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of Private and Public Organizations

HEC MONTRĒAL

Concordia University
John Molson
School of Business

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GIVING SHAREHOLDERS A SAY ON PAY

A MEASURE LEADING TO BETTER GOVERNANCE?

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ABOUT THE IGPPO

Established in September 2005, the **Institute for Governance of Private and Public Organizations** (IGPPO) 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 research, training, by issuing position papers and by the broad dissemination of governance-related information. The Institute supports financially academic research, organizes conferences and training seminars, takes part in public debates on governance issues, reinforces governance-related skills and promotes partnership and knowledge transfer.

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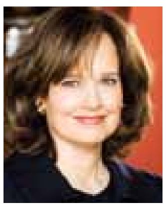

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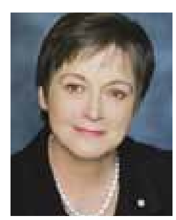

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MESSAGE FROM THE CHAIR OF THE BOARD OF DIRECTORS

After productive discussions, the text of this position paper was adopted by a majority of the Institute's board members, with three members abstaining (in addition to Mr. Louis Morisset who abstained because of his role and responsibility at the Autorité des marchés financiers du Québec).

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Yvan Allaire, PhD (MIT), FRSC

CONTEXT

Ever since the scandals bearing the names of Enron, WorldCom and others in 2001 and 2002, executive compensation, which was widely seen as a cause of these fiascos, has been a stumbling block on the path of good governance. The issue is complex, it is said, but this argument only exacerbates the frustration of investors and, eventually of the public at large, with levels and forms of compensation that, too often, seem extravagant and undeserved. Yet, the Gordian knot of compensation has proved impossible to untangle.

Again in the 2007–2008 season of financial crisis, compensation practices, it is widely believed, contributed measurably to the financial system meltdown. Public reaction to the crisis, the bail-out and the compensation of the protagonists was so virulent that American and European politicians toyed with the idea of imposing limits and controls on compensation in the financial sector. However, except for companies that received State aid to pull them out of the crisis, the idea of controlling compensation went nowhere.

Then, in 2009, the grant of large bonuses to executives of some financial institutions, in the aftermath of a crisis for which American and European taxpayers had to pick up the tab, caused popular anger to boil over again. Politicians, always sensitive to the public mood, began to entertain more radical measures to regulate and oversee financial institutions.

Although the political class, particularly in the U.S., the U.K. and other European countries, clearly feels the need to calm public outcry, no consensus has been reached on how best to achieve this. Public opinion seems to view corporate boards as largely responsible for excessive executive compensations. Boards, it is claimed, have failed to discharge their fiduciary duty in this matter, letting compensation get out of control.

As a result, the idea of giving shareholders a non-binding vote on executive compensation has gained traction. The hope is that this measure, at long last, would force corporate boards to be more diligent and restrained in their compensation practices. That said, a non-binding shareholder vote on executive compensation raises several issues.

Although Canadian financial institutions have emerged unscathed from the financial crisis and did not turn to taxpayers for support, they did not escape the public's sour mood about the compensation of their executives.

THE EXECUTIVE COMPENSATION ISSUE: A BRIEF REMINDER

So, how did these large executive compensation packages come to be? And why have institutional and other investors become so disenchanted with the decisions of corporate boards of directors in this matter?

Throughout the 1980s many publicly-traded companies became targets of corporate raiders operating under the label of "Leveraged Buy-Outs" (LBOs). The argument was that conventional boards of publicly traded companies were unable or unwilling to maximize the economic value for shareholders. These raiders claimed that one of the reasons boards were ineffective had to do with the way they compensated executives, the weak link between the compensation that executives received and the economic value created by them (Jensen, 1989).

Indeed, the typical compensation packages at the time did not link the level of compensation directly to the stock price. However once privatized, the new owners (the LBO fund managers) would put in place compensation practices that motivated executives to produce maximum economic value.

The undeniable success of many of these Leveraged Buy-Out (LBO) operations was a Eureka moment for many investors. They began to press for changes in the way executives were paid, insisting on pay schemes that would motivate executives to "maximize shareholder value." The easiest way to achieve this goal was to grant significant numbers of options on company shares so that executives would become rich to the extent that the stock price appreciated.

