Institute for governance
of private and public organizations

Pay for Value:
Cutting the Gordian knot of Executive Compensation

Policy Paper

PREPARED BY PROFESSOR YVAN ALLAIRE
for the Working Group on Compensation of IGOPP

2012

Toward Value-Creating Governance™

Institute for governance
of private and public organizations

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About IGOPP

Established in September 2005, the Institute for Governance of Private and Public Organizations (IGOPP) is a joint initiative of HEC Montréal and Concordia University (The John Molson School of Business). The Institute is committed to promoting strong corporate governance practices among organizations in Quebec and the rest of Canada.

Its operations focus primarily on key management activities, namely defining the corporate mission, evaluating strategic management and financial performance, recruiting and compensating officers and managing risk. It achieves this through:

- **Policy papers**
- **Training**
- **Research**
- **Dissemination of information**

OUR MISSION

Help public and private organizations to adopt governance habits that create value by offering training, adopting public positions, conducting research and disseminating ideas.

OUR VISION

Through its original contributions, the IGOPP seeks to become a reference organization on governance issues in Quebec, Canada and around the world.

Members of the Board of Directors

Chaired by Dr. Yvan Allaire, a well-known figure in the business world, the Board of Directors of the Institute is made up of **15 prominent individuals from various field: senior executives of big and small businesses, institutional investors, heads of public-sector organizations, university researchers and regulatory experts.**

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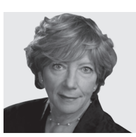

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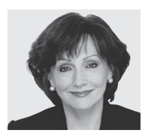

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Message from the Chair

For the sixth time since its creation, our Institute takes a formal position on a significant governance topic. This time, we are making a series of recommendations about the complex and emotionally charged issue of executive compensation.

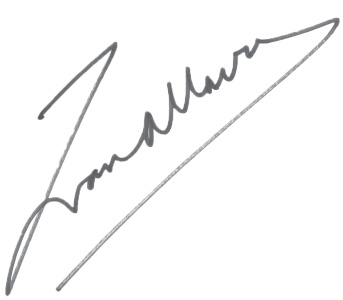
To shape our policy position, IGOPP has assembled in September 2011 a working group of its board members to formulate, discuss, and debate policy suggestions on a topic that has taken on the character of Gordian Knot over the years. The members of the working group, which was chaired by the undersigned, were:

- **Paule Doré**
- **Stephen Jarislowsky**
- **Michel Magnan**
- **Robert Parizeau**
- **Guylaine Saucier**
- **Sebastian Van Berkom**

I am grateful for their precious and savvy contribution to the process and its ultimate product.

Ultimately, the whole board received, discussed and unanimously[1] approved this policy position.

We hope that our analysis and recommendations will prove a valuable contribution to what has become the most salient and vexing governance issue.



YVAN ALLAIRE, PHD (MIT), FRSC
Executive Chair

[1] Except for board member Louis Morisset of the Autorité des marchés financiers who abstained as a matter of AMF policy.

Executive Summary

Executive compensation has moved through different phases over the last 70 years. From a base salary with a modest bonus added on, compensation skyrocketed after the mid-1980s with the practice of large stock options grants Changes in the nature of ownership and governance of publicly listed corporations coincided with this revolution in compensation.

For a period of time, the compensation of Canadian CEOs was but a fraction of their American counterparts. However, the pay of chief executive officers at large Canadian corporations has increased substantially over the years 1998 to 2010, achieving virtual parity with American CEOs by the end of that period.

At the same time, the compensation of CEOs moved up and away from that of the other senior executives at the same company. As well, the relationship of Canadian CEOs' compensation to the average salary of Canadian private-sector employees jumped from 60 times in 1998 to some 150 times in 2010.

The reasons for this much increased compensation are multiple and complex and the various interested parties have very different perspectives on the phenomenon. This policy paper describes how investors, board members, corporate executives and society at large have come to view the issue of setting a fair and appropriate compensation for company executives.

As recommended and urged by investors, some governance specialists and government agencies, a large portion of these pay packages is deemed to be "at risk", meaning that their actual pay is subject to stock price variations and some financial measures of performance. Some (mild) form of claw-back in case of reversal of performance is now built into many compensation programs.

The form of executive compensation has become largely standardized and its level is established on the basis of selected "comparable" companies, deemed to act as a basis to appreciate the market value of a corporation's executives.

This paper is critical of most of these bits of conventional wisdom and makes some specific recommendations for the setting of executive compensation.

Policy Recommendation 1

Gradually reduce stock options as a means of compensating senior executives, with a goal of eliminating this form of compensation.

Policy Recommendation 2

Governments should eliminate all tax benefits (personal and corporate) which favor stock options as a means of compensation.

Policy Recommendation 3

Boards of directors of publicly listed corporations should set what they consider a fair and productive relationship between the CEO's total compensation and median earnings within the firm[2].

Policy Recommendation 4

Boards of directors must remain fully accountable and responsible for the setting of executive compensation. Boards of directors must be credible enough, have enough courage, to set compensation on the basis of qualitative as well as quantitative factors they deem of great importance to the well-being of the company in the long run.

Policy Recommendation 5

Boards of directors should be guided by principles of the following nature:

TAILORING COMPENSATION TO THE PARTICULAR CIRCUMSTANCES OF EACH COMPANY

- Compensation should be linked to *quantitative and qualitative* indicators which drive the economic performance of the company, which **increase the long-term value of the company**; every company is somewhat different in this respect and cookie-cutter programs will not do the job; quantitative indicators should not be stock-price related but of the sort that do measure the long-term health of the company, such as Return on invested capital (ROIC) and Economic value added (EVA); they should not be highly volatile and easily manipulated; qualitative performance should be linked to the more subtle character of an organization, its soul and ethics, the sense of belonging and fairness felt by most members of the organization.

- Abandon the false notion that there is a surrogate market price for executive talent set by what a group of *comparable* companies pay their executives. That is the weakest link of the whole system put in place by compensation consultants. But that was the best answer they could come up with when asked to price executive talent.

REVIEWING AND QUESTIONING THE STANDARD APPROACHES TO COMPENSATION

Move away from the notion that a large percentage of senior management's compensation should be "at risk". Compensation is not actually at performance risk but at the whim of uncontrollable events and macro-economic circumstances. Their compensation being at risk (or, more accurately, dependent on their good or bad luck), senior management then requests protective contractual clauses and very generous pension terms.

[2] The Dodd-Frank Act requires financial-sector firms to divulge the ratio of the chief executive's compensation to that of the median salary in the firm.

FAIRNESS AND EQUITY IN COMPENSATION

- Maintain a relationship between *what is paid to the chief executive and what is paid to other senior managers so as to sustain the spirit of a team at the top*.
- Management and boards of directors should seek effective ways for all employees to share in the economic performance of companies, making all into partners fighting for the long term success and survival of the company.

However, if the widely held corporations continue to be "owned" by transient share swappers, speculators and impatient investors, if their management continues to be subjected to the dictatorship of quarterly earnings per share (EPS) targets and the unrelenting pressure for EPS growth from quarter to quarter, from year to year, if boards of directors are coaxed, urged and impelled to set compensation in a way that links it tightly and exclusively to financial performance and value creation for shareholders, then *discussion of changes in the forms and ways of executive compensation are futile and moot*.

If boards of directors do not fully internalize their legal, fiduciary, mandate to make decisions in the long term interest of the company, if boards of directors continue to face up to the pressures of short-term "investors" and proxy advisors in an isolated, case-by-case, fashion, if institutional investors are not prepared to vote against board members (or "withhold" their vote) who are responsible for compensation schemes that are clearly deficient, then executive compensation will continue to be dysfunctional in terms of the behavior it drives and the values it fosters.

The members of the working group of IGOPP are convinced that a modicum of social trust, loyalty and reciprocity must be re-built in publicly traded companies, and that management must manage for the long-term benefit of the corporation and its varied stakeholders. We are also convinced that this will not happen without fundamental changes in the compensation models currently in use in most companies.

Context

Executive compensation has become a nasty bone of contention in most developed societies. Whatever sound argument is invoked to explain and justify the large amounts paid to executives, the very public disparity of income within a given society and within the same organization turns the issue into, at best, a rallying cry for advocates of a saner society and, at worst, into an invitation to demagoguery.

Only after careful deliberation did our Institute decide to adopt a policy position on this complex and controversial matter. Before coming to some policy recommendations, we believe that it is imperative 1) to look back at how and why executive compensation evolved the way it did, and, 2) to understand the arguments and perspectives of the various parties concerned with executive compensation.

› First, some historical background

Based on U.S. data, the examination of historical trends in executive compensation points to three clear and distinct phases in executive compensation[3]:

- **Phase I-Managerial Capitalism: from the 1930s to the mid-1980s;**
- **Phase II-Transition to Financial Capitalism: from mid-1980s to 2000;**
- **Phase III-The Push Back… of sort: 2000 to nowadays.**

[3] Jensen and Murphy (2004) carry out a similar analysis, reaching different conclusions however.

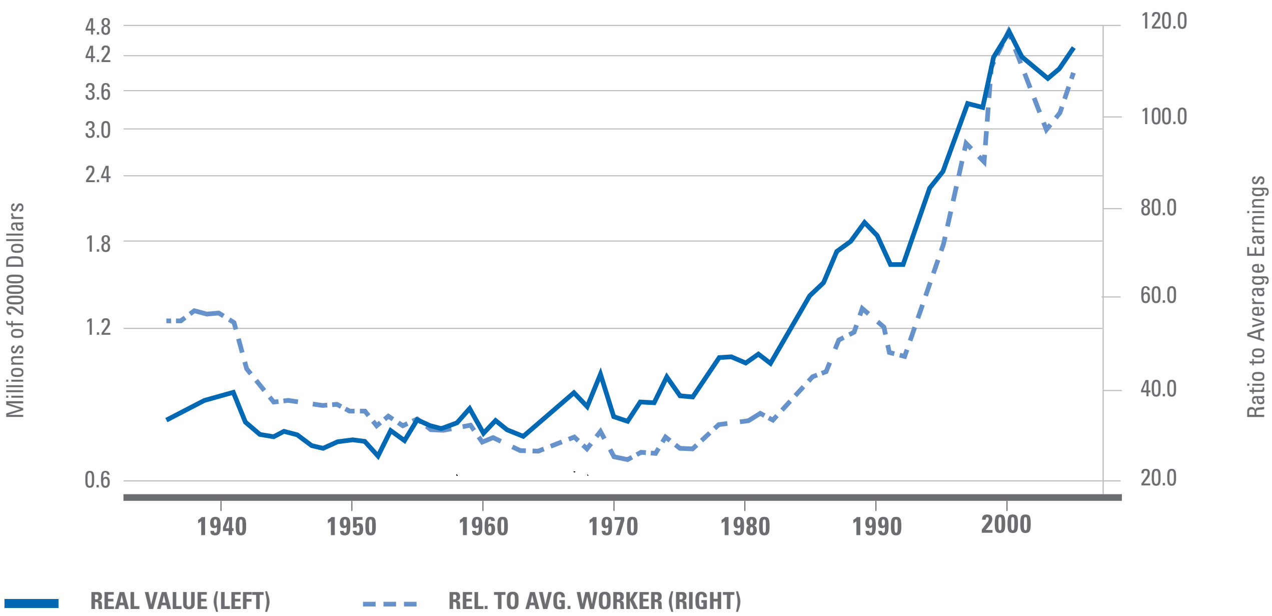
Figure 1 captures well these three phases by mapping out the total level of compensation of the three highest paid executives in constant 2000 dollars and, more tellingly, by comparing the level of executive compensation to the average salary of American workers. For some 50 years, this ratio hovered in a narrow band between 25 and 30 times. From the mid-1980s to 2000, this ratio increased fast and furiously to reach more than 100 and then leveled off since.

Figure 1

Median Value of Total Compensation, 1936-2005
Three highest paid executives of the 50 largest U.S. firms

(Constant 2000$)

SOURCE: FRYDMAN AND SAKS, 2007

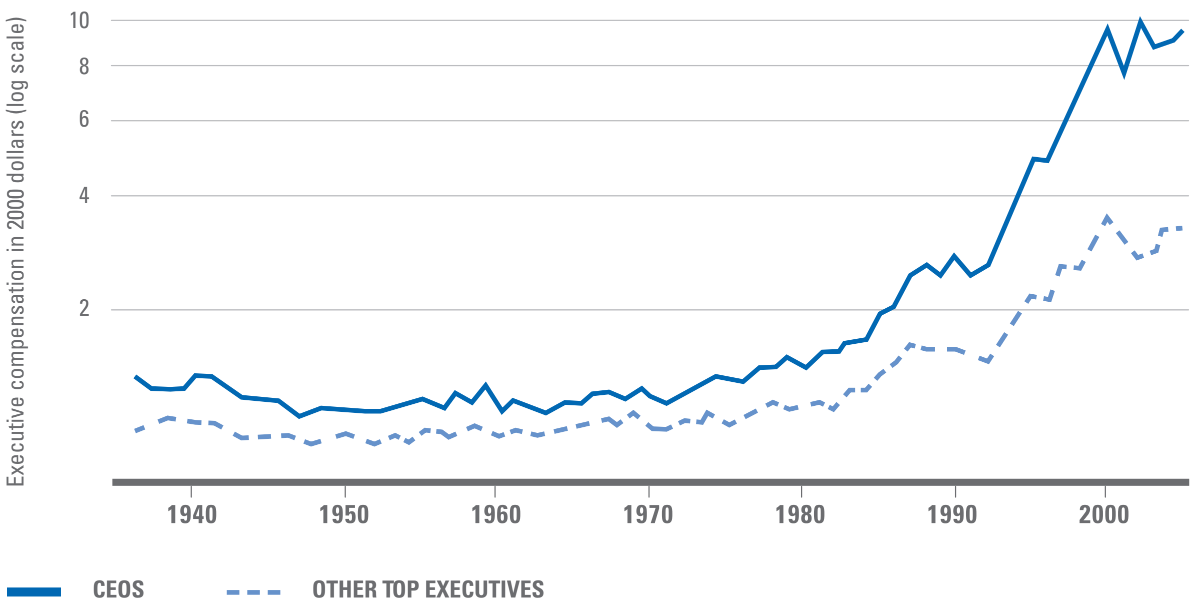


During the same period, the gap between what the CEO was paid and what the two next best paid executives earned widened substantially, as shown in **Figure 2**.

