



“Say on Pay” gains traction in Canada

Introduction

“Say on pay” is gaining traction in Canada. The term “say on pay” generally refers to the ability of shareholders to vote on an annual basis to approve the report of an issuer’s compensation committee. Such advisory votes are typically non-binding resolutions that do not determine whether specific compensation programs or plans will be approved. Rather, they serve as a barometer of shareholder support for compensation policies as presented by the issuer’s compensation committee each year in its proxy.

In recent days, shareholder proposals to adopt a shareholder advisory vote on executive compensation received record levels of support at CIBC (45%), RBC (42%), BMO (34%) and BNS (39%). Clearly, this is an issue that resonates with Canadian shareholders. Not only are such levels of support unheard of for a first time shareholder proposal in Canada but the support appears to be substantially unrelated to the performance of the target issuer. What does this mean for executive compensation in Canada?

Background

A brief review of the history of “say on pay” is instructive. Its adoption through regulation in the U.K. in 2003 has provided an opportunity for observers to assess the impact of implementing such a vote. Most U.K. stakeholders (shareholders, management and directors, proxy advisors and media) agree that the results have been generally positive and less intrusive than some observers had anticipated. The clarity of executive compensation disclosure has improved since issuers now know that shareholders will be deciding how to cast their advisory votes based largely on what they read in the annual shareholder meeting materials; dialogue between issuers and shareholders on executive compensation has increased; and CEO compensation has become more closely aligned with company performance.

Certainly, the disruptive influence that many feared has not materialized. In the years between 2002 and 2007, only 64 out of the approximately 600 companies

that reported voting results received more than a 20% dissent vote (negative plus abstentions) and only eight received majority dissent.

Since 2003 the practice has spread. Australia has also adopted an advisory vote and The Netherlands, Sweden, Norway, Spain and France (2009) have gone further and have prescribed annual *binding* votes on executive compensation.

In the U.S., “say on pay” appears to have broad support and to be gathering momentum. 2006 was the first year that shareholder proposals on the issue were submitted at U.S. companies and the results were significant: the six proposals received an average support of 40% of the votes. In 2007 over 60 proposals were submitted and the average support was around 43%. At seven U.S. companies shareholder proposals on advisory votes received majority votes in favour last year, and several of these companies, including Verizon, subsequently adopted an advisory vote. Another issuer, Aflac, announced it would voluntarily adopt a vote in 2009 after a proposal on the topic was submitted.

Further evidence of support for “say on pay” in the U.S. includes a bill passed by the House of Representatives, by a strong bipartisan majority, that would require all listed companies to implement advisory votes on pay; an identical bill is pending in the Senate. Both leading candidates for the Democratic presidential nomination have expressed their support publicly for the bills and the initiative has strong support from institutional shareholder representative groups and proxy advisory services such as the Council of Institutional Investors, ISS and Glass Lewis. In addition, Yale’s Millstein Center for Corporate Governance and Performance recently released a draft policy briefing with a thoughtful and generally supportive analysis of advisory votes (see http://millstein.som.yale.edu/davis_say_on_pay_policy_briefing.pdf).

The Canadian Experience

Last year was the first year that an advisory vote on executive compensation appeared on the scene in Canada. In 2007, the Shareholder Association for Research and Education (SHARE) wrote to six financial services companies on behalf of Meritas Mutual Funds, to request that they consider adopting an advisory vote. Meritas went on to file shareholder proposals on the issue for the 2008 proxy season at the five major Canadian banks. As of March 5, 2008, the voting results for four of these proposals are known, averaging about 40% support. Such results will strengthen the likelihood, already strong, that “say on pay” proposals will spread to other major Canadian public issuers next year.

Support for these proposals was undoubtedly helped along by the positive recommendation made by ISS Canada, the country's leading proxy advisory firm, to vote in favour. Its recommendation was essentially a cautious endorsement, however, given that it stated that its main reason for recommending a vote in favour was to ensure that the proposal received sufficient votes to qualify for re-submission next year. Shareholder proposals must receive at least 3% of the votes in favour in order to be resubmitted the following year. In this context it is worth pointing out again how unusually high are the percentages of votes in favour of these proposals; it is unusual for shareholder proposals to receive even 15-20% of the votes cast.

Action on "say on pay" was not restricted to Meritas: in 2007 fund manager Ethical Funds sent a letter, not a shareholder proposal, to each of the TSX 60 issuers requesting that they consider the adoption of a shareholder advisory vote on executive compensation.

In January 2008 the Canadian Coalition for Good Governance publicly stated that it does not support "say on pay" at this time: "Canadian companies are already making strides to improve executive compensation practices, address disclosure issues and improve shareholder involvement," the organization observed, concluding that "regulations of this kind are not the answer..." Such developments include the continued adoption of majority voting for director elections, combined with individual votes for directors, which allow shareholders to express their concerns over issues such as executive compensation by withholding votes (e.g. for the Chair of the Compensation Committee); the introduction of new CSA requirements for compensation disclosure; an overall improvement in compensation disclosure practices since last proxy season; and the increasing role of independent executive compensation advisors in the compensation process.

In our discussions with private and institutional shareholders and their representatives, Hugessen detected a notable divergence from CCGG's view among smaller and mid-sized private and institutional shareholders, who widely favour a shareholder advisory vote on executive compensation. The difference would appear to be in part attributable to the demonstrated ability of the largest institutions (CCGG's core membership) to directly engage issuers in discussions about compensation concerns, a channel typically not available to smaller shareholders.

Other observers, including many executives and directors, share the views expressed by CCGG and offer several arguments against the adoption of an advisory vote:

- Setting executive compensation is the directors' duty under law; shareholders would be micromanaging
- Allowing a shareholder advisory vote on executive compensation will open a floodgate of advisory votes on other issues
- Non-binding votes could lead to legal uncertainties
- A concern with winning the approval of shareholders will lead directors to adopt plans based on optics rather than effectiveness
- Shareholders already have the ability to express their disapproval about compensation matters through the shareholder proposal mechanism

What should boards do? Potential responses and actions

The first step for any board will be to ensure its members are thoroughly informed on the issue as soon as possible. For example:

- Review the banks' proxy circulars to see the various responses to the Meritas proposal along with the proposal itself
- Read the briefing published by the Millstein Center for Corporate Governance and Performance (see above for link)
- Convene an informational session of the board on this topic; an issuer's compensation or governance advisor should be able to prepare an overview
- Talk with major shareholders to canvas their views
- Prepare a position paper and/or Q & A for use at this year's annual shareholder meeting since the topic may be a focus of shareholder attention even in the absence of a shareholder proposal being submitted

Boards will next want to develop a strategy for addressing this issue going forward. Possible strategies might include one of the following:

1. Oppose the adoption of a shareholder advisory vote while supporting existing best practices, and plan to adopt the practice only if mandated through regulation or otherwise. In the meantime, work to improve executive compensation disclosure and maintain a dialogue with key shareholders in an attempt to dissuade shareholders from pursuing an advisory vote.

2. Remain open to the idea that the current movement towards an advisory vote may soon culminate in its adoption, either by regulation or evolution of best practices, and begin to prepare for putting one into effect.
3. Respond proactively to the issue and become an early adopter of an advisory vote, as Aflac did in the U.S.

Conclusion

Shareholder advisory votes on executive compensation are a significant part of the corporate governance landscape in many jurisdictions, more broadly accepted in some than others. It is too early to say whether they will become a permanent fixture in Canada, but the time to develop a response is clearly now.

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