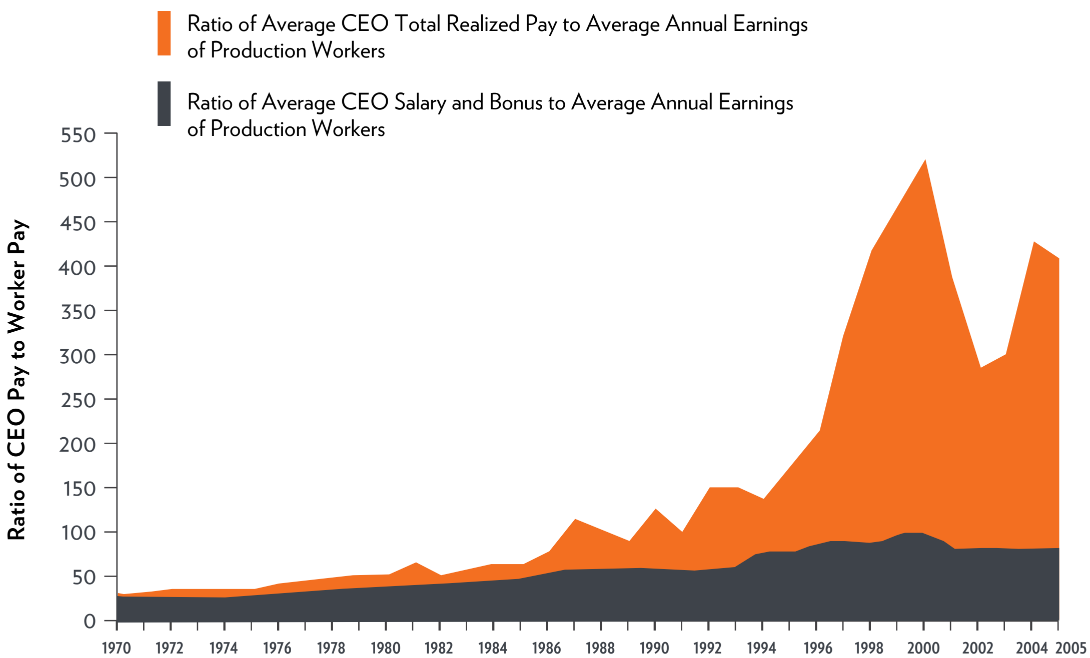
Institutional investors not only approved of this form of compensation, they actively promoted it. It was believed that the CEOs and seniors executives of publicly traded companies, when properly motivated by stock options, would have but a single over-riding objective: increased share price, and that they would work for one single stakeholder: the shareholders.

Corporate boards, counseled by external compensation consultants, aware of the accounting and tax advantages of this type of compensation, convinced that they were thus acting in shareholders' interests, put in place generous options-based plans, as well as other incentives supposed to make management work to create the most shareholder value.

Corporate boards, increasingly, viewed their fiduciary responsibility (indeed it was the prevailing law in several US states) as protecting and promoting the exclusive interests of shareholders.

As the following graph shows, the impact of these new compensation practices on total management compensation programs was spectacular. *By 1994, stock options—once a marginal phenomenon—became the main component of CEO compensation.* CEO compensation went from some 50 times the worker's average salary in the 1980s to over 400 times in the 2000s.

CEO Compensation As a Multiple of Average Worker's, 1970–2005
(S&P500)



Source : mise à jour de l'étude de *Jensen & Murphy, ECGI, 2004* et *11th Annual CEO Compensation Survey, 2004.*

It should be noted that the most dramatic increases in executive compensation occurred at about the same time that institutional investors became collectively the majority shareholders of publicly traded companies, fastidious rules and practices of "good" governance were implemented, and independent members became the majority on most boards.

Eventually, the level of compensation paid to senior executive and, most particularly, the tenuous link between compensation and real contribution to lasting shareholder value generated a great deal of dissatisfaction among institutional shareholders.

(TOO?) ABUNDANT INFORMATION ON EXECUTIVE COMPENSATION

Initially, investors reacted by demanding that additional information about the pay of senior executives be divulged to shareholders and that some pay-for-performance yardstick be made clear and explicit.

