## 6.2.2 Cost Benefit Analysis - Executive Compensation Disclosure - Amendments to NI 51-102 Continuous Disclosure Obligations

**COST-BENEFIT ANALYSIS**
**EXECUTIVE COMPENSATION DISCLOSURE – AMENDMENTS TO**
**NATIONAL INSTRUMENT 51-102 *CONTINUOUS DISCLOSURE OBLIGATIONS***

### Issue

The current executive compensation disclosure requirements in Form 51-102F6 *Statement of Executive Compensation*[1] may not provide investors with the information they need to understand whether management's incentives align with shareholder interests. There is concern that the content of Form 51-102F6 is out of date and does not reflect current compensation practices. This form does not currently require issuers to disclose all executive compensation, and does not require issuers to summarize the total compensation they pay to their executives and directors. As such, the disclosure may not provide investors with the level of transparency, or the consistency they need to make informed investment decisions. For instance, issuers commonly grant shares or units to executives under deferred or restricted plans. Valuing such types of compensation requires a significant amount of assumptions. This can create uncertainty for investors when reviewing executive compensation. Although some issuers do provide all compensation types in their disclosure, this is not the standard, which makes it difficult to compare executive compensation among issuers.

If the current disclosure rules are not amended, the required executive compensation disclosure will fail to keep pace with compensation practices. This may result in increased uncertainty for investors, which can increase the perception of risk. If investors perceive an investment to be more risky, they will demand a higher level of return. This would increase the cost of capital to firms. Also, investors may incur additional monitoring costs for estimating executive compensation.

### Objective

The Canadian Securities Administrators (CSA) are proposing to amend Form 51-102F6 *Statement of Executive Compensation* to require public issuers to disclose all significant[2] forms of compensation. The objective of the proposal is to improve the transparency and consistency of executive compensation disclosure. When proposing rule amendments the CSA must consider their mandate of promoting fair and efficient markets while protecting investors. To fulfill this mandate, the CSA must consider the cost of new regulation imposed on issuers and whether those costs are justified by the likely outcomes.

The proposed amendments would help investors improve their understanding of a company's executive compensation practice, since companies would be disclosing all forms of executive compensation. The rationale for that compensation would be further clarified in the proposed "compensation discussion and analysis". In addition, it will be easier to compare compensation of individual executives since reporting issuers must provide a single compensation figure.

This analysis discusses the issues relating to executive compensation disclosure and analyzes the option of maintaining the status quo (the current Form 51-102F6 reporting requirements) and enhancing Form 51-102F6 under the CSA proposal.

### Stakeholders

The key stakeholders in the execution compensation issue are:

- All reporting issuers are currently required to file the annual NI 51-102F6 executive compensation form unless they are SEC issuers, in which case they can use the SEC disclosure[3]. New disclosure requirements may impose additional costs on those companies that file Form 51-102F6.

- Investors, as owners of a company, would benefit from increased disclosure about how the company's assets are used. The associated costs of providing additional disclosure is also realized by shareholders, through the company's performance.

### Background

### Economic rationale for disclosure

The purpose of executive compensation disclosure is to provide investors with information that will help them assess the stewardship of the company. When a company hires an executive, that individual acts on behalf of the company's owners, its shareholders. The shareholders want executives to maximize the company's profits, which is their return on investment. Similarly, there is incentive for executives to maximize their own earnings, which is paid for by shareholders. These objectives

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1 National Instrument 51-102 *Continuous Disclosure Obligations*

2 In some circumstances, executive perquisites with an aggregate value less than $50,000 (and 10 per cent of the total salary) may not be reported.

3 Some companies are exempt from filing F6 if they meet the conditions stated in Item 14 ("Issuers Reporting in the United States")

may conflict. Without proper compensation disclosure, shareholders cannot determine if management's incentives are aligned with shareholder interests and whether the level of compensation reflects the executive's performance.

If shareholders could perfectly monitor an executive's behaviour, they could determine exactly how much an executive should be paid. However, the monitoring costs would be prohibitive, and as a result, shareholders have incomplete information to assess how well an executive is acting in their best interest.

