

Institutional shareholder and regulator issues with executive compensation

What's happening next, and how will it impact Canadian issuers?

Introduction

Many companies have worked hard over the last several years to meet the increasing demands of shareholders and regulators. Changes have been made in a significant number of areas, including:

- The use of stock options has been reduced
- The use of stock options for directors has been all but eliminated among large issuers
- Disclosure of executive and directors compensation has improved
- Majority voting is increasing (65 Canadian issuers have adopted some form of it)
- Board accountability for executive compensation has improved

In this context, one could be forgiven for thinking that the bulk of the hard work in this area has now been completed; for some issuers, however, it may be just beginning. What happens in the U.S. is often a bellwether for Canada, so it is worth taking note of a set of emerging shareholder and regulatory trends, some of which may be tougher for issuers to deal with than the changes to date have been. Indeed, some observers feel that the latest demands (e.g. advisory votes on executive compensation) constitute a usurpation of board authority by shareholders and regulators, and should therefore be resisted.

These demands include:

1. SEC letters requiring, among many other things, disclosure of specific performance targets (p.1)
2. Shareholder advisory vote on executive compensation (“say on pay”) (p.4)
3. Various shareholder proposals calling for more explicit links between pay and performance (p.5)
4. Various shareholder proposals to cap SERPs and other retirement perks (p.6)
5. Containment of change of control and severance plans, and of “pay for failure” (p.6)
6. Clawbacks of compensation in cases of misconduct or restatements (p.8)

1. SEC letters requiring disclosure of specific performance targets, sent to major issuers in August & September 2007

- In 2006, the SEC implemented new disclosure regulations that required a significantly greater amount of detail regarding executive compensation and executive compensation decision-making.
- Since the new regulations came into force, the SEC’s Corporate Finance division has been analyzing hundreds of proxy statements as part of its “targeted review project”.

- In late August and early September, the SEC faxed comment letters to nearly 300 CEOs, including Coca Cola, Pfizer, Bristol Myers Squibb, General Electric, Schering-Plough, and Prudential Financial, asking for clarifications and details on information provided in those companies' CD&As.
- Though the letters cover a range of issues – including the setting of severance payments, the rationale behind compensation mix, and the role of compensation consultants (for more details on the letters, see the Aug 30th Frederic W. Cook memo at http://www.fwcook.com/pub_date.html) – one of the biggest issues concerned the level of disclosure of performance targets used to determine incentive compensation. John White, director of the Corporate Finance division, complained in an August 14 speech that “we’re seeing a lot of really vague disclosure in this area about ‘individual performance goals and targets’ without further discussion”.
- Many companies have held back information about their specific numerical targets, arguing that to disclose them would result in “competitive harm”, as is allowed for under the regulations. The SEC, while acknowledging that such cases could exist, is demanding that either (a) issuers disclose quantitative and qualitative performance targets in future filings; or (b) issuers both justify their decision to withhold this information, and provide a full description of how difficult their undisclosed performance targets will be to achieve.
- It should be noted that issuers must base their decision to withhold information only “on the established standards for what constitutes confidential commercial or financial information” (i.e. Exemption 4 protection under the Freedom of Information Act, covering the likelihood of “substantial competitive harm”), standards which have been addressed and evolved in case law since the mid-1970s. The SEC is making it clear that their compensation disclosure regulations do not lower the bar in regards to this test.
- Although disclosure of performance targets is normally considered an exercise dealing in retrospective information only (i.e. referring to the targets used in the most-recently-ended fiscal year), the SEC is asking some issuers to disclose changes to those targets in the current fiscal year (i.e. prospective information). This will almost certainly increase issuer concern over the likelihood of competitive harm.
- As the next step in the SEC’s normal back-and-forth process, issuer responses to the letters are expected by Sept 21 (or one month after receipt); the letters and their responses will be made public later this autumn. In the project’s second phase, the SEC will issue a report on its findings that will provide guidelines for the vast majority of issuers who were not reviewed. “Sometime this fall” is the best prediction of publishing date the SEC can offer for now (as of mid-September 2007).
- In the meantime, U.S. issuers will need to decide on their response. According to the Wall Street Journal, “Companies are racing to set up emergency meetings of their board compensation committees to answer the questions.”
- There is a significant level of opposition to the idea of providing specific performance targets. The HR Policy Association, for example, argues that such targets are “typically proprietary”, disclosure of which “can cause substantial competitive harm”. As Michael Melbinger recently observed in his CompensationStandards.com blog: “This is likely to be a battleground issue during the comment process, as a groundswell of resistance is building.”

