Trends in Executive Compensation

Financial Executives International (Canada)
2010 Annual Conference: “**Going for Gold**”
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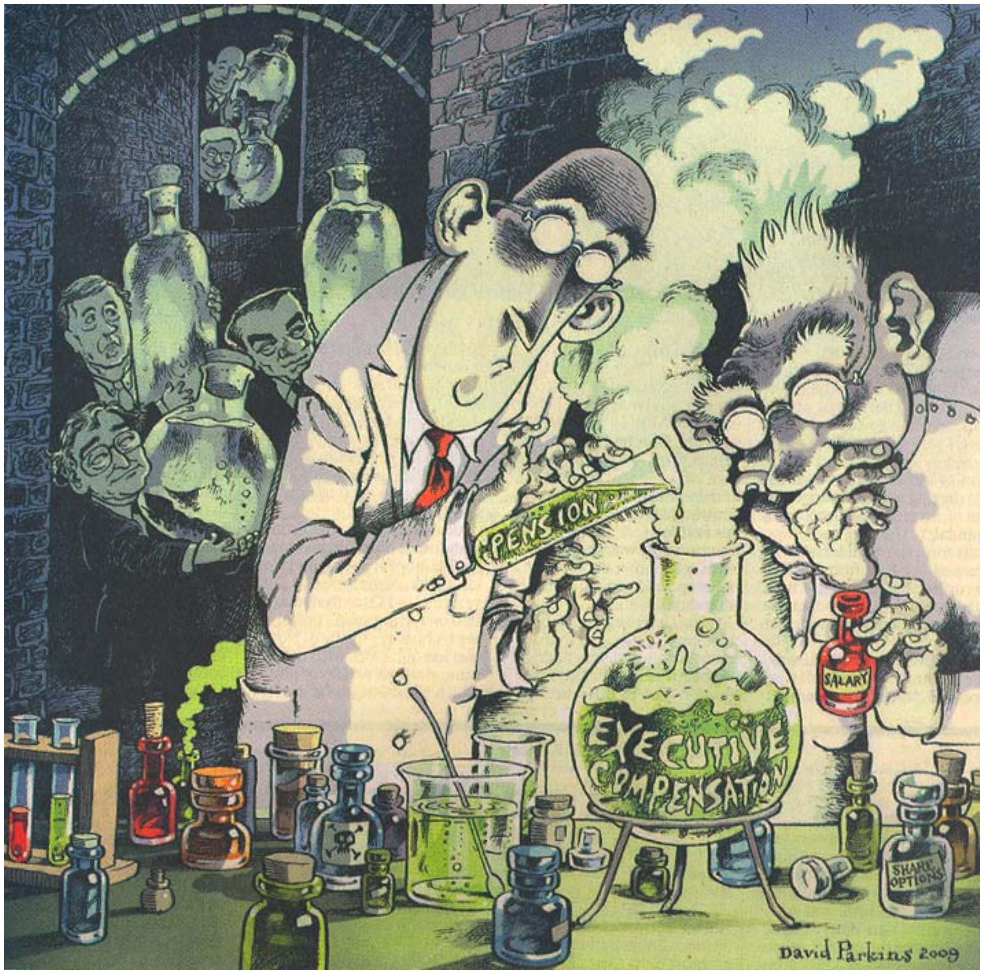

Illustration by David Parkins for the Globe and Mail.
June 23, 2009.

