting service has a staff of five individuals who spend the majority of their time on Say on Pay and remuneration matters. The team covers about 700 companies and is involved in approximately 250 consultations with issuers each year. It organizes consultations on behalf of institutional shareholders as well as participating directly in some consultations.

## Implications for Directors of Public Issuers Adopting Say on Pay

### Issues and Concerns

Directors of Canada's first wave of Say on Pay issuers are acutely aware that their decisions, and related rationale and process, will now be subject to a very public review. With no specific criteria currently available, some companies are concerned not only about an advisory vote rejection and the negative repercussions it will have for the reputation of the board, but also the prospect that they could still end up with little understanding of what caused a "no" vote.

The pressure associated with additional scrutiny and accountability will be disproportionately placed upon the compensation committee chairs and members, even though typically many key compensation decisions are ultimately made by the entire board. Compensation committees find themselves in a politically similar position as audit committees in the wake of Enron and other accounting scandals, but with less clear rules and principles. Say on Pay will likely bring a shift in board dynamics, and we can reasonably expect fewer instances in which the board overrules the committee to approve compensation packages and policies that are more favourable for management.

What seems certain is that board members in general and compensation committee members in particular can be expected to spend more time and effort to study existing and proposed compensation plans and recommendations, as well as to communicate and, if necessary, defend their decisions to shareholders.

### **What Can Directors and Issuers Do?**

Although we believe most of the onus in the early days is on the shareholders, issuers would likely be well advised to work with shareholders to help set the ground rules for implementing Say on Pay, and to take the initiative to do so if they wish to have some input into the agenda. Between now and the advisory vote in 2010, we expect a significant increase in issuer-initiated dialogue with shareholders on compensation.

Initially, issuers who have had limited history of engagement with investors on compensation will likely want to better understand the shareholder community's general views of their existing practices and reporting. On a go-forward basis, issuers will likely want to seek input from shareholders before making significant changes, as has been the case in the U.K. Some practical steps that companies may wish to pursue include:<sup>2</sup>

- Start with a common sense review of policies and disclosure, considering both from the point of view of investors having to cast votes
- Identify the company's largest shareholders and other key influencers who have the capacity to sway investor and public opinion on compensation matters
- Identify practices and policies that may conflict with the views of key stakeholders and develop a compelling rationale for current policies and practices; if unable to develop such a rationale, put the policy or practice up for review
- Prepare an outreach plan and consult shareholders (including a sampling of small/retail investors, if possible) before the compensation report is finalized. Engagement tactics might include:

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<sup>2</sup> Adapted from Stephen Davis, *Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable*

- the chair of the compensation committee offering meetings with key shareholders and with the advisors of both the shareholders and the issuer
- road shows pitched to fund officials responsible for corporate governance
- hosting webcasts/conference calls for interested investors during which concerns and critical comments are encouraged
- responding to investor letters and calls
- having company officials speak at conferences and forums on executive pay philosophy and metrics

Canadian directors are in an advantageous position of being able to observe and learn from the Say on Pay votes due to take place for the first time at a large number of American companies (mostly TARP recipients). In the same way Canadian executive compensation disclosure rules benefitted from the lessons gleaned from the SEC disclosure rules that preceded them, much can be learned about the implementation of Say on Pay during the upcoming proxy season south of the border. Canadian companies should monitor companies' communications practices to find out what works well and what doesn't, and take note of voting trends to gauge investors' views and sentiments.

### **Potential Impact on Compensation Practices**

The impact of Say on Pay on corporate governance and compensation practices has been the subject of intense debate between its supporters and opponents. Partly based on the arguments of both sides, we venture to offer a forecast of how Say on Pay may impact executive compensation in Canada.

Say on Pay can be expected to result in an increase in dialogue on executive compensation for directors, management, and investors, both amongst themselves and with each other. Up until now, discussions on executive compensation with shareholders have primarily been limited to a few leading organizations and to issuers who have egregious practices, severe performance issues, or both. With Say on Pay, we anticipate that virtually all companies will likely have regular conversations with a broader base of shareholders as a matter of course. The increased dialogue and scrutiny will probably have little impact on the policies and practices of companies that currently have sound

compensation systems, but should bring about changes for companies that currently do not follow a rigorous compensation decision-making process. In particular, SOP will likely curtail ad hoc decision making by boards. Advisory votes in the U.K. have been credited for better aligning pay with performance, and they should have a similar impact in Canada.

The increased importance of the CD&A, as the likely basis upon which most investors decide their Say on Pay vote (regardless of what the resolution actually asks), may also lead to improved executive compensation disclosure. Disclosure will likely evolve to give greater clarity and details in order to meet the heightened need for investors to understand and evaluate.

On the other hand, Say on Pay may bring about several negative consequences. A key contention of Say on Pay opponents is that executive compensation is far too complex and nuanced for investors to assess with a simple yes/no non-binding vote, and is best left to the judgment of directors who have intimate knowledge of the business and who make their decisions after considerable amount of time and effort. There is a risk that, faced with the unpleasant prospect of a “no” vote, directors may become more inclined to conform to commonly accepted standards and practices, rather than putting forward seemingly unorthodox solutions that may best address the specific needs of the company. As a result, SOP may engender a one-size-fits-all mentality, stifling innovative and potentially more effective compensation practices. The U.K. experience offers some evidence of this tendency to conform to the prevailing best practices and norms; for example, most companies, across all industries, use TSR as a long term incentive performance measure.

Another possible negative outcome is that Say on Pay may end up taking away the very ability it aims to give shareholders: an effective way to voice their view on executive pay. As discussed earlier, few investors have the necessary resources and expertise to diligently evaluate hundreds of compensation plans and proposals. Overwhelmed with the task, it is possible that many shareholders will become disengaged from the voting process, “outsourcing” it to groups or advisors with “tick the box” answers and potential conflict of interest issues. The enormous influence wielded by IVIS and RREV in the U.K. underscores the importance of carefully selecting decision support for Say on Pay voting.

As to whether Say on Pay will affect the size of executive compensation in Canada, the prognosis is uncertain. Six years into its implementation, Say on Pay has not reduced compensation levels in the U.K., although some observers feel it may have helped to slow the rate of increase. In any event, lowering the absolute level of executive pay was not a stated goal of the advisory vote, notwithstanding the sentiments of the public to see executive pay levels reduced. Given the other factors at work in the current market environment, however, Say on Pay may well be a factor in dampening executive pay levels.

## Conclusions

With the focus on Say on Pay having shifted from a debate of its merits to effective implementation, we highlighted some issues to consider in addressing the central questions of what shareholders will vote on and how they will make their voting decision. In our view, the ball is in shareholders' court. However, as it is the board of directors whose judgment and decisions are being subjected to a public vote of confidence, we believe it would be wise to be a proactive partner in helping to shape this process and make it work, regardless of whether one is, or is not, an advocate of Say on Pay.

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