GOVERNANCE TRENDS AROUND THE WORLD

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Dodd-Frank and U.S. Corporate Governance Changes:

Coming to a Canadian Organization Near You

IT WOULD BE INCORRECT TO BELIEVE THAT recent corporate governance reforms in the U.S. (including those prescribed by last summer's Dodd-Frank Wall Street Reform and Consumer Protection Act) will not impact Canadian practices, non-financial services firms, or other sectors beyond publicly traded companies. As we learned from the impact of Sarbanes-Oxley (S-Ox), no sector or company is immune from regulatory precedent and emerging developments. Note also that the Canadian Securities Administrators (CSA) has not amended its National Policy since 2005, and no doubt will review global regulatory and integrated market developments during its next round of reform.

The regulatory impact is now more rigorous, intrusive, complex and daunting, and extends throughout the U.S. economy beyond the firm level. One commentator recently referred to Sarbanes-Oxley as "kindergarten" compared to emerging developments in the U.S.

Here are some of the key trends and issues in U.S. governance today, incorporating Dodd-Frank and other developments, together with advice for Canadian boards of directors, reporting management and advisors.

Risk Governance

The SEC (Securities and Exchange Commission) is now requiring disclosure of the board's role in risk oversight. The CSA had "Principle 7: Recognize and Manage Risk," in its Dec. 2008 proposal and might wish to address risk oversight by the board in any subsequent proposal, as risk governance is not explicitly and separately addressed in any of the 18 guidelines of the 2005 policy.

Boards (all boards in all sectors) are wise to ensure that all material risks are assured by management, internal and external assurance providers; that the risk-management function reports directly to the board or a committee; that such function is adequately resourced and independent; and that the board receives regular and robust reporting on risk appropriate for the organization.

The board should take all reasonable steps to ensure that its charters incorporate and address all material risks (financial and non-financial/sustainable). External legal counsel's pro-forma review of mandates from a compliance perspective may be inadequate, as the board and management are more familiar with material risks of the organization. All risks should be reflected in board and committee oversight and reporting, to the satisfaction of the board.

Risk-Adjusted Compensation

If a manager takes imprudent risks (any risk, in any organization) because of compensation structure (incentives or quantum), the board should know of this possibility. The board should insist on risk-adjusted compensation metrics; on deferral of payments and longer performance periods; on reduced sensitivity to short-term performance; and on adequate internal controls over compensation, which are all appropriate for the organization. Financial regulators (including the

Financial Stability Board, Basel, FDIC, others) are now honing in on compensation, but these emerging practices are expected to apply to all sectors.

It is crucial that compensation consultants and committees be independent (Dodd-Frank), but further, that board committees insist that management and consultants propose risk-adjusted compensation regimes. Any compensation consultant should be pressed in this regard by the compensation committee and validation should occur consistent with emerging developments appropriate for the company. Metrics such as total shareholder return (TSR), profit, revenue, market share and the like are not necessarily risk-adjusted. Compensation committees should retain negative discretion (that is, the ability to adjust pay downward given unanticipated events or mistakes in judgment made by the committee during stress testing) to adjust rewards as it deems appropriate (thus requiring a full knowledge of the drivers by the committee). Regulators are now emphasizing qualitative judgment and exercise of it by boards. The compensation committee should possess expertise, discretion, qualitative data, resources and good judgment.

Clawbacks and Malus

Provisions for clawing back portions of incentive-based compensation under certain circumstances (e.g., an accounting restatement due to previous material noncompliance) are mandated under Dodd-Frank and will soon become the norm. The threshold (e.g., restatement), the degree of clawback, and the discretion and exercise by the board /committee over the executives should be consistent with regulatory requirements, appropriate for the organization, and the board should exercise full authority here if and when required.

Shareholder Approval of Executive Compensation, or "Say on Pay"

This practice will soon be adopted by all listed companies on U.S. exchanges (for first meetings held after January 22, 2011) as a result of Dodd-Frank. So will "say when on pay" (how often should a company hold a say on pay vote: every one, two or three years?), and "say on golden parachutes." Canadian boards and management teams whose companies are on U.S. exchanges are wise to draft competitive pay policies and plans for approval by shareholders consistent with best executive compensation practices (salary, bonus, LTIP, etc.), and, most important, consistent with shareholder views. There must also be a clear description under Dodd-Frank of the relationship between executive compensation paid and the company's financial performance, as well as pay-equity disclosure (to occur in the future as a result of Dodd-Frank) comparing the median compensation of all employees to that of the CEO.