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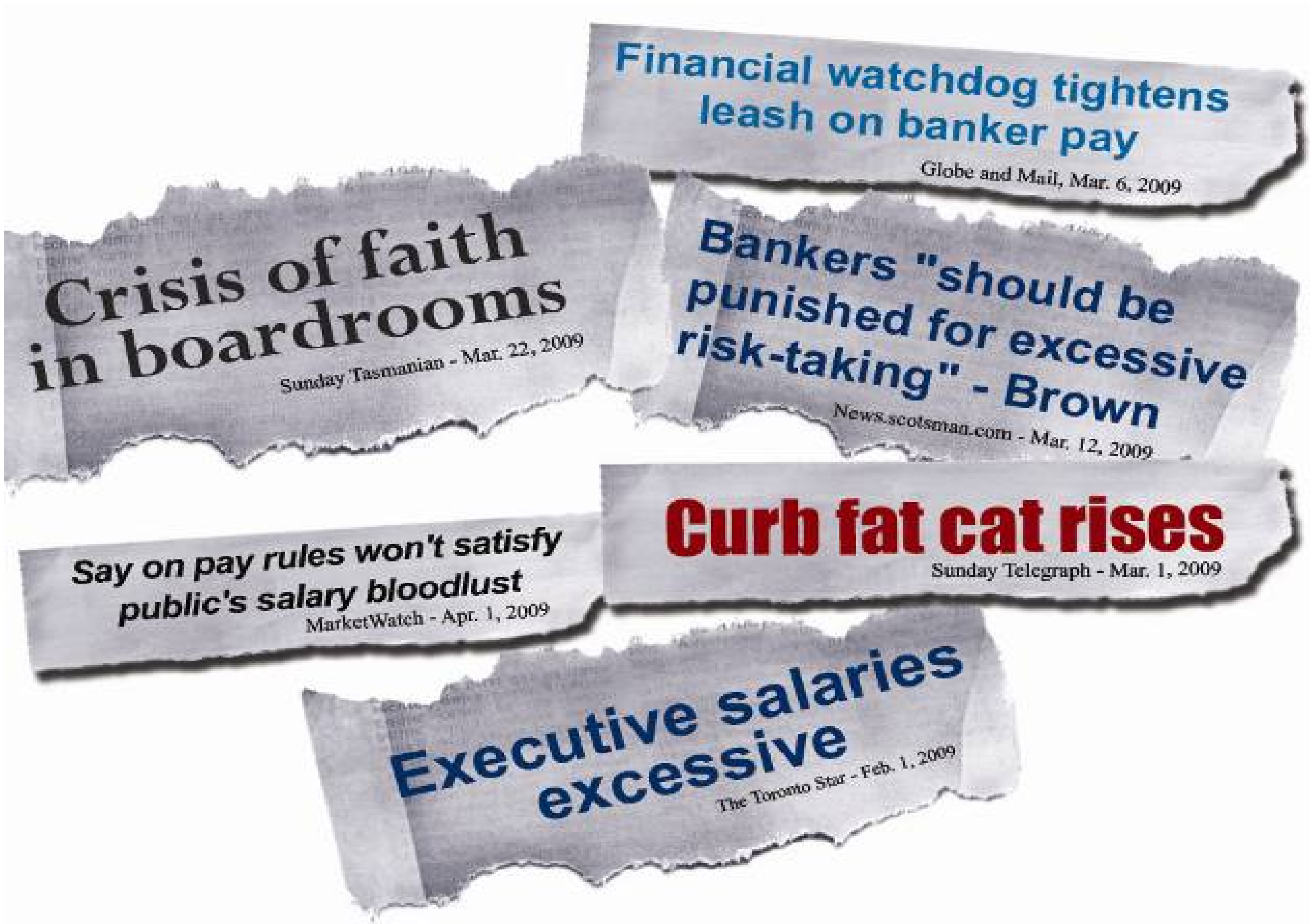
The Headlines