- One implication of such disclosure, apart from whatever competitive harm is being claimed, is that the specificity of performance target information will lead to closer shareholder scrutiny of the targets themselves and the processes by which they are set – including the role of management in recommending the targets they will have to meet and the effectiveness of the board’s evaluation of such recommendations.

Implications for boards:

In Canada, current CSA/OSC regulations allow issuers to withhold “confidential information” about performance targets without requiring specific justification, but proposed regulations would parallel the SEC’s approach by allowing the withholding of “objective, identifiable measures” only if disclosure “would result in competitive harm to the company”. However, implementation of these proposals has been postponed until mid-2008 at the earliest.

Despite this delay, it is likely that increased U.S. scrutiny of performance targets and their link to compensation and the compensation-setting process will result in similar pressures for transparency in Canada, whether this pressure is expressed in regulatory action or more directly through shareholder activism. In their responses to the CSA’s proposed regulations, for example, major Canadian institutional shareholders were virtually unanimous in their support for the disclosure of specific performance targets.

Boards will want to ensure their processes for approving both the choice of performance measures and the standards of performance required to earn awards are robust, aligned with strategy, and display some reasonable level of independence from management.

Update: SEC report on initial review of compensation disclosure

On October 9, the SEC released a report on its initial review of the executive compensation disclosure of 350 public companies (most of which received the SEC comment letters discussed above). Written by the SEC’s Corporate Finance staff, it highlights two principle themes:

1. That CD&As need to be “focused on *how* and *why* a company arrives at specific executive compensation decisions and policies... The focus should be on helping the reader understand the basis and the context for granting different types and amounts of executive compensation.” As in the SEC letters, the report calls for the disclosure of specific performance targets.
2. That clear presentation matters. “The executive compensation rules require companies to disclose a great deal of information. Techniques such as providing an executive summary, or creating tables or charts tailored to a company’s particular executive compensation program, can make the disclosure more useful and meaningful.”

In general the SEC seems happy with the good faith efforts of public companies to adhere to the new disclosure rules, and is thus able to focus its comments on improving particular aspects of communication and on the disclosure of more of the facts lying behind specific compensation decisions.

For more details

SEC press release: <http://www.sec.gov/news/press/2007/2007-214.htm>

SEC report: <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>

Several members of the SEC’s staff are to provide further context in public appearances during the week of October 9th to 12th. Once posted, these speeches can be accessed at:

- Corporate Finance staff: <http://www.sec.gov/divisions/corpfin/cfspeeches.shtml>
- SEC Chairman and Commissioners: <http://www.sec.gov/news/speech.shtml>

2. Shareholder advisory vote on executive compensation (“Say on Pay”)

Over the last decade, institutional shareholders have become increasingly assertive about acquiring meaningful input into some of the fundamental issues that affect them as owners. Attempts to increase the dialogue between shareholders, management, and the board have taken the form of a push for the adoption of majority voting for directors, for example, and of the increased use of the shareholder proposal mechanism.

Of particular concern to shareholders, given the very public excesses of recent years, is executive compensation, in both its magnitude and in the seeming failure to establish a link between pay and performance. One of the major developments over the last few years has been the move to give shareholders an advisory vote on executive compensation, also known as “say on pay”. This issue seems to have “legs”, given both the speed with which it has become a focal point of debate and the enthusiasm it generates among shareholders, along with its generally constructive impact in the U.K., where it was adopted in 2003. Advisory votes have also been adopted in Australia, Sweden and the Netherlands.

Typically, an advisory vote would provide shareholders with the opportunity to vote for or against a non-binding annual resolution on the compensation committee’s report (however, in the Netherlands the vote is binding). It would not give shareholders input into the specifics of executive compensation policies.