Full compensation disclosure helps shareholders compare an executive's compensation to the quality of their decision making. This allows investors to make investing decisions based at least in part on how the company is using its capital and whether executives are worth the pay they are receiving in relation to their performance.

**Quality of disclosure**

In 2002, the CSA randomly selected a sample of companies to test whether their disclosure described how executive compensation was determined and how it related to performance. The study found that 95% of the companies disclosed compensation information in boilerplate language or general terms[4]. This suggests that stronger legislation may be required by regulators to enforce relevant and meaningful discussions. Also, a plain language requirement may help investors understand the disclosure[5].

**Transparency**

To increase transparency, some Canadian companies are providing supplemental information beyond what is currently required in Form 51-102F6. This demonstrates that investors are demanding more information than what is currently required to be disclosed. Other companies are providing less transparent disclosure than what is expected, due to the limitations of the current form.

A U.S. academic study[6] suggested that some executives prefer less transparent compensation because it reduces shareholder backlash. Examples include deferred compensation, post-retirement perks[7], below-market-rate loans[8], loan forgiveness, "backdoor" options[9] and consulting contracts. These benefits are either not reported or are difficult for companies to value for the annual executive compensation table[10] required by the SEC.

Inconsistent reporting also makes it increasingly difficult for investors to calculate the total compensation paid to executive officers. In Canada, examples of semi-transparent compensation include performance-based share units, "top-hat" pensions[11] and incomplete termination policies that do not explain all of the payout conditions.

**Regulatory environment**

In the U.S., the SEC recently revised its executive compensation disclosure requirements as described under File Number S7-03-06, "Executive Compensation and Related Party Disclosure". This increased disclosure is required in a company's proxy statements, with a fiscal year end on or after December 15, 2006.

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4 This review randomly sampled 76 companies. Source: http://www.csa-acvm.ca/html_CSA/news/exec_comp1105.htm.

5 Plain language is "communication that your audience can understand the first time they read or hear it". Source: http://www.plainlanguage.gov/whatisPL/index.cfm.

6 Bebchuk, L. and Fried, Jesse, "Executive Compensation as an Agency Problem" (2003), Journal of Economic Perspectives, Vol 17, No 3, pp 71-92.

7 The Canadian Income Tax Act limits the amount of a defined-benefit pension to $2,111 x number of years in service (for 2006). To adequately reflect pre-retirement earnings, executives obtain additional retirement benefits through a supplemental executive retirement plan (SERP). SERP contacts are difficult to value since they are unique to each company (e.g. topped up initially, whether the survivor gets retirement benefits, benefits adjusted to inflation, etc). Source: Kalyta, P. and Magnan, M, " 'Stealth' Compensation and the Extraction of Rents: Examination of Supplemental Executive Pensions" (2006), Working Paper. Source: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=923573.

8 The U.S.'s Sarbanes-Oxley Act of 2002 now prohibits these loans.

9 Executives buy shares in the subsidiary and force the parent company to buy out their positions in the future. Fortune Magazine, October 30, 2006, p 38.

10 This is under the previous 1992 rules on disclosure of executive compensation. There are new compensation disclosure requirements for companies filing in 2007.

11 A benefit that provides additional years of service to the employee's pension beyond the number of years actually worked.

The major changes include:

- Disclosing and reporting all elements of compensation in a standardized table with a single figure for total compensation. This includes items such perquisites that exceed $10,000, mandatory disclosure of the CEO's and CFO's pay, and disclosure of grants to be received in the future.

- Including a compensation discussion and analysis section. This section provides a discussion and analysis of the material factors underlying the compensation policies and decisions set out in the compensation table.

- Using plain language for almost all proxy disclosures.

The SEC rules also require the CEO and CFO to certify their company's executive compensation disclosure. This may help ensure that CEOs and CFOs are held more accountable to their company's financial statements.