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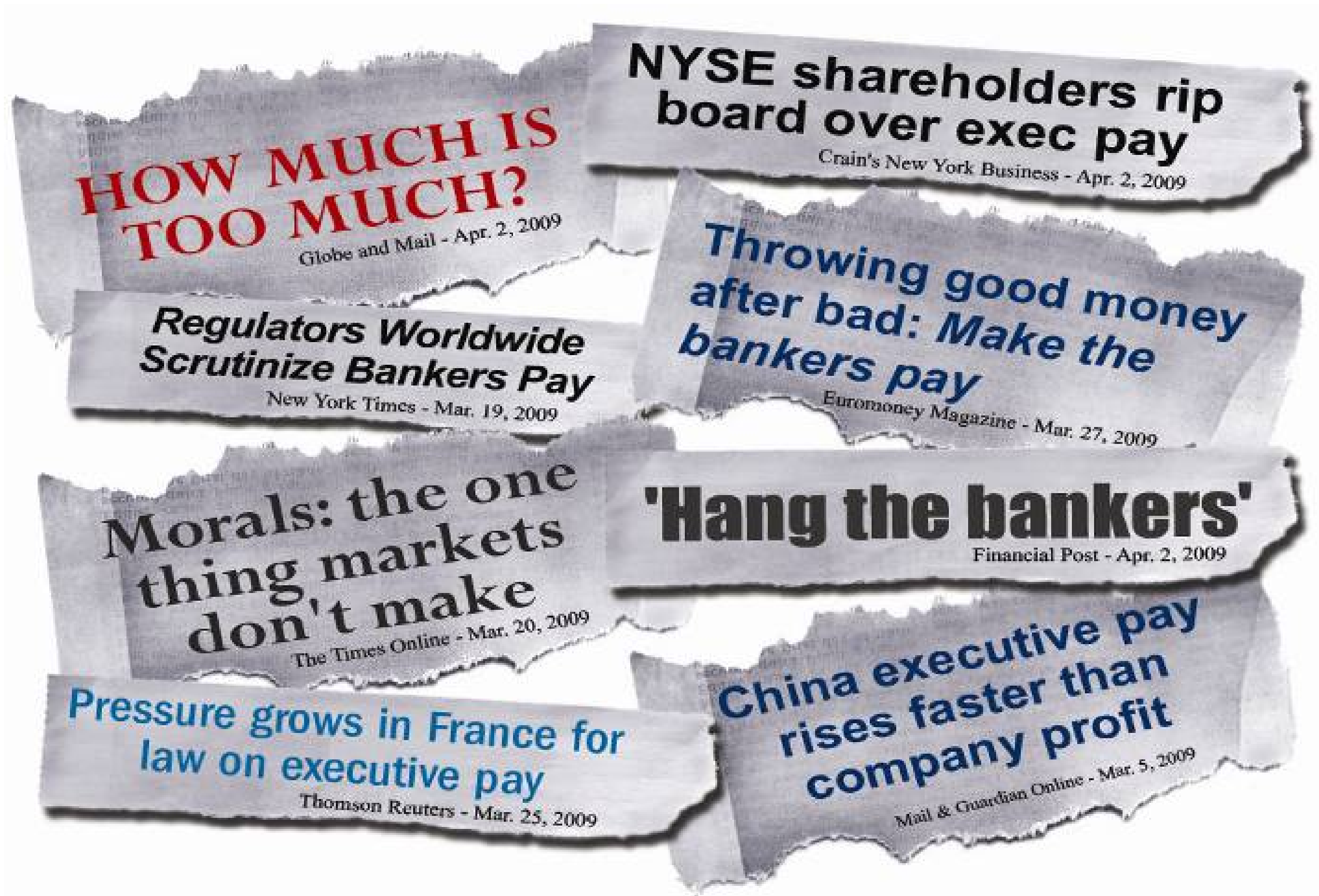
The Headlines *Cont'd*



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Global Focus on Excessive Risk Taking

- Executive compensation considered a contributing factor to the financial crisis
- Public pressure to re-evaluate executive pay policies and constrain compensation practices
- Pressure greatest on banks and other financial institutions
- Constraints migrating into other companies' governance policies

FSF Risk Alignment Principles

Principle: compensation outcomes must be symmetric with risk outcomes

- **Compensation adjusted for risks employees take on behalf of the company (including liquidity risk, reputation risk and cost of capital)**
- **Variable compensation for senior executives considered more risk-aligned when deferred**

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FSF Risk Alignment Principles *Cont'd*

Principle: compensation payout schedules must be sensitive to the time horizon of risks

- **Grants sensitive to risk outcomes over a multi-year horizon and differ across employees who expose the company to risks of different duration**
- **"Golden handshakes" and multi-year guaranteed bonuses are not in line with principle**
- **Departure of employee should not trigger early payout**

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U.S. Guidelines

Treasury Secretary Geithner's Principles:

- Ensure pay reflects corporate performance using standards beyond the company's stock price
- Base compensation on long-term performance, and ask executives to hold stock for longer periods of time
- Give corporate risk managers more authority to prevent excessive risk-taking
- Re-examine retirement packages
- Provide transparency and accountability in how compensation committees set pay

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OSFI (Office of the Superintendent of Financial Institutions):

- Intends to review executive compensation packages as part of broader assessment of risk-management systems (focus on risks not levels)
- Will apply FSF Principles (no decision has been taken to develop additional guidelines)

Canadian Perspectives *Cont'd*

Bank of Canada:

- Mark Carney disappointed by “pushback” against reforms
- Concern with return to paying out large bonuses before the world economy is back on track
- “Maybe regulators will decide”

Canadian Coalition for Good Governance (CCGG)

- CCGG represents Canada’s largest institutional shareholders
- Focus on pay for performance and risk controls (link compensation and risk management)
- “Performance” based on measurable criteria that is risk-adjusted and matched to the time horizon needed to ensure the criteria have been met
- Movement away from stock options to stock ownership (executives should be required to hold equity positions in the company)

