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# Meridian Client Update

## Changes to Executive Compensation Disclosure for 2012

The CSA (Canadian Securities Administrators) have implemented changes to executive compensation disclosure for company fiscal years ending on or after October 31, 2011. Companies should be taking steps now, so they can make favourable disclosure under the new rules for their 2012 circular.

- Disclosure of how compensation practices take risk into account.
- Disclosure of Compensation Committee independence and compensation expertise.
- Disclosure of whether executives and directors can hedge their equity-based compensation.
- Disclosure of fees paid to compensation consultants for executive compensation and other work.
- Enhanced disclosure of the fair value of share-based awards.
- Limitations on the right of companies to avoid disclosing performance targets.

### Meridian Comments

There are no material changes from the draft rules proposed by the CSA in November, 2011. Companies are likely to continue to struggle with the disclosure of performance targets, with less flexibility to avoid disclosure under the new rules. Generally, the CSA seems to be following the approach of the U.S. regulators, but with no mandatory say on pay vote and no required disclosure of the highly controversial ratio of CEO to median employee pay. We may see a further set of changes once the Securities Exchange Commission introduces its final rules for U.S. public companies later this year.

### 1. Risk-Adjusted Compensation

Companies will be required to disclose whether the board or a committee “considered the implications of the risks associated with the company’s compensation policies and practices” and if it did, to disclose:

- The extent and nature of the board/committee’s role in the risk oversight of the company’s compensation policies and practices.
- Any practices the company uses to identify and mitigate compensation policies and practices that could potentially encourage a named executive officer (NEO) or individual at a principal business unit to take excessive risks.

- Any identified risks arising from the company's compensation policies and practices that are likely to have a material adverse effect on the company.

The CSA has identified the following practices as potentially encouraging excessive risk taking:

- Policies that are heavily weighted toward short-term objectives or that pay out before the risks associated with the performance are likely to materialize.
- Policies that are significantly different for a particular business unit or particular executives or that vary from the company's overall compensation structure.
- Programs in which the compensation expense is a significant percentage of the company's revenues.
- Policies that do not include risk management and regulatory compliance as part of their performance metrics.
- Incentive plans which do not have a maximum payout.

### **Meridian Comments**

We expect that companies will more actively consider the implications of risks associated with their compensation programs. Accordingly, in 2011 companies should expressly consider how their compensation plans deal with risk, and consider introducing policies that better integrate risk and performance.

Companies should consider changing compensation policies similar to those listed by the CSA, unless there is a strong business and risk-management case to retain them. Sound incentive design principles aligned with the business strategy, well balanced programs with rigorous short- and long- term goal setting, incentive caps and deferred vesting of awards continue to be the primary tools to motivate prudent performance.

We also expect that joint sessions of the Compensation Committee and the committee of the Board charged with risk assessment and management may become more frequent, both for purposes of education and to ensure that the company's compensation programs appropriately link compensation and risk.

## **2. Independence and Competence of the Compensation Committee**

The first step in what may become a requirement that Compensation Committee members be "compensation literate" is the requirement that companies disclose:

- Whether any of the committee members have direct experience relevant to their responsibilities in executive compensation.
- The skills and experience that enable the committee to make decisions on the suitability of the company's compensation policies and practices.
- In addition, the company must disclose whether each member of the Compensation Committee is independent.

### **Meridian Comments**

We anticipate that this proposal will encourage Compensation Committees to focus on director education to increase compensation literacy and to appoint members who have specific compensation expertise or experience.

### **3. Anti-Hedging Policies for Executives and Directors**

The new rules will require companies to disclose whether or not NEOs or directors are clearly prohibited from hedging their equity-based compensation awards or the value of the securities they hold.

### **Meridian Comments**

Hedging equity-based awards or securities held under a share ownership program seems contrary to the alignment purpose for which these awards and requirements are introduced. Consequently, we expect that most companies will introduce explicit policies prohibiting hedging of equity-based compensation awards and securities held under share ownership requirements.

### **4. Grant Date Fair Value of Share- and Option-Based Awards**

Companies will be required to disclose the methodologies used to calculate the grant date fair value of share- and option-based awards, including the key assumptions and estimates used and why the company chose the methodology even when they use the accounting fair value reported in the company's financial statements.