Thus in 2005, the Canadian Coalition for Good Governance, which did pioneering work in this area, proposed a list of six principles that they believed boards of directors of publicly traded companies should adopt. The first three of the proposed principles, generally adopted by corporate boards, held that:

1. *"Pay for performance" should be a large component of executive compensation;*
2. *"Performance" should be based on measurable risk adjusted criteria, matched to the time horizon needed to ensure the criteria have been met;.*
3. *Compensation should be simplified to focus on key measures of corporate performance.*

Stock options did fit the bill as they link pay to performance and are relatively simple to design. However the number of options granted and the terms of their vesting should be subjected to explicit, quantified, risk-adjusted measures of performance. The same applied to yearly bonuses and other forms of variable compensation.

Financial market authorities in both Canada and the U.S. also mandated an increasing level of disclosure about all aspects of senior executive compensation. In Canada, this initiative led to regulation 51-102 (September 2008) of the Canadian Securities Administrators, which took effect for the financial year ending on December 31, 2008.

This regulation (in its annex A6) calls on publicly traded companies to provide very specific information on the compensation of their executives.

Companies are henceforth required to supply a narrative description of all key aspects of compensation, including notably:

1. **The objectives, or the strategy, of the compensation programs;**

2. **What the compensation program seeks to reward;**

3. **A description of each element of the program;**

4. **The motives which support the payment related to each component of compensation;**

5. **How was the amount to be paid for each component set;**

6. **How does each component of compensation, as well as decisions bearing on these components, support the overall objectives of the compensation policy; how does each component impact and influence the other components of executive compensation.**

Clearly, by 2009, shareholders of a Canadian publicly traded corporation have access to a large quantity of information about the compensation of its executives. With the help of compensation consultants, corporations designed compensation programs to meet those objectives and to satisfy regulatory requirements. That was a step in the right direction but it did result in complex compensation programs as well as long and convoluted descriptions of these programs.

VOTING AGAINST BOARD MEMBERS

If the shareholders of Canadian publicly traded companies are displeased with the compensation practices of a company, they may also, in the cases of most large corporations, vote in a way to signal to specific board members their dissatisfaction with their performance. The prevalence of individual majority voting for the election of board members gives shareholders an effective way to express tangibly their dissatisfaction.

According to the Canadian Coalition for Good Governance, which did exemplary work in pushing this measure along, 74% of the 254 companies in the S&P/TSX had by 2009 adopted a procedure that allows shareholders to vote on each individual member of the board (compared to 61% in 2008). By singling out for a negative (or "withhold") vote specific board members, say those seating on the compensation committees, shareholders may send a powerful message of displeasure.

ARE THESE MEASURES ADEQUATE TO PROPERLY GOVERN EXECUTIVE COMPENSATION?

However, for many investors, these measures did not address the root of the problem, were too indirect to be really effective. The responsibility for improper compensation practices falls squarely on boards of directors Boards, it is claimed, have failed to discharge their fiduciary duty when approving extravagant, poorly designed compensation plans that were deleterious to shareholders' wealth.

In addition to the measures described earlier but which do not solve the problem, perhaps is it time that shareholders be allowed to directly express their opinions on executive compensation. Then, corporate boards may become more judicious and moderate in setting executive compensation and would certainly seek the advice of large shareholders. At first blush, that would seem reasonable, even undeniable.

At this time, the concept of an annual non-binding shareholder vote on compensation (Say on Pay) is clearly popular and enjoys a good deal of opportunistic political support. These votes could easily become part of the standard proceedings at annual shareholders meetings of North American and European public companies, in the same way that the selection of external auditors and the election of board members currently are standard issues at the annual meeting.

The assessment of whether this Say on Pay procedure should be broadened and made compulsory must take account of this context.

This position paper continues around the following themes:

1. **THE PRACTICE OF NON-BINDING VOTES ON COMPENSATION (SAY ON PAY) IN OTHER JURISDICTIONS;**
2. **KEY ISSUES RAISED BY THE SAY ON PAY PROCEDURE;**
3. **THE IGPPO'S POSITION ON THE SUBJECT.**

THE PRACTICE OF NON-BINDING VOTES ON COMPENSATION (SAY ON PAY) IN OTHER JURISDICTIONS[1]

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*.

