December 21, 2018

Mark A. Schaan
Director General
Marketplace Framework Policy Branch
Innovation, Science and Economic Development Canada (ISED)
235 Queen Street, 10th floor, Room 1046A
Ottawa, ON K1A 0H5

Dear Mark;

Thank you for the opportunity to discuss the enhancement of retirement security for Canadians last Friday, December 14th in Toronto. I appreciated the questions and proposals brought forward by the team exploring this at ISED and Finance Canada.

The comments that follow do not touch on the whole range of retirement security options that we believe should be pursued by the federal (and provincial) governments, nor even the breadth of questions in the focused consultation you are currently undertaking. Rather, they are follow-up comments to fill in information based on our earlier in-person discussion. Omission of comments on other points raised in your consultation document should not be considered as approval or disapproval of those proposals.

Clawback provisions

One of the things we discussed was the question of clawback provisions to prevent excessive dividend payments, share redemptions and executive compensation packages when a distressed company has an unfunded pension liability. We favour enhancing the current one-year "look-back" period in the *Bankruptcy and Insolvency Act* (BIA) and the *Companies' Creditors Arrangement Act* (CCAA) to include the power for a court to set aside executive and director bonuses and compensation increases where a company with unfunded pension liabilities enters insolvency within a fixed period.

In our view the BIA and CCAA should allow the use of clawbacks as ordered by the courts where there have been significant dividend payments, share redemptions (at minimum, repurchases from insiders) variable executive compensation and other reviewable transactions in the three to five years prior to insolvency.

I mentioned that the use of clawback provisions within executive compensation arrangements is expressed in the US Dodd-Frank legislation, and that some companies have voluntarily adopted more stringent positions in response to shareholder engagement. As promised, I have included two examples in an Appendix to this letter, although they are of limited use in

this context. However we would support a new provision within the CBCA requiring organizations incorporated under the statute to develop a clawback policy consistent with the above insolvency provisions, as well as allowing clawbacks in the instance of financial restatements (as per Dodd-Frank) and, at the board's discretion, when there has been misconduct resulting in a material violation of law or the Company's policy that causes significant financial or reputational harm to the Company, and the senior executive committed the misconduct or failed in her or his responsibility to manage or monitor conduct or risks. This would also help in ensuring that acceptance of clawback requirements, should they be required, is pre-embedded in executive employment contracts.

Disclosure obligations

The objective of this exercise, of course, should not be just to remedy problems in the event of insolvency but to promote proper funding of pension obligations before insolvency puts that to the test. Additional corporate disclosure, enacted as new obligations under the CBCA, may help to highlight pension fund solvency rates such that executives, shareholders and creditors are focused on the funding status as a potential area of concern to be remedied.

For example, the CBCA could require disclosure in annual statements of financial ratios relevant to the funding status of the pension plan, comparing the ratio of dollars spent on dividends, repurchases or executive compensation to any unfunded liability in the pension plan. While this would not compel any particular course of action, it would draw attention to the issue such that management will seek to improve the ratio before it becomes a reputational liability.

Another disclosure which I mentioned when we met was to ensure that disclosure of financial flows within an organization are clear, such that investors and regulators can be better equipped to monitor any shifting of profits overseas while underfunding continues. One way to help would be to lower the current threshold for reporting subsidiary organizations. Currently reporting issuers are required to include a section in their Annual Information Form (AIF) entitled "Inter-Corporate Relationships" in which they list subsidiaries. Unfortunately, the list of subsidiaries provided in the AIF is not complete. Canadian securities regulations allow companies to omit subsidiaries if they do not exceed 10 per cent of the company's consolidated asset or consolidated revenue. While we have not quantified the extent of the problem in Canada, research in the United States suggests that similar materiality thresholds allow companies to avoid disclosing 85 per cent of their subsidiaries. A lower threshold or full reporting requirement in the CBCA may assist in identifying reviewable transactions related to profit-shifting prior to insolvency.

As an aside, this measure may also find favour with the Canada Revenue Agency (as it relates to base erosion and profit shifting) and with investors that are attuned to aggressive tax avoidance and/or other financial manoeuvres that create risk.

The above disclosures currently have a place in securities regulation rather than corporate law. However as we discussed, recent CBCA amendments have included reporting requirements that are restricted to reporting issuers and the above requirement would be no different in their scope or application.

Restrictions on corporate behaviour

Where a pension deficit is large or persistent, however, disclosure alone will be insufficient to remedy the problem. For this reason, the CBCA should be amended to restrict or reduce dividend payments, share repurchases, and variable executive *and director* compensation until such time as the solvency funding ratio surpasses a specified threshold.

