A Director's Guide to
EXECUTIVE COMPENSATION

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Supplemental Executive Retirement Plans

Managing the Risks

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Organizations often rely on their compensation packages as a means of attracting and retaining executives. One component that can have a significant impact on an executive's compensation package is his or her participation in an organization's supplemental executive retirement plans (SERPs). SERPs are pension plans that provide income to executives on their retirement, typically in amounts in excess of the maximum pension limits prescribed under the Canada *Income Tax Act* ("*ITA*"). SERPs are sometimes referred to as "top-up" or "top-hat" plans because they generally provide a top-up to an organization's registered pension plans.

The benefits payable to executives under SERPs usually increase with the length of time the executive participates in the SERP. As such, SERPs can be an effective form of long-term compensation that retains executives by offering potentially lucrative benefits to executives on their retirement.

Generally, SERPs are not registered with the provincial pension regulators or the Canada Revenue Agency. However, SERPs do have to comply with the restrictions on salary deferral arrangements under the *ITA* to avoid negative income tax repercussions.

Due to the lack of any formal registration requirement, there is a tendency to believe that there are no risks inherent in SERPs. Unfortunately, SERPs have significant risks that have to be managed, including: design, governance, financial, compliance, communication, administration and counterparty risks. The following describes the various risks that can arise with the implementation of a SERP and outlines some ways to manage those risks.

Design and Governance Risks

Description

Design risk is the risk that the design of the SERP will not meet an organization's philosophy and objectives. For example, many organizations implement SERPs to provide a competitive level of total com-

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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From the Editor

I am delighted to present this edition's lead article on the risks associated with supplemental pension plans by Minaz Lalani, Consulting Actuary and Managing Principal of the Lalani Consulting Group. Mr. Lalani is a Fellow of the Canadian Institute of Actuaries and a Chartered Enterprise Risk Analyst with over 30 years of pension and risk consulting.

I am also delighted to include a commentary on the changes in Ontario's *Pension Benefits Act* to grow-in benefits on wrongful dismissals, by Ellen Swan, a lawyer in the Employment and Labour Law group at Davis LLP.

I am pleased to announce the establishment of my new firm, CSuite Law, focusing on employment law and executive compensation. Your comments, questions and contributions to this newsletter can be sent to ncote@csuitelaw.com. This newsletter will continue to provide timely commentaries on executive compensation matters.

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— Nadine Côté LL.B.

ONTARIO'S *PENSION BENEFITS ACT* IS EXPANDING GROW-IN BENEFITS

By Ellen Swan

The framework of grow-in benefits for Ontario regulated defined benefit pension plans is changing. If your organization sponsors a defined benefit pension plan registered in Ontario, your business may be affected.

A "grow-in" benefit is an entitlement to an enhanced early retirement benefit that is triggered by certain events. Under Ontario's current *Pension Benefits Act*, grow-in benefits apply in circumstances of plant closure or other partial or full plan wind-up scenarios when an employee meets the following test:

- a member of a pension plan who's combination of
- age + years of continuous employment OR membership in the plan = 55

Effective July 1, 2012, the events that trigger a "grow-in" benefit will be expanded to include all instances when the employment of employees who are members of that defined benefit pension plan is involuntarily terminated without cause. This expansion will increase the employer's funding requirements for such defined benefit pension plans.

In addition, employees whose employment is terminated before July 1, 2012, but whose reasonable notice period extends to or beyond that date, will likely take the position that they are also entitled to the value of the "grow-in" benefit they would have been entitled to had their employment been terminated after July 1, 2012. Employers may therefore be required to take into account those "grow-in" benefits in implementing termination packages or in wrongful dismissal damages for terminations before July 1, 2012.

Thanks for the contribution of Ellen Swan, a lawyer at Davis LLP, specializing in employment law and pensions.

pensation to attract and retain executives. However, many SERPs do not have a clearly articulated policy on the purpose of the pension arrangement. Failing to articulate or poorly articulating the purpose of the plan can lead to a plan design that does meet the organization's objectives.

Governance risk is the risk that can arise due to the lack of structure, process and documentation in implementing and managing the SERP. For example, a SERP may be established for executives who benefit as participants in the SERP, but those same beneficiaries also have fiduciary obligation to the organization. In these circumstances, it is imperative that there is an independent and objective governance structure and a well-defined process to prudently manage the SERP and avoid any conflicts of interest. Failing to ensure there is an appropriate, documented governance process could result in litigation, as well as loss of reputation and confidence among shareholders and prospective investors.