The requirement to hold votes by shareholders on executive compensation may be introduced in two ways: it may result from a proposal adopted by a majority of shareholders (the *shareholder proposal method*) or a government enacts a law or regulation that mandates a vote of shareholders on compensation (*the legislative and statutory method*).

The *shareholder proposal method* requires that a Say on Pay proposal be presented by one or more shareholders and that it be submitted to a vote. If the proposal obtains sufficient votes as required by its articles of incorporation, the company must then hold an annual consultative vote on executive compensation. The shareholder proposal method thus requires two inter-related elements: (1) The Say on Pay proposal submitted by shareholders and (2) the vote as such.

One of the weaknesses of the *shareholder proposal method* stems from the fact that the companies that have bad executive compensation practices are often also those in which governance rules are less well-established. As a result, these companies are less likely to facilitate or to implement consultative votes on these policies. Companies that have so far voluntarily adopted regulations to submit compensation issues to a consultative vote, generally also follow fairly sound governance rules (for example the large Canadian banks and IBM). These in fact are likely the businesses that least need consultative votes. That's because due to their sound governance, they likely already follow sound compensation practices.

As the name implies, the *legislative or regulatory method*, consists of implementing government regulations or legislation to require businesses to submit their remuneration reports to shareholders.

1 This part of the report is inspired by the document *Is Say On Pay An Effective Governance Tool?* prepared for the IGPPO by Michel Magnan and Claudine Mangen. This document is available in the Website: www.igopp.org

THE BRITISH EXPERIENCE

British regulations adopted in 2002, comprise five (5) steps that companies which trade on the stock exchange need to follow. They must:

1. Publish an executive compensation report along with their annual financial results;

2. Divulge in this report the compensation of each of the senior executives;

3. Explain the philosophy underlying the compensation of the company's senior executives;

4. Define the respective roles of the board of directors and the human resources committee concerning executive compensation;

5. Submit the compensation report to a consultative vote and the shareholders' annual general meeting. These principles were incorporated into the UK Companies Act, which was adopted in 2006.

Finally, the British version of Say on Pay only affects executives for whom details of their remuneration packages are already made public. The reports of the human resources and compensation committees only divulge information regarding the best paid executives. Binding votes dealing with remuneration are limited to approving the number of shares issued, or which will eventually be issued in the future through a Deferred Share Unit regime or through an options plan.

At the time of the vote, the company's intensions regarding how shares will be distributed among directors is not disclosed.

In the UK, precedents were set when high-profile proposed compensation policies were rejected at two major companies. In 2003, 50.7% of the GlaxoSmithKline shares voted against a compensation report that provided a (£) 22 million golden parachute (consisting of salaries and bonuses) to the company's CEO Pierre Garnier, if he resigned or was fired before 2007.

Royal Dutch Petroleum is the other company in which shareholders rejected an executive compensation report. In 2009, 59% of Royal Dutch Petroleum outstanding shares voted against the company's compensation policy. Among reasons cited was the feeling that company executives shouldn't get bonuses since Shell had ranked fourth that year in performance out of the five largest oil companies.

The British experience provides three key lessons. Firstly, companies that bore the brunt of shareholders' wrath were those where executive compensation (particularly bonuses and options grant) were more generous than industry norms and those that had had sub-standard stock performance.

The second lesson stemming from the British experience is that shareholder discontent tends to be weak and to fade away gradually. Shareholder rebellions regarding executive compensation packages only occurred in between 4% and 5% of businesses during the past five years.

In fact, according to a recent study which is favorable to the idea of consultative votes, (Deborah Gilshan, *Say on Pay: Lessons from the UK experience*, Railpen and PIRC, September 2009), only 4% of all votes on executive compensation during 2008 were against the proposed initiatives. Proposal opponents only get more than 20% of votes less than 10% of the time. This low level of discontent can be explained by fact that corporate boards tend to negotiate the proposal details with institutional investors before the AGMs are held. These exchanges provide institutional investors a chance to express their points of view.

