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Our Corporate Governance Series

Introduction

A great deal of discussion and legislative and regulatory initiatives with respect to corporate governance are currently occupying public attention, in large part in reaction to the issues raised by the Enron, Worldcom and Tyco events in the U.S. In the post-Enron environment of responsible corporate governance, public companies and regulators are going to great lengths to regain the trust of the public in the capital markets. Changes, both voluntary and involuntary, are taking place and will continue to take place in all areas of corporate activity which are affected by governance issues.

This booklet, produced by Fasken Martineau, is part of a series intended to provide an overview of corporate governance issues as they affect public companies and their officers and directors. This booklet discusses Executive Compensation. Other existing booklets discuss Corporate Disclosure and Investor Communications, Director Independence, Audit Committees, Board and Director Evaluation, Orientation and Education, Board Charters and Codes. The next booklet, which will be the last in the series, will cover Regulatory Penalties and Directors’ and Officers’ liability, including indemnification and insurance coverage matters, as relates to each of the areas discussed in the preceding booklets. Directors and officers may be able to secure at least partial protection against such liabilities but the processes of putting protective measures in place, and enforcing them when claims arise, raise complex issues requiring careful planning and execution.

By its very nature, a publication of this kind is not intended to provide a detailed analysis of all the issues, laws, regulations and policies affecting corporate governance. It is designed to provide a broad overview of the subject matter and to stimulate the reader to obtain further information as required in the reader’s particular circumstances. More comprehensive legal advice will be required to fully meet the specifics of each situation. What are presented in this booklet are suggestions for consideration by the reader.

For convenience of the reader, certain capitalized terms are defined in the Glossary at the end of each booklet.

Fasken Martineau is a multi-service law firm and a Canadian leader in the practice of business law and litigation. With over 560 lawyers in offices in Vancouver, Calgary, Toronto, Montreal, Quebec City, New York, London and Johannesburg, we provide services to our clients in virtually all areas of the law, on a national and international basis.
Executive Summary

- The potential for abuse of the power to compensate executives raises significant corporate governance concerns.
- Shareholder activism is being fuelled by examples of executive compensation gone to extremes.
- Directors’ vigilance in oversight of executive compensation is often seen as lacking.
- Responsibility for executive compensation oversight is frequently delegated to compensation committees.
- Current Canadian regulatory environment for compensation committees is fairly unrestricted - but that is changing.
  - TSX Governance Guidelines
  - Proposed Policy 58-201
  - Proposed MI 58-101
  - NI 51-102
- All compensation committee members should be independent directors.
- Disclosure on compensation currently provided by companies in response to existing Canadian securities regulation is considered inadequate.
- Recent Canadian and American jurisprudence has significantly raised the standards for directors’ exercise of their fiduciary duties with respect to executive compensation.
- Best practices suggestions by the conference Boards, of Canada, the United States and Europe for compensation committees of public companies will be very helpful in providing guidance with respect to executive compensation.
The Temperature Is Rising

Executive compensation has become one of the most significant polarizing issues of corporate governance today. Words such as “excessive” and “abusive” are often used to describe compensation plans that seem to reward senior management while the companies they serve suffer declines in revenue and profitability. Tyco, WorldCom, General Electric and even the NYSE, are often cited as examples of executive compensation gone wrong.

The collapse of the dot.com bubble, where equity incentive compensation instruments such as stock option plans were widespread, and the wake of recent accounting scandals, have further focused attention on this highly visible component of corporate governance. Directors have taken particular heat, as they are responsible for setting compensation for management and in many instances are not perceived as sufficiently “independent” to critically evaluate compensation plans. In many instances, they appear to rubber-stamp what is proposed by management.

Regulatory reform to date has focused on accounting irregularities and the role of the audit committee. That will change. Mounting shareholder unrest will vault executive compensation to the front burner as shareholders increasingly seek redress from boards of directors and the courts, and make greater demands for legislative and regulatory reform. The recent controversy surrounding Lord Black and Hollinger Inc. and the resignation of Don Carty as chief executive officer of American Airlines, are merely two examples of shareholder discontent with the compensation process within public companies.