Canadian Coalition for Good Governance *Cont'd*

- **Severance:**
  - Termination for failure to meet performance targets should not result in a large severance settlement
- **Change of control:**
  - Should have a "double trigger" requirement: (1) actual change of control and (2) executive terminated during a specified time after the change of control

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Say-on-Pay

- Shareholders' annual, nonbinding votes on top executives' compensation
- Major Canadian banks and some public companies moving to offer shareholders non-binding say-on-pay vote
- Directors are unlikely to ignore the message
- Clear communication of rationale behind executive compensation arrangements is needed

"Risk-Aligned" Compensation

Summary:

- Share awards considered superior to options
- Recommend placing cash and equity grants "in escrow" with clawbacks for poor performance
- Require longer performance periods: defer payments until profits and risks related to individual's performance are known

Non-Tax Issues

- Legal questions regarding clawback mechanisms
- Performance sensitivity creates more complexity and conflicts with demand for simple understandable plans
- Regulatory difficulties in controlling pay
- Competition for top talent
- Environment for boards and compensation committees becoming more difficult

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Tax Issues

- **Canadian tax rules and policies are inconsistent with “risk-aligned” deferral of compensation:**
  - Stock options are most tax-effective method but considered inferior under risk-aligned analysis
  - Salary deferral arrangement (SDA) rules penalize deferral of cash awards beyond 3 years
  - Clawbacks have particularly harsh tax consequences - forfeited amounts are generally not deductible from income

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Tax Issues *Cont'd*

- Placing deferred amounts "in escrow" does not provide relief from SDA immediate income inclusion
- SDA definition covers conditional rights as well as absolute rights
- CRA broadly interprets the SDA rules: "plans designed to circumvent the SDA rules by purporting to involve a substantial risk of forfeiture will fail"
- If in fact a deferral of income, CRA presumes that one of the main purposes is to defer tax

Long-Term Incentive Plan

Performance Appreciation Rights:

- SDA rules can be avoided by awarding rights to receive amounts that relate only to future services rendered over a multi-year horizon after the time of grant
- Future payments based on appreciation in value of the business measured by specified financial performance and adjusted for risks the employee takes on behalf of the company

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Performance Vesting:

- Vesting criteria not just time based
- Must reach specified performance levels and satisfy risk management factors
- Criteria established at the time of grant

Restricted Stock

- **Restricted Stock Held in Trust:**
  - Restricted stock results in an immediate taxable benefit at the time it is acquired even if there is a substantial risk of forfeiture - capital loss on forfeiture cannot be applied to offset benefit included in income
- **Alternative:**
  - If shares are held in trust until certain conditions are satisfied there will be a deduction for employees if shares are forfeited as a result of employee not meeting the conditions

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Restricted Share Units

RSUs Settled with Equity:

- RSU/Phantom share: right granted to receive value of one share at a future date (proxy for shares of employer)
- RSUs settled in cash are limited to 3-year deferral under SDA rule and RSUs settled in shares come under stock option rules
- If providing for settlement in treasury shares the deferral period can be extended under stock option rules
- Upon settlement of RSUs, employee will be taxed on fair market value of shares (or cash) received

Deferred Share Units

- Exempt from SDA treatment if DSU plan satisfies conditions of regulation 6801(d)
- Participant taxed when amounts received under DSU plan after death, retirement or termination of service
- If director elects to replace fees with DSUs, must make election before entitled to receive fees to avoid constructive receipt
- Cannot be easily or quickly wound up

Repricing Options

- Institutional investors take firm position against repricing
- Securities law issues
- Some companies adopting option exchange programs
- Paragraph 110(1)(d): deduction can be preserved

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Supplemental Executive Retirement Plans ("SERPs")

- CCGG concerned that SERPs may be used as a form of non-performance linked compensation
- Cannot avoid characterization as SDA simply by referring to benefits as pension or retiring allowance

Supplemental Executive Retirement Plans ("SERPs")

- **CRA May 2007:**
  - although a SERP may be a plan to pay pension benefits it will be subject to SDA rules if supplemental pension benefits are "unreasonable"
- **2008 CRA Roundtable:**
  - supplemental pension benefits reasonable if terms apply to beneficiaries of underlying RPP and provide for substantially same benefits in type and quantum

Thank You

Gloria J. Geddes
Partner and National Leader,
Executive Compensation Group
Gowling Lafleur Henderson LLP

T: 416.369.4583
F: 416.862.7661
Email: gloria.geddes@gowlings.com

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Lawyers • Patent and Trade-mark Agents