In fact the report also notes that discussions between board members and institutional investors can easily morph into a form of negotiation. The company representatives put forward an initial, unacceptable, proposal, only to later agree to a "compromise" position, which is actually the proposal that management wanted to implement all along.

The final lesson from the British experience is that shareholder votes tend to slow the growth of executive compensation packages; it can lead to shrinkage of compensation packages in cases of blatant failure. Compensation thus tends to fluctuate more with bad results, than it does with good ones. There appears to be a better alignment between results and compensation.

Recent research by two Harvard professors, Fabrizio Ferri and David Maber, 2009, *Say on Pay Vote and CEO Compensation, Evidence from the UK*, appears to confirm these results. Say on Pay contributed to a reduction in the number of flagrant cases of compensation failures, by better aligning bonuses with the company's true results.

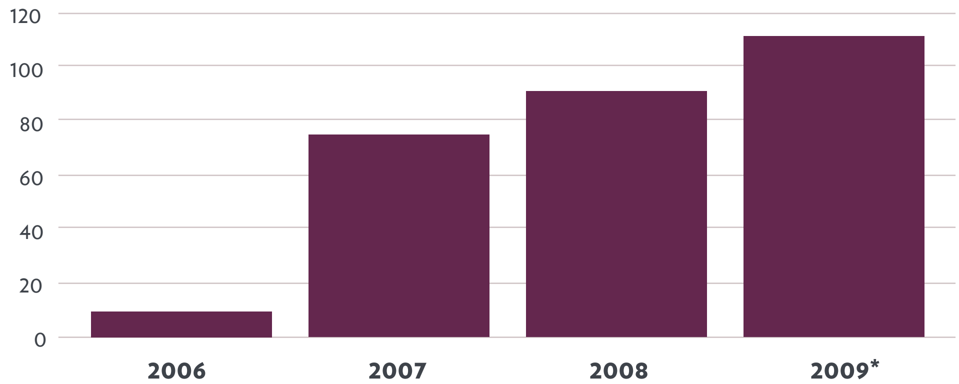
THE AMERICAN EXPERIENCE

In the United States, the American Family Life Assurance Company (Aflac) became in 2007, the first company to adopt non-binding vote by shareholders on compensation. Fromm 2006 on, shareholder proposals calling for a shareholder vote on compensation quickly mushroomed, as the following chart shows.

On June 10, 2009, US Treasury Secretary Timothy F. Geithner announced that the government would approve measures presented in Congress to increase shareholders' power in matters related to executive compensation.

At the beginning of June, Democrat Senator Charles Schumer (NY) and Congressman Barney Frank tabled legislation that would force publicly-traded companies to submit their executive compensation policies to a consultative vote by shareholders.

I Say, I Say, I Say
Number of requests for Say on Pay votes received in the US



*Year to May 15th
Source: RiskMetrics Group

These measures will likely be adopted, as US politicians appear to regard them as a panacea cure against the compensation abuses that we saw in the financial sector, or failing that, as an astute political move that would appease popular anger by providing the impression of major changes.

However the results of empirical research regarding the efficiency of such initiatives are ambiguous. Say on Pay has made shareholders more sensitive to issues of executive compensation. It should have brought about more moderation and rigor in the setting of compensation. Yet, the implementation of consultative votes did not prevent the compensation of British senior executives from rising by more than 70% between the time it came into effect in 2002, and 2007. Furthermore, the likelihood that the board's report on executive compensation be voted down by shareholders is quite remote.

Making shareholder votes obligatory imposes additional costs on businesses, many (most) of which have not been derelict in their compensation practices: costs which cannot be really justified when weighed against the few advantages (if any) that many businesses derive from them. These benefits appear to be limited to shareholders in a small sub-group of poorly performing companies that are paying their CEOs too much. Furthermore numerous governance mechanisms already exist to deal with the problems posed by poorly performing companies (these notably include simple market pressure stemming from a possible hostile takeover as well as the possibility that non-performing directors risk not being re-elected to their posts).

In addition, recent attention paid by experts and the media in general to executive compensation issues and to Say on Pay initiatives, has already played a significant role in making corporate boards more vigilant.