Figure 2

Median Compensation of CEOs and Other Top Officers, 1936-2005

SOURCE: FRYDMAN AND JENTER, 2010



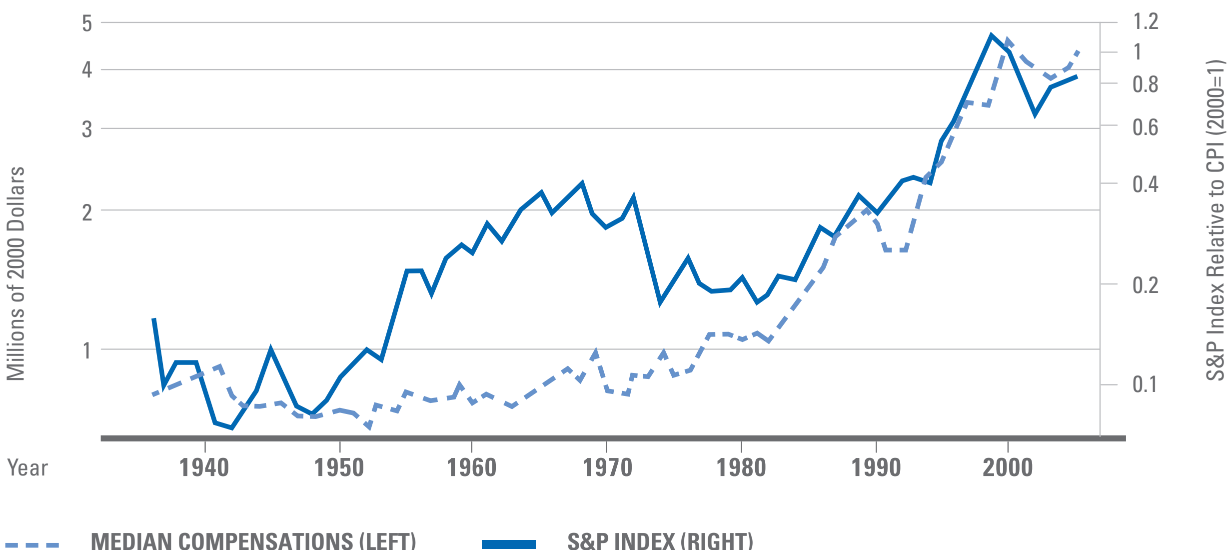
Up to the mid-1980s, the compensation of senior executives was relatively independent of stock market gyrations. From that point on, as shown by **Figure 3**, compensation of senior executives is tightly correlated to stock market performance.

Figure 3

Total Compensation of the Three Highest Paid Executives of the 50 Largest U.S. Firms Compared to the S&P Index

(Compensation Amount in Constant 2000$)

SOURCE: FRYDMAN AND SAKS, 2007



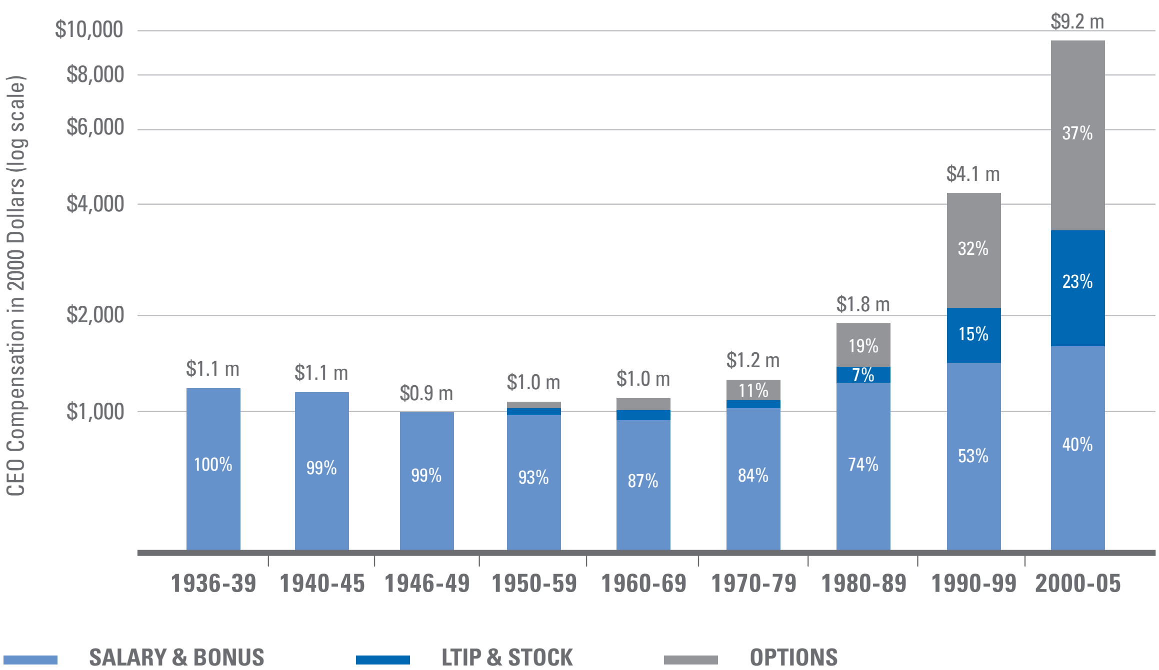
Of course, this phenomenon is easy to explain by examining the structure of CEO compensation of the 50 largest American corporations, as **Figure 4** does. While total compensation has increased *nine-fold* over the period, salary and bonus in constant dollars have not increased much. However, stock options and stock-linked compensation account for 47% of total compensation in the period 1990-1999 and 60% in the period 2000-2005.

Figure 4

The Structure of CEO Compensation in the 50 Largest U.S. Corporations, 1936-2005

(In Constant 2000$)

SOURCE: FRYDMAN AND JENTER, 2010



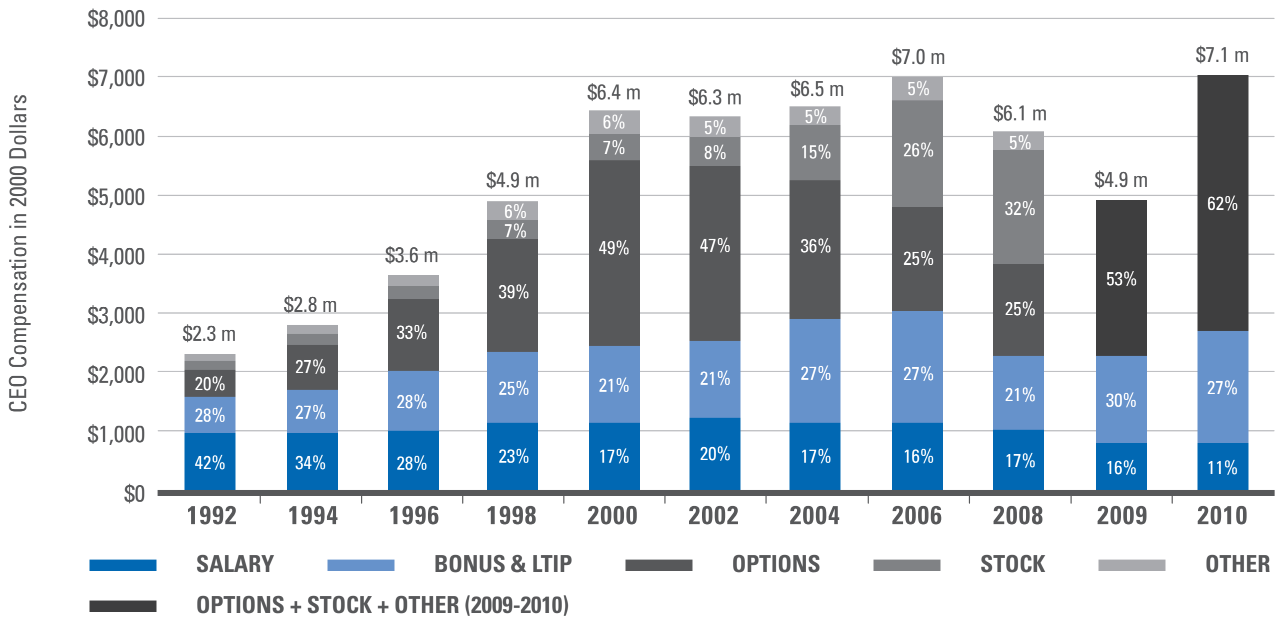
A more recent and detailed view of American CEO compensation for all of the S&P 500 companies during the period 1992-2008 is provided in **Figure 5**.

Figure 5

The Structure of CEO Compensation from 1992-2008 – S&P 500

(In Constant 2000$)

SOURCE: FRYDMAN AND JENTER, 2010



In constant 2000 dollars, there seems to be a leveling of compensation beginning in 2000, after a tripling of compensation between 1992 and 2000. That may be a sign of more effective push-back by investors and boards of directors; or it may simply reflect the fact that compensation is now largely made up of stock options and restricted shares, both of which is valued at the time of grant with some variant of the Black-Scholes pricing model, a metric which in no way informs us of the real cash compensation that will be realized eventually.

To be concrete, **Figure 5** shows that of the roughly $6 million in median compensation in 2008, some 25%, or $1.5 million, takes the form of stock options. The options will vest over some period of time and may be exercised usually within ten years of the date of grant. What these options will generate in actual cash for the executives holding them is unknown but that amount may be several times larger than $1.5 million.

› What about Canadian executive compensation?

Good reliable information on executive compensation in Canada only dates back to 1998; but for that period of twelve years, we have collected and arranged the compensation data to make them comparable to the U.S. data. Our analysis covers the largest 60 companies by market capitalization. We believe that this group compares in some way to 500 largest American companies making up the S&P 500.

Indeed, the smallest company of the S&P 500 had revenues of $1.4 billion and a market cap of $1.6 billion (December 31st 2010). The smallest of the 60 Canadian companies had revenues of $1.4 billion and a market cap of $3.4 billion (December 31st 2010). Of course, the Canadian group is more heavily loaded with mining, energy and financial service companies. (See Appendix I for the list of 60 Canadian companies on December 31st 1998 and 2010)

In nominal (or current) dollars, the compounded annual rate of increase in the compensation of the CEOs of the TSX 60 companies over the period 1998-2010 was 10.9 %. The compounded annual rate of increase in the market value of the TSX 60 during the period 1998-2010 was 5.9%.

Figure 6 shows the level and structure of the CEO compensation for these Canadian companies. As with the American CEOs, salaries in constant dollars do not increase much during the period. Stock options as a percentage of total compensation also reach a peak of 35%-36% in the period 2000-2002 (as compared to 49% in the US) and have fallen to 22% in recent years (25% in the US).

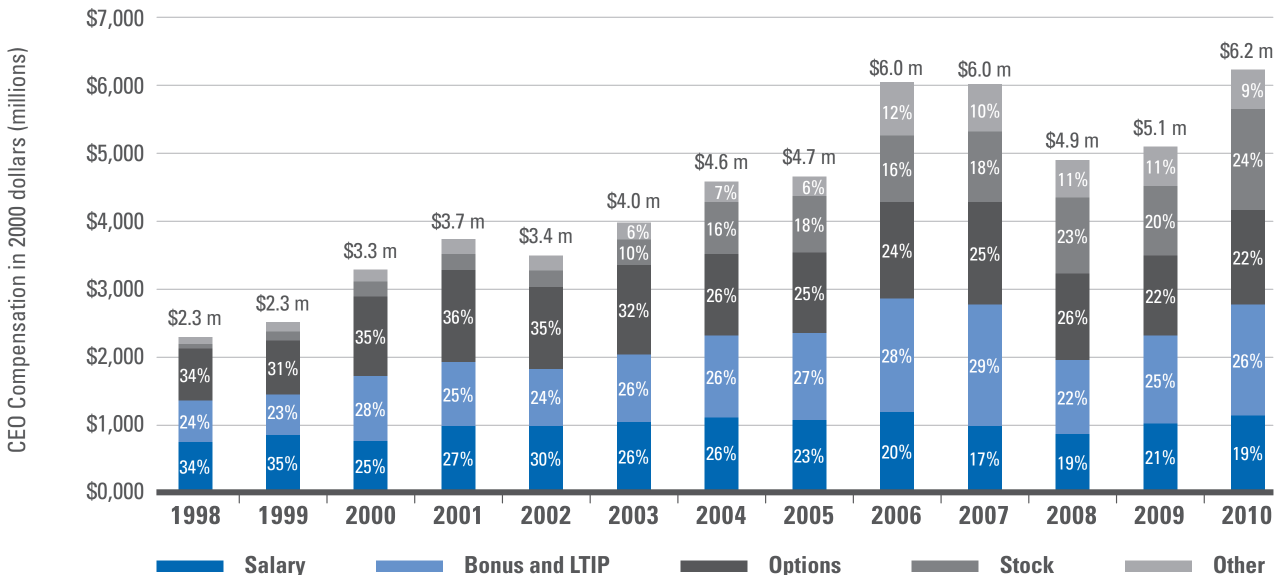
The biggest change over this period has been the increasing popularity of restricted shares as a means of compensation, rising from insignificant in 1998 to 24% of total compensation in 2010.

Figure 6

Level and Structure of CEO Compensation for TSX 60 Companies (1998-2010)

(Median and constant 2000$)

SOURCE: COMPILATION BY IGOPP BASED ON MANAGEMENT INFORMATION CIRCULARS FROM SEDAR, 2011



It is also noteworthy that "other" as percentage of total compensation, which includes pension funds, is markedly larger for Canadian CEOs than for US CEOs (10-12% vs. 5%).

This difference may be traced, in part, to the role that pension funds play in the overall compensation of Canadian and American executives. Long subjected to no, or limited, disclosure, the costs of retirement programs granted to senior executives were not well understood; as disclosure rules eventually forced companies and their auditors to account for the actuarial costs of these programs, their impact on total compensation turned out to be very substantial.

