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Meridian Client Update

Five Governance Initiatives Compensation Committees Should Act on in 2011

All of us involved in the management and oversight of executive compensation are eagerly awaiting the implementation of new disclosure rules proposed by the Canadian securities regulators. Regardless of when and how the new disclosure rules are finalized, we recommend that Compensation Committees address five key issues in 2011. Being proactive in these areas will position companies well going into the 2012 fiscal year and proxy season and will demonstrate a Board's commitment to progressive governance supporting sound business strategy. We encourage you, if you have not already done so, to discuss these five important governance issues at your next Committee meeting. Our next bulletin will discuss several key incentive plan design, performance metric selection and target setting issues that Committees are dealing with in 2011.

- Address risk in your compensation programs
- Prohibit hedging of share-based compensation
- Introduce a clawback provision
- Provide education sessions for your Compensation Committee
- Engage with your shareholders

1. Address Risk in your Compensation Programs

Risk-adjusted compensation is likely to be a challenging issue for Compensation Committees for the next few years. Compensation practices have been criticized by many for encouraging excessive risk taking, which significantly contributed to the recent economic crisis. As a result, Canadian financial institutions are under pressure from their regulators to implement compensation programs that appropriately take risk into account. The Canadian securities regulators have proposed changes to executive compensation rules to require disclosure by public issuers of the manner in which compensation programs take risk into account.

Implementing risk-adjusted compensation programs is a complex process which requires a full understanding of the company's exposure to and tolerance for risk. We expect that it will take companies some time to fully integrate risk management into their compensation programs.

Meridian Comments

For 2011, there are a few essential first steps.

- Compensation Committees should be thinking and talking about how their compensation programs take risk into account.

- Vesting or deferral periods should be adjusted to take into account not just retention, but also the period in which the risks relating to the deliverables are likely to materialize and the realization of those risks should be a factor in designing appropriate vesting of that compensation.
- Awards with staggered vesting periods will allow companies to continue to take risks into account as they materialize and will reduce the ability of management to defer the realization of risks until after the payment of compensation.

2. Prohibit Hedging of Share-Based Compensation

The proposed executive compensation disclosure rules will require companies to disclose whether they prohibit directors and named executive officers from hedging shares and share-based compensation. Share-based compensation and share ownership requirements are designed to foster alignment of the interests of management with the interests of shareholders. This goal of alignment will be defeated if hedging is permitted.

Prior to March 2010, insiders were not required to report hedging arrangements. Changes to the insider reporting rules in March 2010 likely require insiders to report hedging arrangements, but these rules are complex and not clear in their application to hedging arrangements. This increases the likelihood that Compensation Committees may not be aware of hedging by their executives. Many executives in the beleaguered financial sector were found to be using hedging strategies to save millions of dollars of losses¹. During this same period, shareholders suffered catastrophic losses on their holdings.

Meridian Comments

We recommend that companies which have not already done so expressly prohibit their directors and employees from hedging all share-based incentive awards and all shares held to satisfy shareholder ownership requirements.

3. Introduce a Clawback Provision

Clawback policies are becoming increasingly prevalent in Canada. In fact, 45% of the S&P/TSX 60 companies reported clawbacks in 2010. In the U.S., 82% of the Fortune 100 had clawback policies in 2011, up from just 18% in 2006.

Many clawback provisions allow a company to recover compensation paid to an executive if three triggers are met:

- Financial statements are materially restated;
- The restatement was caused by executive misconduct; and
- The incentive amount paid to the executive was higher than it would have been, but for the misconduct.

Of the S&P/TSX 60 companies which have clawbacks, roughly 60% employ this “triple trigger” approach.

Meridian Comments

We expect clawbacks to become increasingly common because the Dodd-Frank Act in the U.S. mandates recovery of compensation paid based on restated financial statements. Additionally, clawbacks are viewed as an important part of a risk-adjusted compensation programs. Triple trigger clawbacks should not be adversely viewed by management because of the serious misconduct generally required to trip the three triggers.

4. Provide Education Sessions for your Compensation Committee

The proposed changes to executive compensation disclosure will require companies to disclose:

- The Compensation Committee's direct experience relevant to its executive compensation responsibilities; and
- The skills and experience that allow the Committee to make decisions whether the company's compensation policies are consistent with its risk profile.

The disclosure requirements are an important step towards a “compensation literacy” standard for Compensation Committees, similar to the financial literacy standard which has been imposed on Audit Committees. Companies are starting to ensure that the members of their Compensation Committee have the skills, experience and education to meet a compensation literacy standard.

5. Engage with your Shareholders

“Say on pay” seems to be here to stay. Based on Meridian research, 65% of S&P/TSX 60 companies have introduced say on pay advisory votes. None of these companies had a failed say on pay vote in the 2011 proxy season. By contrast, in the U.S., already eight of the S&P 500 companies failed a say on pay vote and ISS recommended that shareholders vote “no” to say on pay in 13% of proxies. Companies which have received positive say on pay votes, despite a negative ISS vote recommendation, attribute this to their direct engagement of their shareholders on their compensation arrangements.

Meridian Comments

We expect more Canadian Companies will introduce say on pay advisory votes to ensure they are engaging with their shareholders on compensation issues. However, proxy advisory firms in Canada are likely to follow the U.S. path of recommending a no vote on more of these resolutions. Committees can prepare for this by communicating with their shareholders in an active and thoughtful way before a negative say on pay vote is looming.

Announcement

We are pleased to welcome Christina Medland to Meridian Compensation Partners. Chris comes to us from Torys LLP, one of Canada’s most prominent law firms. She is recognized as a leading executive compensation expert in Canada and we are privileged to have her join our strong team in Canada.

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¹ See, for example, “Stock-Hedging Lets Bankers Skirt Efforts to Overhaul Pay”, February 2, 2011, Eric Dash, New York Times