THE CANADIAN EXPERIENCE

The Canadian financial system avoided the excesses and consequences of the recent financial crisis and did not call upon the support of taxpayers to pull them back from the brink, as its US and European counterpart did.

Nevertheless, in 2010, a dozen large Canadian companies, mostly in the financial sector, will for the first time consult with their shareholders regarding the process they have followed to establish senior executive compensation. What's at stake here is not of course disclosure of new information. The Canadian Securities Administrators regulation 51-102 (and its Appendix A6) mandates that all publicly traded companies provide substantial and detailed information regarding the compensation of their five highest paid executives.

As in the United States, all Canadian companies that have adopted the non-binding votes of shareholders on executive compensation policy did so in the wake of shareholder proposals, and not because they were required by law to do so.

Organisms dedicated to good governance such as MEDAC, the Canadian Coalition for Good Governance, the Council of Institutional Investors as well as governance consulting groups (RiskMetrics Group, Glass Lewis & Co.) expressed their support for the notion of non-binding shareholder votes on executive compensation.

The Canadian Coalition for Good Governance has in fact published several documents on the subject. On October 22, 2009 and January 19, 2010 it made public a standard formulation that could be submitted to shareholders:

> *"Resolved, on an advisory basis and not to diminish the role and responsibilities of the board of directors, that the shareholders accept the approach to executive compensation disclosed in the Company's information circular delivered in advance of the [insert year] annual meeting of shareholders".*

It should be noted that the consultative vote refers to the *approach* adopted by the compensation committee to set the level and form of executive compensation, and not on its specific amounts or other substantive elements.

KEY ISSUES RAISED BY SAY ON PAY

The debate surrounding Say on Pay bears on the purpose and consequences of such a measure as well as on the advisability of extending this requirement to all publicly listed companies, even though most companies have given little reason for concern about their compensation policies.

THE FIDUCIARY RESPONSIBILITY OF CORPORATE BOARDS

Undoubtedly, the call for a non-binding, shareholder vote on executive compensation signals a clear mistrust for boards of directors. This measure is a small but significant shift in responsibility for corporate governance away from boards of directors towards shareholders.

This proposed measure represents a vote of no confidence for boards of directors. If that lack of trust and confidence extends beyond financial institutions (where recent events in the United States have clearly damaged this trust and confidence), it would imply a wholesale revamping of corporate governance. What other decisions, once the exclusive purview of corporate boards, should be submitted to a shareholder vote (non-binding at first, binding eventually). If corporate boards cannot be trusted to make the right decision on executive compensation, how can shareholders rely on their judgment for other equally important decisions?

Some may argue that how a board discharges its duties on executive compensation provides a good indication of the general quality of its governance. If the company's board of directors handles compensation issues effectively, it probably handles other governance matters well also, so the logic goes but there is little empirical evidence to support this stance.

Yet, the Supreme Court of Canada has made the point forcefully in the course of two recent judgments (Peoples v. Wise [2004] and BCE/Bell Canada v. Bond-holders [2008]) that the fiduciary duties of directors, under the Canadian Business Corporations Act (as well as under its Quebec counterpart, adopted in December 2009) is to act in the interests of the corporation, and not exclusively in the interests of shareholders.

> *"The fiduciary duty of the directors to the corporation is a broad, contextual concept. It is not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation."*
>
> *(BCE/Bell Canada, article 38)*

> *"In considering what is in the best interests of the corporation, directors may look to the interests of, inter alia, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions."*
>
> *(ibid., article 40)*

> *"At all times, directors and officers owe their fiduciary obligation to the corporation. The interests of the corporation are not to be confused with the interests of the shareholders, the interests of the creditors or those of any other stakeholders."*
>
> *(Peoples, article 43)*

In Canada, boards of directors of publicly listed companies have a fiduciary responsibility to set fair and reasonable compensation programs, taking into consideration not only the interests of shareholders, but mostly the company's long term interests. Indefensible levels of compensation may undermine the company's social and political legitimacy.

Board members must recognize that the stakes in this regard extend beyond *maximizing shareholder value*. The goal of linking pay to performance should not be interpreted narrowly to mean only “performance for shareholders”.

