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Tariffs and Their Impact on Executive Pay Governance in Canada

Background

In early February, U.S. President Donald Trump announced he would impose import tariffs of 25% on goods (excluding energy resources) entering the United States from Canada, and a 10% tariff on energy resources. In response, the Government of Canada announced it would impose tariffs on $155B of certain U.S.-made goods coming into Canada.

Since then, tariffs from both countries were paused for 30 days. In mid-February, President Trump imposed a 25% tariff on all steel and aluminum imports to the U.S., including from Canada. Later in February, President Trump affirmed that tariffs would go into effect on April 2, as originally proposed.

We do not currently know: 1) if general tariffs will actually be imposed by the U.S. on Canadian goods; 2) how long tariffs will be in place; and 3) whether Canada (or other countries) will impose retaliatory measures/escalations. We do know some economic impacts of tariffs, both short-term and long-term:

Short-Term Impacts of Tariffs	Long-Term Impacts of Tariffs
• Higher prices for U.S. consumers on Canadian goods leading to inflation in the U.S., potentially slowing interest rate cuts in the U.S.	• Recession in Canada – initial analyst estimates from RBC suggest tariffs of this size may wipe out Canadian growth for up to 3 years (reduction in Canadian GDP of 3% to 4%)[1]
• Reduced demand for Canadian goods being sold in the U.S. market (offset to a degree by a weakening Canadian dollar, and probably by price reductions by Canadian producers)	• Higher unemployment levels, particularly in manufacturing sectors directly affected by the tariffs
• Sharp decline in the value of the Canadian dollar, relative to the U.S. dollar	• A continued weakening of the Canadian dollar, particularly if the U.S. maintains or raises interest rates at current levels
• Immediate layoffs and reductions in force (RIF) at Canadian manufacturing companies, as demand for Canadian made goods starts to drop off	• Industries secondary to manufacturing like restaurants, leisure travel etc. will likely experience similar demand shocks, as consumers spend less discretionary income

[1] https://thoughtleadership.rbc.com/wp-content/uploads/EN-A-US-Canada-trade-shock-now-in-play-first-economic-takeaways.pdf

In this client alert, we focus on the following executive compensation-related implications of tariffs and considerations for compensation committees as they navigate Q1 meetings:

1. Incentive plan adjustments and principles
2. The impact of a volatile CAD-USD F/X rate on compensation programs
3. Long-term incentive award sizing and equity mix during times of share price volatility and decline

1. Incentive Plan Adjustments and Principles

The most recent widespread economic shock to affect the Canadian economy was COVID-19. This "Black Swan" event was not anticipated and required greater flexibility and judgment on the part of compensation committees. We found that companies that relied on adjustment "principles" rather than defined formulas and rules were able to react most flexibly to the changing environment and ensure pay outcomes aligned with performance outcomes at year-end.

What are adjustment principles?

Incentive compensation is intended to be at-risk. Accordingly, adjustments should be made to:

- Avoid rewarding or penalizing management for unbudgeted events that management is not expected to manage
- Ensure that incentives remain aligned with long-term business strategy and the best interests of stakeholders
- Provide flexibility to deal with unexpected events so that that performance goals can be set on a rigorous basis, rather than on a basis that provides allowances for unexpected events
- Ensure that incentive plan payouts make sense taking into account the organization's performance viewed holistically
- Avoid penalizing management if "doing the right thing" for the business negatively impacts incentives

How might adjustment principles be used in relation to tariffs?

While not all adjustments can be categorized in advance, it is helpful to develop a framework by which the Committee considers adjustments each year.