It is not just small investors who are raising concerns about executive compensation. Institutional investors are championing responsible and appropriate executive compensation- the Ontario Teachers Pension Plan Board has written to the compensation committees of major companies encouraging reforms, while the Canada Pension Plan Investment Board has announced that it will oppose all stock option plans. In the United States, the money management firm of Tweedy, Browne led the charge against Lord Black, while Warren Buffet has recently said that the issue of executive compensation is so important, that it will be the “acid test for [corporate governance] reform”.

It has become increasingly clear that directors will need to deal pro-actively with any deficiencies in executive compensation plans in the companies over which they have stewardship responsibilities.
The Role of the Compensation Committee

The responsibility for establishing executive compensation rests with the board of directors as a whole. In larger public companies the board will frequently establish a sub-committee to manage compensation issues generally, but in particular, executive compensation. According to the O’Callaghan Survey of 300 Canadian public companies, 95% of the respondents had a compensation committee - the second most common board committee after the statutorily mandated audit committee.

Typically the compensation committee has primary responsibility for evaluating the performance of senior management and setting their compensation. The committee will generally work with an outside consultant or the company’s own in-house personnel. While a company’s compensation program should be designed to attract, retain and motivate management, it must be done in a manner that is consistent with industry standards and with a view to the best interests of the company. The role is so central to the executive compensation process that, in the view of the Conference Board Commission, strengthening the compensation committee is the “starting place” for redressing executive compensation problems.

Canadian Regulatory Requirements

Currently, there are few Canadian regulatory requirements imposed on compensation committee functions and composition. However, recent proposed changes demonstrate that this area of corporate governance has not escaped the attention of the regulators.

What exists today-

- The TSX Governance Guidelines for listed companies recommend that a board committee should review the adequacy and form of the compensation of directors and ensure that compensation realistically reflects the responsibilities and risk involved in being an effective director. These guidelines also recommend, as they do for board committees generally, that the compensation committee be composed of independent [unrelated] directors.

- Canadian securities regulators require public companies to disclose executive compensation of senior officers, particularly the CEO, in the form of a report by the board of directors, or the executive compensation committee (if one exists), or another board committee performing equivalent functions (if that is the case). That report must also disclose the names of the directors performing these functions and the manner in which any relationships they may have with the senior officers may affect their independence.

- Despite the existing regulations and guidelines, the CSA Report highlighted the inadequacy of compensation committee disclosure as the “one main area of concern where improvement is needed”. Although the focus of the CSA Report was compliance with executive compensation disclosure requirements, the report revealed that, while 95% of the public
companies reviewed had a compensation committee, only 60% of such committees were composed entirely of independent members. The following were the key areas of concern identified in the CSA Report:

- the use of “boilerplate” language rather than an adequate explanation of reasons for paying bonuses, granting options or other compensation;
- the failure to adequately explain the relative emphasis of each of the various components of compensation;
- the failure to disclose whether the amount and terms of outstanding options, stock appreciation rights, restricted shares and restricted share units were taken into account when determining if new option grants would be made;
- the failure of issuers to describe the specific relationship of corporate performance to executive compensation despite the requirement to explain how corporate performance affected executive compensation; and
- the failure to provide all the required disclosures for the CEO’s compensation.