Differences in tax treatment as well as the significant shift in the USA to defined contribution plans (versus the still dominant defined benefit plans in Canada) may account for the differences between Canada and the USA but the issue is a complex and esoteric one.

As the compensation of bank CEOs has been of particular interest and a source of much lamentation, we extracted from the data of **Figure 6** the data on the CEO compensation for the six largest Canadian banks. **Figure 7** shows a similar pattern as that observed in **Figure 6**, except that the quantum of compensation is much larger for the bank CEOs. It used to amount to twice the median compensation of the overall 60 CEOs; by 2008-2010, the bank CEOs were paid about 50% more than the overall median compensation for all 60 CEOs.

Figure 7

Level and Structure of CEO Compensation of Canada's Big Six banks 1998 to 2010

(median and constant 2000$)

SOURCE: COMPILATION BY IGOPP BASED ON MANAGEMENT INFORMATION CIRCULARS FROM SEDAR

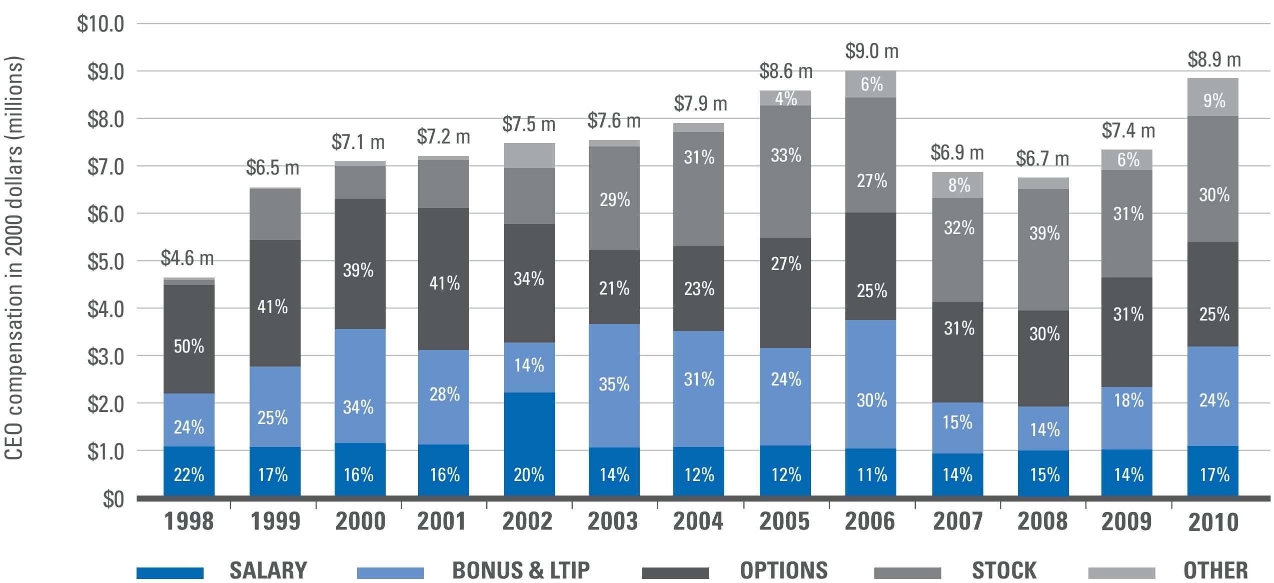


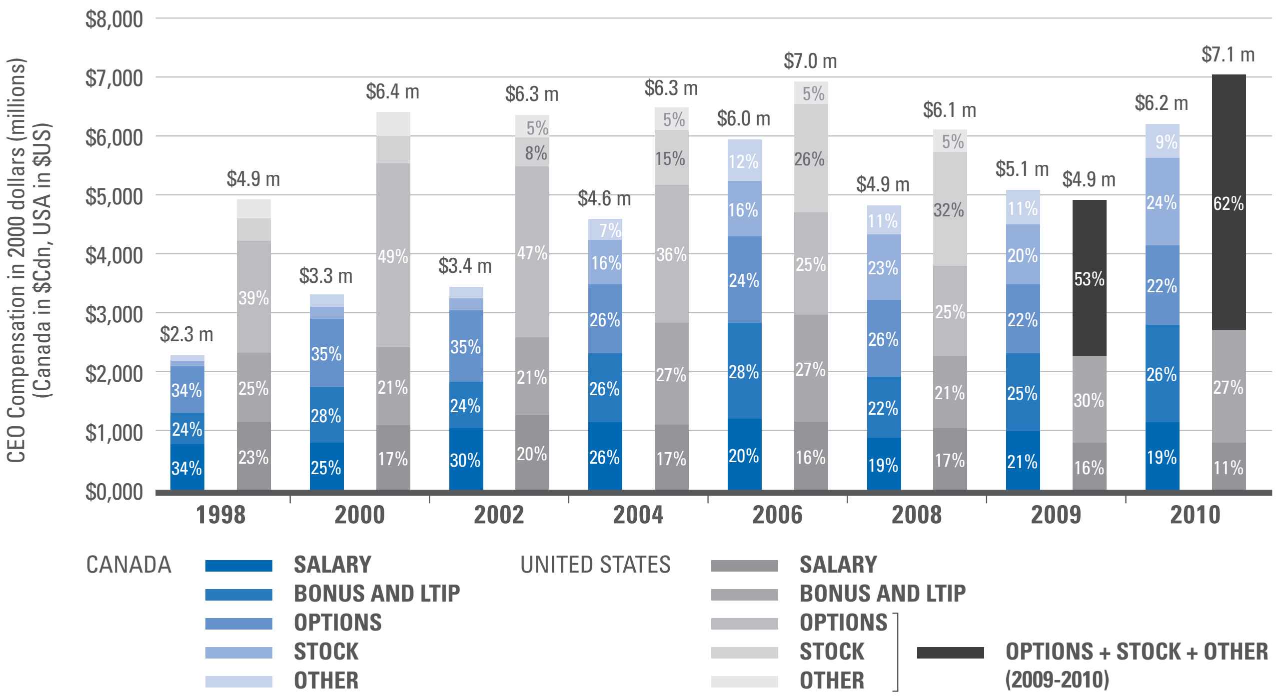
Figure 8 juxtaposes the pay packages of US and Canadian CEOs. US CEOs used to be paid *twice* what Canadian CEOs were paid (without translating US$ in Canadian$; in Canadian$, US CEOs were paid *three* times what Canadian CEOs were paid in 1998).

Figure 8

Level and Structure of CEO Median Compensation (1998-2010)

(Canadian vs. American CEOs in 2000$)

SOURCE: CANADA > COMPILATION BY IGOPP BASED ON MANAGEMENT INFORMATION CIRCULARS FROM SEDAR
UNITED STATES > 1998-2008 FRYDMAN AND JONITOR, 2010 AND 2009-2010 GMI, 2011



However, the median compensation of Canadian CEOs does not level of in 2000, as it does for US CEOs, but keeps increasing until it reaches a level similar to the compensation of U.S. CEOs from 2006 onward.

Could that be a result of the fact that an increasing number of larger Canadian companies include U.S. corporations among the "comparator" set of companies for the purpose of setting the pay package of their CEO?

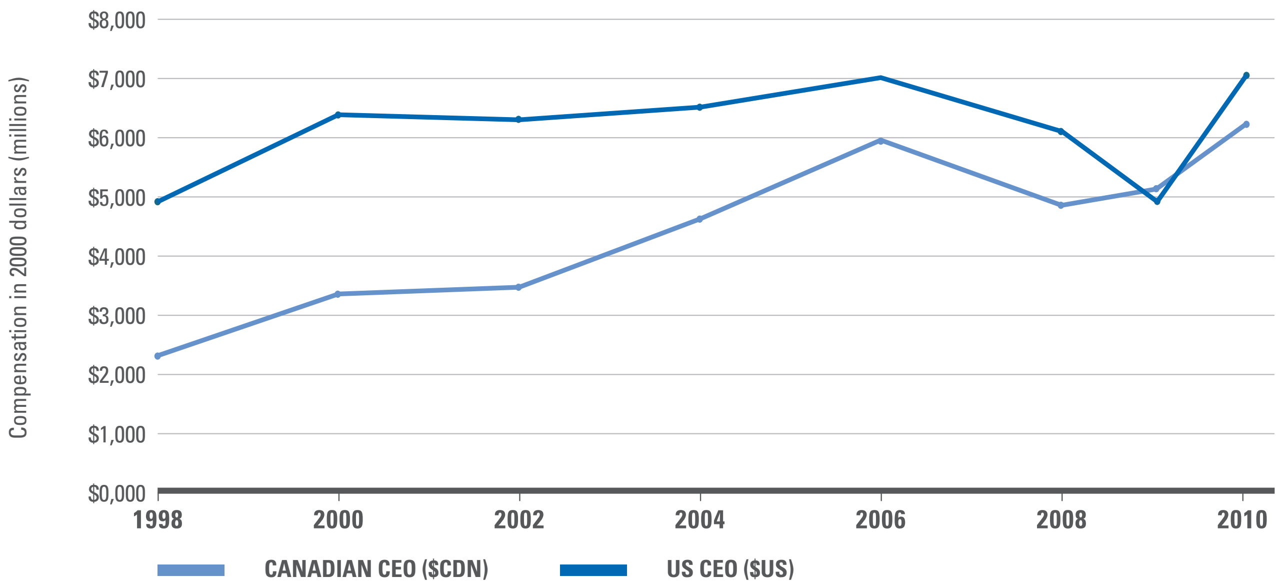
The convergence between Canadian and US compensation of CEOs is indeed notable[4] in **Figure 9**.

Figure 9

American and Canadian CEO Compensation-TSX 60 vs. S&P 500

(Median value in constant 2000$)

SOURCE: CANADA > COMPILATION BY IGOPP BASED ON MANAGEMENT INFORMATION CIRCULARS FROM SEDAR
UNITED STATES > 1998-2008 FRYDMAN AND JENTER, 2010 AND 2009-2010 GMI, 2011



[4] Sapp and Southam (2003) carried out a fine-grained comparison of Canadian and American CEO compensation with a sample of companies matched for size and industry over the period 1998-2002. Their conclusion at the time was as follows: *"Even though the total compensation packages for executives in Canada and their matched U.S. counterparts are not significantly different, we do find significant differences in the way the CEOs are compensated (e.g. the percentage from each of the different portions of their compensation package)"*. Our data indicate that by 2010 there has been convergence also in the way Canadian and American CEOs are compensated.

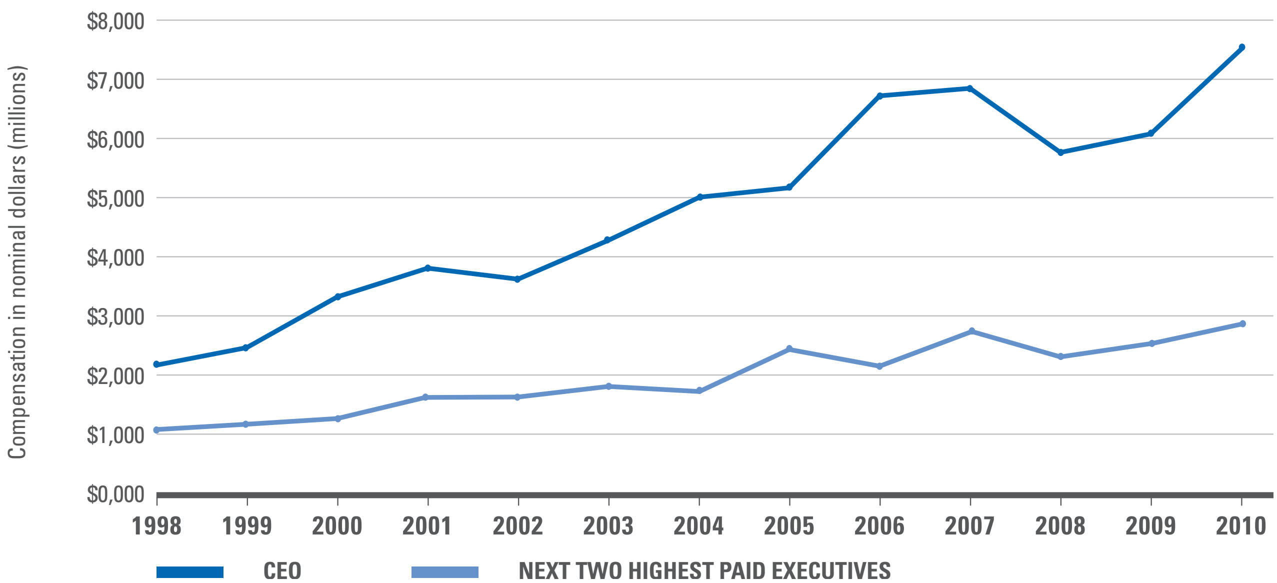
As in the United States, compensation of Canadian CEOs has also gradually become a larger ratio of what their next two best paid colleagues were paid (**Figure 10**). That ratio (in nominal $) moved up from roughly twice to more than 2.6 times over the short period 1998-2010.

Figure 10

Trend in Canadian CEO Compensation vs. Compensation of the Next Two Highest Paid Executives (1998-2010)

(Median compensation in nominal dollars)

SOURCE: COMPILATION BY IGOPP BASED ON MANAGEMENT INFORMATION CIRCULARS FROM SEDAR



PAY EQUITY IN CANADA?

