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CLARKSON
Centre for Board Effectiveness

Before and After Say on Pay
Say on Pay in Canada: 2009-2011

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Say on Pay and the Adoption of Key Compensation Practices and Disclosure Components

In 2009, the Clarkson Centre for Board Effectiveness (CCBE) began tracking the adoption of Say on Pay advisory votes by firms on the S&P/TSX Composite Index (TSX Index). In 2011, a total of 66 firms out of 252 had adopted Say on Pay, making up 26% of all firms on the S&P/TSX Composite Index.

To better understand compensation governance trends among firms that adopt Say on Pay, the CCBE compared the adoption rate of 20 key Compensation Practices and Disclosure Components (Components)[1] by firms before and after the adoption of Say on Pay over a three-year observation period (2009-2011). For the purposes of this report, we chose a sample that includes the 122 firms who joined the TSX Index prior to 2008 and who remained on the index throughout to 2011. Of the 122 firms, 51 had adopted Say on Pay since 2009, making up 41.8% of the sample.

The firms in our sample continue to adopt new Components over time, with an average increase of 1.9 components per firm between 2008 and 2011. We predicted that the increased exposure to shareholder scrutiny and judgment resulting from Say on Pay might influence boards to adopt behaviours that further bolster their compensation governance and pay and performance alignment after adopting Say on Pay. As such, the CCBE wanted to determine whether the adoption of Say on Pay prompts firms to increase their adoption rate of key Components.

At the beginning of our observation, the average number of Components adopted per firm among 2009 Say on Pay adopters increased from 10.77 in 2008 to 11.08 in 2009, for a total increase of 0.31, while non-adopters of Say on Pay in 2009 increased from 5.7 to 6.1, for a total increase of 0.39. These figures highlight two important findings that we investigate further below: early adopters of Say on Pay had already implemented significantly more Components than other firms, and adoption of Say on Pay does not appear to influence the rate of implementation of new Components.

In 2010 and 2011, slight increases in Component adoption rates continued overall. Meanwhile, the increase in Component implementation for Say on Pay adopters just barely surpassed that of non-adopters. Those who adopted Say on Pay in 2011 went from an average score of 7.61 in 2010 to 8.38 in 2011, for a total average increase of 0.78, whereas non-adopters of Say on Pay had a score increase

[1] For a full definition of these Components, see Appendix 1.

from 6.08 to 6.85; an average increase of 0.76. Most notable in these findings is that new adopters of Say on Pay in 2011 have a significantly lower level of Component implementation (7.61) in 2011 compared to the earliest adopters in 2009 (10.77).

There is no clear indication that the adoption of Say on Pay prompts firms to increase their rate of Component adoption. Rather, we found that the causality appears to work in the opposite direction. In other words, firms with higher Component adoption rates are more inclined to adopt Say on Pay and do so earlier on. At the onset of Say on Pay adoption in Canada, the first wave of firms to adopt Say on Pay in 2009 had adopted an average of 10.77 components before adoption, compared to the non-adopters who averaged 5.7 for the same time period. 11 of the 13 firms (85%) who adopted Say on Pay in the first wave were large financial institutions who had robust compensation practices as well as good governance practices in place. According to the Rotman Board Shareholder Confidence Index (BSCI), these 11 financial institutions had an average governance score of 90 compared to the rest of the Index with an average governance score of 76. This suggests that firms with already-robust governance systems in place are most likely to adopt new best practices, such as Say on Pay. In other words, good governance (as defined by the BSCI and adoption of Components) is a predictor of Say on Pay adoption.