EVALUATING AND REWARDING THE PERFORMANCE OF EXECUTIVES

It is claimed that a shareholder non-binding vote on compensations would foster a tighter link between executive performance and their compensation; and this link should be expressed in quantified, measurable terms to demonstrate to shareholders that executives do deserve their compensation.

However the performance of effective, high level executives may not, will not, be captured by quantitative measures, no matter how sophisticated they may be. Boards of directors need to show judgment when evaluating an executive’s performance. The job of high level executives is complex, fluid, and often qualitative. Assessing their performance should not be limited to their reaching some quantitative goals.

The very quest for a direct and quantitative link between executive compensation and performance has led to increasingly complex compensation systems and esoteric performance metrics. This quest could lead to the same sort of over-quantification which gave us risk models of unsurpassed complexity and little relevance. If, as a result of the Damocles sword of shareholder votes, boards of directors were to focus exclusively on quantifiable performance metrics to reward executives, important challenges to the long-run performance and survival of the company may well go unattended.

PROCESS VERSUS SUBSTANCE

As we noted above, due this insistence on direct, quantitative links between financial performance and compensation, companies provide shareholders with long and complex texts describing their various compensation programs.

A significant difficulty of the Say on Pay shareholder vote is to establish on what are shareholders to vote. Are shareholders to vote on each compensation element? Or, should they vote on each of the five named executive's pay package? Otherwise, how should a negative vote be interpreted? Which aspect of the compensation package are shareholders objecting to? It would be difficult, if not impossible, to obtain, through a single vote, the non-binding opinion of shareholders on the multiple components of compensation plans for five executives.

The Canadian Coalition for Good Governance, which likely recognized the same issue, proposed that the shareholder vote bear only on *the approach to executive compensation disclosed in the Company's information circular.*

DIALOGUE WITH INSTITUTIONAL INVESTORS

The requirement to hold a consultative vote by shareholders on executive compensation would provoke and sustain a fruitful dialogue, ahead of the annual meeting, between large, usually institutional, investors and the company's board of directors. That is a key argument of those in favor of this measure. Institutional investors will have to invest the time to fully understand the compensation programs; they will have the right forum to ask for changes in compensation policies; the board will have the opportunity to fully explain the reasoning and logic of the company's compensation programs.

This process however raises two concerns:

1. Why should one class of shareholders have privileged access to board members to voice their displeasure and ask for changes, while other shareholders only have the right to a non-binding "up or down" vote? One could argue (though this remains to be proved) that the interests of the two classes of shareholders are always aligned and convergent. If that were true, all shareholders could benefit from the process.

2. How can meetings be held between institutional investors and board members without risking that non-public information be communicated to these investors? The British report cited above (Railpen and PIRC, September 2009) concludes that one of the benefits of the obligation to hold a shareholder consultative vote come from the fact that:

> *It allows an informed debate to take place about the nature of compensation plans, their structure, the degree of alignment garnered through the plans and importantly, how it **supports the company's strategy**.* (Our emphasis)

However, corporation which operate in highly competitive markets do not publicize their strategies or any changes in strategy. How can board members discuss with investors the link between the company's strategy and the compensation programs without divulging what that strategy is? Yet, that is very confidential information that board will not want to become public knowledge.

Some Canadian institutional investors have adopted a practice of engaging the board members of companies in which they are substantial shareholders. They have shown a remarkable sense of responsibility and a fruitful shareholder activism that must be acknowledged. Other institutional investors should be encouraged to follow their example.

THE IGPPO'S POSITION

The arguments pros and cons a non-binding vote by shareholders on executive compensation do not readily tip the balance in one direction or the other. The vague sense of unfairness and the frustration with some patent cases of excessive compensation have generated a good deal of sympathy for more direct and vigorous measures to curb extravagant compensation practices. Nevertheless, boards of directors fully responsible and accountable for the governance of publicly traded corporations do form the cornerstone of our system of corporate governance.

ARGUMENTS IN FAVOR OF SAY ON PAY

A key argument in support of non-binding votes by shareholders on executive compensation is the belief that boards would then want to open lines of communication with institutional investors who are substantial shareholders of the company. These investors would thus have an opportunity to express their views and reservations. Board members would have to take full responsibility for executive compensation policies and explain the reasoning upon which the level and form of compensation are based. Of course, these discussions would be carried out in full compliance of the rules on divulgation of privileged information.

