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2024 HUMAN RESOURCES COMMITTEE OUTLOOK

January 2024

As we look forward to 2024, we reflect upon the various factors that are expected to have an impact on Human Resources (HR) Committee workplans in Canada. When we look back at 2023, we saw:

- Improving financial and share price expectations as we approached the year given lower inflation rates, and pausing of the interest rate hiking cycle
- Challenging labour markets, particularly for companies trying to recruit executives into Canada given low exchange rates and a relatively strong U.S. economy
- Implementation of the SEC's new pay v. performance disclosure rules for U.S. companies
- The Canadian Coalition for Good Governance (CCGG) release a report advocating for stronger share ownership policies for executives
- Continued focus on the incorporation of environmental, social and governance (ESG) priorities within incentive plans but with increasing pushback in certain markets
- Little change in shareholder perspectives on executive pay given relatively strong say-on-pay votes and minor changes coming from the proxy advisors, including ISS and Glass Lewis

RECAP OF 2023 PREDICTIONS

Last year at this time, we had the following predictions (refer to this article for further details on each prediction) and below we summarize what occurred through 2023:

Prediction	Our Assessment of 2023
1. ESG shifting to sustainable value creation	There was a shift towards more climate and diversity measures and adoption of ESG measures within long-term term incentive plans. Read more in our 2024 report: 2024 Global Trends in ESG Incentives: Entering the Next Phase of Maturity. However, more time is needed for companies to better articulate the connection between stakeholder and shareholder value, particularly given the anticipated release of global standards.
2. Incentives under pressure	CEO actual total cash (ATC) compensation disclosed in 2022 increased by 34% for the companies in the TSX Composite Index based on 2021 performance. CEO ATC disclosed in 2023 decreased by 10% given a significant year-over-year decline in actual bonuses (as a percentage of target) based on 2022 performance. This aligned with the lower year over year growth in financial performance and negative total shareholder returns through 2022 (minus 6% in 2022 for the TSX Composite v. plus 30% in 2021).

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Prediction	Our Assessment of 2023
	The moderation in year-over-year changes in pay appear to have been positively received by shareholders given continued strength in average say-on-pay support at 91% in 2023 (v. average support of 91% in both 2022 and 2021). Refer to this article for details.
3. Greater focus on the long-term	No significant shift in the long-term orientation of executive compensation was observed through 2023 but, more focus on real share ownership considered. When we reviewed the S&P/TSX 60 companies, we found average longevity of 2.4 years (e.g., period needed for total awarded compensation to become realizable including vesting schedules and total compensation (salary and incentives)). This means that a CEO fully realizes their total pay in only 2.4 years which may not reinforce a long-term orientation and/or align with the risk tail of their strategic decisions. Related to alignment to shareholders, we found more HRCs had discussions on minimum share ownership responding to the perspectives of the Canadian Coalition for Good Governance (CCGG) and their white paper “Management-Shareholder Alignment: Effective Ownership Policies.” CCGG advocates for more real share ownership that is expressed as a multiple of total compensation that increases overtime. We anticipate more discussion on how to elongate pay longevity and real share ownership through 2024.
4. Time to update clawback policies	As noted in this article, Canadian issuers have been reviewing their clawback policies this past year, relative to the U.S. SEC updates which come into effect December 1st. Foreign Private Issuers (FPI) listed on U.S. stock exchanges must comply with the new SEC requirements, where a clawback must be triggered for any form of financial restatement that indicates overpayment of past incentive awards. Among Non-FPIs there were little to no changes made for 2024 based on our consulting experience despite the changes in the U.S. Glass Lewis, in their 2024 Benchmark Policy Guidelines, is encouraging clawback policies to be available and applied by the board for a broader set of business circumstances, including misconduct and reputational damage, regardless of a financial restatement. Market practice in Canada is mixed so we anticipate continued focus on clawbacks through 2024, for those who have not completed a recent review.
5. Holistic view of the employee experience	HRCs did spend more time in 2023 on the overall employee experience and the underlying culture of the organization. Most organizations are still in the early stages of developing the right strategy and aligning on the employee insights and data to measure and track progress. 2023 salary budgets across Canada were 4.0% (50th percentile) and aligned with the original forecast. We had initially anticipated that actual budgets may have come in higher than forecast, but inflation rates lowered sooner than expected reducing the upward pressures on salaries.

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Prediction	Our Assessment of 2023
	Both BC and Ontario introduced pay transparency legislation in 2023 (BC's took effect on November 1, 2023, while Ontario's is still pending). This has put a sharper focus on the compensation system to ensure that it is defensible and fair, including a clear compensation philosophy, solid job leveling, alignment to market and clear rules to administer pay.

2024 PREDICTIONS

We continually monitor the market for emerging trends and best practices and gather insights from our clients. Our top five predictions for 2024 include:

1. Innovative share ownership policies

The 2023 CCGG report on executive share ownership will encourage discussions on the design of minimum share ownership requirements beyond following "market practice" with a focus on the "competitive" multiple of salary. Most companies are cautious when it comes to doing something different than current market practice. The CCGG's recommendations take a fundamentally different view of the purpose and approach to share ownership. The philosophy is much more of a consistent proportionate investment by the executive over time which grows at the same rate at total compensation (not salary) and is in the form of real shares or DSUs.