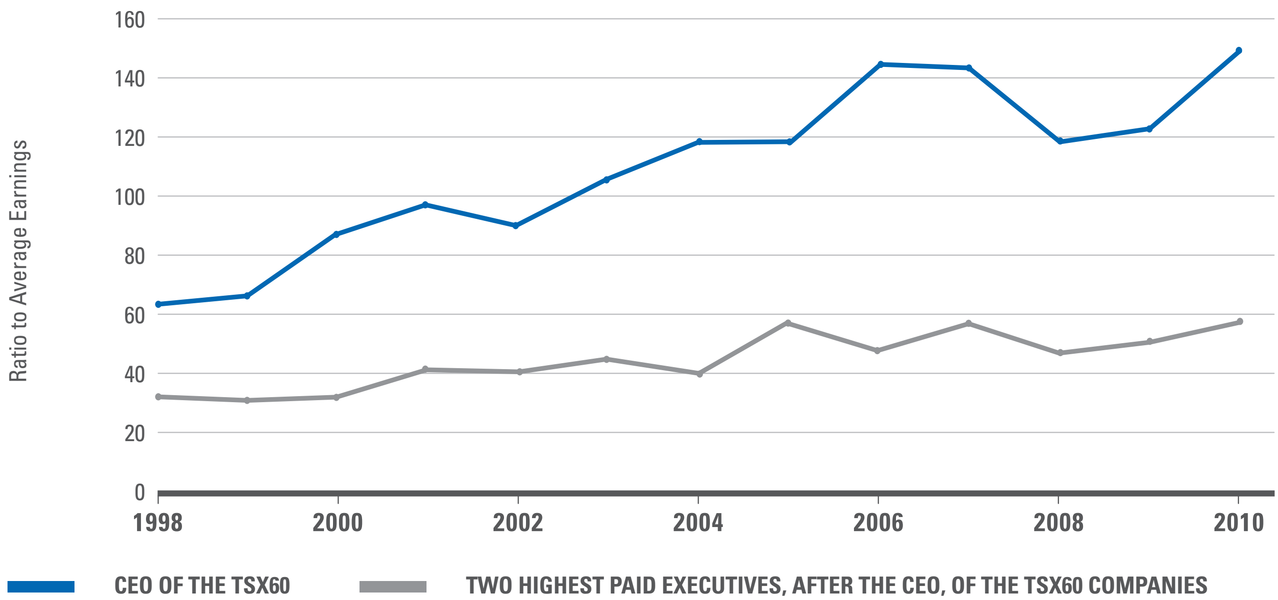
As graphed in **Figure 11**, the ratio of median CEO compensation to that of the average salary in the private sector soars from 60 in 1998 to over 140 in 2010. During the same period, the ratio of the compensation of the two next highest paid executives to the average salary of Canadian private sector workers increases moderately, going from 31.5 in 1998 to 57.

It would seem that the equity issue in compensation is largely an issue of CEO compensation.

Figure 11

Median Value of Executive Nominal Compensation as a Ratio of the Average Salary of Canadian Private Sector Employees (1998-2010)

SOURCE: CANADA : COMPILATION BY IGOPP BASED ON MANAGEMENT INFORMATION CIRCULARS FROM SEDAR
STATISTICS CANADA. CANSIM, TABLE 383-0010

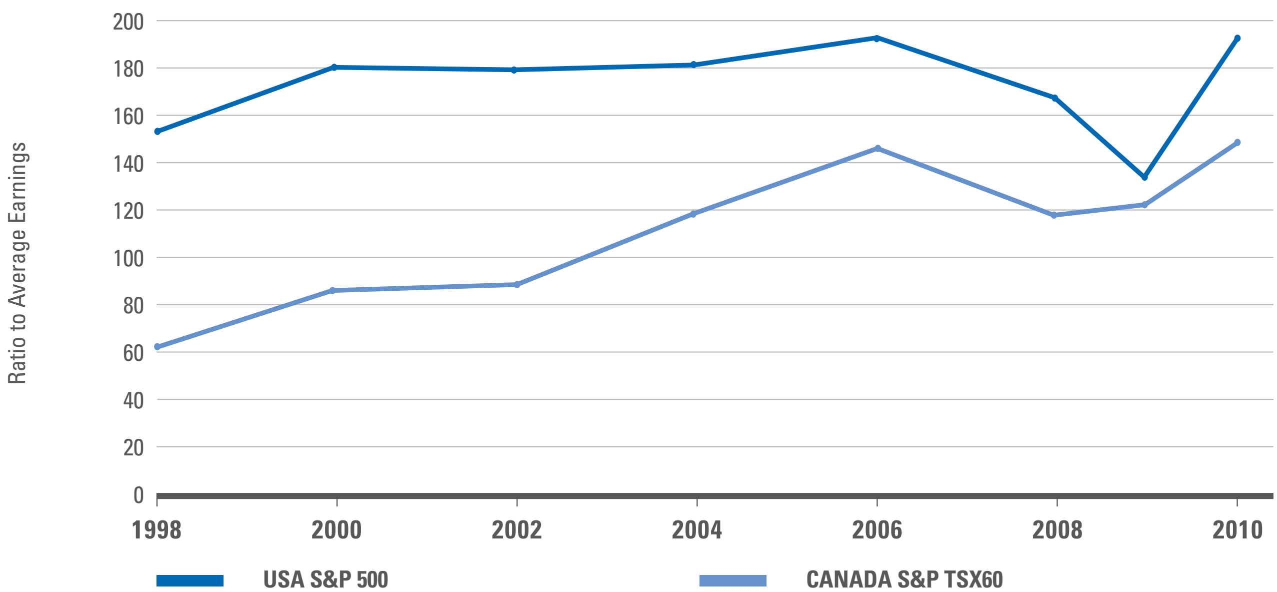


Indeed, the ratio of CEO compensation to the average salary of private sector employees in the USA, which was already in the 160-180 range in the 1998-2000 period, leveled off ever since. By contrast, the ratio for Canadian CEOs kept increasing over the whole period and has now reached a level that comes close to the US level as shown in **Figure 12**.

Figure 12

Median Value of CEO Compensation in relation to average salary of workers in the private sector: Canada vs. USA (1998-2010)

SOURCE: CANADA : COMPILATION BY IGOPP BASED ON MANAGEMENT INFORMATION CIRCULARS FROM SEDAR
STATISTICS CANADA. CANSIM, TABLE 383-0010



› Significant Changes in "Ownership" and Governance of Companies over the last 30 years

The remarkable evolution in executive compensation mapped out in the preceding figures did not happen *sui generis* but was linked, causally or not is debatable but linked it was, to changes in the nature of publicly listed corporations. These changes happened first and with more intensity in the United States but the same phenomena have been observed in most developed economies.

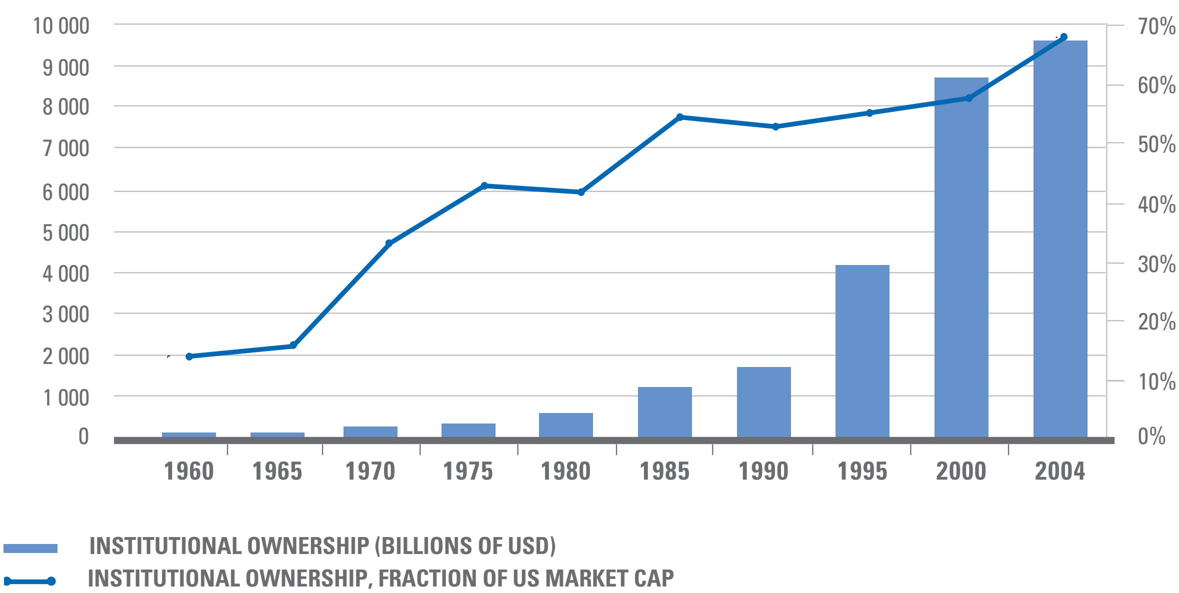
The first major change to occur, a momentous one, was the increasing percentage of shares of corporations held by institutions, to the point that, by 1985, institutions held a majority of shares in American publicly listed companies. That percentage has kept increasing so that it is now above 70%. Technically, and legally speaking, the majority owners of publicly listed corporations are institutional shareholders and funds (pension, mutual and others of whatever types). **Figure 13** presents an eloquent picture of this evolution.

Figure 13

Evolution of Institutional Ownership (U.S.)

1000 U.S. Publicly Listed Companies

SOURCE: GORDON, J.N. 2006

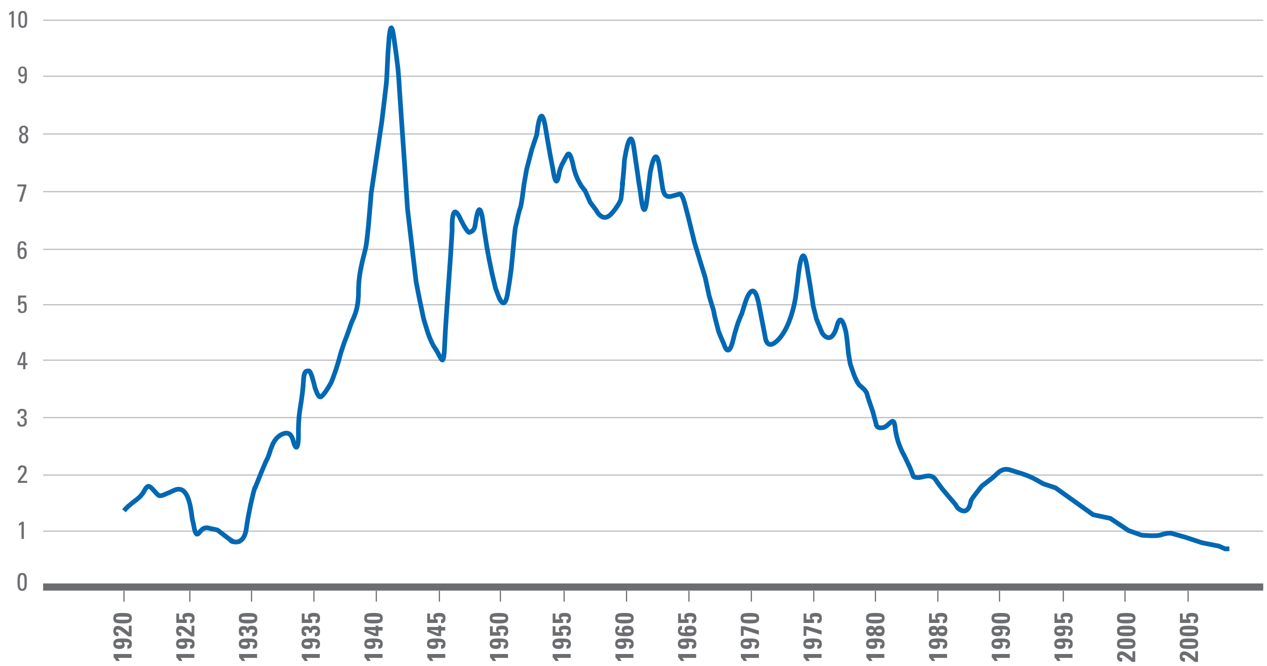


Then, the average holding period of shares, influenced by trading games and fund management strategies, began to drop in the 1980s from an average 5-6 years to less than one year nowadays for the New York Stock Exchange **(Figure 14)**.

Figure 14

Average stock holding period (in years) - NYSE 1920-2008

SOURCE: SG GLOBAL STRATEGY RESEARCH

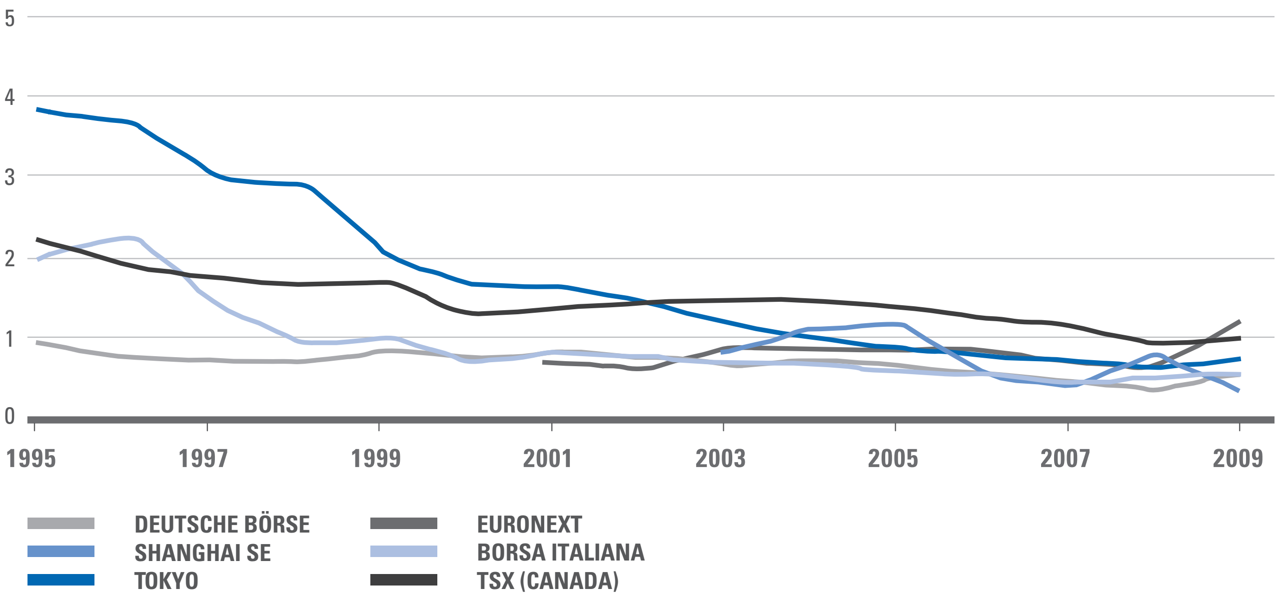


But the phenomenon is a global one as **Figure 15** makes clear.

