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Meridian Client Update

CCGG 2013 Executive Compensation Principles

The Canadian Coalition for Good Governance (CCGG) has released its new executive compensation principles. The CCGG represents Canadian institutional shareholders who manage almost $2 trillion of assets on behalf of major shareholders and is viewed as a leader in promoting governance changes at Canadian companies. While the new principles largely follow the 2009 principles there are some interesting differences which are the focus of this update.

The 6 principles are:

1. A significant component of executive compensation should be "at risk" and based on performance.
2. "Performance" should be based on key business metrics that are aligned with corporate strategy and the period during which the risks are being assumed.
3. Executives should build equity in the company to align their interests with those of shareholders.
4. A company may choose to offer pensions, benefits and severance and change of control entitlements. When such perquisites are offered, the company should ensure that the benefit entitlements are not excessive.
5. Compensation structure should be simple and easily understood by management, the board and shareholders.
6. Boards and shareholders should actively engage with each other and consider each other's perspective on executive compensation matters.

Meridian Comment:

The new principles are generally consistent with the prior CCGG principles, except that principle 6, the shareholder engagement principle, replaces the prior principle which related to effective succession planning to reduce retention costs. As well, there is a generally increased focus on the compensation committee being actively and directly involved with establishing compensation philosophy, setting performance measures and assessing performance.

Principle 1—A significant component of executive compensation should be "at risk" and based on performance.

The new Principle 1 increased the emphasis on pay for performance, and directs companies to measure performance using both absolute (internal) and relative measures. As well, there is a new discussion about the potentially negative consequences of stock options, including a perspective that option awards can lead to excessive risk taking and reward outcomes that are not aligned with long term performance. While CCGG does not entirely reject stock options, it would like to see options de-emphasized and serious consideration given to performance vesting conditions for options.

Meridian Comment:

In practice, many Canadian companies are retaining options as a component of long term incentive compensation, but increasing the weighting of performance share units. Options with a performance condition for vesting remain a small minority practice.

Principle 2—"Performance" should be based on key business metrics that are aligned with corporate strategy and the period during which the risks are being assumed.
CCGG has increased its emphasis on:

1. Committees using informed judgment (discretion) to ensure that incentive payouts reflect absolute and relative performance of the business and to reduce compensation when positive results are achieved as a result of factors outside management's control; and

2. Committees being actively engaged in setting performance goals, determining appropriate level of stretch and assessing performance against goals.

As well, CCGG includes specific commentary about the types of metrics (broad financial metrics as well as measures key to managing risk) and suggests that there should be an explicit connection between performance metrics and business strategy. While noting that recoupment (clawback) policies are useful, CCGG prefers that payouts be aligned with the risk realization period and companies use economic efficiency metrics, such as EBITDA, rather than just top or bottom line metrics, like revenue and cost containment and having equity-based compensation, rather than relying on a recoupment policy.

CCGG has included a specific caution about the practice of benchmarking compensation to above median levels of a peer group and payment of compensation primarily for retention (rather than performance) considerations.

Meridian Comment:
CCGG emphasizes Committee involvement in reviewing and approving appropriate performance metrics and measuring performance, which is consistent with the CCGG's thoughtful approach which encourages Committees to actively perform their role, rather than follow a set of formulaic, "check the box" principles. This is demonstrated by their suggestion that realized value of past equity grants be considered and disclosed. Committees should also review "sharing ratios" between management and shareholders at key points along the incentive plan curve (threshold/target/maximum) to ensure proper alignment.

Principle 3—Executives should build equity in the company to align their interests with those of long term shareholders.
CCGG has included a specific comment about the negative effect that hedging and monetization can have on the alignment that share ownership is designed to achieve, but does not make a definitive statement that hedging is always inappropriate.

Meridian Comment:
Interestingly, although not in its summary of the principles, CCGG adds a reference to alignment with **long term** shareholders in its detailed discussion. This may provide some guidance to Committees which have to manage differing stakeholder interests. As well, CCGG comments that "hold periods" for equity after cessation of employment are "ideal" rather than mandatory.

Principle 4—A company may choose to offer pensions, benefits and severance and change of control entitlements. When such perquisites are offered, the company should ensure that the benefit entitlements are not excessive.
CCGG has added specific commentary that the definition of change of control should be a change in legal control (50% of the voting securities) and that the definition should be disclosed. CCGG states that while severance benefits should generally be the same on a termination following a change of control as on a regular termination without cause, it may be appropriate to accelerate vesting of equity awards on change of control. CCGG continues to require a "double trigger" (change of control and termination) to activate change of control benefits.

Meridian Comment:
The substance of CCGG's comments on severance and change of control protection are consistent with their past position; what is different is their unusual characterization of these aspects of compensation as "perks".

Principle 5—Compensation structure should be simple and easily understood by management, the board and shareholders.

CCGG has added an express comment that, as a governance best practice, the consultant retained by the board or committee should be independent of management.

Meridian Comment:
This is consistent with the increased emphasis in Canada on importance of an independent consultant to the Committee and is also directionally consistent with the more specific requirements under U.S. regulations (Dodd Frank), that the Committee expressly consider whether its consultant is independent.

Principle 6—Boards and shareholders should actively engage with each other and consider each other's perspective on executive compensation matters.

The inclusion of shareholder engagement as a new key principle is an important development. Under this principle CCGG recommends that companies:

1. Adopt say on pay
2. Consult with opposing shareholders where there is significant opposition to say on pay, to understand shareholder concerns
3. Follow up with shareholders when say on pay support declines year over year, even if support remains relatively high

Meridian Comment:
The inclusion of this principle should provide some comfort to Committees who are not sure whether they should be engaging with shareholders. As well, the specific comment that shareholders who intend to vote against say on pay should contact the board to discuss their concerns appropriately emphasizes the bilateral nature of this engagement and may make it easier for Committees to get the attention of the company's significant shareholders to discuss executive compensation issues and share responsibility for doing so.

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