### **5. Fees for Compensation Consultants**

Canadian regulators are following the U.S. lead and are requiring expanded disclosure of the role of, and fees paid to, compensation consultants. The proposed rules will require for each consultant:

- A summary of the consultant's mandate.
- When the consultant was originally retained.
- If the consultant provided any other services to the company, its affiliates, directors or management, a description of the nature of this work and whether the board or Compensation Committee must pre-approve services the consultant performs at the request of management.
- For the two most recent years, the "executive compensation-related fees" and the "other fees" paid to each consultant with a description of the services provided for the other fees.

### **Meridian Comments**

In response to comments received on the proposed rules, the CSA stated that "compensation consultant or advisor does not include legal, accounting or tax". It is not clear whether the CSA intends to exclude these services, or these service providers from the disclosure requirements. If the former, then arguably these types of services should not be included in the fees disclosed, even if provided by the Compensation Committee's consultant. If the latter, the CSA has overlooked the potential conflict that lawyers and accountants have when, for example, they provide significant legal transaction services at the direction of management, then draft incentive plans at the direction of the Compensation Committee.

## 6. Disclosure of Performance Targets

The new rules tighten the exemption from the requirement to disclose specific performance goals:

1. Companies relying on the prejudice exemption must state that they are relying on the exemption and explain why disclosure would seriously prejudice the company's interests.
2. Disclosure of targets based on broad corporate financial metrics such as earnings per share, revenue growth and EBITDA is deemed not to seriously prejudice the company.
3. Disclosure is required of whether the board can exercise, or has exercised, discretion to increase or decrease performance compensation for NEOs.

## 7. Miscellaneous Changes

The new rules propose a number of other changes in response to the disclosure made by companies since the last change to the disclosure rules and comments received on the proposed changes to the rules:

- Companies are required to disclose their decision making process related to compensation, which will increase the emphasis Compensation Committees are already placing on good governance in their deliberations.
- Companies cannot add columns to the summary compensation table and can only add tables or information that, to a reasonable person, would not detract from the prescribed information in the summary compensation table.
- There is a new requirement that the form be written in plain language to provide an understanding of:
  - How decisions about NEO and director compensation are made.
  - How specific NEOs and director compensation relates to the overall stewardship and governance of the company.
- Disclosure is required about whether the company will be making significant changes to its compensation policies and practices in the next year. In response to comments received on the proposed rules, the CSA confirmed that this requirement only applies if the company has committed to the changes.
- If the company used any benchmarking in determining any compensation, the benchmarking group must be included and the company must describe why the group and the selection criteria are considered relevant. This is in response to a concern that companies did not fully explain their benchmarking methodology and how they used that information in making compensation decisions.
- Named NEOs includes executive officers of subsidiaries of the issuer. In response to comments received on the proposed rules, the CSA confirmed its view that the individual needs to have a policy making function in respect of the company (rather than the subsidiary).
- If options are granted in a currency other than the currency used for the tables, the company must footnote the currency and exercise price.

- Company contributions to an RRSP or other savings plan are required to be disclosed in the other compensation column of the summary compensation table.
- Compensation can be disclosed in Canadian currency or in the currency used for the company's financial statements. The CSA says that it has provided flexibility if the company's performance goals are in a currency other than the currency used in the tables. However, the only real flexibility appears to be that either Canadian currency or the currency used in the financial statements can be used in the narrative, but that the chosen currency must be used in the tables.
- Disclosure is required of the market or payout value of vested share-based awards that are not paid out or distributed.
- In quantifying the annual lifetime pension benefit payable to an NEO, the company must assume that the NEO is eligible to receive benefits at the year end.
- The requirement to disclose the non-compensatory component of retirement benefits (any employee contribution and investment return) has been eliminated.
- Change-of-control and termination benefits may be disclosed in a table.
- Disclosure is required of all the compensation that an external management company paid to an NEO or director for services provided to the company, its parent or a subsidiary.

**Meridian's Overall Observation:**

Compensation Committees should have these new disclosure requirements and the integration of risk into their compensation programs on the agenda for this year.

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