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Managing Design and Governance Risks

To manage the design and governance risks associated with SERPs, organizations should: (a) have a clearly articulated policy outlining the purpose of the SERP; (b) document the policy; and (c) actively manage the SERP to ensure it is meeting its policy objectives. Effective governance of these plans should ensure that any design variance from the stated purpose of the plan is clearly thought out, justified and documented to avoid any real or perceived conflicts of interest. Maintaining a consistent primary purpose for a SERP will result in an effective SERP design, with easily understood plan features and simple plan administration.

Financial and Compliance Risks

Description

Financial risk is the risk that the SERP will have an unanticipated negative impact on the organization's finances. For example, the financial risks could include a risk that the actual costs of the SERP are greater than the anticipated costs, which results in an impact on the income statement. The financial risks could also include a risk that the pattern or timing of the costs is volatile, which negatively impacts the organization's cash flow. If the SERP is funded, there is also a risk that the funding costs greatly exceed the planned costs, which can arise for various reasons including: higher than expected salary increases; higher than expected annual bonuses included in the SERP calculation; special bonuses included in the SERP calculation; earlier than expected retirement dates; and, enhanced payouts triggered on a change of control of the organization.

Compliance risk is the risk that the SERP does not comply with accounting disclosure requirements in an organization's financial statements or the executive compensation disclosure requirements in the organization's annual proxy circular. Accounting disclosure requires the use of prescribed actuarial methodology and discount rate.

Managing Financial and Compliance Risks

Prudent governance and independent board oversight can control financial costs that are not experience related. For experience related costs due to actuarial assumptions, scenario testing must be undertaken to clearly understand the financial impact of actual experience differing from expected assumptions. To minimize compliance risks, the board must have a clear understanding of the actuarial assumptions used in the calculations for disclosure purposes and the reporting requirements to avoid frequent revisions to assumptions and results, which may be difficult to explain to shareholders and prospective investors. It is also important that a well-documented assumption setting process is undertaken to develop a defensible set of actuarial assumptions for the accounting disclosure. The SERP disclosure in the annual proxy disclosure should ensure that the assumptions are well thought out and there is adherence to the reporting requirements.

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Communication, Administration and Counterparty Risks

Description

Communication risk is the risk that can arise if the provisions of the SERP are not clearly and accurately communicated to the plan participants and third parties. Deficiencies in the communications can lead to litigation, which may include claims for misrepresentations to plan participants and third parties and breaches of the agreement with the plan participants.

Administration risk is the risk that can arise due to errors and omissions in the administration of the SERP. Errors can arise if there is poor documentation of the plan provisions, poor administrative practices or inaccurate or incomplete information. For example, organizations often customize the pension arrangements and introduce special provisions for select executives, but fail to properly document the special arrangement or circulate the details of the special arrangement to those who administer the SERP. These situations can elevate the administrative risks associated with the SERP.

Counterparty risk is the risk of errors or omissions by the third-party to whom certain tasks or the plan administration is delegated.

Managing Communication, Administration and Counterparty Risks

To minimize communication risks, all information relating to the SERP, including the plan documents, executive agreements setting out the terms of the SERP participation, plan updates, memos to plan participants and total compensation statements to plan participants should be reviewed and approved by those who are responsible for administering the SERP and disclosing the terms of the SERP in the financial statements and the proxy circulars and any external advisors, such as pension consultants and legal advisors, who also assist in these matters.

Administration risk can be minimized by maintaining consistent and uniform terms of the SERP applicable to all participants. Structured and well-documented administrative practices can also assist in reducing administrative risks.

Counterparty risk can be minimized by implementing detailed service agreements that clearly outline who is responsible for completing which tasks. In addition, the third-party service agreements should be regularly reviewed and updated as necessary to ensure they continue to accurately reflect the terms of the arrangement between the signatories.

Properly implementing and maintaining a SERP can be beneficial to executives and organizations. Managing the risks associated with the SERP can reduce an organization's exposure to any potential litigation and instill confidence in the executives who participate in the plan and other stakeholders.

CSA updates

CSA's 2011 Enforcement Report

The Canadian Securities Administrator (CSA) released its 2011 Enforcement Report. There were 124 cases concluded, down from 174 cases in 2010, which involved 237 individuals and 128 companies, up from 207 individuals and 100 companies in 2010. The following statistics are noteworthy:

- Illegal insider trading resulted in fines and administrative penalties of $3 million
- Disclosure violations resulted in fines and administrative penalties of $2.4 million
- Court proceedings resulted in jail terms for 8 individuals, ranging from 30 days to 3 years

This newsletter reflects the views of the author(s) and is provided only for informational purposes. This newsletter does not constitute legal, tax, accounting, compensation consulting or other professional advice and cannot be relied upon as providing such advice. Your inquiries on these matters can be directed to Nadine Côté, CSuite Law at ncote@csuitelaw.com