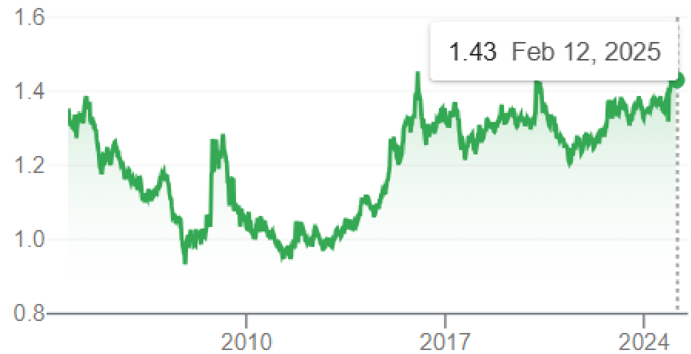
Adjustment Principle	Classic Example	Tariff Considerations
• Adjustments considered for material events that occurred after, and were not reflected in the budget/plan	• Adjustments would be considered for events that are outside normal organizational planning and budgeting	• Clearly outside of normal planning and budgeting, particularly given changing probabilities day-by-day of 1) if, 2) when, 3) how long, and 4) how much
• Adjustments would be considered for events that are outside the scope of management's control	• A significant change in government regulation that requires management to incur significant unbudgeted costs might be adjusted • Management is, of course, still expected to mitigate these risks to the fullest extent possible (adjustments should not detract from this mitigation)	• Tariffs are clearly outside management's ability to control, in particular the timing, duration, and magnitude • Management is still expected to manage the business optimally to diversify customer bases and supply chains, lock in pricing, build up supplies etc.

• Adjustments should be treated symmetrically	• For example, if the detriments of an event are excluded in one year, the benefits from the same event would be excluded in a future year	• Reduced U.S. demand for Canadian products weighs on top line growth (detriment) • Canadian earnings benefit from a weakening dollar for U.S. sources of revenue (benefit) • Canadian companies may benefit from a "buy Canadian" movement

2. Weakening Canadian Dollar

Financial metrics

Where a company has sources of revenue from multiple countries, exclusions for currency fluctuation may already be built into adjusted earnings and cash flow definitions – this is a relatively common *formulaic* adjustment for incentive purposes and rarely causes investor concerns.



Some companies may decide to only adjust for currency at the "extremes". For example, no adjustment for F/X when the Canadian dollar is within a C$1.35-C$1.45 corridor, but adjustments are made outside these extremes. Companies may choose to take this approach when the overall impact of F/X volatility to financial results is de minimis *except* outside those extremes and/or management is expected to manage F/X volatility at the business level (e.g., through hedging, pricing negotiations etc.). It is very helpful to set out such corridors/exclusions in the definition of the adjusted financial metric itself, so that adjustments are made as a matter of course and do not need to be considered on an exception basis by compensation committees.

North American compensation peer groups

Many large Canadian companies include U.S. companies in their compensation peer groups out of necessity when:

- There are insufficient publicly traded industry comparators in Canada
- The company actively recruits senior executive talent from the U.S. market or loses talent to the U.S. market
- A significant portion of operations, employees, assets or capital is located in the U.S.

The inclusion of U.S. companies in the peer group raises the question of how to treat currency for benchmarking compensation, specifically when benchmarking pay for Canadian-resident executives.

There are two general approaches to treatment of currency for a North American blended group:

- Meridian's default "nominal" methodology—treat USD compensation at par with CAD (1 USD = 1 CAD) for USD compensation paid to U.S. resident executives and convert compensation using a 12-month average exchange rate for USD compensation paid to Canadian resident executives
- Convert all pay to CAD methodology—convert USD compensation paid by U.S. companies to U.S. resident executives to CAD using a 12-month or longer average exchange rate

The table below compares these two approaches to currency when U.S. companies are added to the peer group:

Argument	Meridian methodology (Nominal 1 USD = 1 CAD)	Convert all USD compensation to CAD
Talent	• Allows for the inclusion of U.S. companies to provide insights into the U.S. market: — Compensation at U.S. companies is higher (directionally, ~20-30% higher, although this may vary by industry) than at comparably sized Canadian companies — Approach avoids further inflating the "competitive market" by adding a variable additional 30-35% premium to the pay at U.S. companies, which trends closer to a 40-45% premium when the Canadian dollar weakens significantly	• Acknowledges argument that USD pay could be required to attract U.S.-resident executives to move to Canada to join a Canadian company • However, this increases "market compensation" for all executives to account for a unique recruitment scenario
Volatility	• Eliminates F/X driven pay volatility (except for Canadian resident executives paid in USD, where F/X reflects true pay volatility and a true market premium) *for clarity, we do convert USD pay to CAD for Canadian-resident executives paid in USD (uncommon occurrence, though some precedent in the Canadian market)*	• Converting USD to CAD adds year over year volatility to pay levels unrelated to real movement in pay, confusing market movement with F/X changes • Under a converted to CAD methodology, a market benchmark between 2023 and 2024 moved 5%, but 3% was driven by real pay movement and 2% by F/X
Pay and Expenses	• Matches, approximately, currency of compensation to currency of expenses	• Ignores that USD pay for U.S. resident executives matches USD expenses—e.g. U.S. executives' purchasing power does not change with change in CAD F/X rate, relative to the U.S. dollar
Proxy Advisors	• Allows for U.S. companies to be added to the group to gain exposure to U.S. competitive pay levels, without a disproportionate effect on a Canadian company's compensation philosophy and sense of market compensation • Alleviates external criticism from some investors and proxy advisors that the inclusion of U.S. companies is primarily done to "inflate" compensation levels	• The largest proxy advisor ISS only uses Canadian companies in its peer group and quantitative analysis for Canadian domiciled companies • Benchmarking to a peer group with F/X adjusted U.S. compensation materially increases the "market" a Canadian company is using to set pay, increasing pay levels and increasing the risk of a pay for performance disconnect on the proxy advisor quantitative tests which, in turn, increases Say on Pay risk

