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Investor and regulator interests drive change in corporate governance and executive compensation

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New and renewed investor focus on issues of board diversity and proxy access and an increasing interest in climate change disclosure accounted for some of the most significant developments in corporate governance in 2017. Regulatory developments this year will impact corporate governance and executive compensation disclosure in 2018 and activist defence tactics in the years to come, while proposed changes to U.S. taxation of executive compensation are potentially game-changing.

Diversity: Much interest, modest improvement

Osler's third annual report on diversity disclosure practices found that women held 14.5% of the board seats of Toronto Stock Exchange (TSX) listed issuers that provided disclosure (an increase of 1.9% from 2016), the percentage of all-male boards had dropped sharply and the proportion of companies with a written board diversity policy had increased significantly. It also found that the percentage of women executive officers was essentially unchanged from the previous year. Despite some "green shoots," these findings reflect glacial progress at the board level, and highlight that relying on director turnover is not enough to result in meaningful improvement. This is particularly true given the Canadian Securities Administrators' (CSA) findings that board turnover accounted for only 9% of board seats and that these vacant positions were filled by women only 26% of the time.

However, investor interest in board diversity increased in 2017, with leading institutional investors demanding that companies include women directors and accelerate the pace of change. Institutional Shareholder Services has also announced that, starting in 2019, it will recommend that investors withhold from voting for the chair of the nominating committee (or the board chair if there is no nominating committee) if the company has not adopted a written gender diversity policy and there are no female directors on the board. Whether this increasing pressure will be enough to accelerate the rate at which women are added to boards and executive officer ranks remains to be seen.

There has also been some movement towards mandating disclosure relating to a broader range of diversity characteristics. Proposed regulations under the *Canada Business Corporations Act* would introduce a requirement for public companies to disclose whether or not they have a written policy on diversity other than gender, or explain why they do not.

U.S.-style proxy access comes to Canada

In response to the level of shareholder support received for shareholder proposals to adopt U.S.-style proxy access at the annual meetings of The Toronto-Dominion Bank (52.2%) and

Royal Bank of Canada (46.8%), six of Canada's major banks have now adopted U.S.-style proxy access policies.

The ability of shareholders to submit a shareholder proposal requiring a company to include in its proxy circular director nominations submitted by the shareholder has long been a feature under Canadian corporate law. In the U.S., however, proxy access is a fairly recent development. Generally, under the U.S. style of proxy access, up to 20 shareholders collectively holding at least 3% of the outstanding voting shares for at least three years are permitted to submit nominations for up to 20% of the director positions on the board for inclusion in the company's proxy circular.

The proxy access policies adopted by Canada's major banks are consistent with the U.S. style of proxy access except that, in order to comply with applicable law, the nominating shareholders must collectively hold at least 5% of the outstanding voting shares. Two banks have written to the Department of Finance seeking to revise the *Bank Act* provisions on shareholder nomination of directors to reduce the share ownership threshold for making such proposals to 3% from 5% and to reflect other key terms of proxy access on the same basis as their respective policies. The Canadian Coalition for Good Governance issued its final policy on proxy access encouraging issuers to adopt by-law changes reflecting U.S.-style proxy access. We expect proxy access to receive continuing focus in Canada in 2018.

Increasing interest in climate change disclosure

Climate change and public disclosure regarding climate change preparedness were areas of investor focus in 2017. The CSA launched a review of climate change disclosure practices in March 2017 in response to the report of the Financial Stability Board Task Force on Climate-Related Financial Disclosures. This report recommended, among other things, disclosure of the organization's governance relating to climate-related risks and opportunities and the actual and potential impacts of these on the organization's businesses, strategy and financial planning. Disclosure of the organization's processes for identifying, assessing and managing climate-related risks and the metrics and targets used to assess and manage these risks and opportunities is also recommended.

Additionally, 11 of the world's leading banks, including Royal Bank of Canada and The Toronto-Dominion Bank, are working collectively to find ways to improve the assessment and disclosure of climate-related risks and opportunities by financial institutions. This may lead to a more consistent and standardized approach to climate change disclosure in the future.

