January 17, 2011

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Office of the Attorney General, Prince Edward Island
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

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Re: **Request for Comments – Proposed Amendments to Form 51-102F6 *Statement of Executive Compensation* and Consequential Amendments**

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We are writing in response to the Canadian Securities Administrators' (CSA) request for comments on proposed amendments to Form 51-102F6 *Statement of Executive Compensation*[1]. NEI Investments commends the CSA for its continuing efforts to enhance corporate disclosure on executive compensation, and for seeking input in this process.

With over $4.8 billion in assets under management, NEI Investments' approach to investing incorporates the thesis that companies integrating best environmental, social and governance (ESG) practices into their strategy and operations will provide higher risk-adjusted returns over the long term. Through our company evaluations, our active engagement with the companies in our funds, and our issues research, we have developed considerable insight into good practices and weaknesses in executive compensation disclosure and practice, which we endeavour to share in the context of consultations on policy and standards.

Our ESG analysts evaluate the policy and practice of major Canadian and international issuers against an array of environmental, social and governance indicators. In 2010, in support of our corporate engagement activities, they undertook benchmarking research into executive compensation disclosure and practice in two sectors that in different ways are highly exposed to risk: oil and gas, and financials. A special focus of this research was to explore how companies are linking compensation to ESG performance indicators. We have been engaging companies on this topic for a number of years: in April 2006 we wrote to all companies on the TSX Composite Index, asking them to take steps to link executive and director performance evaluations and compensation plans to the achievement of long-term ESG objectives.

In the following pages we set out our comments and recommendations on the CSA disclosure proposals, drawing on our recent research. We also refer back to our earlier letter to CSA on compensation disclosure, submitted in 2007 during consultations on the present requirements[2].

Compensation as a driver of long-term sustainable value

Compensation is a key driver for executive behaviour, and compensation frameworks should incentivize effective risk management and building long-term sustainable value. In its *Executive Compensation Principles*[3], the Canadian Coalition for Good Governance (CCGG) states that good compensation frameworks integrate pay for performance and "the effective implementation of risk controls suitable for the particular business by directly linking risk management with the executive compensation structure". Executive compensation disclosure should enable investors to understand how decisions on compensation are made, and how compensation is linked to corporate and individual performance.

In its *Global Corporate Governance Principles*, the International Corporate Governance Network (ICGN) defines the objective of the company as "sustainable value creation", and states that "sustainability implies that the company must manage effectively the governance, social and environmental aspects of its activities as well as the financial"[4]. CSA's own

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[1] **Canadian Securities Administrators.** Proposed Amendments to Form 51-102F6 Statement of Executive Compensation. [Online] 2010. http://www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20101119_51-102_rfc-amd-f6.pdf

[2] **Ethical Funds.** Re: Proposed Form 51-102F6 Statement of Executive Compensation. [Online] 2007. http://www.osc.gov.on.ca/documents/en/Securities-Category5-Comments/com_20070628_51-102_walkerr.pdf

[3] **Canadian Coalition for Good Governance.** Executive Compensation Principles. [Online] 2009. http://www.ccgg.ca/site/ccgg/assets/pdf/2009_Executive_Compensation_Principles.pdf

[4] **International Corporate Governance Network**. Global Corporate Governance Principles: Revised. [Online] 2009. http://www.icgn.org/files/icgn_main/pdfs/best_practice/global_principles/short_version_-_icgn_global_corporate_governance_principles-_revised_2009.pdf

recently-published guidance on environmental disclosure[5] has underlined that non-financial issues may be material for publicly-traded companies. Increasingly, investors are integrating environmental, social and governance (ESG) considerations into their decision-making both in Canada and internationally. In a 2009 report[6], the Social Investment Organization (SIO) found that assets invested according to responsible investment guidelines in Canada had reached over $609 billion (almost 20% of total assets under management); while internationally investment institutions with assets under management of US$ 22 trillion have committed to integrate ESG considerations into investment decision-making and ownership practices under the Principles for Responsible Investment (PRI)[7]. As more and more investors begin to consider ESG factors as risks or opportunities for long-term company value, they will expect ESG-related performance to be integrated as a variable in compensation frameworks – and they will expect companies to provide disclosure on this.