The Committee should ultimately rely on its business judgment about the competitive realities of each position in setting compensation relative to those benchmarks (e.g., market data is only one factor in the pay decision making process).

3. Share Price Volatility

LTI grant sizing

While we do not fully understand the impacts of tariffs on the economy, we do expect greater share price volatility. In industries directly negatively impacted by tariffs, a precipitous share price decline may require a company to rethink its approach to long-term incentive grant sizing. Below is a list of common "guardrails" we have seen implemented in prior economic crises, to manage equity spend:

- **Award same number of share units as prior years.** Materially decreases compensation value and increases retention risk. Prior awards are not re-priced, so lower current award values may be viewed as a double penalty. Generally used when the share price decrease is expected to be short-term.

- **Use a long-term volume weighted average trading price.** Used to determine the share price for share units. Can be used in all market conditions to moderate underlying share price volatility. If adopted, this approach should be used consistently in all market conditions (e.g., 5-day, 30-day, 60-day average).
- **Manage number of share units to be awarded.** There may be insufficient shares in the reserve, with no choice but to reduce the number of share units granted or the number of participants who receive equity awards. The value of share units not awarded under this scenario may be provided in another form of long-term incentive awards, such as cash-settled RSUs or PSUs, or forfeited.
- **Manage number of share units to be awarded taking into account the annual "burn rate".** Some companies set a maximum burn rate (i.e., 0.5% of the outstanding issue) and manage award levels within that rate.
- **Calculate the number of share units as normal and apply an arbitrary reduction.** This is, as suggested, an arbitrary solution, but was an approach commonly used in the energy sector when oil prices significantly decreased in the past (reductions in the range of -10% to -30%).
- **Set a limit on the percentage increase in the number of share units awarded year over year.** Cap the number of share units relative to the number (rather than the value) of share units/options awarded in the prior year, or the average of the 3 prior years. This alternative also arbitrarily reduces compensation.
- **Make a portion of the equity awards in early 2025, with the balance 6 months later.** Mitigates risks on both sides and helps bridge the gap between Committee/investor expectations on the one hand and executive expectations on the other hand. This reduces leverage and dilution and may mitigate potential windfalls if the reduction in share price is shorter-term.

Companies granting stock options

For companies that grant stock options, share price volatility will have several impacts on the valuation of an option:

- Higher volatility will increase the valuation as a % of face value
- A significant reduction in share price value may lead to a temporarily high dividend yield, which significantly reduces the valuation as a % of face value

Without adjustment, companies may need to grant significantly more stock options to deliver equivalent value. In extreme cases, taking a longer-term average of historical stock option valuations may be appropriate, if the current value is not aligned with historical valuations. Companies may also re-examine the weighting of stock options in their LTI mix, as options continue to fade in popularity in Canada.

Concluding Thoughts

In the coming weeks and months, the efficacy and resilience of compensation plan designs will be tested. While there are many items to think about, first and foremost should be:

- Defining the estimated impacts of tariffs on the business, which will be unique to each company
- Taking care of employees, customers and stakeholders in the face of the continued threat of tariffs
- Running the business to the best of management's ability, and not letting the incentive plan get in the way of making choices that are best for the business and its shareholders
- Relatedly, not letting concerns over potential proxy advisor reactions get in the way of making the right choices for the business

We stand ready to assist our clients think through these and other challenging compensation problems, in a turbulent time for the Canadian economy.

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