Website disclosure of corporate governance documents

New TSX rules require all listed issuers to post on their corporate website the issuer's articles or other constating documents and its by-laws, majority voting policy, advance notice policy for director nominations, position descriptions for the chairman of the board and the lead director (if applicable), board mandate and board committee charters. This requirement comes into effect on April 1, 2018 and will make it easier for shareholders to access the issuer's key governance documents.

OSC draws the line on proxy contest private placements

The Ontario Securities Commission (OSC) overturned a decision by the TSX conditionally approving a private placement of shares made in the throes of a proxy contest, effectively drawing a line on the increasing use of private placements to friendly parties as a defensive

tactic in a proxy battle. The OSC's *Eco Oro* decision effectively unwound the private placement unless it was approved by shareholders. As a result of this decision, the TSX issued a staff notice clarifying that information to be disclosed to the TSX in a notice of a private placement should include disclosure of any upcoming shareholders meeting, merger, acquisition, take-over bid, change to capital structure or other significant transaction, and of any potential dissident shareholders and/or anticipated proxy contests. Greater scrutiny is likely to be placed on applications to the TSX seeking approval of a private placement generally and in the context of an ongoing proxy contest and other contested situations in particular.

TSX issuers must provide new equity compensation disclosure in their proxy circulars

TSX-listed issuers are now required to disclose in their proxy circulars, (i) the annual burn rate for each security-based compensation plan for the last three years, (ii) where a security-based compensation arrangement includes a multiplier that increases the number of shares to be issued on settlement based on performance, the effect of that multiplier on the burn rate and (iii) vesting and term requirements for all security-based compensation plans, not just stock option plans. In addition, information on security-based compensation arrangements (other than the annual burn rate) now should be provided as at the end of the most recently completed financial year instead of the date of the meeting materials. However, if shareholders are being asked to approve a security-based compensation arrangement at the shareholders meeting, the information must be provided as at the date of the meeting materials.

SEC provides guidance on CEO pay ratio disclosure requirements

The U.S. Securities and Exchange Commission (SEC) pay ratio rule, which requires U.S. domestic registrants to disclose the ratio of their CEO's annual total compensation to the median employee's annual total compensation, applies to issuers as of the first fiscal year beginning on or after January 1, 2017. On September 21, 2017, the SEC released interpretive guidance to assist companies with their efforts to comply with the rule. The guidance addressed the SEC's views on the use of reasonable estimates, assumptions and methodologies, the use of appropriate existing internal records in determining whether non-U.S. employees are required to be included in identifying the median employee, and the use of widely recognized tests to determine who is an employee.

Although foreign private issuers generally are not required to provide the pay ratio disclosure, any Canadian issuer that is a foreign private issuer in the U.S. and chooses to satisfy executive compensation disclosure requirements under Canadian securities laws in accordance with Item 402 of Regulation S-K will need to provide the pay ratio disclosure.

U.S. re-examines tax rules on executive compensation

Current U.S. tax reform efforts may bring about substantive changes to the tax rules affecting executive compensation. While initial proposals to repeal Section 409A of the *Internal Revenue Code* (Code) and effectively eliminate deferred compensation as we know it are no longer on the table, modifications to the $1-million deduction limit for compensation paid to certain employees of U.S. publicly traded companies under Section 162(m) of the Code remain. Both the House and Sentate tax reform bills would eliminate the exceptions for commissions and performance-based compensation and would expand the

scope of covered employees (and in the case of the Senate, covered employers). While the use of performance-based compensation is widespread for reasons other than corporate tax benefits, the elimination of the tax benefit for performance-based compensation may cause compensation committees to consider the use of compensation arrangements that include both quantitative and qualitative factors.

With a number of important developments now in play in both Canada and the U.S., the pace of change in the corporate governance and executive compensation landscape shows no sign of slowing. Companies will need to continue to actively monitor these changes and consider how their existing disclosure measures up as both legal requirements and market expectations continue to evolve over the coming year.