While this feels like a dramatic shift, we believe parts of the recommendations may be accepted and adopted, e.g., aligning share ownership requirements to a multiple of total compensation (instead of salary) and requiring a minimum holding in common shares (v. unvested share units).

For organizations interested in a more substantive change, the use of a "retention ratio" may become more common where a certain percentage of after-tax gains from equity awards are required to be held in shares. The current practice is to employ these requirements until the minimum share ownership levels are met; however, this may evolve to become a more permanent requirement to better align share ownership with actual compensation earned overtime.

We believe it is imperative companies at a minimum have the proper tools to deliver real shares to executives through the LTIP programs. This means the adoption of an omnibus or equity-settled treasury share plan (i.e., to go beyond the three-year tax limitation of cash-settled incentives in Canada). Interestingly, DSUs are also accepted by the CCGG as real shares so more innovative companies may utilize DSUs on a more regular basis.

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2. Clarifying adjustments made to measures for incentive purposes

In our experience, the use of adjusted (or non-GAAP) financial measures is common, most often in the short-term incentive plan and less common in longer-term PSU plans. Many companies already provide supplemental disclosure to explain the differences to GAAP, either in a footnote, or a detailed reconciliation. Others have yet to add this disclosure, making it challenging for investors and proxy advisors to understand the extent and impact of adjustments made, particularly the potential misalignment to actual reported results. Lack of disclosure may also influence say-on-pay vote recommendations and results, particularly in a year where adjustments are made that are counter to reported results. We anticipate that companies will enhance disclosure to explain the differences between non-GAAP and GAAP results, and the impact on compensation outcomes, including rationale for these adjustments.

3. Greater quantification of ESG measures

As ESG strategies continue to mature in the years ahead, we will expect greater consistency in performance definitions and the ability to better assess performance given historical trends. While not directly derivable from the data of this year, our experience with clients suggest that companies are starting to take a more rigorous approach to setting ESG performance targets and the ranges around targets, borrowing from the development over time of more precision in financial performance measurement. We anticipate a higher percentage of quantifiable ESG metrics being disclosed to enhance credibility of ESG measures and to align with specific performance outcomes.

4. Pressures on directors' compensation

In Southlea's 2023 Director Compensation Trends report, we found a 9% increase in total board member compensation in 2022 with median total compensation for the TSX Composite increasing to $199,000 (from $182,000 in 2021). Canadian companies increasingly have a global footprint requiring directors with broader experience, particularly from the U.S. This can put pressure on Canadian compensation packages given higher pay in the U.S. – for example, total board member compensation among the S&P 500 is $312,000 USD (or ~$420,000 CAD which is double Canadian pay levels). Given the pay differential between Canadian and U.S. pay levels, Canadian companies have adopted various compensation models – e.g., location-based pay (Canadian directors paid in CAD and U.S .directors in USD on a one-for-one basis), paying all directors in USD, paying all directors in CAD but incorporating U.S. data within the benchmarking analysis. All of these models will continue to put upward pressure on Canadian board member compensation.

Most Canadian companies continue to grant deferred share units (DSUs) to board members; however, they have significant restrictions that limit redemption until a board member retires from the board; which links to specific tax implications. Similar to the discussion on real equity ownership for executives, companies are looking at alternative forms of equity for directors (e.g., RSUs, common shares) to support share ownership while providing greater flexibility to reflect individual director circumstances.

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5. Changes to pay v. performance disclosures

The new pay v. performance disclosure rules in the U.S. were implemented in 2023 providing investors with a new tool to assess the pay and performance relationship. The primary feature of the disclosure rule is a focus on Compensation Actually Paid (CAP) that accounts for realized and realizable pay compared to the total compensation in the Summary Compensation Table, total shareholder returns (for the company and its peers) and other financial measures.

Many large Canadian companies have voluntarily adopted a similar summary of historical CEO compensation that compares awarded compensation to realized/realizable compensation by year. The primary difference between Canadian and U.S. disclosure is related to timing. The U.S. CAP approach measures the change in management wealth overtime such that it captures the net increase or decrease in overall pay during the year, including multiple equity awards (new equity, unvested equity, vested equity), while Canadian disclosure generally looks at pay by year.

The benefit of the U.S. approach is that there can be a relationship between CAP and the total shareholder returns (TSR) in each year, as CAP captures the total change in equity value in a year which is primarily influenced by TSR. There are also some differences in how equity gets valued (e.g., using an updated fair value in the U.S. v. in-the-money value in Canada). We anticipate that some larger Canadian issuers – particularly those with a large U.S. shareholder base – may look to align with the U.S. rules more closely for greater comparability.

ABOUT US

Southlea is a national independent compensation advisory firm that provides global perspectives as a GECN Group company working with over 150 compensation professionals in 15 countries. We are headquartered in Toronto with an office in Montreal and with clients across Canada, representing all industries and organization structures. Our team of advisors is multi-disciplined with diverse backgrounds and experiences. We are proud to be a certified Women's Business Enterprise by WBE Canada and to be Rainbow Registered as an LGBT+ friendly organization.

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