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Governance: Board composition and compensation in the spotlight

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Board composition and recruitment were key governance issues in 2015 as a result of changes to corporate governance disclosure requirements and initiatives by institutional investors to promote proxy access in the United States and Canada. Compensation also remained a major focus, as institutional shareholders expressed their displeasure by saying “nay” on pay at three large Canadian issuers, and the Securities and Exchange Commission advanced several compensation-related regulatory initiatives.

BOARD COMPOSITION

**Board Diversity Disclosure** – Effective December 31, 2014, most Canadian issuers (other than TSX Venture Exchange issuers and investment funds) became subject to disclosure requirements regarding the representation of women on boards and in executive officer positions. Our survey of disclosure by TSX-listed issuers provided a snapshot of current practices – and the picture is disappointing. We noted significant areas of non-compliance, low representation of women on boards and executive officer positions, few issuers with board policies or goals to improve gender diversity on boards and virtually no issuers with targets for women in senior executive positions. Canadian boards should be considering ways to enhance board and executive officer diversity. The extent to which Canadian issuers make progress in increasing the representation of women in leadership positions will drive the corporate governance agenda in 2016.

(For more information, refer to our report entitled “Diversity Disclosure Practices [PDF]”)

**Board Renewal** – Issuers subject to gender diversity disclosure requirements are also required to disclose any term limits for board service or other board renewal mechanisms, or explain why they do not have such mechanisms. Earlier this year, the Institute of Corporate Directors (ICD) issued its report concluding that term limits can be a supporting mechanism, but should not be the only process used for board renewal and may even be counterproductive. Instead, the ICD recommended that board renewal be based on performance management within a culture that demands accountability of directors and focuses on the future needs of the board.

A review of corporate governance disclosure practices to July 31, 2015 by the Canadian Securities Administrators (CSA) staff showed that only 19% of the issuers reviewed had adopted some combination of service term limits and/or age limits. Of these, over half (53%) adopted only age limits, 24% adopted
only service term limits and 23% adopted both. The vast majority of issuers, however, have no formal mechanism for board renewal beyond their director assessment process. Canadian boards continue to discuss the utility of adopting various formal mechanisms for board renewal.

Proxy Access – “Proxy access” refers to proposals to enable qualified shareholders to submit nominations for directors to be included in the issuer’s proxy materials. SEC proposed rules to implement proxy access were struck down in court, prompting institutional shareholders to submit shareholder proposals for proxy access to U.S. corporations through by-law amendments. The SEC has permitted these to be presented despite objections from U.S. issuers, with the result that an increasing number of U.S. issuers have adopted proxy access.

Consistent with the original SEC proposed rule, proxy access in the United States permits shareholder(s) collectively holding at least 3% of the outstanding shares who have been shareholders for at least three years to nominate up to 25% of the positions on the board and have their nominees included in the issuer’s proxy circular. In some cases, issuers have either limited (to 10 or to 20) the number of shareholders that may collectively make such a nomination or have retained the ability to exclude nominations if the issuer has received notice of an intention to nominate directors pursuant to the issuer’s advance notice provisions for director nominations.

Most Canadian corporate statutes already permit shareholders to make a shareholder proposal that includes nominees to replace up to 100% of the positions on the board and to have that proposal included in the company’s proxy circular, provided that the submitting shareholder(s) hold a prescribed minimum number of shares and have been a shareholder for a prescribed period before making the submission.

The Canadian Coalition for Good Governance (CCGG) is promoting a version of proxy access that differs both from the Canadian statutory provisions and the version adopted in the United States. The CCGG proposal is to permit shareholder(s) collectively holding at least 3% of the outstanding shares (5% for smaller companies) to nominate up to 25% of the positions on the board and have their nominees included in the issuer’s proxy circular, without any pre-submission shareholding requirement. The absence of any shareholding requirement is somewhat surprising given recent criticism of “short-termism” by leading investors, including members of the CCGG. In light of the existing corporate statutory provisions for proxy access in Canada, and especially since these are more shareholder-friendly than proxy access proposals in the United States, Canadian corporations are unlikely to voluntarily adopt either the U.S. version of proxy access or the CCGG’s proposal.

Overboarded Directors – In its most recent update to its proxy voting guidelines, Institutional Shareholder Services (ISS) adopted a new stricter standard for determining when a director is “overboarded.” Now a director who is the CEO is considered to be overboarded if he or she sits on more than one public company board in addition to his or her employer’s board (previously more than two). A non-CEO director is overboarded if he or she sits on more than four public company boards in total (previously more than six).