Strong compensation disclosure requirements serve investors by encouraging reporting that enables them to assess if good practices are being followed, or if issues are being ignored in a way that could pose risk. An increasing number of Canadian companies are offering shareholders an advisory vote on executive compensation ("say on pay"). Against this background, clear and comparable compensation disclosure is more essential than ever, to enable investors to determine whether the compensation framework is aligned to long-term sustainable value creation, and make effective use of their vote. Enhanced disclosure requirements can also be a driver to improve compensation practice. In this context, we note that corporate advisors are already suggesting that companies should, where necessary, consider amending questionable compensation practices in anticipation of the new disclosure requirements[8].

In Staff Notice 51-331 *Report on Staff's Review of Executive Compensation Disclosure*[9], CSA found weaknesses in disclosure on the linkage of compensation to performance, the process of decision-making, compensation benchmarking, and performance goals (with the latter being the area in which most issues were found). From our own benchmarking of compensation practice among issuers in two key Canadian sectors (financials and oil and gas), we would agree that these are key areas of concern.

Based on our benchmarking, a further cause for concern is that, based on their disclosure, few companies appear to be linking compensation to long-term ESG indicators. We are currently engaging the boards of several of Canada's largest financial and oil and gas companies on this issue. It is telling that most of the best practice examples we have been sharing with oil and gas companies come from peers outside Canada.

Comments on the proposed amendments

In the following sections, we address the questions posed by CSA, as well as offering other specific comments on the draft. We have followed the lay-out of the draft, highlighting where we have addressed the questions posed by CSA.

[5] **Canadian Securities Administrators.** Staff Notice 51-333 Environmental Reporting Guidance. [Online] 2010. http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20101027_51-333_environmental-reporting.pdf

[6] **Social Investment Organization.** Canadian Socially Responsible Investment Review 2008. [Online] 2009. http://www.socialinvestment.ca/documents/caReview2008.pdf

[7] **Principles for Responsible Investment.** Report on Progress. [Online] 2010. http://www.unpri.org/files/2010_Report-on-progress-press-release.pdf

[8] See, for example: **Tory's.** Changes to Executive Compensation Disclosure. [Online] 2010. http://www.torys.com/Publications/Documents/Publication%20PDFs/AR2010-51.pdf

[9] **Canadian Securities Administrators.** Staff Notice 51-333 Report on Staff's Review of Executive Compensation Disclosure. [Online] 2009. http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20091120_51-331_rpt-ecd.pdf

ITEM 2 – Compensation Discussion & Analysis (CD&A)

Section 2.1(3) - Benchmarking

Based on our research among financials companies, we would like to see better disclosure on peer group comparability and the rationale for benchmarking decisions. While disclosure of the companies in the peer group is mandated and provided, in general little information is provided on why that peer group is relevant. For example, we have seen smaller banks include in their peer group much larger banks (in terms of revenue, employees, etc) with little explanation of how the peer group is determined, and no information on whether any adjustment or scaling has been done to make the peer group more relevant in terms of scope and extent of risks and challenges. More positively, we noted that Scotiabank's proxy circular included a table setting out peer group companies' revenue, net income, market capitalization and employees, and showing where Scotiabank ranks in each category (although it was not clear if it had adjusted or scaled for these ranking differences in its compensation framework). We also detected a tendency at the banks for total rewards to be "reverse-engineered" – pre-determined by targeting them to the median of the company's peer group.

