Say on Pay

Where Are We Heading in North America?

By Gary Finch and Elif McDonald

During our most recent lectures at The Directors College and HRCC Specialist meetings, it became abundantly clear that Say on Pay is a key issue for discussion amongst Board members. Where is Say on Pay going in North America? What are the most recent developments on the issue? With feedback from The Canadian Coalition for Good Governance and the Toronto Stock Exchange and TSX Venture Exchange, we have compiled this article aiming to provide clarity on the issue.

Driven by the threat of an extended global recession and fears of a double-dip in the markets, shareholders are directing their frustration and anger at corporations and their Boards. Investors rely on the Board of Directors to be accountable and help manage the performance of the company, including executive performance-based compensation. If shareholders no longer feel the Boards are fulfilling their responsibilities, armed with votes, they will demand governments or others take action.

The recent financial crisis exposed executive pay plans at some global financial institutions tied to short-term financial incentives that lead to excessive risk taking, such as overleveraging and credit default swaps, which helped pave the path to financial chaos. These executive compensation plans were approved by Boards of Directors at the time, and included significant risk for short-term gain.

In the United States, shareholders are voicing their concerns loudly vis-à-vis the Say on Pay bill, especially in the wake of massive bonus payouts at previous TARP recipients announced in the fall of 2009.

In the UK, France and Germany in response to public outcry, a super-tax of 50% will be imposed on cash bonuses over €27,000 (US$39,700) at firms that received public funds in 2009.

Now, more than ever, Board members must understand their responsibilities in a changing environment of Board ***fiduciary responsibility and liability***.

> **"Boards must clarify what they are paying their CEO's for."**
> *William Donaldson – Former Chairman, U.S. Securities and Exchange Commission*

Wall Street and Washington

Recently, some high-profile TARP recipient Wall Street firms announced massive bonus payments to their executives, and were met with a very angry response from not only shareholders, but outraged citizens as well. In a bid to quell public anger, some large financial institutions including Goldman Sachs decided to eliminate cash bonuses for their top executives, and are offering shareholders a chance to vote on compensation programs.

Creating legislation also creates the opportunity to work around the legislation.

In December 2009, the SEC approved new rules aimed at improving corporate disclosures regarding risk, compensation and corporate governance matters, such as "true" performance-based compensation. The Obama administration also imposed pay curbs, restricting the salaries and bonuses of the executives of TARP recipient firms, as long as they owed the government money. Eight financial institutions have since paid back their debt. Most of the repayment was done with capital raised from the issuance of equity securities and debt not guaranteed by the US federal government.

The method of repayment of TARP funds to obtain bonuses eerily echoes the pattern of risky behavior taken by Executives to meet short-term goals in the past. Have the goals set out by the Government to achieve bonuses replaced those set by Boards?

Washington appears to be sending mixed messages. Kenneth Feinberg, who was appointed at the Department of the Treasury to manage compensation issues for companies receiving federal bailout money, and has been able to slash the pay of the top 25 executives at TARP recipient firms by 90% from 2008 levels, said he hoped other companies will follow his changes, but that "it's not the government's place to impose any laws on executive compensation".

How Much Do Shareholders Understand Executive Pay?

Despite current sentiment, allowing shareholders Say on Pay cannot guarantee a quick turnaround in corporate performance. There is no magic wand that will restore portfolio wealth to pre-recession levels. Most investors, while they may follow stock quotes daily in the media, do not regularly attend AGMs and do not actively read the proxy statements, or have enough management experience to review and make decisions on corporate pay structures.

However, there have been clear examples of shareholder revolt in recent history. In May 2003, GlaxoSmithKline shareholders in the UK voted 50.72% against a £22mln bonus salary and stock severance package for Jean-Pierre Garnier, CEO.

Given the inherent complexity of pay plans, allowing shareholders a position to vote may create bigger problems for Boards and corporations. Preparing a pay plan involves a tremendous amount of market research, including competitor analysis, studying peer group data, sifting and sorting through thousands of pages of proxy statements and public disclosures. This information must then be normalized, assessed, reviewed and then translated and applied into company-specific pay plan structures.