The current level of compensation disclosure in Form 51-102F6 is significantly different than that in the U.S. because of these recent changes in U.S. regulation. If investors view Canadian disclosure as less thorough than the U.S., some investors may perceive Canadian firms as riskier investments. This could impede Canada's ability to retain domestic capital and attract international capital.

**Costs and benefits**

This section analyzes the costs and benefits of maintaining the status quo and enhancing compensation disclosure requirements, as described in the CSA proposal.

**1. Maintain the status quo**

The CSA could maintain the current executive compensation disclosure requirements, as specified in Form 51-102F6.

**Costs**

- Investors will continue to have incomplete compensation data when making investment and voting decisions.

- Investors will continue to incur higher monitoring costs[12].

- The recently implemented change to the SEC's executive compensation disclosure requirements provides more transparency over the current Canadian regulation. This may impose a higher cost of capital on Canadian issuers that are not registered with the SEC.

**Benefits**

- No increased costs to the company.

**Risks**

- New innovative forms of executive compensation may not be captured under the current NI 51-102F6 reporting requirements and the disclosure will be increasingly inadequate. This may make it difficult for a board of directors to fully understand the total compensation paid to its executives[13].

- As discussed previously, there is an incentive for executives to maximize their salary, which is paid for by shareholders. An empirical study suggests that executives may use earnings management on income-decreasing discretionary accruals once their maximum bonus is reached[14]. For example, they may decelerate the recognition of sales or expense repair expenditures. If the company has no maximum bonus, management may prefer income-increasing salary accruals to boost their salary level. Regardless of the bonus scheme, it may be difficult for investors to detect manipulation, since total accruals are made up of discretionary and non-discretionary values, and management can estimate the former. If a company's executives are consistently exceeding their performance goals, disclosing this information will increase scrutiny of their numbers.

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[12] Lowering monitoring costs helps alleviate the "collective action" problem, where shareholders become "rationally apathetic" and depend on others to do the monitoring (and personally realize costs) for the benefit of all. This disclosure may increase the probability of shareholder influence on executive compensation. Source: Iacobucci, E. "The Effects of Disclosure on Executive Compensation" (1998), University of Toronto Law Journal, Volume XLVIII, Number 4 Source: http://www.utpjournals.com/product/utlj/484/484_iacobucci.html.

[13] Jensen, M, and Murphy, K, "CEO Incentives - It's Not How Much You Pay, But How", Harvard Business Review, May/June 1990, No 3, pp 138-153. This document is also available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=146148.

[14] Healy, P, "The Effect of Bonus Schemes on Accounting Decisions," (1985), Journal Accounting and Economics, 7, 1-3, pp. 85-107.

**2. Enhance disclosure requirements as described in proposal**

The major enhancements in the proposal are:

- Providing a compensation discussion and analysis section (replaces item 9 in form 51-102F6). This provides insight into the compensation numbers included in the tables on the underlying executive compensation figures.
- Updating the summary compensation table to include all elements of compensation and to also include a single total compensation number.
- Improving disclosure on pension benefits and termination payments.

In the proposed amendments to Form 51-102F6, the CSA views that the form should be a starting point for good disclosure. Companies, for example, may add and delete columns in the compensation tables to more accurately reflect their compensation practices.

**Costs**

There are costs associated with the preparing the proposed compensation discussion and analysis section and updating the summary compensation table. These initial and ongoing costs include:

- external consultants, who might be required to estimate previously undisclosed non-cash items
- in-house compliance fees (legal and accounting)
- system changes
- higher total number of hours for document preparation

**Benefits**

Increasing executive compensation transparency provides more information about the company (or decreases information asymmetry)[15]. This may help:

- improve the accuracy of the share price since the total amount of executive compensation, a potentially significant expense, is factored into the company's financial data
- provide a lower cost of capital for companies that reveal sound compensation practices, since investors are better able to assess the risk of the company
- investors make better-informed investment decisions
- investors also make better-informed voting decisions, for example, a shareholder could withhold voting for a board of directors if the company is providing an unreasonable level of executive compensation
- provide insight into how financially prudent a company is in allocating its capital
- reduce the monitoring cost to investors, since more informative disclosure and executive compensation performance measures may ensure that they are acting in the investor's best interest
- dissuade some executives who seek to maximize their compensation through earnings management

A bottom-line disclosure figure will also help compensation committees make better decisions because they will have a clear understanding of how much they are paying their executives and how their policies compare with similar companies.