Figure 15

Average holding period in other major stock exchanges (1995-2009) - (in years)

SOURCE: WORLD FEDERATION OF EXCHANGE



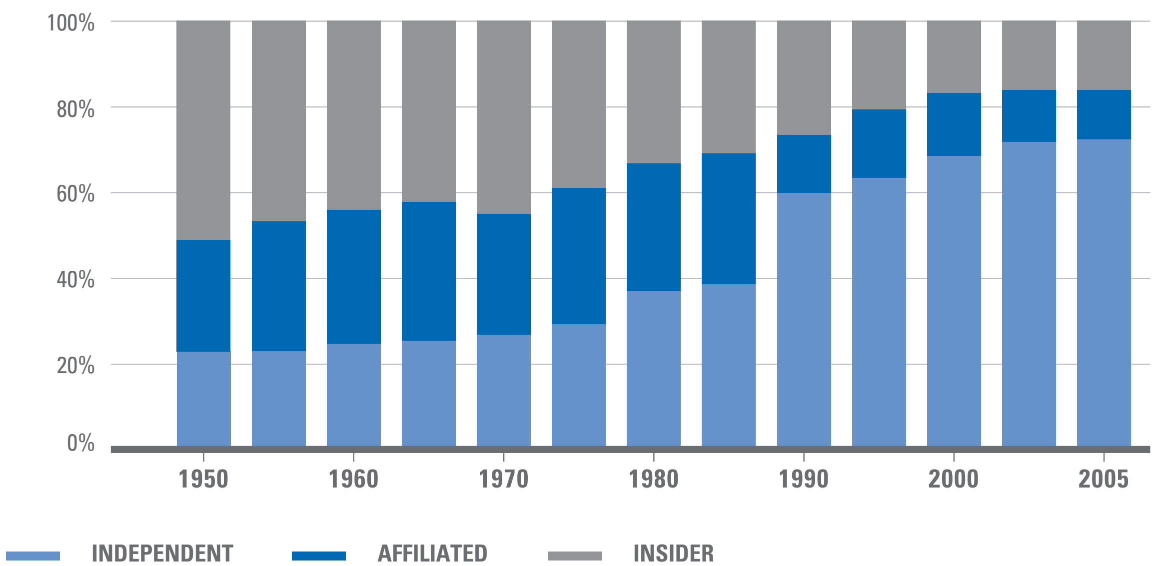
With institutional investors as majority shareholders, the pressure for changes in governance practices was sharpened, helped in good part by the scandals of the early 2000s. A cornerstone of good governance promoted by institutional investors held that a majority of board members should be independent of management. That came to pass.

By 1990, more than half of all board members of American publicly listed corporations were formally classified as "independent" (**Figure 16**).

Figure 16

Board Composition of U.S. Corporations 1950-2005

SOURCE: ADAPTED FROM GORDON, J.N. 2006



By 2009, "independent" board members made up[5]:

- 82% of all board members for U.S. companies (S&P 500);
- 79% for the largest 100 Canadian companies;
- 62% for the 150 largest U.K. companies (Spencer Stuart Board Index 2009)

[5] The correlation between, on the one hand, the growing percentage of independent board members, the majority ownership of shares by institutional investors, and, on the other hand, the booming rise in executive compensation is certainly intriguing.

Let's summarize what this brief retrospective has taught us about these three distinct phases:

PHASE I - MANAGERIAL CAPITALISM: FROM THE 1930S TO THE MID-1980S[6]

This first phase lasts from 1936 to sometime around 1985, the period when *managerial capitalism*[7] was the dominant mode of economic arrangement for large corporations:

- The three best paid executives earned less than 30 times the average income of workers; (**Figure 1**)
- The CEO was better paid than his next two colleagues but by a modest ratio; (**Figure 2**)
- Executive compensation was not related to overall stock market performance; (**Figure 3**)
- Compensation was made up almost entirely of salary and bonus, which did not increase that much in constant dollars over the period from 1936 to 1980; (**Figure 4**)
- The majority of shares in companies are owned by individuals; (**Figure 13**)
- Shareholders hold on to their shares on average for six to eight years, except for the stock market bubble of the 1920s; (**Figures 14 and 15**)
- Boards of directors are made up of a majority of insiders and affiliated people. (**Figure 16**)

PHASE II - TRANSITION TO FINANCIAL CAPITALISM: FROM MID-1980S TO 2000

All of the above changes dramatically, beginning in the mid-1980s.

- Institutional funds become majority shareholders of publicly listed corporations around 1985; (**Figure 13**)
- The average holding period of shares drops quickly to some two years and then to under one year; (**Figures 14 and 15**)
- Sometime between 1985 and 1990, independent members achieve majority on corporate boards; (**Figure 16**)
- Several influential academic papers claim that the reason traditional companies do not deliver maximum value for shareholders can be traced to the paltry percentage of the wealth created for shareholders that accrues to senior management. (Jensen and Meckling, 1976, Jensen, 1989, Jensen and Murphy, 1990). The experience of the 1980s leveraged buy-out (LBO) of publicly listed companies offered seemingly persuasive evidence that the traditional forms of governance and executive compensation were "value-destroying" for shareholders.

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[6] This period is a convenient one, given the availability of American statistical data. Canadian data are much less available over that same period.

[7] Berle and Means (1932), Barnard (1938), Drucker (1954, 1972, 1976), Whyte (1956), Sloan (1964), Chandler (1962, 1977, 1994), Galbraith (1967) and others have described the workings of this model of the corporation.

- Institutional investors, convinced by that argument, become more adamant about boards of directors promoting their interests. The way to achieve this goal was obvious: grant to senior management much larger number of stock options and they will become single-minded, almost fanatical, about *shareholder value creation*.

  - "*What we find particularly disturbing is that without any significant empirical evidence to test the recommendations of Jensen and Murphy (1990), during the 1990s corporate boards expanded stock options schemes and did not monitor carefully the value of these equity based compensation packages or consider the opportunity cost for shareholders.*" (Michaud and Gai, 2009)

- Up to 1985, stock options represented a very small percentage of total executive compensation. That form of compensation then grows exponentially and, by 1996, becomes the largest component of overall executive compensation. (**Figures 4 and 5**)

- In the early '80s, companies, one after another, tore up the old "contract" of job security, promotion from within and secure retirement for their managers. Pushed by the tough recession of 1981-1982, by the deregulation of markets and foreign competition, and by less passive institutional investors (now holding a majority of their shares), companies wanted the flexibility to hire whomever they wanted and to fire whenever they wanted. Thus, a market for managerial talent emerged as senior managers became increasingly mobile, both as a result of their being laid off or in search of better conditions.

As a result:

- In the USA, total compensation of the three best paid executives reaches a multiple of more than a hundred times the wages of workers; in Canada, in 2000, that ratio is around 50.

- The CEO's compensation is a growing multiple of his/her two best paid colleagues reaching more than three times by 2000; the notion of the "star" CEO replaces the concept of "the team at the top"; however, again in 2000, the Canadian CEO earns only twice what his two highest paid colleagues earn.

- The total compensation of executives follows closely the stock market indices;

- From the 1930s onward, *salary and bonus in constant dollars do not increase much*; however, total compensation surges as a result of stock options and restricted stock[8] grants. (Salaries and bonus move in constant dollars from $1.1 million in 1936-1939 to $1.5 million in the 2000-2005 period; but total compensation soars to $9.2 million for the 50 largest US corporations); (**Figure 4**)

- The percentage of total CEO compensation, which is *at risk*, once negligible, increased to over 70% of total compensation; institutional investors and governance advocates strongly support this trend;

- New financial players, private equity funds, hedge funds, speculative funds of all sorts, have mushroomed; their principals earn gigantic sums of money, dwarfing executive compensation;

[8] Restricted shares are a form of compensation whereby the executive receives shares of the company which may not be sold for a stated period of time; the restriction may also include the requirement that specific performance objectives must be achieved for the executive to acquire the ownership of these shares.

some 25 hedge fund managers, in 2010, earned collectively *more than three times the total compensation of all CEOs of the S&P 500 companies*.

PHASE III - THE PUSH BACK…OF SORT: 2000 TO NOWADAYS

- The implosion of the Internet-telecom bubble and the scandals bearing the names of Enron, WorldCom and others in 2001 and 2002, have made executive compensation, which was widely seen as a cause of these fiascos, into a major issue for investors, agencies of governments and governance specialists.
  - Fortune magazine publishes in June 2001 an influential article[9] titled "*The Great CEO Pay Heist-Executive compensation has become highway robbery*";
  - In 2006, the Wall Street Journal published a series of articles on options back-dating, the practice of setting the exercise price of stock options at an earlier date when the stock price was lower thus benefiting the executives. As a result, the SEC and the U.S. Department of Justice carried out investigations in 131 companies and 60 senior executives were terminated or resigned; Steve Jobs was the most famous executive entangled in this sort of arrangements; he was eventually found faultless;
- The total compensation of CEOs of the S&P 500 companies has leveled off in constant dollars at around $6-7 million since 2000. (**Figure 5**) Institutional investors have become more effective at pressuring boards of directors to rein in compensation, or more accurately, to link compensation more closely to performance (hopefully, of the long-term sort).
- *The Canadian data however show that CEO compensation, lagging US CEO compensation in 2000, continued to move up until 2006 by which time it has largely converged to the level and structure of compensation of American CEOs*. Whatever push-back occurred in the U.S. after 2000 did not begin until 2006 in Canada.
- Since 2000, there have been a plethora of reports, official guidelines, blue ribbon committees[10], rules and recommendations in an effort to come to terms about what would be an appropriate compensation regime for executives. The focus of all this agitation has clearly been on *linking compensation to financial performance, both short-term and long-term*.
- The dramatic financial crisis of 2008, when unhinged compensation played a significant role, pushed into action various legislators, securities commissions, the G-20 Financial Stability Board (FSB), the European Commission, the Bank for International Settlements, the Dodd-Frank Act, etc. They have all weighed in with their prescriptions for an improved compensation system in the financial sector. The compensation practices of banks and other financial players have

[9] In 1991, compensation consultant Graef S. Crystal turned against his clients with a book titled *"In Search of Excess: The Overcompensation of American Executives"*. The book had a good deal of coverage at the time but faded away in the ebullient 1990s.

[10] Among which the excellent report of *"Blue Ribbon Commission on the governance of executive compensation in Canada"* for the Institute of Corporate Directors, June 2007.

inflamed public opinion and spurred some tentative measures by governments, although the push back by the industry has been vigorous and well-financed.

- The Dodd-Frank Act, the FSB principles and the EU directives all insist that variable compensation should be linked directly, linearly, mathematically if possible, to financial performance and must include some form of claw-back of past compensation.

- Boards of directors have been the butt of criticism in matters of compensation and suffer from a growing lack of confidence in their competence and vigilance in matters of compensation.

- As a result, the drive for an *advisory*, *non-binding* vote by shareholders on executive compensation (an initiative known as *Say-on-Pay*) has gained traction since 2005; it is now a legal obligation in the U.S. as a result of the Dodd-Frank Act of 2010. Through shareholder proposals or legislative actions, *Say-on-Pay* has been imposed on corporations in several countries[11]. In Canada, by 2011, 71 issuers included in the S&P/TSX Composite Index have committed to holding "say-on-pay votes". This shareholder vote on compensation, though generally non-binding, has added measurably to the clout of proxy advisory firms who now get to counsel investors about the adequacy of compensation plans and to guide their voting.

- The focus on "pay-for-performance", which is a *leitmotiv* of the argument for non-binding votes by shareholders on pay programs (*Say on Pay*) could lead to unexpected results. The quest for a direct and quantitative link between compensation and performance has already spawned complex forms of compensation and esoteric performance measures. The threat of a negative vote by shareholders if this linkage is not sufficiently persuasive may well shift the ways boards set compensation. Boards and management may well focus on short and medium terms financial ratios while neglecting longer term challenges and less tangible aspects of running a company, which are critical to its success and survival. **Figures 17 and 18** show the drivers of short-term and longer-term compensation for American companies. The dominance of strictly financial figures is striking, particularly for "longer term" incentive plans for which TSR (Total Shareholder Return) is increasingly prevalent.

[11] The United Kingdom, Australia and Sweden adopted *non-binding* votes for all their publicly listed companies in 2002, 2004 and 2006 respectively. In Holland (2004), Norway (2007) and Spain (2008), shareholder votes on compensation are binding.