Clearly, by regulating pay in this fashion, Congress is sending a message that boards have been incapable of reining in excessive compensation, and that therefore reposing approval authority in the hands of shareholders, and documenting rigorous pay practices and disparities, are both reasonable and necessary. The amount of new work however, including documentation and data collection, and obligations for compensation committees, will be significant and intrusive, involving for example the calculation of compensation of each employee in every jurisdiction in which the company operates. This pay legislation applies, with exceptions, to all listed U.S. companies, not just financial institutions.

Shareholder Engagement and Proxy Access

Proxy access under Dodd-Frank is expected to be a "game changer." Any group of shareholders with 3% of a company's equity held over three years is intended by the SEC to be entitled (subject to certain conditions) to propose candidates (up to 25% of the board) for election to the board of the company, in the proxy circular, and have the costs for doing so funded by the company. Canadian companies (particularly those listed on US exchanges) are wise to understand their shareholder base and its concerns,

and the board (not only management) should have direct regular access with key (and eventually, a wider base of) shareholders in an appropriate manner (e.g., transparent, controlled, with a level playing field, using virtual meetings and other technology appropriate for the shareholder base) to facilitate access and communication. Policies should be drafted by companies for board approval that address constructive and meaningful dialogue between the board and investors.

Board and Committee Leadership

U.S. companies (under Dodd-Frank and the prescribed SEC rule) must disclose their leadership structure – e.g., independent chair vs. chair and CEO, lead director – and how that is appropriate for each company's specific circumstances and characteristics. One academic studying board leadership has questioned the focus on the separation of roles of Chair and CEO: "There is no evidence of substantive, systemic relationships between corporate financial performance and board leadership structure." Thus there may be compelling circumstances in which to combine board leadership roles, and if so, they should be disclosed to regulators and shareholders.

For Canadian companies, there should be a position description for the chair that includes competencies and skills the chair is expected to bring to the board in exercising his or her role and responsibilities, and the chair should be regularly assessed by directors, having regard to this position description. Selection procedures and succession planning for the board chair should be disclosed. For each board leadership position (chair of the board and committee chairs), position descriptions and the competencies and skills expected of the incumbents should be disclosed and readily accessible to shareholders.

Diversification of Boards and Disclosure of Director Qualifications

The SEC (and the province of Quebec, the UK, EU, Australia, and other jurisdictions) have now started to look at board diversity in a serious way, given the aftermath of the global financial crisis (GFC). There is academic research that indicates more diverse boards may lead to less group-think, be more innovative, and be more effective in group decision-making. For U.S.-listed boards, diversity plans should address definitions, targets, objectives, internal reviews and culture. Canadian boards are wise to follow suit.

There is also scholarship seriously questioning the U.S. and UK (pre-GFC) regulatory primacy accorded to director independence. The SEC and UK have since amended their rules and codes, focusing now on director skill, qualifications and experiences. All boards would be wise to disclose for current and prospective directors a full competency matrix (including that prescribed under Canada's National Policy), including which directors possess which competencies and skills deemed appropriate by the board. Competencies such as leadership, financial acumen, industry knowledge, compensation, international, governance, etc., should be fully disclosed and available to shareholders, along with behavioural attributes expected of all directors (e.g., integrity, communication, teamwork, commitment, etc.). Directors should be regularly assessed on the possession of these competencies and skills – in a manner appropriate by the board – and re-nomination should incorporate these assessments. Some regulators are now advising third-party facilitations to review these assessments on a regular basis.

Boards may be wise to emphasize that prospective directors nominated by shareholders under proxy access should also be expected to possess some of the foregoing desired qualifications (including competencies and skills) appropriate for the organization. This would address concerns expressed by business groups about "one issue" candidates with particular agendas not necessarily in the long-term interests of the organization. The National Association for Corporate Directors, on October 1, released a white paper entitled "Board Building – Analyze, Recruit, Evaluate," containing a template for disclosure of director skills and attributes.

The above governance-related provisions under Dodd-Frank and other U.S.-based regulation are not exhaustive, but represent the major provisions at this point. Clearly, directors, boards and organizations should all prepare for more rigorous regulation and accountability in coming years in the way organizations are run and governed.

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