The U.S. experience over the last two years shows the momentum of this issue:

- It was the shareholder proposal initiative with the strongest push last year: more than 60 proposals with average shareholder support of around 43% (an extremely high number for any shareholder proposal, let alone a new one)
- Five companies received majority votes in favour last year (Blockbuster, Motorola, Verizon, J.C. Penny and Ingersoll Rand)
- Legislation requiring an advisory vote (the “Shareholder Vote on Executive Compensation Act”) was passed by Congress with a 2-to-1 margin on April 20, 2007, and is currently being considered by the Senate’s Banking, Housing, and Urban Affairs Committee and has not yet been scheduled for debate.
- In February 2007, Aflac became the first U.S. company to agree to implement an advisory vote on compensation, to be implemented with its 2009 proxy. Aflac did so after receiving a proposal from long-time shareholder Boston Common Asset Management and other shareholders; Aflac CEO Dan Amos said the decision was “in keeping with Aflac’s longstanding pay-for-performance compensation policy and our commitment to transparency at all levels.”

We can also look to the U.K. experience to get a sense of how such a vote actually works in practice:

- The vote has been in place in the U.K. since 2003.
- Generally considered to be less of an issue than may have been anticipated by all parties involved: shareholders and their representative groups, issuers, regulators, and proxy advisors.
- The vote’s most significant impact: it has apparently increased shareholder dialogue and has increased links between pay and performance.

- Contrary to what many expected, it has not been a problem for the vast majority of issuers; since adoption, only around 11% of advisory resolutions have received less than 80% positive votes, and very few resolutions have failed to gain approval (i.e. failed to receive at least 50% support).

In Canada, the issue has just arrived:

- In early summer 2007, six financial institutions received letters from shareholder representative group SHARE asking the issuers to adopt an advisory vote.
- No shareholder proposals on an advisory vote have been submitted to date in Canada.
- Institutional shareholders we contacted are generally in favour (e.g. OMERS, CPPIB).
- CCGG does not yet (as of mid-September 2007) have a published position on the issue.

Implications for boards:

The momentum which this issue continues to show suggests that compensation committees may want to consider their position with respect to advisory votes sooner rather than later. They may also want to consider what their policy will be prior to actually receiving an advisory vote proposal, including addressing the question of whether the company wants to voluntarily adopt an advisory vote mechanism as Aflac did.

3. Linking Executive Pay to Performance

In the last few years in the U.S. and Canada there have been numerous shareholder proposals encouraging boards to establish a stronger link between executive pay and performance:

- In 2007 there were more than 60 proposals filed in the U.S. calling for companies to more closely link executive pay and company performance, making this the second most frequently filed proposal after majority voting, with average support levels of around 35%.
- Twelve pay-for-performance proposals in the U.S. were withdrawn, indicating that companies are more willing to engage with stockholders in selecting performance metrics.
- The number of pay-for-performance proposals submitted to Canadian companies in 2007 is 15, twice 2004's amount, with support going as high as approximately 40%.

Implications for boards:

Compensation committees may want to consider in advance how they would respond to the submission of a pay-for-performance shareholder proposal at their own companies. These proposals, in conjunction with the SEC initiative, again suggest that compensation committees will want to ensure their performance-based compensation processes are robust, strategy-based, and demonstrate an appropriate level of independence from management.

4. Move to Cap Supplemental Executive Retirement Plans and Other Retirement Perquisites

As part of the overall focus on executive compensation, continuing attention is being paid to the role of Supplemental Executive Retirement Plans (SERPs) in increasing total compensation without any connection to corporate or individual performance and, until recently, with virtually no disclosure of related costs and liabilities. SERPs are sometimes viewed as compensation “by stealth” because, while leading-edge issuers provide full disclosure of their SERPs’ true cost, there remain many issuers who do not.

There have been a range of proposals by institutional shareholders and others on ways to cap SERP excesses:

- Impose an absolute cap, not a proportion of salary
- SERPs should not include special provisions that are not available to an issuer’s general workforce (such as credit for years of service not actually earned)
- Long term incentive compensation should not be included for purposes of calculating pension benefits. The Council of Institutional Investors, a U.S. institutional shareholder representative group, holds that annual bonuses should also be excluded.
- There should be no special perquisites in retirement (e.g. apartments, cars) since executives are highly compensated employees who should be able to cover the costs of their own retirements

Implications for boards:

Compensation committees will want to ensure they have a complete understanding of their companies’ SERPs. They should be aware both of the optics and the true cost of SERPs when considering either their adoption or amendment, should review the level of disclosure in their most recent proxy circular to ensure that such disclosure is complete and meaningful.