Figure 17

Measures to Determine Corporate Performance (2008-2010)

Metrics Used in Short-Term Incentive Plans

SOURCE: LARCKER AND TAYAN, “WHAT IS CEO TALENT WORTH”, SSRN 1991251, JANUARY 2012

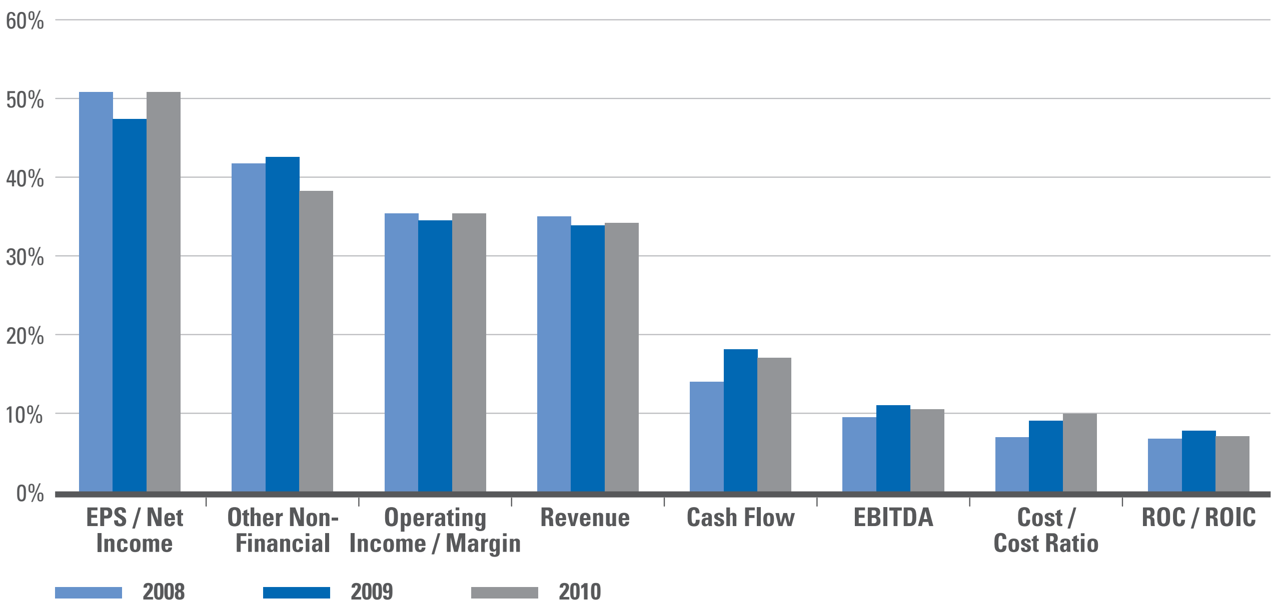
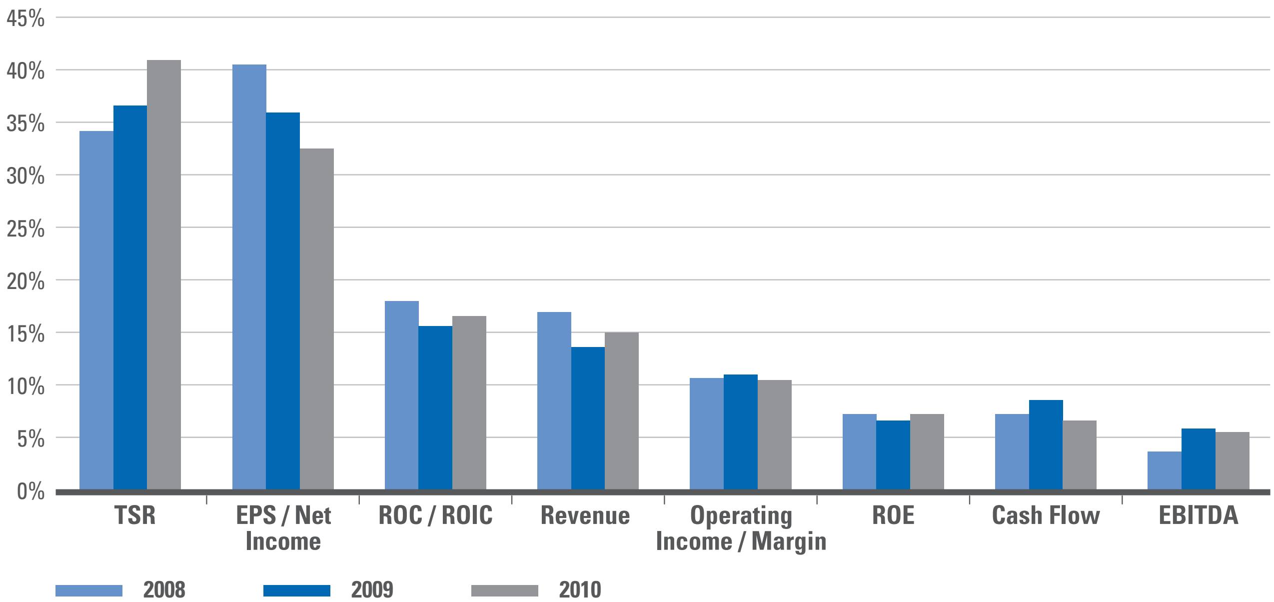


Figure 18

Measures to Determine Corporate Performance (2008-2010)

Metrics Used in Long-Term Incentive Plans

SOURCE: LARCKER AND TAYAN, "WHAT IS CEO TALENT WORTH", SSRN 1991251, JANUARY 2012



Furthermore, the ISS/Risk Metrics proxy advisory firm has issued the guidelines for its 2012 recommendation on "Say-on-Pay" proposals:

> *The revised policy also measures the relative alignment between CEO pay and company total shareholder return (TSR) within the peer group for a one- and three-year period (with a 40 percent emphasis on the one-year period and a 60 percent emphasis on the three-year period), as well as absolute alignment between CEO pay and company TSR over a five-year period. Where this alignment is perceived by ISS to be weak, ISS will consider how a number of factors affect alignment of pay with shareholder interests, such as a company's benchmarking practices, completeness of disclosure and ratio of performance based pay to overall compensation.*

There are no indications that canadian companies will not be assessed in the same manner.

- Until the late 90s, there was a great deal of faith in the "efficiency" of financial markets, their ability to sort out good from bad performances. If one believes financial markets are efficient, stock options would be a fine way of compensating executives; the price of the stock would reflect all relevant information; it would see through accounting gimmickry; it would reflect present value of future cash flows discounted at a rate that accounts fully for risks; it would not be swayed by infatuations, fashion and mass hysteria; it would be the arbiter of true value, so says the theory.

  The early years of the 21st century sure put a stake in the heart of that theory. Yet, the practice of large stock option grants persisted in the first decade of the 21st century, though their importance in overall compensation was gradually reduced in favour of restricted stock grants. Restricted shares moved ahead of stock options (32% vs. 25% for U.S companies in 2008 and 24% versus 22% in 2010 for Canadian companies).

  Several criticisms are levied at stock options:

  - They provide large upside benefits but have a dramatic impact on executive *paper wealth* and possibly (although controversial) their motivation whenever the stock price falls below the exercise price; for instance, the following table (**Figure 19**) captures well the conundrum of stock options.

Figure 19

Paradox of Stock Options as Management Compensation: Economic and Financial Performance of Company XYZ

(Based on an actual case)

SOURCE: ALLAIRE, Y., 2011

MAY 31ST	2003	2002	2001	2000	1999
RETURN ON ASSETS	14.08%	13.44%	13.49%	13.54%	13.99%
RETURN ON EQUITY	16.65%	15.73%	14.92%	15.70%	15.54%
STOCK PRICE	$16.42	$8.60	$17.16	$15.22	$9.05
EVA (THOUSANDS OF C$)	65,492	45,926	29,821	21,678	27,190
P/E RATIO	22.78	13.61	33.99	31.44	21.00

Here's a company that performed very well over the whole period showing strong and stable returns on assets and on equity as well as adding an increasing amount of economic value (EVA).

Suppose each member of the management team of this company received 200,000 options on May 31st 1999 at the exercise price of \$9.05. A year later, these managers are all *paper millionaires* (option value=\$1,234,000). By May 31st 2001, they have a paper value of \$1,611 million.

On May 31st 2002, *their entire paper wealth has vanished*, yet the management team has delivered much better results than the preceding three years.

By May 31st 2003, the managers are again paper millionaires, but forever anxious that this wealth may again disappear through no fault of theirs but because of the general behavior of stock markets over which they have no influence. No doubt that this hazardous form of compensation shapes the actions and decisions of senior management.

- They incite management to take undue risks as they share in the upsides but not in the downsides[12].
- They tend to reward "luck" as much as performance; a booming stock market lifts all boats; unless the exercise prices of stock options are indexed to some stock market index (a rare practice that raises some thorny issues), "lucky" executives who happen to live through one of these recurring phases of stock market exuberance will become very rich; those who happen to spend a good deal of their career when stock markets are in doldrums will not be so lucky.

All in all, the level of executive compensation has taken off in the early 1990s, at first at the urging and with the blessing of institutional investors; then, these investors began to lament the lack of relationship between compensation and performance. That lament has driven a search for ever more esoteric ways of linking compensation to performance.

The sharp and insistent criticism of stock options has led to a relative curtailing of that form of compensation in favour of "restricted" shares. This form of compensation gets around, to some extent, the feature of stock options whereby their value is nil when share prices fall below option exercise price; and it does result in management sharing more of the downside risk of their decisions. Otherwise, restricted shares raise some of the same issues as stock options: when do they vest? What are the performance conditions for "earning" the restricted shares? When can these shares be sold? How can their value be clawed back if performance deteriorates soon after they have been cashed in?

[12] Sanders and Hambrick (2007) show that moderate levels of stock options (20% to 50%) do induce executives to become more risk neutral (less risk averse) with performance symmetrically divided between losses and gains. On the other hand, more option-loaded executives produced more big losses than big gains (Sanders and Hambrick, 2007, p.1070).

› Various Perspectives on Executive Compensation

THE PERSPECTIVE OF INVESTORS

- *Investors* come in many guises; the transient, speculative types have little interest in matters of executive compensation; the institutional investors with a longer term commitment to companies expect from the senior management of public companies total dedication to the creation of value for them, the shareholders, the presumed collective *owners* of the company. They also expect boards of directors to be highly responsive to their interests and to take swift and decisive actions when necessary, including the replacement of any CEO who fails to deliver on expectations.

- They expect the board to set up a compensation plan that links incentive pay clearly and effectively to performance for the shareholders. There are two distinct beliefs underpinning this stance:

Belief I

In most large companies, the CEO and other senior executives make a significant difference in the performance of the company. The notion that CEO and senior management drives corporate performance receives mixed support from empirical research[13]. Common sense and practical experience would support the argument that there is a strong linkage between the quality of management and firm performance. Yet, the issue is tricky as this contribution will vary greatly across types of industries and contexts. For instance, the contribution of management tends to be less significant in companies operating in regulated industries (e.g. in years past, electric utilities, telephone, banking, etc.), companies with strong brand and market franchise resulting from investments over many years (Coca-Cola, etc.), companies operating in commodity markets where performance is highly correlated to international commodity prices over which management has no control (e.g. aluminum, paper, gold, oil, etc.). At the other end of the spectrum, contract and service businesses and firms where risky innovation and product development are critical require a high quality of "human capital" and first-rate leadership to sustain their performance. Ideally, the board should establish what part of the company's performance is really attributable to senior management, not an easy task in practice.

Belief II

Institutional investors tend to believe *that compensation drives management's performance*. Again, common sense and practical experience would seem to support this belief. Yet, empirical research has found this relationship to be quite elusive. For a recent instance, Michaud and Gai (2009) have carried an extensive analysis of relationships between six types of CEO compensation (salary, cash bonus, restricted shares, stock options, long-term incentive plans,

[13] *"Research on what percentage of the variance in firm performance is explained by a firm's CEO ranges from a low of 3.9% (Thomas, 1988) to a high of 14.7% (Wasserman, Nohria, and Anand, 2001). The size of this 'CEO effect' is much smaller than the impact of industry and other firm attributes on a firm's performance. Other scholars have also documented the relatively modest impact that leaders have on organizational performance in a variety of empirical settings (Bass, 1990; Hambrick and Finkelstein, 1996)".*Mackay's research however, finds CEOs explained close to 30% of firms' performance, a much higher result than in other research (Mackay, 2006, p.3).

total CEO compensation) and corporate performance (ROA, EVA, etc.). They conclude thus: "*None of the six payment types had significant effects on firms' performance. This finding suggests a rethinking of the role of the CEO compensation as an incentive for improving corporate performance, i.e. can the CEO actually affect the annual profit of firms of this scale*."

That sort of research, though interesting, is not convincing. The performance of a firm is the product of several entangled variables, reflects past decisions, is contingent on macro-economic factors, and is subject to qualitative and subtle influences, all of which may be quite different from firm to firm and from time period to time period.

We are generally skeptical about the power and subtlety of statistical tools, no matter how impressive they may seem, to isolate the influence on company performance of a particular variable, say, the CEO's compensation or the number of independent members on the board and so on. We are even more skeptical of studies that purport to show a significant relationship between such variables.

- Boards of directors, in the view of many institutional investors, have too often proven inadequate to the task of setting executive compensation; from the perspective of many investors, boards are often poorly informed and inexperienced in these matters and thus rely too heavily on outside compensation consultants, the undisclosed ally of management. As a result, investors tend to believe that boards of directors too often failed in their explicit duty to protect shareholders' interest against expropriation of their wealth by management. They were oblivious to the incitement to risky behaviour built into most popular compensation systems. They did not provide the checks, the safeguards, and the "push back" on management that were assumed by investors. Hence, investors strongly support the *Say-on-Pay* advisory vote by shareholders.

- Institutional investors are concerned that the current system of compensation is flawed in several ways:

  - Almost all companies, under the advice of a small set of compensation consultants, have adopted the now standard compensation package of salaries, bonus, stock options, restricted shares, long-term incentive plan (LTIP), and pension benefits; the package is the same only the quantum of the compensation varies; to set the level of compensation, consultants come up with a set of comparable or reference companies they claim are close enough in size and complexity to act as a *surrogate market*; then the company's compensation will be set at the median of the compensation granted to the CEO and other executives of these comparable companies[14]; by a savvy selection of these companies (including American companies to set the compensation of Canadian CEOs), it is possible to arrive at a median compensation that will please the executives of the target firm; then, the dynamics of this process will be such that target compensation will keep increasing[15].

[14] Paying one's CEO less than the median, except perhaps for a short period at the beginning of his/her tenure, would be akin to admitting he/she is of inferior quality!

[15] A modicum of familiarity with system dynamics will suffice to understand that if all firms scoring below the median raise their compensation levels to the median and those above the median stay put or certainly do not decrease their compensation, then the median will rise substantially from year to year.