Recent developments—

- The OSC has issued draft policies relating to corporate governance for comment - Proposed Policy 58-201 and Proposed MI 58-101. The proposed policies would apply in all provinces and territories except for Quebec and British Columbia.
- Proposed Policy 58-201 would not be mandatory. Public companies are encouraged to adopt the recommendations “flexibly and sensibly to fit the situation of individual issuers.” The proposed policy suggests the following best practices for a compensation committee:
  - it be composed entirely of independent directors;
  - it have a written charter that establishes the committee’s purpose, responsibilities, member qualifications, member appointment and removal, structure and operations, and the manner of reporting to the board;
  - it be given authority to engage and compensate any outside advisor that it determines to be necessary to permit it to carry out its duties; and
  - it be responsible for:
    i. reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO’s performance in light of those goals and objectives, and making recommendations to the board with respect to the CEO’s compensation level based on this evaluation;
ii. making recommendations to the board with respect to non-CEO compensation, incentive compensation plans and equity based plans; and

iii. reviewing executive compensation disclosure before the issuer publicly discloses this information.

- Proposed MI 58-101 requires the company to disclose if it has a compensation committee and, if so, to disclose (a) whether or not it is composed entirely of independent directors and (b) the text of the committee’s charter, if it has one. If a compensation committee does not exist, or if it exists but is not comprised entirely of independent directors or does not have a charter, an explanation as to why this is appropriate must be provided, including a description of the processes by which the board determines executive compensation. This requirement does not apply to so-called “venture issuers”, which includes companies listed on the TSXV or whose securities are not listed or quoted on the TSX, a registered U.S. national securities exchange, or a marketplace outside of Canada and the United States.

U.S. Regulatory Developments

The NYSE Rules and the NASDAQ Rules impose greater responsibilities on compensation committees than existed before, including that they must be comprised entirely of independent directors. These rules will be phased in but all affected companies must, at the latest, be in compliance by October 31, 2004. However, a “controlled company” (i.e. where more than 50% of the voting power is held by an individual, group or another company) is exempt from the requirement that compensation committees be composed entirely of independent directors.

Foreign private issuers listed on the NYSE are permitted to follow their home country practices with respect to executive compensation in lieu of the NYSE Rules, provided such companies:

- have an audit committee pursuant to the NYSE audit committee requirements under the rules of the Exchange Act,
- notify the NYSE in writing after any executive officer becomes aware of any non-compliance with any applicable NYSE Rules, and
- provide a brief, general summary of any significant ways in which its governance differs from that under the NYSE Rules.

Similarly, the NASDAQ Rules exempt foreign private issuers from complying with its compensation committee rules if such rules would be contrary to a law, rule or regulation of any public authority of their home jurisdiction. Such an exemption, however, must not be contrary to the U.S. federal securities laws or the audit committee requirements and rules of the Exchange Act.
Directors’ Duties and Executive Compensation—Judicial Developments

All directors have a general fiduciary duty to the company of which they are directors. This duty requires directors to act honestly, in good faith and in the best interests of the company. These principles also apply to directors acting in their capacity as members of the compensation committee or in respect of executive compensation matters. Case law has helped in the evolution of the interpretation and application of these principles, most recently with respect to compensation-related issues.

Recent Canadian Case Law

In the context of executive compensation, and the discharge of directors’ fiduciary duties, the Ontario case of UPM-Kymmene Company v. UPM-Kymmene Miramichi Inc. (“Repap”) is highly relevant and instructive. The court set aside an employment contract between a company and its former CEO and Chairman, Steven Berg. Although the board initially refused to approve a generous compensation package for Mr. Berg that Mr. Berg himself proposed, a reconstituted compensation committee eventually approved those terms. Almost all of the directors who were initially opposed to the agreement had resigned prior to its acceptance, including the chairman of the compensation committee. New directors who were not informed of the previously constituted committee’s resistance replaced them.

The court determined that Mr. Berg had breached his fiduciary duty to the company and that the board had breached its duty of care by failing to make its decision on the employment contract on an informed and reasoned basis. While a compensation consultant was retained to prepare a report, the consultant was provided with little time and information. The members of the reconstituted committee, for example, did not take any steps to inform themselves of prior deliberations of the committee or the board, met only briefly, barely considered the proposed executive compensation agreement, and relied too heavily on the ill-informed consultant, before recommending it to the board.