Despite calls for greater equality of pension provisions between executives and a company’s general workforce, committees may find it difficult to eliminate all special arrangements for senior executives (e.g. crediting years of service not earned) particularly when recruiting mid-career hires who may be forfeiting retirement benefits when they leave their current employer.

Finally, committees should take note of the fact that the Canada Revenue Agency has recently confirmed its position that SERPs may be subject to the salary deferral arrangement rules under the Income Tax Act if the benefits provided are considered to be “unreasonable” (e.g. to provide higher benefits as a percentage of cash compensation than those in place for other employees), a decision that would result in negative tax consequences for the recipient.

5. Containment of change of control and severance plans, and of “pay for failure”

Severance and change in control (CIC) payments continue to attract investor and media scrutiny. The example on everyone’s tongue has been Bob Nardelli, the former CEO of Home Depot who left that company in January 2007 with a now-fabled \$210 million package; though doubling sales and profits between 2000 and 2005, Nardelli left the company’s stock at the same price he found it on his arrival. To angry shareholders and many critics, this constituted “pay for failure”.

It should be noted, however, that most of Nardelli’s \$210 million was not a “severance payment”,

but was made up of the following components:

- a cash severance payment of \$20 million (equal to about 3X salary and bonus)
- the acceleration of unvested deferred stock awards currently valued at approximately \$77 million and unvested options with an intrinsic value of approximately \$7 million
- the payment of earned bonuses and long-term incentive awards of approximately \$9 million
- the payment of account balances under the Company's 401(k) plan and other benefit programs currently valued at approximately \$2 million
- the payment of previously earned and vested deferred shares with an approximate value of \$44 million
- the payment of the present value of retirement benefits currently valued at approximately \$32 million
- the payment of \$18 million for other entitlements under his contract which will be paid over a four year period and will be forfeited if he does not honor his contractual obligations

There are increasing worries over directors' personal liability for payments to departing CEOs. Morgan Stanley's board faces a lawsuit for breach of fiduciary duty over payments received by outgoing CEO Phillip Purcell and co-president Stephen Crawford (who got a golden parachute payment of \$32 million after being in his role for only 3½ months).

Of the recent letters sent to major issuers by the SEC, as part of its executive compensation disclosure review project, a high proportion asked for further details on how payment levels for severance and CIC were determined.

Implications for boards:

In Canada, the CSA's disclosure rules have largely followed the SEC's own regulatory changes, so severance and CIC payments will only become more transparent to Canadian investors. Canadian boards would therefore be well-advised to review their practices in light of the following possible remedies:

- Focus on the original purpose of severance and CIC. Severance pay is meant to tide an executive over until he or she can find a new job, to compensate an incoming executive for the risks of moving to a new company, to remove the need for the board and the executive to negotiate severance terms on an ad hoc basis, and to minimize the risk of litigation. CIC payments are meant to retain key management and mitigate their personal concerns about employment security through a CIC, by providing them severance protection, a CIC notwithstanding.
- The "tiding-over" period should be limited (consider a year or two at most).
- Once the personal risk borne by a new executive hire has decreased with time, say over five years (the Council of Institutional Investors recommends three), a severance plan may no longer be needed.