Setting the appropriate peer group, for example, is one variable that is important in preparing executive compensation plans. It is not as simple as assessing a company based on where it sits in a stock market sector, rather it is product of diligent research, review and analysis that unless done properly can completely produce the wrong peer group and wrong pay results.

Executive Compensation Plans are Highly Complex With Specialized Components Tailored to the Individual Corporation

Executive Compensation Plans Should Reflect:

Accurate peer group determination

Normalized financial data and peer group performance assessment

Appropriate benchmarking and pay-for-performance assessment compared to peer group

Base, Short, Medium and Long-term Incentive Plan assessments and financial performance link

Incentive Plan Design in compliance with Governance Principles

Forward and backward testing of incentive plan payouts to corporate performance

Changing the pay structure at the Executive level may also upset the entire pay dynamic for the company and the industry. This ripple effect could create the need for modification to areas that were not directly linked to pay, but will have to be adjusted as part of the broader restructuring needed to reflect changes. This could end up costing the companies millions of dollars in restructuring fees and charges, thereby negate any gains, turning the exercise into a zero-sum game.

A third party, independent Executive Compensation Advisor is the best way to eliminate conflict of interest issues. Ideally, the independent advisor would have restricted access to the Executive teams. The independent advisor would report directly to the Board of Directors and be paid directly by the Board. This would satisfy the recent SEC rulings on independent advisor positions and conflict of interest issues. (Final Rule: Proxy Disclosure Enhancements, Exchange Act Rel. No. 34-61175, December 16, 2009)

Say on Pay in Canada

The TMX Group, which operates Canada's two national stock exchanges, does not have any listing requirements in place for listed issuers on Say on Pay, nor do the TSX/TSXV have any plans to introduce any Say on Pay rules for issuers in the immediate future. They are keeping a watchful eye out for what is developing abroad and how other markets are taking action.

The position of the TSX/TSXV reflects the current domestic status quo. Canada was one of the very few and fortunate nations that did not have to provide bail-outs for financial firms. Canada is, technically speaking, out of the economic recession. (Bank of Canada Monetary Policy Report, July 2009)

Furthermore, unlike other nations, shareholder citizens and politicians have not taken aim at corporations or the Canadian financial industry, which is generally regarded as well regulated.

For the TSX/TSXV, there are challenges that surround enforcing Say on Pay and implementing them for exchange listed issuers that vary in size and scale. While larger companies, such as those on the TSX 60, may have the resources to implement this process, smaller corporations may see Say on Pay as an onerous and costly inclusion. Listing requirements have to be fair and applicable.

It is important to note that many corporations in Canada raise capital in the United States as multi-listed companies. As a consequence, many have moved towards increased disclosure based on SEC guidelines. Say on Pay may become inherent in their governance disclosure, and may be a function of waiting for US legislation.

Canada has a long history of following market regulation changes in the United States and applying them domestically. For Canadian regulators to ignore Say on Pay legislation and changes in the United States would be ignoring historical precedent.

Who protects the investors, if not the market operators and regulators in Canada?

Evolutionary Wave of Governance

The Canadian Coalition for Good Governance (CCGG) was formed to promote good governance practices in the companies owned by group members. Generally, these companies are members of the S&P/TSX Composite Index. Coalition members believe that good governance practices contribute to a company's ability to create value for its shareholders at lower risk levels.

The CCGG recommends that "boards voluntarily add to each annual meeting agenda a shareholder advisory vote on the company's report on executive compensation".

In January 2010, the CCGG released a model "Say on Pay" policy for Boards of Directors. This policy was developed after significant discussions with the issuers who have publicly announced that they will be holding "Say on Pay" shareholder advisory votes in 2010, their advisors and other shareholder groups.

Stephen Griggs, the Executive Director of the Canadian Coalition for Good Governance believes that "in the Canadian marketplace, we are anywhere from 5-7 years away from having complete Say on Pay legislation". As a result, the coalition advocates a voluntary approach on Say on Pay.

As Boards take on the role of helping advise and steward the corporation, we support the Canadian Coalition for Good Governance in opening the communication pathway between the Board and stakeholders, in preference to existing management and stakeholders.

If Say on Pay does become law, boards must be alert and be actively prepared to act accordingly. Boards have the opportunity and motivation to actively review and revise their executive pay plans now. Taking no action could be the costliest approach for Boards.

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