COMPENSATION

Say on Pay – Failed say on pay votes this year at Barrick Gold Corporation (73.4% against), Yamana Gold Inc. (62.73% against) and Canadian Imperial Bank of Commerce (56.84% against) demonstrated that executive compensation disclosure continues to be subject to close scrutiny by shareholders and the media. This was Barrick’s second failed say on pay vote, having received both the lowest level of shareholder support on a say on pay vote in Canada (14.8% in 2013) as well as the second lowest (26.6%
in 2015). In some cases, shareholders also expressed their dissatisfaction by withholding from voting for the compensation committee chair and, in the case of Barrick, the compensation committee members.

(For more information, refer to our Update entitled “Say on pay votes come back in a big way: Three failed votes in one week”.)

Say on pay is voluntary in Canada and adoption rates continue to increase, although very slowly. This summer, the CCGG sent letters to issuers to encourage those who have yet to do so to adopt say on pay. However, this year’s vote results are an important reminder that issuers must carefully consider disclosure implications when making pay decisions, should be transparent about the rationale for their decisions – especially when making decisions that may be unpopular – and should avoid surprising their shareholders.

**Pay Ratio Disclosure** – The SEC issued final rules for disclosure of the ratio of CEO pay to pay of the median compensated employee, which will require such disclosure effective in 2018. Canadian issuers that are foreign private issuers in the United States will not be required to comply with this requirement unless they choose to satisfy Canadian executive compensation disclosure requirements by providing disclosure in accordance with U.S. rules. As noted by the SEC, neither the Dodd-Frank Act, which requires the SEC to adopt such rules, nor its legislative history states what objectives or benefits the requirement is intended to provide. Canadian issuers are unlikely to provide such disclosure, although they may find it interesting for internal purposes to estimate what their ratio would be.

**Pay for Performance** – The SEC issued proposed rules on pay for performance disclosure in April 2015. Again, Canadian issuers that are foreign private issuers in the United States will not be required to comply with this requirement unless they choose to satisfy Canadian executive compensation disclosure requirements by providing disclosure in accordance with U.S. rules. In anticipation of such rules and in response to demands from institutional shareholders to better demonstrate the relationship of corporate performance to CEO compensation, several U.S. and Canadian public companies have taken a variety of different approaches to provide supplemental information regarding the CEO’s realized or realizable pay over a period of three to five years.

The SEC’s proposed rule takes a different approach, prescribing a manner for calculating compensation that requires disclosure in comparison to total shareholder return (TSR), and requiring disclosure not only with respect to the CEO but also with respect to all other named executive officers as a group. If the SEC adopts a final rule in line with the proposal, it may further reinforce use of TSR as a performance metric and increase company and investor focus on short-term stock price movements.

(For more information, refer to our Update entitled “SEC proposes pay-versus-performance disclosure rules”.)

**Compensation Clawbacks** – In the summer, the SEC issued proposed rules to require issuers of securities listed on U.S. stock exchanges to adopt, disclose and enforce incentive-based compensation clawback policies to recover excess incentive-based compensation received in the three-year period preceding the date the issuer is required to restate previously issued financial statements due to an error. Whether or not the executive officer engaged in misconduct or otherwise shared any responsibility for the error prompting the financial misstatement is irrelevant to determining both whether the executive officer is affected and the amount to be clawed back.

All issuers listed on a U.S. stock exchange, including Canadian companies that are foreign private issuers, would be subject to the proposed clawback requirements. Foreign private issuers would be permitted to
forgo recovery in very limited circumstances if recovery would violate their home country law. A significant number of Canadian issuers, including Canadian issuers not listed on a U.S. stock exchange, have adopted compensation clawback arrangements. Most of these contemplate a double-trigger, involving both a financial restatement and misconduct on the part of the executive contributing to the restatement. However, some Canadian issuers have a “no fault” standard where the absence of misconduct by the executive is not relevant. The SEC’s proposal is likely to accelerate clawback arrangement adoption rates in Canada and increase the number of arrangements triggered by a financial restatement even in the absence of misconduct.

(For more information, refer to our Update entitled “SEC proposes listing standards for clawback of erroneously awarded incentive-based compensation”)


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