- Base pay for the purposes of severance/CIC multipliers needs to be considered in each case. As a general rule, and in recognition of Canadian common law, the inclusion of annual salary plus target or historic annual bonus is generally appropriate, whereas the inclusion of LTI is almost never appropriate. Additionally, many companies have established maximum multipliers, and require shareholder approvals of agreements exceeding such amounts.
- Determine how much wealth has already been transferred to an executive by preparing tally sheets. Severance payments may look redundant in the light of millions of dollars of vested options and restricted stock, and could reasonably be scrapped.
- Similar to tally sheets, “walk-away” charts should be prepared that show all of the payments an executive will receive should he or she leave the firm tomorrow. The eight distinct payments that Bob Nardelli received from Home Depot (outlined above) should give a good sense of how comprehensive such a chart could be.
- Work towards the elimination of single triggers in CIC and associated LTI plans. “Double-triggered” means that compensation is payable only (1) after a control change actually takes place and (2) if the executive is terminated (or deemed terminated) within 2 or 3 years following the control change. Boards should be careful to review the relevant LTI provisions, because even in double-triggered CIC plans, the suspension of all restrictions on unvested stock and options is often single-triggered by the control change itself. As soon as possible, this should be changed to a double trigger and non-vested equity roll-over provisions should be put in place.
- Do it right the first time. In the cases of both Home Depot’s Bob Nardelli and Morgan Stanley’s Purcell and Crawford, the original fault lies in the contracts that the boards offered these executives to recruit them. Wrote Allan Sloan of Newsweek earlier this year: “The time to have the debate over CEO compensation isn’t when the CEO is fired. It’s when he’s hired.”
- If you got it wrong, fix it. Do not hide behind contracts. If an executive was hired with a contract authorizing severance and CIC payments that in hindsight are clearly unwarranted, the board should do what it can to correct this situation so that it does not find itself liable down the road. Good executives will agree with the board’s view of the problem, and will help to solve it: GE’s Jeffrey Immelt, Northern Trust’s William Osborn, and Wachovia’s Kennedy Thompson are all examples of CEOs who gave up their severance arrangements due to lack of personal need and shareholder concerns – leading a broader trend to eliminate or at least reduce (e.g. by getting rid of 280(g) gross-ups) potential CIC payments.

6. Clawbacks – Recoupment of Pay Following Financial Restatement

Clawback provisions enable an issuer to recoup variable compensation from senior executives if the issuer’s financials are restated or if there has been financial malfeasance that executives benefited from. While clawback policies have long supported non-compete and anti-soliciting provisions in employment contracts, in the wake of numerous corporate disasters in the early part of the decade they have come to be seen as a way to address unjust enrichment by executives in the face of corporate failure resulting from misconduct.

In the U.S., the adoption of clawback policies is seen as the result of newly assertive boards. In

fact, at some issuers the clawback provision is in the compensation committee charter, and is not merely adopted as policy.

As evidence of its strength in the U.S.:

- A form of clawback provision was included in the Sarbanes-Oxley Act: Section 304 requires the CEO and CFO to reimburse the company for any bonus or incentive-based compensation received and any profits realized from securities sales during the 12 months following a restatement due to misconduct.
- Legislation has been proposed to broaden clawbacks to any option income realized, regardless of the presence of misconduct.
- Many companies have provisions broader than the SOX requirement. Kraft Foods mandates the recoupment of bonus and option or sale-of-share gains, plus the cancellation of restricted stock.
- Six U.S. companies received clawback-related shareholder proposals in 2007, averaging 35.5% support. Two proposals received majority support (Motorola, Wyeth) in 2007.
- An ISS (RiskMetrics) 2006 survey found overwhelming institutional support for clawbacks.

Canadian experience to date:

- There are few Canadian companies with clawbacks (examples: Brookfield Asset Management, Nortel Networks, CIBC)
- CCGG strongly supports including provisions in senior executive agreements for the “disgorgement” of all performance-related compensation in the event of a restatement.
- The ICD’s Blue Ribbon Commission on the Governance of Executive Compensation in Canada recommends the clawback of bonuses and LTIP payments in cases of malfeasance or significant accounting adjustments.

While clawbacks may be a good idea in theory, however, there are issues with respect to their enforceability:

- Equity plans and agreements are contracts and it may therefore be difficult to recoup monies paid under such contracts without initiating legal battles.
- Monies will be harder to recoup if the clawback does not rely on intentional misconduct.
- Monies will be harder to recoup if compensation has already been received and taxes paid on it.
- Worth considering is CIBC’s use of performance-linked compensation where money is not paid out for a specified period of time after performance targets have been reached. Monies not yet paid out are easier to recoup.

Implications for boards:

After reviewing their company’s current policy and practices with respect to clawbacks, and the related disclosure, if any, in their most recent proxy circular, compensation committees may wish to consider amending or, where none exist, incorporating some sort of clawback provision into their compensation arrangements (perhaps even in the committee’s charter), given the increasing support for such provisions from shareholders and their representatives.

Conclusion

The changes that boards have made so far to their companies' executive compensation practices and disclosure policies have been important, but generally well within their comfort zone. But the shareholder and regulator-driven issues that boards are facing now are of a different nature, many of them implying changes to the distribution of power between management, boards, and shareholders. Given the magnitude, complexity, and public nature of the decisions that boards and their compensation committees will soon find themselves having to make, the time to start thinking about these issues is now.

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