Section 2.1(4) - Performance goals

The examples of objective measures and quantitative and qualitative indicators provided in section 2.1(4) and the associated commentary do not extend beyond financial indicators. In its *2009 Executive Compensation Principles*, CCGG provides a useful discussion on characteristics of good performance metrics: relevant, tied to key strategic goals, covering a range of dimensions of long-term performance, and potentially including non-financial indicators such as environmental performance. In a study on methodologies to align risk to compensation schemes[10], the Bank for International Settlements discussed the measurement of risks that lead to the reward, noting that "targets based on revenue, profit or income, cash flow or return on equity are still frequently used as a performance measurement... such measures rarely capture the full range (or any) of risks that employees' activities pose for the firm". The study also found that the more that non-risk based measures are used to assess performance, the greater the need for risk adjustment. It would be helpful if the requirements encouraged companies to take a wider perspective on performance criteria – specifically, by including reference to longer-term performance indicators and ESG indicators.

In our research, we found that Canadian banks are including some long-term ESG measures such as customer satisfaction as performance metrics, but that these are either used as secondary factors or are supposedly built into individual targets. Even in an industry where ESG issues pose extreme and obvious risks, such as the oil and gas industry, we find that companies are providing limited disclosure on compensation metrics such as safety performance and environmental compliance. In the wake of the 2010 BP disaster, this is not acceptable. In our 2007 submission we asked CSA to consider adding additional guidance on the scope and content of narrative description of targets to cover company and sector-relevant ESG indicators, and we reiterate that suggestion now.

We would also like to see more clarity in the discussion of NEO accomplishments. In Staff Notice 51-331, one of the weaknesses highlighted by CSA is that "companies should have explicitly linked the discussion about performance goals in the CD&A with their NEOs' compensation". At the banks, we find there is often discussion of accomplishments under NEOs, but it is unclear if or how these relate to individual targets or corporate targets – giving the appearance of an attempt to rationalize away the amount that is being paid.

[10] **Bank for International Settlements.** Range of Methodologies for Risk and Performance Alignment of Remuneration. [Online] 2010. http://www.bis.org/publ/bcbs178.pdf

CSA Proposal 1: Serious prejudice exemption in relation to the disclosure of performance goals or similar conditions

We support limiting the scope of the "serious prejudice" exemption under 2.1(4), as well as requiring a company to state explicitly if it is relying on the exemption, and to explain why. In our 2007 submission, we expressed concern that there could be considerable disparity in how companies would apply the exemption. Based on the CSA's review finding that a number of companies were improperly relying on the exemption, these concerns appear to have been realized. In our experience disclosure on performance goals and measures often leaves investors in the dark as to whether the exemption has been applied, or whether metrics simply do not exist. In 2007 we noted that current year performance targets are already historical at the time of disclosure in the proxy circular, reducing the potential for competitive harm; that while companies may hesitate to disclose specific targets for forward-looking performance criteria, a general description of qualitative and quantitative performance criteria has little potential for competitive harm; and that other jurisdictions already require detailed forward-looking disclosure of compensation plan performance criteria.

As noted earlier, in the course of our benchmarking we found that disclosure of ESG-related performance goals or measures in the compensation context was particularly weak among oil and gas companies. Yet many of these companies disclose relevant ESG performance data in annual reports or corporate social responsibility reports (e.g. health and safety statistics, oil spills, environmental fines, carbon emissions). Therefore even under the original requirements, the "serious prejudice" exemption should not apply. Ideally we would like to see explicit reference to the need to disclose compensation performance goals related to ESG metrics, if these do not meet the exemption criteria.

Item 2 Commentary 1 (page 10746)

The commentary could be enhanced with more guidance on the kind of information that would facilitate a reasonable person to "understand the disclosure elsewhere in this form". We agree that CD&A disclosure should provide investors with insight into the principles of a company's compensation framework, and explain the decisions that have been made, and that "disclosure that merely describes the process for determining compensation… is not adequate". We do, however, value the type of process disclosure that allows us to follow through the different stages of the compensation calculation and understand how the company arrives at the total. At present we find that some companies jump from the basic compensation philosophy to the compensation end result, without showing the calculation stages in between. In this context, we would find it helpful if companies provided an overview (perhaps in the form of a table or graphic) enabling investors to grasp efficiently how the final compensation figures were generated. The type of information we are looking for in this context includes the structuring of compensation (salary and bonus); the metrics, targets, results and weighting underlying the business performance factor; the contribution of the individual performance factor; and to what extent the board has exercised its discretion.

