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Meridian Client Update

Effective Governance of Executive Compensation Benchmarking

Benchmarking is commonly used to set and assess executive pay levels and design practices. Strong compensation governance processes and careful development and use of benchmarking data are essential for HR Committees to critically evaluate executive pay. Executive pay decisions are highly visible, have lasting impact and are one of the most important accountabilities of HR Committees and Boards, as good stewards of shareholder assets.

Independent and Qualified Board Oversight

The following governance practices are critical:

- Appoint only independent directors to the Compensation Committee
- Ensure all Compensation Committee members are fully compensation literate, so they can bring their independence and expertise to bear on compensation decisions
- Schedule pre-meetings with HR Committee Chairs to set and review agenda
- Actively engage the Committee in setting executive pay, with multiple meetings for complex or controversial matters

Internal Talent and Succession Management

Effective internal talent and succession management, including addressing developmental needs of internal candidates can help organizations effectively manage compensation of executives. External candidates typically have higher leverage in negotiations which can lead to higher pay and may also require "buyout" of outstanding incentive awards from their current organization.

Establish Pay Philosophy and Objectives

The pay philosophy includes setting an appropriate mix of pay and level of pay at risk. The pay objectives set out the level of pay relative to "market". Generally, target compensation should be set within a competitive range of the market median for median performance, unless there is a strong rationale for a different approach. However, actual pay should vary above or below median levels based on executive and company performance, often across multiple dimensions.

Selection of Peer Group(s)

Constructing an appropriate peer group is key to quality benchmarking of executive compensation. The peer companies should be appropriate in terms of: size using revenue or assets as a primary screen, depending on the business; nature of the business/industry sector; geography; and competitors for executive talent. The peer group should contain enough companies to generate statistically significant results and should be reviewed annually for continued appropriateness.

Canadian companies frequently struggle with whether to include U.S. companies in their peer group. Generally, U.S. companies pay higher and with more leverage, and structure compensation differently than their Canadian counterparts. Canadian companies generally consider including U.S. companies in their peer group if they have significant U.S. operations or sales, consider U.S. based competitors for talent, and/or few comparable Canadian companies. Some of the criticisms of using U.S. peers can be avoided if U.S. companies are included in a secondary reference group to provide additional context for compensation decisions, rather than for direct benchmarking.

Ensure Integrity of Market Data

Benchmarking should:

- Critically evaluate any premiums or discounts based on the scope of the role
- Use a consistent methodology for valuing long-term incentive grants across peer companies
- Account for special one-time awards, such as new hire grants (including buyouts of previous employer awards) and retention grants
- Compare total executive pay (not just individual components) to market

Consider Executive Pay Actions in the Context of Pay Decisions for the Broader Company

Committees should make executive pay decisions in light of pay for the rest of the company, to understand how the Company's resources are being shared at different levels of the organization. For example, salary increases provided to executives should be compared to the merit budget for the rest of the organization as well as industry norms.

Avoid Literal Application of Market Data

Benchmarking is one input into the compensation setting process, but it should not be applied literally. Informed business decisions on pay should reflect:

- The company's business strategy and performance
- Real retention risk
- Scope of the roles being benchmarked
- Seniority and experience of the incumbent
- Long-term performance of the incumbent

Clear, Concise, and Transparent Proxy Circular Disclosure

The CD&A should discuss, in plain language, how the comparator group is developed, both target and actual pay positioning and how benchmarking data is used in setting executive pay. Canadian public companies are required to disclose the peer group, the selection criteria and why the peer group is relevant.

The Canadian Coalition for Good Governance, in its 2013 Executive Compensation Principles, suggests that having an independent consultant provide executive compensation advice to the Committee is also a best practice. An independent consultant can help ensure that benchmarking comparator groups are set appropriately and that benchmarking data appropriately compares pay levels and scope of roles.

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The ***Client Update*** is prepared by Meridian Compensation Partners.

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