Should there be extenuating circumstances that would require special treatment, an appeal for special relief should be available, but the onus should be on the corporation to argue for an exemption from the norm, not the other way around.

Similarly, authority to apply similar payout restrictions when considering special pension funding relief in any other circumstances should be granted to the Minister of Finance, at her or his discretion. For guidance, these potential restrictions should be articulated in a non-exhaustive manner.

Directors' duties

We discussed whether the CBCA should clarify directors' duties in light of Canadian case law which invokes a broader vision of stakeholder-centric governance. Some jurisdictions have moved to reflect this trend in their domestic legislation, such as in the United Kingdom where the UK *Companies Act 2006* defines directors' duties to include consideration of long-term consequences, employees, suppliers, customers, community, and the environment.

While *BCE Inc v 1976 Debentureholders*, found that directors are required to "act in the best interest of the corporation, viewed as a good corporate citizen" and that they may look to "the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions", the court did not set out in any detail the meaning of responsible corporate citizenship.

In light of the general nature of the *BCE* decision, developments in other jurisdictions and the unmistakeable trajectory of the increasing importance of corporate responsibility, ISED should take this opportunity to codify director duties in the CBCA. In particular, the requirement that directors consider the interests of a broad range of stakeholders – including the workforce, and the environment, should be clarified.

Further comments

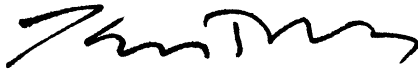
The comments above, in many cases, would also be applicable to provincial corporate statutes and a coordinated approach on retirement security between the federal and provincial governments would be preferable to a piecemeal approach adopted by individual jurisdictions. We would welcome efforts to discuss extending similar protections and requirements under provincial laws with the applicable provincial governments.

I hope that the above comments, as a follow-up to our more fulsome discussion in person, will assist in the development of a balanced and principled approach to retirement income security in Canada.

What happened recently at Sears Canada was not the first time retirees were cheated of their deferred wages, but we should expend every effort to make sure it is the last.

If you would like to discuss any of this further, please don't hesitate to get in touch.

Regards,



Kevin Thomas
Executive Director
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Appendix: US Compensation Clawback Provisions

The legislative provision for executive compensation clawbacks is found in the Dodd-Frank Act and reads:

> SEC. 10D. RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION POLICY.
>
> (a) LISTING STANDARDS
> .—The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirements of this section.
>
> (b) RECOVERY OF FUNDS
> .—The rules of the Commission under subsection (a) shall require each issuer to develop and implement a policy providing—
> (1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
> (2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

The Dodd-Frank provision specifically addresses material restatements, which is a different issue, and it is intended to be implemented through securities law (i.e. by the Securities Exchange Commission), which is not what you are considering.

Notwithstanding, it is interesting in that it focuses on all incentive-based compensation (which would encompass both short-term and long-term incentive plans) which is a useful standard.

Many US companies have indeed gone beyond this minimal provision to adopt policies that are more comprehensive in their scope. For example, Zimmer Biomet Holdings Inc.'s 2018 proxy circular says:

> In February 2011, the Board adopted an executive compensation recoupment policy. This policy applies to cash incentive compensation paid and equity incentive awards granted to executive officers. In the event we are required to prepare an accounting restatement due to our material noncompliance with any financial reporting requirement under federal securities laws, the Board will review the facts and circumstances that led to the requirement for the restatement and take any actions it deems appropriate with respect to incentive-based compensation. The Board will consider whether an executive officer received compensation based on performance reported, but not actually achieved, or was accountable for the events that led to the restatement, including any misconduct. Actions the Board may take include: seeking recovery of incentive-based compensation received by an executive officer during the three-year period preceding the date we are required to prepare an accounting restatement in excess of what would have been paid to the executive officer under the accounting restatement; imposing disciplinary actions; and pursuing any other remedies. In addition, the committee is monitoring regulatory developments with

> respect to compensation recoupment policies and will recommend to the Board any changes to the current policy that are necessary or appropriate in light of final rules to be issued by the SEC and the New York Stock Exchange.
>
> In addition to the executive compensation recoupment policy described above, our equity incentive plan and related award agreements contain provisions that permit the committee, in its discretion, to require a participant to forfeit his or her right to any unvested portion of an award and, to the extent that any portion of an award has previously vested, to return to us the shares of common stock covered by the award or any cash proceeds the participant received upon the sale of such shares, in the event that the participant engages in activity that is deemed detrimental to the interests of the company, including, but not limited to, breach of restrictive covenants or violations of our Code of Business Conduct and Ethics or other policies, procedures or standards.[1]

Here, the key provision is that activity in breach of company policies, procedures or standards – and not just fraud or noncompliance with accounting standards – may result in clawbacks.

[1] https://seekingalpha.com/filing/3960878