A standard practice in discussing compensation packages is to disclose what percentage of an executive's total pay is variable, or "at risk". We suggest the CSA should provide explicit guidance as to when compensation can be termed "at risk". In order for the term to be truly meaningful, it should imply that there is a real risk that a compensation element will not be awarded if performance does not meet expectations. But often, what is really "at risk" is the size of the payout, not its existence. We found that short term incentive plans are more likely to be truly "at risk" – as demonstrated at several companies during the recent recession, where no short-term bonus was granted. But most mid- to long-term incentives are neither truly performance-based, nor truly "at risk". Compensation committees regularly represent equity-based awards as being performance-based, with the rationale that there is an incentive to improve performance because if the stock price goes up, so does the pay package. In reality, executives still receive a significant benefit if the share price has decreased from the date of award. By contrast, a long-term share award that will only vest

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if, after a period of at least five years, the share price hits a certain target price, can be considered "at risk" and performance-based.

Item 2 Commentary 3 (page 10746)

Adding a reference in the commentary to disclosure on the use of discretion is useful, but given the degree to which boards appear to rely on discretion, we would suggest that this topic should be integrated into the main text under Section 2.1, so that it is clear that if discretion is used it must be disclosed and discussed.

Use of discretion is contrary to the concept of pay for performance. As outlined in the CCGG *Executive Compensation Principles*, once metrics are agreed boards should be hesitant to make exceptions and should disclose fully how and why discretion was used. In our benchmarking research we found excessive use of discretion generally, but also that many boards are failing to describe how and why discretion has been used, making it difficult for investors to determine if compensation decisions were prudent or warranted. There will always be extenuating circumstances in which discretion needs to be applied, such as in the case of significant positive or negative performance that was unforeseen, but failing to meet targets that proved overly-ambitious is not a justification to abandon the compensation framework. Too often, boards choose to use discretion to reward under-performance: when company performance is good then bonuses are awarded based on metrics, but when the company performance is bad then discretion is applied to award bonuses.

2.1(5) Compensation risk management

CSA Proposal 2: Risk management in relation to the company's compensation policies and practices

CSA Question 1: Would expanding the scope of the CD&A to require disclosure concerning a company's compensation policies and practices as it relates to risk provide meaningful disclosures to investors?

Yes, we believe expanding the scope in this way is useful. It would give us new insight into compensation policies and practices that could lead to excessive or inappropriate risk-taking by employees, as well as NEOs. Investors learned to their cost during the recent downturn that at many companies, compensation policies and practices had been contributing to risk rather than building long-term sustainable value. As the Financial Stability Forum (FSF) noted in its 2009[11], "the incentives provided by compensation can be extremely powerful. Without attention to the risk implications of the compensation system, risk management and control systems can be overwhelmed, evaded, or captured by risk-takers". From an investor perspective, if a risky compensation practice causes losses, it makes no difference whether that practice applied to NEOs or other employees. This disclosure requirement may drive improvements in practice, as companies will likely wish to demonstrate that they understand the link between risk and compensation, and are managing this issue.

In a high-risk industry, few oil and gas companies are providing adequate information on how compensation relates to risk, and how compensation mitigates or increases risk. Specifically, discussion of how short term incentives could impact on ESG performance indicators, which are often long-term in character, is rarely provided.

[11] **Financial Stability Forum.** FSF Principles for Sound Compensation Practices. [Online] 2009. http://www.financialstabilityboard.org/publications/r_0904b.pdf?frames=0

CSA Question 2: Is the commentary of the issues that a company may consider to discuss and analyze sufficient?