The court noted that the compensation committee:

- exercised “no oversight role whatsoever, although it was the independent duty of that group of directors to have such involvement”; and

- must exercise a significant oversight role in determining executive compensation by providing clear instructions to outside consultants, carefully reviewing their reports or opinions and informing itself of prior deliberations of the previous committee or of the board.

As the Repap decision illustrates, although courts will generally afford corporate directors a significant degree of deference – the so-called “business judgement rule” - this protection will not apply where directors, in exercising their decision-making power, fail to act diligently and on an informed and reasoned basis.
Recent U.S. Case Law

While not binding on Canadian courts, legal decisions in the United States are often of significant influence and, at the very least, are typically indicative of issues that will also find their way into Canada. A decision in late 2003 involving The Walt Disney Company ("Disney") addressed the issue of directors’ fiduciary duty in connection with executive compensation. The Disney directors asked a court to dismiss a suit by shareholders who alleged that CEO Michael Eisner had unilaterally hired his long-time friend Michael Ovitz, despite earlier objections by the board of directors. The compensation committee had met briefly to discuss the hiring, did not review a draft of the agreement, and did not consult a compensation expert. Despite the lack of information, the package was approved and the committee agreed not to review the final negotiated product. The board as a whole met subsequently and after minimal consideration, agreed to Mr. Ovitz’ hiring and left the final negotiations of the executive compensation package to Mr. Eisner.

A year later, Mr. Ovitz left the company pursuant to a non-fault termination provision in the agreement with a termination package allegedly worth U.S. $140 million. The terms of the non-fault termination provision differed significantly from what had been previously described to the compensation committee and the board.

The court allowed the suit to proceed on the basis that the facts supported a breach of the directors’ duties owed to the company and its shareholders. The court found that the business judgement rule, which affords protection to directors against those who may second-guess their decisions, was not applicable in this scenario. In order for such a rule to apply, directors must act honestly and in good faith so as to advance the best interests of the company. The conduct of the directors fell outside the ambit of protection provided by the business judgement rule.

The analysis by the court in this case, as in other similar cases in the United States, suggests what conduct is appropriate for directors and for a compensation committee, including the use of a compensation expert, the consideration of other compensation packages in the same industry and a detailed review of the actual compensation agreement.
Directors’ Compensation

Compensation for directors, particularly for independent directors, is also coming into focus although to a lesser degree than executive compensation. While developments including regulatory changes are exerting downward pressures on compensation for senior executives of companies, directors’ compensation, including use of stock options, is generally not seen being similarly affected. Studies in the U.S and U.K have shown that median compensation for independent directors has risen sharply in the last year. The reasons for this are varied. It is clear that the increased time directors are expected to spend on company affairs, and the perception of increased legal and reputational risk, mean the directors will need to be compensated in a way that will reflect the reality of current expectations.
Moving Forward

In light of recent scandals involving abuses of executive compensation and the important role played by the compensation committee as well as continuing regulatory developments, Canadian public companies should consider establishing a compensation committee, if they do not already have one. In addition to giving careful consideration to the guidelines set out in Proposed Policy 58-201, those establishing such a committee should review the best practice suggestions described in the Conference Board Commission Report which recommends that the compensation committee:

- should be made up of only independent directors, i.e. those who are free of any relationships with the company (except for any remuneration received in their capacity as directors) and its management and who can carry out their responsibilities independently of management;
- must oversee all matters relating to executive compensation policy;
- must make the chairman of the committee available at shareholder meetings to answer questions;
- should be responsible for all aspects of executive officers’ compensation arrangements, including approving all employment, retention and severance agreements;
- should approve any compensation arrangement for a senior executive officer involving any subsidiary, special purpose entity or other affiliate;
- should retain any outside advisers and consultants who would only report to the committee;
- should exercise independent judgement in determining the proper levels and types of compensation and not be constrained by industry compensation statistics or by the company’s past compensation practices and levels; and
- should meet as and when required, including without management present, and set its own meeting agenda.