- There is a strong element of luck built in the system; the stock market's rising tide, during the 1990s and again in the 2002-2007 time period, lifted all boats, rewarding the lucky executives who happened to be there and to cash in at the right time; compensation often rewards executives for a company's good performance that is due largely to macro-economic factors or international commodity prices.
- There is no effective claw-back provision in most compensation programs, should performance deteriorate sharply after a couple of good years;
- Compensation plans are giving executives great upsides (whether the company's performance is due to their efforts or the results of fortuitous circumstances) and are designed to minimize their down-sides, through management contracts with large lump-sum payments in case of firing or change of control, and generous pension plans; the post-retirement benefits lavished on CEOs are also irksome; these retired executives received huge compensation while in office with which they can well afford to pay for their preferred lifestyle in retirement;
- Though partly responsible for this result, institutional investors are critical of the complexity of currently popular compensation programs suggested by compensation consultants and adopted by companies in their forlorn attempt at meeting the test of an effective link between compensation and performance;
- Investors believe that senior managers should have skins in the game, that they should own outright a significant number of shares, in addition to their restricted stock and stock options; such a policy has been adopted by many listed corporations; however, it turns out that executives are allowed to protect themselves against stock price drops by resorting to derivatives[16]; the Dodd-Frank Act only requires that companies state (somewhere in their many filings with the SEC) that the company authorizes management to use derivatives; the European Union prohibits this practice; the Canadian securities commissions seem to be going the way of the USA; in the view of most institutional investors, that practice should be banned as it defeats the purpose of stock-related compensation: aligning the interests of shareholders and senior management.

While we share several of these views, we must point out three areas of serious disagreement:

1. **Shareholders as owners**: Given the dismal statistics on average holding period for shares and the various games played with company stock by speculative funds and other like-minded short-term *investors*, it is fanciful to consider these share swappers, these momentary holders of shares, as the legitimate *owners* of a company! Corporations owe much to other stakeholders who have made long-term commitment to the company and have a great deal at risk.

[16] Derivative products can act, for example, as a form of insurance against the risk of a sudden drop of share prices; there are several ways to achieve this (and new ones are continuously concocted; that's what financial innovation means). The simplest would consist of buying a put (a right to sell (*or put*) a specific number of shares at a set price) maturing some months later at a price somewhat below the current price of the company's shares. In uncertain times, such a put would set a cap on the amount of the loss to which an executive is exposed from his/her holding of company shares.

2. **Compensation should be set to maximize returns to shareholders**: boards of directors of publicly listed companies have a fiduciary responsibility to set fair and reasonable compensation programs, *taking into consideration not the interests of shareholders, but the company's long term interests*. That is the law in Canada and in several other jurisdictions. Boards of directors must insist with institutional investors that the stakes in this regard extend beyond *maximizing shareholder value*. Indefensible levels of compensation may undermine the company's social and political legitimacy. Large differences in compensation within companies bring in its wake a loss of the sense of community, of *all being in the same boat*.

3. **Linking compensation to financial measures of performance is the holy grail of compensation practices**. The more regulators, institutional investors and governance champions call for a direct linkage between compensation and financial performance, of the short or long term sort, the more they aggravate the problem and trigger the kind of executive calculus that led to the last crisis. This insistence on such performance-related compensation is ill advised and speaks of a vision of the company as entirely dedicated to creating value for "shareholders", the root cause of recent fiascos; it assumes wrongly that senior management's performance, in the short and in the long term, may be reduced to some quantitative financial measure. The insistence on linking compensation to measurable financial indicators comforts the notion, the illusion, that the long-term performance of a company may be traced back to a particular form and level of compensation.

THE PERSPECTIVE OF BOARDS OF DIRECTORS

- Boards of directors share with investors the view that good management has a large impact on company performance and that incentive compensation spurs management to high performance; however, boards also know that senior management's effectiveness includes many qualitative elements, not susceptible to quantification, but critical to the long term welfare of the company, such as protecting and nurturing talent and innovation, sustaining a culture of commitment, probity and loyalty. Boards of directors have the very difficult task of setting compensation in a way that will spur the right kind of performance.

- Boards of directors know, or should know, that people are not motivated by money alone. Great companies always give "surplus meaning" to their goals and raison d'être, appeal to the "better angels of our nature"; companies must learn to balance and integrate in their motivation and incentive systems the gamut of needs and aspirations that people bring to work for organizations; there are large variations across cultures and societies, as well as across individuals within the same organization, when it comes to the power of monetary incentives; in all cases, boards of directors know, or should know, that too exclusive an emphasis on monetary incentives linked to financial performance may bring about a utilitarian, mercenary attitude in the organization that will sooner or later create serious problems, produce a climate that nurtures greed, short-term calculus, and financial performance at all costs.

- Boards of directors are acutely aware that stock options and restricted stock as a means of compensation carry large fiscal benefits; they impose no monetary costs on the firm; in some jurisdiction, in the U.S. for instance, companies get corporate tax benefits from this form of compensation; of course, Canadian senior management gets the benefit of taxation at capital gain rates on their stock options and restricted shares when and only when they decide to cash in.

- Boards of directors are squirming between a rock and a hard place on this issue of compensation; they are subjected, on the one hand, to the pressures of investors, regulators, and proxy advisers to keep executive compensation reasonable and linked to measurable, quantitative metrics of performance and, on the other hand, to the expectations of senior management fuelled by compensation consultants' demonstrations of their *market value*; incurring the ire of the first group may lead to all sorts of problems: being singled out for a negative vote in majority voting for board membership, a negative vote on the *Say-on Pay* resolution, challenge at the annual meeting of shareholders, unfavourable media coverage, etc.; failing to meet the expectations of senior management may lead to the loss of key executives and poor relations between the board and senior management.

- Faced with this conundrum, most boards of directors have taken the safe path of adopting the standard pay package designed by outside compensation consultants; the compensation package should ensure that some large percentage (70%-75%) of total CEO compensation is *at risk*; that is, it is linked to some quantitative performance measures that will determine the amount actually paid; they may know that this form of compensation fails to take into account important aspects of managerial performance, that it may steer management towards an unbridled quest to achieve the *numbers* that will trigger their incentive compensation; they may know that this is not in the best long-term interest of the company but what are they to do? Any alternative plan of compensation, designed to achieve what incentive compensation should, will bring grief to them from all quarters if it strays too far from the *generally accepted compensation practices*.

THE PERSPECTIVE OF SENIOR MANAGEMENT

- People who reach the top echelons of large corporations tend to be ambitious, smart, driven, focused, and, yes, in the current context calculative. Their success may have come at the price of one's family life and one's health.

- Executives are well aware that since the early '80s, companies, one after another, tore up the old "contract" of job security, promotion from within and secure retirement for their managers. Companies do not provide succor, support and security any longer; they could lay off senior managers at their most awkward age and in the most difficult of circumstances if it were convenient for the company.

- Corporate executives believe very strongly that, in the modern corporation, talent, not capital, creates value. They read what all the gurus in strategy are writing about intangible assets, core competencies, know-how and skills, leadership and the "war for talent." These, it is claimed, are the true drivers of market value, the sources of lasting competitive advantage. In the old days companies got all of that on the cheap in exchange for job security, promotion from within and loyalty to their employees. Now that companies, to please their new breed of shareholders, have changed the rules of the game, management talent has become mobile and portable; it is scarce and there is an active market of bidders for that talent.
- Executives operating in this context come to believe that their *market value* will be enhanced by promoting themselves and marketing their achievements. There is, they believe, a market price for their talent. In their mind, they are the equivalent of star athletes in professional sport; they must maximize their wealth when they are at the top of their game. Companies want them as long as they believe they can produce results and create value for the shareholders. Fine, they say, but they want a piece of the action. They want to share in the upside. This external market drives compensation up and explains the large ratio of executive compensation to average wages. This evolution merely reflects the "winner-take-all" phenomenon that prevails in all activities where market demand determines price and financial rewards.
- In this context, the actual level and form of compensation will be the result of more or less formal negotiations with the board of directors (or its compensation committee); as with all negotiations, *whatever the outcome*, if there is agreement between the parties, then all is fine.
- In the current state of financial markets, it is difficult for senior executives to think of shareholders as patient and loyal owners living off their dividends. There may be a few of those around but that's not who they see. As CEOs, they are probed and questioned by analysts and fund managers for whom the hard work of thousands of people, their dreams and hopes, the long-term investments, the strategy that unfolds over time, mean nothing but some significant numbers: consensus quarterly earnings per share or some variant thereof. If they do not deliver the *numbers*, they will be punished rather severely[17]. In the view of management, these "investors" too often do not act as shareholders, loyal owners of the company; they have no attachment, no loyalty, and no long-term interest in the company.
- At the first signal of wavering stock price, short-fused activist funds threaten to take action against management; short sellers and other speculators bet on the company's misfortunes and broadcast their sombre views to one and all; boards of directors, formerly a buffer between management and shareholders, are now intimidated by activist shareholders and proxy advisory firms; in this context, executives with "paper" wealth are anxious to cash in some of these riches, well aware that their wealth may vanish overnight if the stock market, in general, or their company's stock in particular, were to experience a major drop in price.

[17] *"Failing to meet two analyst consensus forecasts in a year is associated with a bonus cut for the CEO equal to 10% of salary, a 36% equity cut relative to a world with no misses, and a 20% higher probability of being dismissed."* Mergenthaler, Rajgopal, and Srinivasan (2009).

- Now, institutional investors, governance gurus and even governments are wailing at the "excesses" of executive compensation. However flawed the current system of compensation, and it is flawed in some ways, corporate executives will not go back to the old days of modest compensation without the benefits of the old contract. Everyone has to learn to live with the new contract of "high risk and high rewards".

While there are kernels of truth in this view of the world, we have three reservations:

1. Management has become accustomed to huge, open-ended compensation supposedly reflecting their market value and their performance. But their *market value* is actually based on how a set of arbitrarily chosen companies pay their own executives; these companies have also set their senior management compensation on the same basis. All these companies are advised by the same small set of compensation consultants who have come up with complex pay schemes that end up boosting all compensations; compensation consultants are well aware that their employment hinges on delivering higher compensation. Lately, companies have tried to cope with this criticism by divulging the amounts paid to these compensation consultants for work other than advising the board on executive compensation. In addition, several consulting firms have cropped up, claiming to be more "independent" of management by only offering services to boards of directors. Although worthwhile initiatives, these measures fail to persuade that management has no say in, nor influence on, the selection of consultants or on their recommendations. Certainly, these newer breeds of compensation consultants do not seem to have steered executive compensation in new directions.

2. Indeed, companies have torn the old contract of long-term secure employment and replaced it with market driven compensation; but the "high risk-high reward" argument rings hollow; too many compensation plans combine the benefits of the old system (management contracts, large pay-offs in case of dismissal, large pension, etc.) with the lavish incentive pay of the new regime (stock options, etc.)! That is difficult to justify.

3. A company's performance reflects the hard, sustained, work of all employees; the notion that it is the singular result of the CEO or a few senior managers is a curious notion; compensation used to be established with internal equity as a goal; now, it is argued that there is a market out there for "mobile" senior managers only; thus the growing chasm between executive compensation and average wages; responsible executives must ask themselves how their compensation affects the attitudes and motivations of people working for their company, how it may contribute to instill a mercenary spirit throughout the organization.

THE PERSPECTIVE OF GOVERNMENTS AND SOCIETY AT LARGE

- Inequality of income and wealth stands at the cross-roads of philosophical dilemmas and confrontations. A broad acceptance of the benefits of a market economy and the value of a meritocratic society tend to generate a good deal of tolerance for disparities in income and wealth; however, there seems to be some threshold above which a society becomes uneasy, even hostile, about the riches of the few. This threshold however tends to vary measurably across countries and societies. The uneasiness with, or hostility to, income disparity is also greatly sharpened by the perception that these riches have not been earned fair and square, do not result from some activity benefiting the broader society. This phenomenon is well captured by the general acceptance of the wealth of successful entrepreneurs, à la Steve Jobs, Bill Gates and others, or by the benign tolerance for the huge income of sport stars. But the income of financial types, hedge fund managers, traders and investment bankers generates anger and revulsion. The pay packages of corporate executives stand somewhere between these two poles, but are now more completely documented and divulged than any other group's income.

- If boards of directors are to fully discharge their legal duty of *acting in the long-term interest of the company*, they must be concerned by the impact of large, controversial compensation on the social legitimacy of private business enterprises.

- All governments are trying to contain and manage the politically dangerous outrage of citizens about the excesses of compensation, particularly, but not exclusively, in the financial sector; measures are announced but rarely implemented; statements are bold but actions are timid; they hope the issue will fade away as they really do not know how to intervene in this area.

  Lately however, the debate on fairness in taxation and income distribution has taken front stage in the equity/class warfare debate of the incipient 2012 U.S. presidential election. In Great Britain, Prime Minister Cameron recently stated "that large pay packages, during times when many households have to tighten their belts, understandably *make people's blood boil*". (NYT, January 22, 2012)

  Governments dearly wish to pass the buck of responsibility to securities commissions and boards of directors. However, the Dodd-Frank Act does include two politically driven measures: the obligation for all listed companies to hold a non-binding vote of shareholders on compensation (*Say-on-Pay*); the obligation for financial sector companies, to divulge the ratio of the CEO compensation to the median compensation in the company.

- Securities commissions rely on transparency and divulgation in matters of compensation. Thus, it was believed that imposing the full divulgation of all elements of compensation for the five highest paid executives would lead to some moderation; the quantum of executive compensation, made public and publicized in the media, would trigger some *shame factor* and lead to less egregious compensation. But for the audience that counts for executives, large compensation is a badge of honour, a sign of merit, a trigger of "bonus envy" among peers. John Stewart Mill wrote: "*Men do not desire to be rich but to be richer than other men*".

- Employees, middle managers as well as unionized workers, understand too well that under current pay schemes, the compensation of senior executives will be enhanced if these executives could find a way of eliminating their jobs. Stock markets tend to react favorably to *rationalization of work force* and *outsourcing to low-cost countries*. Executive wealth moves in sync with the stock market.

- Social trust, reciprocity, loyalty, sharing of goals, and pride in the organization will dissipate slowly but surely where compensation schemes are viewed by employees as unfair and dramatically skewed in favour of the few. Without the cementing property of these values, without the surplus meaning that they bestow on work in organizations, a business firm soon becomes a marketplace for mercenaries, unmanageable and fragile.

Recommendations

In summary, the compensation of Canadian executives of large corporations has moved up dramatically over the last twelve years, now reaching virtual parity with that of U.S. executives. In Canada as in the USA, over the last twelve years, the pay packages of CEOs have been particularly generous, gradually moving away from the pay packages of the next two senior executives as well as soaring when compared with average salaries in the two countries.