No, we suggest that the commentary be expanded. In particular, we would like to see the following poor practices highlighted in the commentary:

- Absence of critical non-financial metrics and targets (e.g. environment, health and safety, customer satisfaction) within the performance metrics used in determining compensation. Non-financial issues pose risks and opportunities that are significant for company performance, but the impacts often manifest over a longer period, so that they may be ignored in favour of shorter-term metrics and incentives.
- Significant equity-based awards that simply vest over time. Companies often provide a significant portion of NEO long-term compensation in equities that vest over several years, but without imposing any performance conditions for vesting.
- Excessive and unexplained application of discretion (as discussed earlier).

CSA Question 3: Are there certain risks that are more clearly aligned with compensation practices the disclosure of which would be material to investors?

In addition to the points mentioned above, our detailed *Proxy Voting Guidelines*[12] highlight a number of compensation practices that we view with concern, including:

- egregious employment contracts, including excessive severance provisions;
- excessive benefits that dominate compensation;
- large bonus payouts without performance linkage;
- large salary increases without a performance linkage;
- excessive options granted to senior executives;
- company loans to executives;
- egregious SERP (Supplemental Executive Retirement Plan) payouts;
- internal pay disparity, based on comparison of total compensation of top executives with that of workers receiving lowest or average pay.

Decision-making structures in which NEOs are determining their own compensation, or conflicts of interest on the Compensation Committee involving directors who are also NEOs of other companies, can also create risk. This is discussed further below.

Finally, even in an otherwise well-designed performance-based framework, extremely high compensation can in itself create risk, if it insulates the recipient from the consequences of future risky behavior. In the financial sector in particular, compensation is a "hot-button" issue that creates reputational risk. For example, Goldman Sachs included discussion of the compensation and reputation issue in their disclosure last year.

[12] **NEI Investments**. Proxy Voting Guidelines. [Online] 2010.
http://www.neiinvestments.com/NEIFiles/PDFs/5.2.3%20Proxy%20Voting/5.2.3%20Proxy%20Voting%20proxy_voting_guidelines.pdf

CSA Question 4: Are there any other specific items we should list as possibly material information?

The focus of the new requirement is on disclosure of practices that increase risk – but investors also have an interest in disclosure on practices that companies put in place to mitigate risk. Some companies are already describing such activities, but mentioning risk mitigation practices in the requirements could inspire further disclosure (and ultimately adoption of good practices). Good practices that we would like to see more widely adopted include:

- Incorporating risk assessment into compensation decision-making. For example, at TD Bank, there is an explicit risk adjustment based on a report by the Chief Risk Officer (CRO), while at Scotiabank the Compensation Committee meets with the Risk Committee and receives a report from the CRO. This type of practice should help to align compensation with the company's risk appetite.
- Disclosing the total compensation of all NEOs as a percentage of overall revenues or as a percentage of overall compensation and benefits expenses. Ideally, we would also like to see companies disclose how this percentage compares to the median at peer companies.
- Undertaking scenario analysis to stress test the compensation plan – a good practice highlighted in the 2009 CCGG principles, and one which we raised in our 2007 submission to CSA.

We would reiterate that the commentary should be more explicit in guiding companies to address how long-term ESG risks are mitigated or increased by compensation practices, including short-term incentives.

Section 2.1(6) - Hedging

CSA Proposal 3: Disclosure regarding executive officer and director hedging

We support the proposed requirement for the company to disclose if NEOs or directors are permitted to undertake what we consider to be a questionable practice. If NEOs can buy insurance on their variable compensation then they are being rewarded for both the upside and downside of performance, defeating the object of the exercise. Indeed, this is an example of risky compensation practice that could shed light on the general quality of governance at the company. We would rather see this practice cease, but where companies are allowing it we would certainly like to know about it.

Section 2.2 - Performance graph

In addition to the present requirement, it would be helpful to add a sector performance line. Ultimately, a company's performance should be judged against its sector peers, not against the TSX Composite Index, as this may mask true over- or under-performance.

Section 2.4 (2) – Compensation committee

We suggest adding the following potential areas of conflict of interest to disclosure on the compensation committee:

- Disclose if any of the members of the compensation committee are currently NEOs of similar sized companies.
- Disclose if any of the issuer's NEOs currently serve (or have previously served) on the board or compensation committee of another company, where any of that company's NEOs are members of the issuer's board or compensation committee.