Moreover, in view of provincial securities regulators’ efforts to harmonize the disclosure of compensation (e.g. NI 51-102 and the CSA Report), compensation committees must prepare executive compensation disclosure that adequately explains their compensation decisions and addresses other disclosure requirements, and not rely on the use of boilerplate language.
Conclusion

In following best practices and addressing the issues that have surfaced concerning excessive executive compensation, companies, and compensation committees in particular, must always be mindful of a most important practice point highlighted by the Conference Board Commission Report: when setting compensation arrangements, there must not be incentives for top executives to act contrary to the company’s best interests nor should such arrangements be interpreted in such a way as to violate the requirements or spirit of the law or accounting rules. While the establishment of an effective, independent and empowered compensation committee is not an end in itself, it is a positive step forward in addressing the growing shareholder concerns about excessive and abusive compensation.
Glossary

For ease of reference, the following is a glossary of certain terms that are referred to in this booklet.

Bill 198
An Act to implement Budget measures and other initiatives of the Government, S.O. 2002, c.22

CICA
The Canadian Institute of Chartered Accountants

Conference Board Commission Report

CSA
Canadian Securities Administrators

CSA Report
Report by the CSA on compliance by issuers with executive compensation disclosure requirements under Canadian securities regulatory disclosure rules (November 2002)

Exchange Act
U.S. Securities Exchange Act of 1934

JCCG
Joint Committee on Corporate Governance, which was a committee of representatives of the TSX, TSXV and CICA, chaired by Guylaine Saucier, that examined corporate governance issues

JCCG Report

MD&A
Management’s Discussion and Analysis as required to be included in a public company’s annual information form, annual report or other similar document, pursuant to securities legislation

MI 52-109
Multilateral Instrument 52-109 - Certifications of Disclosure in Issuers’ Annual and Interim Filings

MI 52-110
Multilateral Instrument 52-110 - Audit Committees

NASDAQ
The NASDAQ National Market

NASDAQ Rules
The rules concerning NASDAQ’s Marketplace Rules

NI 51-102
National Instrument 51-102 of the CSA regarding Continuous Disclosure Obligations

NI 52-108
National Instrument 52-108 of the CSA regarding Auditor Oversight

NP 51-201
National Policy 51-201 of the CSA regarding Disclosure Standards

NYSE
New York Stock Exchange
NYSE Rules
NYSE listing standards

O’Callaghan Survey

OSC
Ontario Securities Commission

OSC Rule 61-501
Rule 61-501 of the OSC regarding Insider Bids, Issuer Bids, Business Combinations and Related Party Transactions

Proposed MI 58-101
Proposed Multilateral Instrument 58-101 issued by the CSA regarding Disclosure of Corporate Governance Practices

Proposed Policy 58-201
Proposed Multilateral Policy 58-201 issued by the CSA- “Effective Corporate Governance”

Sarbanes-Oxley Act
U.S. Sarbanes-Oxley Act of 2002

SEC
U.S. Securities and Exchange Commission

SEC Certification Rules
Rules established pursuant to Section 302 of the Sarbanes-Oxley Act respecting certification of certain reports filed under the Exchange Act

SEC Rules
Rules adopted by the SEC pursuant to the Exchange Act

SEDAR
The System for Electronic Document Analysis and Retrieval, used by public companies in Canada in connection with filing of documents pursuant to Canadian securities laws

TSX
Toronto Stock Exchange

TSX Company Manual
The manual published by the TSX which contains the TSX Rules, TSX Governance Guidelines, TSX policy statements and other matters relating to listing on the TSX

TSX Disclosure Guidelines
TSX Policy Statement on Timely Disclosure and Related Guidelines contained in the TSX Company Manual

TSX Electronic Disclosure Guidelines
TSX Electronic Communication Disclosure Guidelines contained in the TSX Company Manual

TSX Governance Guidelines
TSX Governance Guidelines contained in the TSX Company Manual

TSX Rules
Rules contained in the TSX Company Manual

TSXV
TSX Venture Exchange
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