As recommended and urged by investors, some governance specialists and government agencies, a large portion of these pay packages is deemed to be "at risk", meaning that their actual pay is subject to stock price variations and some financial measures of performance. Some (mild) form of claw-back in case of reversal of performance is now built into many compensation programs.

The form of executive compensation has become largely standardized and its level is established on the basis of selected "comparable" companies, deemed to act as a basis to appreciate the market value of a corporation's executives.

This paper has been critical of most of these bits of conventional wisdom. We now proceed with some recommendations for the setting of executive compensation. But, first, we must set out three prerequisites to a society's ability to move forward on this issue.

THREE PREREQUISITES

1. If widely held corporations continue to be "owned" by transient share swappers, speculators and impatient investors, if management continues to be subjected to the dictatorship of quarterly earnings per share (EPS) targets, and the unrelenting pressure for EPS growth from quarter to quarter, from year to year, if boards of directors are coaxed, urged and impelled to set compensation in a way that links it tightly and exclusively to financial performance and value creation for shareholders, then *discussion of changes in the forms and ways of executive compensation are futile and moot*.

2. If nothing is done to curb the scandalous income of speculators, traders, hedge fund managers, private equity fund managers, then these activities of no social value and little economic contribution will continue to attract the best young minds away from the world of real business; if rules, policies and practices were adopted to make executive compensation more reasonable without any change here, then senior managers with a financial bent may well migrate to these wastelands. If public pension funds and endowments continue to feed these funds, instead of starving them, the same vicious circle will continue to spin.

3. If boards of directors do not fully internalize their legal, fiduciary, mandate to make decisions in the long term interest of the company, if boards of directors continue to face up to the pressures of short-term "investors" and proxy advisors in an isolated, case-by-case, fashion, if institutional investors are not prepared to vote against board members (or "withhold" their vote) who are responsible for compensation schemes that are clearly deficient, then executive compensation will continue to be dysfunctional in terms of the behavior it drives and the values it fosters.

The members of the working group of IGOPP have examined the issue of compensation from all possible angles[18]. We are convinced that a modicum of social trust, loyalty and reciprocity must be re-built in publicly traded companies, and that management must manage for the long-term benefit of the corporation and its varied stakeholders. We are also convinced that this will not happen without fundamental changes in the compensation models currently in use in most companies.

We have come to the conclusion that:

> *It was a major mistake, and a source of many shenanigans, to make stock options a large component of executive compensation.*

It may have seemed a simple, tax-efficient and effective way of tying the interest of management to the interest of shareholders. In practice, however, stock prices are very volatile, and are driven by numerous factors beyond the control of management.

It is time to cut the Gordian knot of a compensation system largely based on stock options, a system that prevails only since the 1990s and has wreaked havoc on many companies.

› POLICY RECOMMENDATION 1

Gradually reduce stock options as a means of compensating senior executives, with a goal of eliminating this form of compensation.

It may be difficult for companies to singly and swiftly eliminate stock options; regulations could do the trick but it is not advisable to bring the government into these matters; boards of directors could, and should, reduce gradually the percentage of total compensation derived from stock options. As the figures presented above indicate, this is already happening in Canada and the USA.

Great companies were built and innovative firms were created in the past without the crutch of stock options.

Furthermore:

› POLICY RECOMMENDATION 2

Governments should eliminate all tax benefits (personal and corporate) which favor stock options as a means of compensation.

Depending on tax jurisdictions[19], the tax benefits granted to stock options are very generous and make this form of compensation irresistible. It is difficult to justify the special tax treatment of what is basically a form of compensation and should be subjected to the same tax treatment as other forms of compensation.

[18] For instance, St-Onge and Magnan (2008) have proposed an excellent set of policy guidelines in matters of compensation which are consistent with those proposed here. Several recommendations contained in the Jensen and Murphy paper of 2004 are also aligned with what is proposed here.

[19] For instance, in the USA, the difference between the exercise price of a stock option and the market price at time of exercise is deductible as an expense for the corporation. The impact of this single measure on corporate income tax is enormous. In Canada, the profit from the exercise of stock options is deemed a capital gain and taxed at half the rate of ordinary income (except in Quebec where the standard provincial income tax is applicable).

› POLICY RECOMMENDATION 3

Boards of directors of publicly listed corporations should set what they consider a fair and productive relationship between the CEO's total compensation and median earnings within the firm[20].

Although companies will not revert to the days when CEOs earned 25 times the average earning of their employees, the board should be sensitive to the social, cultural and industrial circumstances within which the company operates.

Societies differ in their acceptance and tolerance of income inequalities. Industrial sectors differ as to what is an effective relationship between the average pay for employees and what the top executives get in compensation.

For these reasons, governments should not try to set some arbitrary form and level of compensation, at this time. That is the duty of boards of directors. Furthermore, *the board's decision on this matter should not have to be made public as this sort of information requires a great deal of context for interpretation*. Without context, it becomes fodder for sensationalistic reporting. However, publicly listed companies should have to declare in official filings that their board of directors has adopted policies on fair and equitable compensation including the setting of a cap on that relationship after consideration of all relevant factors.

Of course to reach this cap, the company must have performed exceptionally well as measured by valid economic (non stock-price related) indicators.

It will be argued that unless all companies proceed hand in hand to implement these changes, those who do will lose key executives to those who don't. It is perhaps more accurate to state that companies might lose their most mercenary managers, but that may be a benefit.

› POLICY RECOMMENDATION 4

Boards of directors must remain fully accountable and responsible for the setting of executive compensation. Boards of directors must be credible enough, have enough courage, to set compensation on the basis of qualitative as well as quantitative factors they deem of great importance to the well-being of the company in the long run. The members of the compensation committee of the board must have the requisite competence (including in financial matters) to design a compensation program for *the very specific circumstances* of their company; compensation programs and actual pay-outs must be tightly coordinated with the audit and risk management committees.

[20] The Dodd-Frank Act requires financial-sector firms to divulge the ratio of the chief executive's compensation to that of the median salary in the firm.

› POLICY RECOMMENDATION 5

Boards of directors should be guided by principles of the following nature:

Principle: Tailoring compensation to the particular circumstances of each company

- Abandon the false notion that there is a surrogate market price for executive talent set by what a group of *comparable* companies pay their executives. That is the weakest link of the whole system put in place by compensation consultants. But that was the best answer they could come up with when asked to price executive talent.
- Compensation should be linked to *quantitative and qualitative* indicators which drive the economic performance of the company, which **increase the long-term value of the company**; every company is somewhat different in this respect and cookie-cutter programs will not do the job; quantitative indicators should not be stock-price related but of the sort that do measure the long-term health of the company, such as Return on invested capital (ROIC) and Economic value added (EVA); they should not be highly volatile and easily manipulated; qualitative performance should be linked to the more subtle character of an organization, its soul and ethics, the sense of belonging and fairness felt by most members of the organization.
- The competence of management at factoring in its operations the concerns of society at large and the expectations of key constituencies should be reflected in the compensation system of corporate leaders. The success and survival of the corporation hinges on first rate performance on this score.

Principle: Reviewing and questioning the standard approaches to compensation

- Step away resolutely from the notion that a large percentage of senior management's compensation should be at risk to satisfy the demands of investors, proxy advisers and sundry governance raters. Compensation is not actually at performance risk but at the whim of uncontrollable events and macro-economic circumstances. Their compensation being at risk (or, more accurately, dependent on their good or bad luck), senior management then requests protective contractual clauses and very generous pension terms.
- A reasonable bonus linked to well-selected performance indicators is an effective and tangible way to motivate management, one which has become too perfunctory in the current overall pay packages of executives[21].
- Reduce or, preferably, eliminate **stock options** from the compensation program.

[21] *The bonus earned each year could be "deposited" in a bonus bank and a third of the amount in the "bank" paid annually.* This system provides a built-in claw-back on compensation. Short-term performance realized at the expense of longer-term performance will be punished by its impact on the bonus bank. In industries, such as the financial sector, where large annual bonuses are the norm, the "bonus" might be negative (what is called a "malus")

- **Restricted shares programs** should have a vesting period reflecting the investment cycle of the company and should range between five-to-ten years[22]. These restricted shares should have to be earned by meeting performance hurdles of the qualitative and quantitative sorts as described above. *Restricted shares should not be granted on an annual basis*; it might be advisable to grant such shares at significant points in a senior manager's career at the company (e.g. when joining the company at a senior level, at the time of significant promotions or at multi-year intervals);
- Senior management should own outright a multiple of their salary in shares of the company;
- A **change of control** of the company should not trigger an automatic vesting of incentive plans; no part of the compensation plan should become an incentive for management to sell the company;
- **Pension benefits** should be linked to the actual number of years of service to the company and result in a reasonable ratio of an executive's **base salary** (not his/her total compensation!), payable only at a set retirement age. Senior management, upon retirement, should be provided with some guarantee of the solvability of their unfunded pension plan;
- The more generous the compensation programs, the larger the pay-out, the fewer, if any, should **the post-retirement benefits and privileges** be;
- If the securities commissions do not prohibit the practice, boards of directors should not allow managers, executives or board members to use derivative products to minimize their exposure to the company's stock price;

Principle: Fairness and equity in compensation

- Set what the board considers a fair and productive relationship between the compensation of the CEO and median earnings within the company.
- Maintain a relationship between *what is paid to the chief executive and what is paid to other senior managers so as to sustain the spirit of a team at the top*.
- Management and boards of directors should seek effective ways **for all employees to share in the economic performance of companies**, making all into partners fighting for the long term success and survival of the company.

Unfortunately, many boards, for a host of reasons, have been unable to design a compensation system to achieve these goals.

[22] As far back as the 1920s, at Du Pont and General Motors, senior managers were asked to buy shares of the company with a loan at current market interest rates; the shares were held as collateral for the loan; annual bonuses served in part to pay interest and repay capital; the loan had to be repaid over seven-to-ten years, at which time the senior manager owned the shares outright. (See Sloan, 1964) There are valid lessons here for today's compensation dilemma.

Conclusions

Managers and leaders of large corporations, particularly those of the widely held sort, have become suspended in a web of motivations and pressures which often steer behavior in dysfunctional directions. It is a web that they have, in part, spun themselves, but, in large part, it has emerged from the collective changes described in the early parts of this policy paper and at great length in **Black Markets and Business Blues** (Y. Allaire and M. Firsirotu, FI Press, 2009).

Senior executives, understandably in the current context, know full well that if they disappoint the financial markets in any way, the stock price will drop precipitously (and so their paper wealth) and they may be forced out of their job, or, at the very least, subjected to intense pressures.

Yet, through all this, management is expected to manage for "the long term" and to behave ethically in all circumstances. Indeed, *what is surprising is that, in spite of these incentives and pressures, many executives do behave ethically and with a sharp sense of their social responsibilities*. But it is dangerous and unfair to continue with forms and levels of compensation that test and stress the ethics and values of senior management. If we, investors, regulators, society at large, want to motivate management to act in the long term interest of the company's stakeholders, we must demand that incentive systems be changed in a fundamental way.

Compensation systems must foster and protect trust and a sense of fairness within and around the company, give all members of the organization the sense of "being all in the same boat", and instill in them a long-term view of the company.

Fundamental changes in compensation practices will happen only if and when management's performance is measured more by the way the company meets its broader obligations and less by growth in earnings per share and by meeting the quarterly earnings expectations of analysts.

However as stated in the prerequisites to these policy recommendations, institutional shareholders, governments, and boards of directors have to bring about a different business context, one that allows management to plan and decide with a longer-term perspective and to give due consideration to *all* relevant stakeholders.

Management, boards of directors and institutional investors bear a great responsibility for making this happen.

Annex 1

Figure 20

Companies on the TSX 60 in 1998 and 2010

SOURCE: TSX REVIEW, 1998, P. 32
TSX EREVIEW, 2010, CHAPTER 7, P. 9

IN 1998 AND 2010	1998	2010
› Agrium	› Abitibi Consolidated	› Agnico-Eagles Mines
› Bank of Montreal	› Alberta Energy	› Arc Energy
› Bank of Nova Scotia	› Alcan Aluminium	› Brookfield Asset Management I
› Barrick Gold Corporation	› Anderson Exploration	› Cameco Corporation
› BCE	› Ati Technologies	› Canadian Oil Sands
› Bombardier Inc.	› Biochem Pharma	› Cenovus Energy
› Canadian Imperial Bank of Commerce	› Canadian Occidental Petroleum	› Eldorado Gold Corporation
› Canadian National Railway	› Dofasco	› Encana Corporation
› Canadian Natural Resources	› EdperBrascan	› Enerplus Resources Fund
› Canadian Pacific Railway	› Euro-Nevada Mining	› First Quantum Minerals
› Canadian Tire Corporation	› Falconbridge	› Fortis
› Enbridge	› GEAC Computer Corporation	› Gildan Activewear
› Imperial Oil	› Gulf Canada Resources	› Goldcorp
› Loblaw Companies Limited	› Hudsons Bay Company	› Husky Energy
› Magna International	› Imasco	› Iamgold Corporation
› National Bank of Canada	› Inco	› Inmet Mining Corporation
› Potash Corporation of Saskatchewan	› Laidlaw	› Kinross Gold Corporation
› Royal Bank of Canada	› MacMillan Bloedel	› Manulife Financial Corporation
› Shaw Communications	› Mitel	› Metro
› Suncor Energy	› Moore Corporation	› Nexen
› Talisman Energy	› Newbridge Networks Corporation	› Penn West Energy
› Teck Resources	› Newcourt Credit Group	› Power Corporation of Canada
› Telus Corporation	› Noranda	› Research in Motion
› Thomson Reuters Corporation	› Northern Telecom	› Rogers Communications
› Toronto Dominion Bank	› Nova Corporation	› Saputo
› Transalta Corporation	› Petro-Canada	› Shoppers Drug Mart Corporation
› Transcanada Corporation	› Placer Dome	› SNC-Lavalin Group
	› Poco Petroleums	› Sun Life Financial
	› Renaissance Energy	› Tim Hortons
	› Seagram Company	› Valeant Pharmaceuticals International
	› Teleglobe	› Weston Ltd. George
	› United Dominion	› Yamana Gold
	› Westcoast Energy	› Yellow Media

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