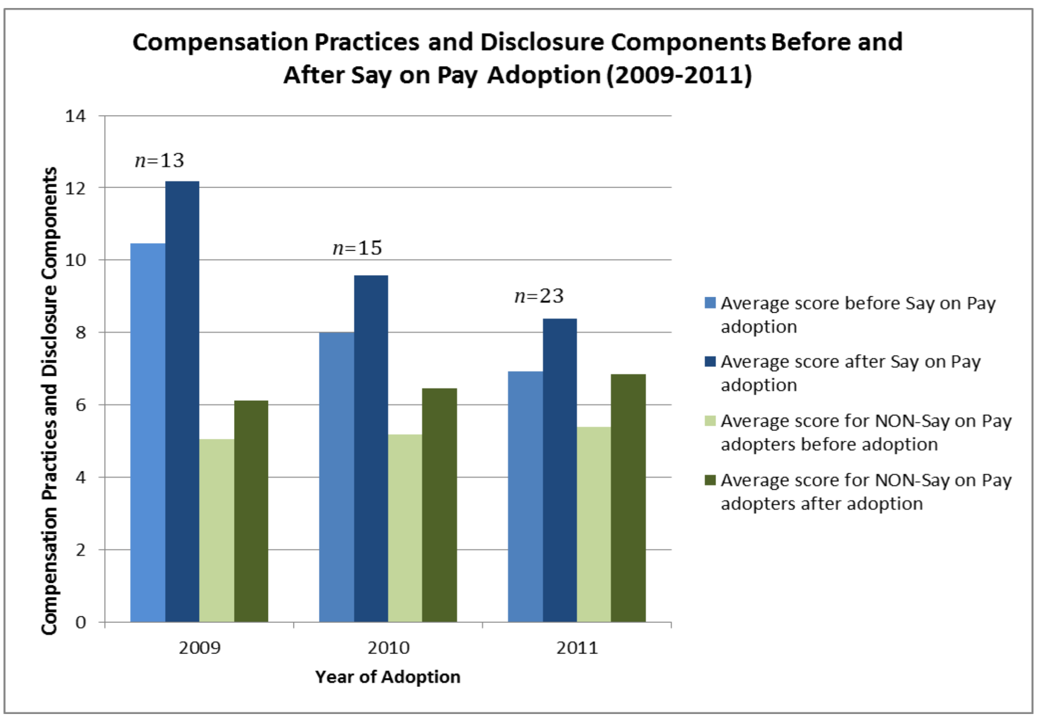

Figure 1.

Following the initial wave of Say on Pay adopters in 2009, we see the gap between the very high performing firms in terms of Component adoption and the lower performing firms shrink. For example, in 2010 the average number of Components adopted by new Say on Pay adopters before adoption was 8, whereas the average score for non-adopters for the same time period was 5. In 2011, the trend continues, with an average score of 7 before adoption for Say on Pay adopters and 5 for non-adopters. This further bolsters our belief that good governance is a predictor of Say on Pay adoption, rather than Say on Pay adoption leading to the implementation of new governance best practices.

Say on Pay and Firm Size/Good Governance

Firms who score highly in Compensation Practices and Disclosure (Components) continue to be top performers in governance. From our sample, the 51 adopters of Say on Pay had an average governance score of 79 while non-adopters had an average governance score of 54 according to the 2011 Rotman Board Shareholder Confidence Index (See Figure 3). Further, adopters of Say on Pay tend to have larger market capitalization. The average market cap of Say on Pay adopters is much higher than non-Say on Pay adopters, with an average market cap of $20.5 billion compared to $6.8 billion respectively, in 2011 (See Figure 2). This indicates that both firm size and governance best practices are predictors of Say on Pay adoption.

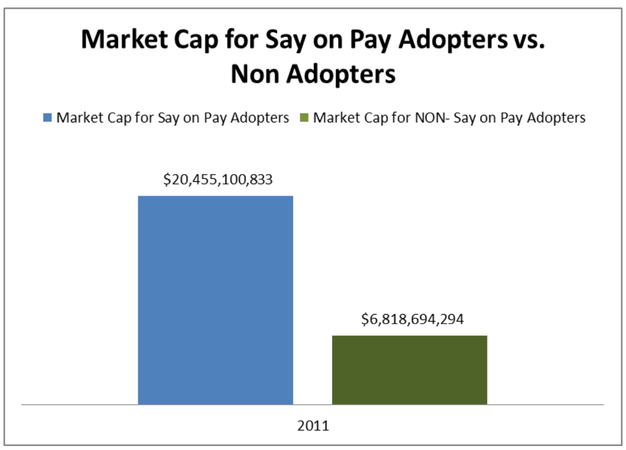

Figure 2.

