

# Torys on Corporate and Capital Markets

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## Corporate Governance Developments in Canada and the United States

By [Cornell Wright](#) and [Leslie McCallum](#)

Corporate governance was a major focus of attention for lawmakers, securities regulators and investors during 2010, and we expect further significant developments in 2011. The Ontario Securities Commission (OSC) has announced a shareholder democracy initiative, which involves soliciting input from market participants on say-on-pay, majority voting and the overall effectiveness of the proxy voting system. Executive compensation and the work of compensation committees are under increased scrutiny, with new regulatory initiatives focusing on the relationship between compensation practices and risk management. This bulletin reviews these and other recent corporate governance developments in both Canada and the United States, and recaps where things stand as the 2011 proxy season approaches.

### Say-on-Pay

The U.S. Securities and Exchange Commission (SEC) has adopted final rules on shareholder approval of executive compensation, as required under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). Canadian and other foreign private issuers are exempt from the new rules. A non-binding say-on-pay vote must occur at least once every three years, beginning with the first annual shareholders' meeting held on or after January 21, 2011. Companies are also required to hold a "frequency vote" at least once every six years to allow shareholders to decide how often they would like to be presented with a say-on-pay vote.

Companies will also have to provide a non-binding shareholder vote on certain "golden parachute" compensation arrangements in connection with changes of control, if the transaction is otherwise subject to shareholder approval (i.e., tender offers will not require a vote). These voting requirements will apply to meetings for which proxy materials are filed on or after April 25, 2011. Exemptions apply when the compensation arrangements involve executive officers of foreign private issuers.

Although say-on-pay is not mandatory under Canadian law, it has already been adopted voluntarily by approximately 45 Canadian companies. The practice is also supported by Canadian institutional investors, and the Canadian Coalition for Good Governance (CCGG) has published a [model say-on-pay policy for boards of directors](#). The OSC is currently seeking comment, as part of its shareholder democracy initiative discussed further below, on whether say-on-pay should be mandatory in Canada.

Notably, during the 2010 proxy season there were three high-profile instances in which shareholders of U.S. companies expressed their dissatisfaction with executives' compensation by voting "no" in the say-on-pay vote. Although say-on-pay votes are not binding, most companies will certainly want to avoid a negative outcome by engaging with shareholders to hear and address their concerns before the annual meeting. To

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this end, we believe that the most significant aspect of say-on-pay is not the outcome of the vote per se, but the incentive it creates for companies both to engage in this dialogue with shareholders and to improve their executive compensation disclosure to ensure that shareholders have a good understanding of every element of the compensation program.

## OSC Shareholder Democracy Initiative

The OSC recently announced that it is considering regulatory changes to enhance shareholder democracy at public companies. The following issues are being considered:

**Slate voting and majority voting.** The OSC is assessing whether reforms to securities law are appropriate to facilitate individual director voting and majority voting in uncontested director elections. This is a key governance issue for the 2011 proxy season. The CCGG has developed a [majority voting policy](#) and is actively promoting the adoption of majority voting by assisting its members in submitting shareholder proposals to Canadian companies, and in the United States, CalPERS and other activist shareholders have been submitting proposals to U.S. companies. While many large Canadian companies already have majority voting policies, many smaller companies do not.

**The effectiveness of the proxy voting system.** The OSC is reviewing the proxy voting system to determine whether securities law reforms are needed to facilitate shareholders' making informed voting decisions and having their votes counted at shareholder meetings. Issues that may be considered include "empty voting" (where the voting rights attached to shares may be exercised by someone who does not have the full, or any, economic interest in those shares) and the role of proxy advisory firms. In mid-2010, the SEC similarly solicited comment on the effectiveness of the U.S. proxy voting system. We expect the SEC to move forward with regulatory proposals, but the timing is uncertain given its focus on implementing the many new rules mandated by the Dodd-Frank Act.

**Shareholder advisory votes on executive compensation.** The OSC has been monitoring international developments on say-on-pay, including in the United States, the United Kingdom and Australia, where say-on-pay is already mandatory, and is considering whether to make it mandatory for Canadian public companies.

The OSC is seeking comments from market participants on the above issues until March 31, 2011, and intends to coordinate the development of any regulatory proposals with the other Canadian securities regulators.

## Executive Compensation and Compensation Committees

The Canadian Securities Administrators (CSA) recently proposed changes to the disclosure requirements pertaining to executive compensation and Compensation Committees. Under the proposals, companies would have to disclose, among other things,

- risks arising from compensation policies and practices that are likely to have a material adverse effect on the company,
- whether directors and officers are permitted to hedge the value of their holdings of the company's equity securities,
- the level of compensation expertise of Compensation Committee members, and
- fees paid to compensation consultants for executive compensation and other work.

The CSA's executive compensation proposals are open for comment until February 17, 2011, and are expected to be implemented for the 2012 proxy season. For additional details and steps that companies can take to begin preparing for these changes, see the article [Changes to Executive Compensation Disclosure in Canada](#). In 2011, we expect Canadian securities regulators to continue to focus on the quality of executive compensation disclosure.