- Disclose if compensation committee members sit together on the compensation committee of another company.

Section 2.4(3) – Compensation advisors

We support the addition of this section. Our *Proxy Voting Guidelines* favour proposals to require disclosure of fees paid to compensation consultants and fees for other services that could create potential conflicts of interest for the consultants. We also specify that the independence of the consultant must be maintained, disclosed, and annually reviewed.
We would suggest adding a requirement to disclose if the consultant is involved in determining the compensation for any members of the compensation committee at another company, as this is a further area of potential conflict of interest.

CSA Proposal 4: Disclosure of fees paid to compensation advisors

CSA Question 5: The proposed disclosure requirement calls for disclosure of all fees paid to compensation advisors for each service provided. Should we impose a materiality threshold in disclosing the fees paid to compensation advisors based on a certain dollar amount?

No, we recommend against imposing a materiality threshold based on a dollar amount. We seek comparable data, and can judge for ourselves if it is material. We normalize audit fee data, and can easily normalize compensation fee data to determine if it is material. What is not material to the client company could nevertheless be significant for the consultant, in terms of creating conflict of interest.

ITEM 4 - Incentive Plan Awards

Section 4.3 - Narrative discussion - Commentary

Under the commentary on this section, it is noted that companies should provide disclosure on "general descriptions of formulae or criteria that are used to determine amounts payable" and "performance goals or similar conditions, or other significant conditions." In our benchmarking, we found weak disclosure on the background to long-term incentive awards. At the banks, we found a significant amount of disclosure around the rationale and calculation of the cash bonus (or short term incentive), little around the mid-term bonus and almost nothing on the long-term bonus. Among the oil and gas companies, disclosure was almost universally weak with respect to the relationship of incentive awards to ESG-related performance conditions: despite almost all stating explicitly in their compensation discussion and analysis that they included some form of ESG performance criteria when determining executive compensation, very few of the companies we reviewed actually provide "descriptions of formulae or criteria" or "performance goals". As a result, it is impossible to determine how ESG performance impacted actual incentive awards – if at all.

In our wider experience of examining proxy disclosure, we have come across several examples of companies including a table showing how NEO incentive plan payouts correspond to performance targets and results. Specifically, such tables describe the metrics, the targets set at the beginning of the year, the actual performance against that target, the weighting given to each metric, and the resulting percentage of the target payout awarded[13]. Where companies have concrete metrics and targets within the incentive plan, it would be helpful to shareholders if the commentary included the suggestion that these could be presented in the form of a table.

[13] An example can be found in the Barrick Gold proxy circular.

ITEM 5 – Pension Plan Benefits

Section 5.2 – Defined contribution plans table – Commentary 2

We are not convinced of the benefit of offering two options for where to disclose company contributions to personal registered retirement savings plans. Allowing this disclosure in column (h) of the summary compensation table implies that it will be aggregated with disparate types of compensation, including such perquisites as use of the company jet. We believe this will provide less clarity for investors.

Conclusion and main recommendations

We commend CSA's continuing commitment to review and enhance executive compensation disclosure. We support the proposed amendments, and ask CSA to consider the additional suggestions we have made. In particular, we believe the requirements would by enhanced through the following additions:

- Make specific reference to longer-term performance indicators and ESG performance indicators, and to how excessive reliance on short-term financial indicators can mask risk in other areas.
- Require disclosure of detail that allows investors to follow through the stages of the compensation calculation, including disclosure of performance targets used and actual performance against those targets.
- Require disclosure on how and why discretion has been used.
- Expand the list of risky compensation practices that should be disclosed.

Should you have any questions with regard to this submission, please do not hesitate to contact Michelle de Cordova, Manager, Public Policy & Research (mdecordova@NEIinvestments.com, 604-742-8319).

Sincerely,

NEI Investments

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CC: Board of Directors, NEI Investments