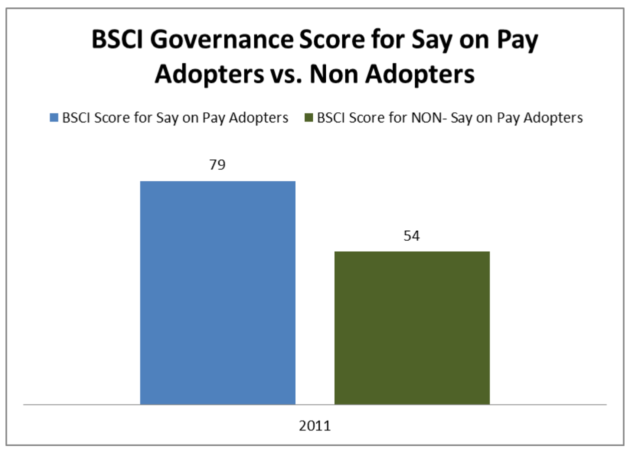

Figure 3.

A further explanation for this pattern may be that firms who have a high adoption rate of key Compensation Practices and Disclosure are properly equipped to provide shareholders with detailed information needed to make educated determinations on executive compensation packages. A common criticism of Say on Pay is that shareholders may not have sufficient information and knowledge on executive compensation to make an educated judgment regarding the appropriateness of a proposed compensation plan. Shareholders depend upon the information provided to them by an issuer in the report on executive compensation in the Management Circular to make their Say on Pay decision. If an issuer has not adopted best practices in governance oversight and disclosure (e.g. the Components), they may be less inclined to adopt Say on Pay. A firm, particularly with a smaller market cap (fewer resources) and one who does not exhibit best governance practices may be less compelled to take on the additional costs to implement the Compensation Practices and Disclosure required to allow for effective shareholder engagement on executive compensation, whereby shareholders are equipped with the necessary tools to cast informed Say on Pay votes. On the other hand, firms who already exhibit strong governance and robust Compensation Practices and Disclosure appear to be more confident in the additional shareholder influence that Say on Pay invites.

Say-on-Pay and Pay-and-Performance

We found little evidence that suggests that strong pay and performance alignment prompts companies to adopt Say on Pay. Pay and performance, measured using total CEO pay and TSR, in both short and long-term observation periods are not significantly better aligned in firms who adopt Say on Pay compared to non-adopters of Say on Pay.[2] Therefore, firms who adopt Say on Pay do not appear to be driven by their confidence in good pay and performance alignment, or lack thereof. According to ISS' 2009-2010 policy survey of international shareholders, "an overwhelming 94 percent of institutional respondents indicated that pay-for-performance would be a critical or important consideration for their "Say on Pay" vote determinations.[3] Although pay and performance alignment is a prominent point of consideration for shareholders when voting on Say on Pay, it does not appear to factor into issuers' decisions in Say on Pay adoption. Whether Say on Pay drives stronger pay and performance alignment, however, is unclear due to its very recent introduction to the Canadian marketplace. This is a topic that CCBE will examine in several years, at which time meaningful correlations can be observed.

[2] Pay and performance assessments are made using data collected for CCBE's ongoing, unpublished pay/performance study.

[3] Gary Hewitt and Carol Bowie. *Evaluating Pay for Performance Alignment: ISS' Quantitative and Qualitative Approach.* Institutional Shareholder Services. December 2011. Retrieved from: http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf

Conclusion

While it is not evident that the adoption of Say on Pay directly impacts the adoption rate of key Compensation Practices and Disclosure Components, it is evident that firms with an *already robust* culmination of Compensation Practices and Disclosure are most inclined to adopt Say on Pay and were the first to do so in Canada. The CCBE will continue to monitor the impact of Say on Pay on compensation behaviour in upcoming years.

Appendices

Appendix 1. Compensation Practices and Disclosure Components

The Clarkson Centre for Board Effectiveness (CCBE) tracks the adoption of the following 20 key Compensation Practices and Disclosure Components:

A) Equity Components

1. Option Vesting Period
2. Option Performance Requirements
3. Holding Period (General)
4. Evergreen Option Plan
5. Hurdles on RSUs
6. CEO Holding Period (Retirement)
7. Double Trigger on Option Vesting
8. Equity Monetizing Prohibited

B) Alignment Components

9. Look-Back Table
10. CEO SOG
11. Cost of CEO as % of Corporate Performance
12. Clawback
13. Bonus is related to financial metrics
14. Performance measured against peer group
15. Possible $0 bonus
16. Stress Testing

C) Disclosure Components

17. Double Trigger on Change of Control
18. Pay for performance disclosure with conclusions
19. Weightings provided
20. Company spells out performance outcomes and bonus payouts