The CSA's proposals are similar to new rules that the SEC must implement under the Dodd-Frank Act. In addition, under Dodd-Frank, all Compensation Committee members of U.S. companies will have to be independent; enhanced disclosure will be required of the relationship between executive compensation and issuers' financial performance; and the compensation of individual officers may be clawed back if financial results are restated (even if the officer engaged in no wrongdoing).

## Risk Management

The CSA's executive compensation proposals reflect the regulators' current focus on risk management. The regulators have provided specific examples of compensation practices that could encourage excessive risk-taking, such as weighting compensation toward short-term objectives or making performance-based payouts before the associated risks are likely to materialize. More generally, the CSA stated in its 2010 report on corporate governance disclosure (discussed further below) that risk-management practices are under increased scrutiny, and regulators are monitoring this area closely.

The same is true in the United States. At the end of 2009, the SEC adopted new proxy circular rules requiring companies to disclose, among other things, information about the board's role in risk oversight and, in certain circumstances, how the company's compensation policies and practices relate to risk management. More broadly, the Dodd-Frank Act mandates various new requirements pertaining to risk management, with the overall objective of reducing systemic risk in the U.S. financial markets following the recent financial crisis and subsequent government bailouts.

## Disclosure of Corporate Governance Practices

The CSA conducted a review in 2010 of the quality of Canadian issuers' corporate governance disclosure and concluded that the level of compliance is unacceptable. The [CSA's report](#) urges issuers to provide less boilerplate and more transparent, robust disclosure about their corporate governance practices. There is guidance on how issuers can improve their disclosure about directors' independence, as well as on new director orientation and continuing education, performance assessments, nominating procedures and other matters. For additional detail, see our bulletin [CSA Report on Corporate Governance Disclosure in Canada](#).

## CCGG Initiatives

The CCGG continues to be an active voice for the interests of institutional shareholders. In addition to its ongoing board engagement program, under which the CCGG plans to meet with 45 to 50 public company boards of directors during 2011, the organization has published updates of several of its policies and best practices, including [Building High Performance Boards](#). The CCGG has indicated that in 2011 it plans to publish guidance on how the principles in *Building High Performance Boards* apply to controlled companies and on corporate governance at companies with dual-class share structures. The CCGG has also published its latest guidance on proxy circular disclosure (best practices for executive compensation and director-related disclosure); guidelines for boards on engaging with their shareholders; and guidelines for shareholders on monitoring, voting and engaging with companies. These can be found on the [CCGG website](#).

The CCGG has expressed its support for a national securities regulator and has filed a factum in the Supreme Court of Canada's reference on the constitutionality of the proposed federal Securities Act.

## Proxy Access

The SEC recently liberalized its rules on proxy access for shareholders wishing to nominate their own candidates for election to public company boards of directors. If and when implemented, the new rules will require U.S. public companies to include shareholder nominees in their proxy statements, meaning that dissident shareholders will not have to prepare and mail their own proxy circulars. Proxy access would be available for shareholders or groups owning 3% or more of the company's stock for at least three years. The maximum number of shareholder candidates would be one or 25% of the board, whichever is greater, and shareholders proposing a candidate could not have a change-of-control intent.

Proxy access was originally scheduled to commence with the 2011 proxy season, but the SEC has stayed the new rules pending the resolution of a legal challenge. U.S. market participants are now expecting proxy access to commence in 2012.

Although corporate statutes in Canada have long permitted shareholders to submit proposals that include nominations for the election of directors, we expect proxy access as introduced in the United States to be a focus of debate in Canada during 2011, as institutional investors continue to seek a greater voice in choosing the individuals who will serve on public company boards of directors.

## Website Posting of Proxy Materials

Canadian securities regulators have published for comment proposed changes to National Instrument 54-101, *Communication with Beneficial Owners of Securities of a Reporting Issuer*. The proposals (discussed in our bulletin [Canadian Securities Regulators Propose Permitting Website Posting of Annual Proxy Materials](#)) include "notice-and-access," which permits reporting issuers to make their annual proxy-related materials available to securityholders by posting these materials on the issuer's website. The proposals are similar to the U.S. notice-and-access regime recently implemented by the SEC – the one significant difference being that Canadian issuers would still be required to mail hard copies of their annual financial statements and MD&A to securityholders, whereas U.S. issuers are not.

## Whistleblower Incentive Payments in the United States

The Dodd-Frank Act authorizes the SEC to pay whistleblowers for information about violations of U.S. securities laws if the information leads to a successful prosecution or civil suit. Directors and in-house counsel have expressed concern that such financial incentives could compromise the effectiveness of companies' in-house whistleblowing procedures by encouraging employees to bypass them in favour of direct reporting to the SEC, especially given that the potential payments by the SEC are substantial: between 10% and 30% of the penalty paid by the defendant in the relevant proceeding. The SEC is required to adopt rules implementing the Dodd-Frank whistleblower program by March 2011. **T**