[15] Verrecchia, R, Essays on Disclosure, Journal of Accounting and Economics, Volume 32, Number 1, December 2001, pp. 97-180.

**Risks**

Increasing the level of disclosure may have the following unintended consequences:

- Wage inflation (the "Lake Wobegon"[16] effect), where all companies must pay above average to attract the right executive talent. This effectively inflates every CEO's salary, since hiring below average is a strike to the company's institutional pride[17]. This compensation effect, however, may be limited since officers and directors have a fiduciary duty to "act honestly, and in good faith, with a view to the best interest of the corporation"[18] [19]. Directors may also put their reputation at risk if they are seen as "being asleep at the wheel" by approving unsound compensation. That is, they risk their own future career opportunities and stature[20].

- The poaching of "star" executives by rival companies[21] [22]. Competing companies could offer attractive compensation packages significantly above the executive's current salary. It may also be difficult for lower-paying companies to attract talent.

- The "tournament effect", where people lower on the executive ladder are willing to accept their relative lower salary in anticipation of obtaining a high-paying opportunity in the future. Full disclosure of compensation may intensify this effect. This would likely be classified as a benefit to shareholders, since it lowers the salary average of the company. Alternatively, salary inflation as described above may be another consequence of disclosing larger than expected executive compensation.[23].

- If a plain language requirement is not explicitly stated in the rule, companies may unknowingly make it difficult for investors to understand their compensation practices.

**Summary**

Through qualitative research, we analyzed the costs and benefits of executive compensation disclosure. We analyzed the options of maintaining the status quo and implementing the CSA proposal. Our preliminary analysis suggests that maintaining the status quo is not an option, since the current NI 51-102F6 disclosure is not adequately capturing all forms of compensation.

Improving executive compensation disclosure may benefit stakeholders by:

- helping investors make better-informed investment decisions;

- lowering the cost of capital to the firm;

- lowering monitoring costs for investors, and

- encouraging the flow of capital to Canadian markets.

We are soliciting feedback from stakeholders in order to evaluate the costs and benefits of the proposed amendment relative to the status quo. Your response will help us determine whether the CSA proposal will result in undue hardship on issuers, whether the CSA proposal will result in the desired benefit for investors, and whether we should consider other options.

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16 This term was taken from Garrison Keillor's novel, "Lake Wobegon Days", where all of Lake Wobegon's children are "above average".

17 Supra note 12.

18 Refer to Section 122(1) of the *Canada Business Companies Act.*

19 Nearly all Canadian companies purchase insurance to protect their directors and officers against lawsuits. This limited personal responsibility helps support the Lake Wobegon effect. Source: Cheffins, B. and Black, B "Outside Director Liability Across Countries". Texas Law Review, Vol. 84, pp. 1385-1480, 2006. Source: http://ssrn.com/abstract=438321

20 Davis, Kenneth, "The Directors Duty of Oversight- Pre-Enron; Post-Enron" (2002), presentation paper; International Conference to Commemorate the Fortieth Anniversary of the Korean Commercial Code

Source: http://www.law.wisc.edu/facstaff/download.php?iID=103.

21 HR Policy Association's comment letter to SEC on executive compensation. Oct 23, 2006. Source: http://www.sec.gov /rules/proposed/s70306/jmcguiness7086.pdf.

22 Current F6 reporting requirements already impose this risk. The new reporting requirements may intensify this effect when previously undisclosed forms of executive compensation are revealed.

23 Iacobucci, E and Trebilcock, M, "The Law and Economics of Executive Compensation" (1996), C.D. Howe Institute, Source: http://www.cdhowe.org/pdf/icabucci.pdf.