Say on Pay voting by shareholders may indeed persuade more companies to hold consultations with important shareholders on executive compensation prior to annual meetings. Of course, such consultations are already possible and have been held for a good while with many companies. However, it is claimed that without the threat of a formal (and possibly negative) vote by shareholders, consultations are less effective.

The obligation to hold a vote, coupled with the possibility that this vote could be negative, would imbue compensation committees of the board with renewed vigor, motivate them to take full charge of the compensation policies and practices, and may provide them with a forceful argument to resist pressures by executives on compensation issues.

Prior consultation and the possibility of a negative vote on compensation policies provide institutional investors with a more subtle, less disruptive, tool than the blunt and perturbing process of voting against the election of specific board members.

A positive vote by shareholders on the approach used to establish executive compensation becomes a vote of confidence in the overall quality of the company's governance. If the board of directors handles this process well, the implication is that overall business governance is likely in good hands.

Of course, having received the seal of approval of a positive vote by shareholders, if the approach used to set compensation programs did produce extravagant compensations in the future, no one could legitimately complain.

ARGUMENTS AGAINST

Though real and frustrating, the issue of extravagant compensations is not common to the point of warranting the imposition of a cumbersome process on all companies, even medium-sized ones.

A consultative vote by shareholders on executive compensation deviates from the logic and legal standing of boards fully responsible and accountable for the governance of corporations. It opens the doors to a creeping encroachment by shareholders who would intervene directly on matters previously regarded as the board's exclusive responsibility.

The focus on "pay-for-performance," which is a *leitmotiv* of the argument for 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. They may gradually emphasize the achievement of short and medium terms financial ratios while neglecting longer term challenges critical to the success and survival of the company.

As for the benefit of dialogues between large shareholders and boards of directors, to the extent that all precautions are taken to avoid the communication of privileged information, institutional investors should continue this practice.

In the *specific cases* of unsatisfactory compensation practices, institutional investors should propose a Say on Pay vote by shareholders in the future as a deterrent and a form of punishment for delinquent boards. Ultimately, investors should be prepared to use their right to vote (or “withhold” their votes) against specific directors in the few cases where board members have clearly failed to act in a responsible manner.

Before tampering with existing governance rules in a broad and wholesale manner, it would be appropriate to first assess the results achieved by recent changes. The Canadian Securities Administrators have already substantially increased the range of information that companies must henceforth divulge to shareholders about their compensation policies and practices. In addition, the procedure whereby shareholders may vote for individual candidates to board membership has now been adopted by a majority of large Canadian corporations. These measures provide a potential channel for shareholders to express tangibly a negative sentiment about executive compensation.

However, the Institute proposes two measures which could enhance further the quality of corporate governance:

1. When a candidate for a board of director receives a majority of “withhold” vote, the candidate should be forced to submit his/her resignation; the board would then have to rule on whether this candidacy would be maintained or replaced;

2. The chair of the compensation committee should present a report on compensation at the annual meeting of shareholders and answer questions from shareholders[2]. The board could also, following the annual general meeting, hold a conference call with shareholders that could not attend the meeting to answer their questions about compensation issues.

These two measures are fully consistent with the governance responsibilities of boards of directors, which is not really the case with Say on Pay.

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2 Robert Parizeau, who is a member of the IGPPO’s board of directors made a suggestion of this nature in his text: “Le vote sur la remuneration des dirigeants: un bel example de miroir aux alouettes!”, which was published in the *Revue de l’Institut des administrateurs de sociétés*.

CONCLUSION

The Institute is not favorable to a general requirement that companies hold a non-binding vote by shareholders on their compensation policies and practices. The practice of a dialogue between large shareholders and board of directors should be continued and expanded. The adoption of a Say on Pay procedure should be reserved for companies where shareholders have reasons to be dissatisfied with their executive compensation programs. If that proves insufficient, or in cases of egregious compensation practices, a negative vote on the election of specific board members would likely bring about improved governance practices.

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