**Feedback on the proposed amendments**

As part of the comment process, the Ontario Securities Commission is soliciting feedback from investors and issuers on the costs and benefits of the proposed changes to Form 51-102F6. We ask that interested parties submit their responses to the questions below within the 90-day comment period stated in the accompanying notice.

Please send your responses and inquiries to the following:

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**Investor survey on the proposed amendments to Form 51-102F6**

1. In what capacity do you use the information contained in Form 51-102F6?

   [ ] Investment or credit rating analyst

   [ ] Institutional investor

   [ ] Retail investor

   [ ] Other (please specify) __________________

2. Do you believe the proposed changes to Form 51-102F6 will provide useful information for capital market participants? Please explain.

3. Will the additional content have a positive or negative affect on your ability to evaluate a company as a potential investment?

4. When reviewing an issuer's disclosure, have you ever contacted the firm to seek clarification about their executive compensation disclosure?

   a. If you have, were you able to find the information you were looking for?

   b. How many times per year do you seek further compensation information from an issuer?

   c. How much effort (in hours per year) is spent on that activity?

   d. In your opinion, would the proposed changes to Form 51-102F6 reduce the incidence of needing further information from issuers?

**<u>Company survey on the proposed amendments to Form 51-102F6</u>**

**Do not complete survey if your company is exempt from filing Form 51-102F6 by meeting the conditions of Item 14 ("Issuers Reporting in the United States"). This exemption was drafted into the current proposal.**

We will only publish the results in an aggregate form. Please indicate if you consider any of the information that you are providing is confidential. You should be aware that this information could be requested under the *Freedom of Information and Protection of Privacy* Act.

1) What is your company's current total assets (i.e. current plus long-term) and market capitalization (in $000)?

What was your company's administrative expenses in the most recent fiscal year (in $000)?

2) Estimate the <u>incremental</u> costs realized on an initial and on-going basis (in work hours and hourly wage rate in Canadian dollars) per year under the CSA proposal.

For example, assume a firm is currently allocating 60 hours of compliance work per year to prepare Form 51-102F6 with wages at $150/hour. Under the CSA proposal, the firm estimates that its total number of compliance hours would increase to 67 in the first year and 63 after that. The compliance cost will be reported as:

Compliance: 7 hours @ $150/hour (initial) and 3 hours @ $150/hour (ongoing)

i) Redrafting compensation practices into compensation discussion and analysis (CD&A):

| | Initial cost (report # of hours and $/hr) | Ongoing costs (report # of hours and $/hr) |
|---|---|---|
| Preparing CD&A disclosure | | |
| Ensuring compliance with rule (legal and accounting) | | |
| Other (please specify) | | |

ii) Amending the executive summary compensation table:

Provide cost estimates for preparing the table :

| | Initial cost (report # of hours and $/hr) | Ongoing costs (report # of hours and $/hr) |
|---|---|---|
| Preparing the new compensation table format | | |
| Ensuring table data are in compliance with rule (legal, accounting, testing data integrity, monitoring top salaried named executive officers, etc.) | | |
| Other (please specify) | | |

iii) Valuating previously undisclosed executive benefits.

Outline each benefit (e.g. actuarial value of defined benefit pension plans, severance benefit, etc.) and whether the valuation is done in-house or requires external expertise.

| Benefit | Cost of valuating benefit (# of hours and $/hr) | In-house or external (or both)? |
|---|---|---|
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Are there any other costs (e.g. system maintenance or other non-labour costs) that should be included? Please specify and indicate whether they are initial or ongoing costs.

iv) Estimate the initial and ongoing costs (in $000) for preparing the director's compensation table and supporting narrative section.

3. Do you believe that plain language should be required to enhance investor comprehension? What will your start-up and ongoing costs be for plain language training (provide work hours and hourly wage rate)? Alternatively, if you would seek external consultants to provide this service, please state and estimate your start up and ongoing costs (in $000/year).