Institute for governance
of private and public organizations

Executive compensation:
Cutting the Gordian knot

Policy Paper N° 9

2017

Toward Value-Creating Governance®

Institute for governance
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Written by

Yvan Allaire, PhD (MIT), FRSC
Executive Chair, IGOPP

2017

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Message of the Executive Chair

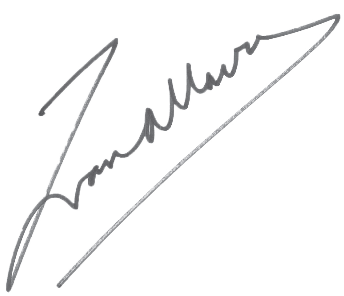
This policy paper, the ninth of a series, received the unanimous approval of the IGOPP board of directors[1]. For the second time, IGOPP is outlining proposals to address and cope with crucial issues of executive compensation.

The IGOPP is indeed fortunate to count on experienced and judicious board members to shape our policy positions. I wish to express my warmest gratitude to the IGOPP board members who have accepted to participate to the working group given the task to put together this policy paper. The informed exchanges among group members, their years of high-level experience with compensation issues were indispensable to the production of this policy paper.

The members of the working group were:

- Yvan Allaire, chair
- Isabelle Courville
- Paule Doré
- Robert Greenhill
- Michel Magnan
- Robert Parizeau
- Guylaine Saucier

With many thanks,



Yvan Allaire, PhD (MIT), FRSC
Executive Chair

1 Board member Louis Morisset, President and CEO of the Autorité des marchés financiers (AMF) has abstained as per the policy of the AMF.

Executive Summary

The median total CEO compensation has more than doubled between 1998 and 2007, followed by a 17.7% correction in 2008 and an uptick afterwards. Since 2010 however, CEO compensation has stabilized at about $8 million.

The chief executive officers of the big six Canadian banks are obviously (?) better paid with a total compensation of $10.5 million, a significant decrease from the $11.8 million they were paid (at the median) in 2010.

The ratio between the median compensation of Canadian CEOs and the average salary of workers in the Canadian private sector increased from 62:1 in 1998 to an apex of 159:1 in 2013, and now stands at 140:1 in 2016.

The ratio between the compensation of the **bank CEOs** and the average salary of Canadians is also appreciably higher at 184 in 2016.

Over the past twenty years, executive compensation has drawn sharp and unrelenting criticism, much of it justified.

To cope with the dissatisfactions voiced about the way compensation was set, most boards of directors have opted for a prudent approach by adopting the compensation system which has now become the standard and the norm, designed in large part by a small number of compensation consultants.

As a result, the description and disclosure of compensation systems have become longer, more detailed, and indeed labyrinthine. The average number of pages (34) required to describe executive compensation in the management proxy circular has quintupled in barely 15 years.

This "prudent approach" makes sense in the circumstances where boards of directors are targeted individually, have to respond on a case-by-case basis, and have no collective forum in which they can take positions, and when appropriate, to collectively resist the pressures from investors and other stakeholders. In short, boards of directors have no forum, no association and no "coalition" to bring them together, as the Canadian Coalition for Good Governance does for large institutional investors.

This policy paper makes the case that the current, standardized processes for setting executive compensation in publicly listed corporations are deeply flawed.

Moving away from the standardized way of setting compensation

This ritualized process, indeed reassuring by virtue of the large number of firms abiding by it, fails to take into account the very particular character or business model of each corporation, the specific nature of its industry, the time horizon of its strategy implementation, the drivers of its value-creation. It locks corporations in a mold of compensation devised by consultants, generating large compensations, yet satisfying critical observers; but it does not achieve what compensation programs should aim for.

This standardized process of setting compensation rests largely on false assumptions and empirically dubious hypotheses : high inter-firm mobility of management talent at the top, the transferability of management skills from one company to another, from one industry to another, «at risk» compensation as a motivator of high performances; an overestimation of the relationship between stock price and individual efforts of executives (minimizing the role of luck in producing large incentives); a well-selected peer group of companies representing a sort of quasi-market from which to set the value of the corporation's CEO and other executives, etc.

Boards of directors of large publicly listed corporations must urgently devise some mechanism, set up some forum to address in a concerted manner the issue of how to change this system. Their legitimacy and credibility hinge on their finding some collective way forward.

This policy paper puts forth a number of proposals which would go a long way towards a new approach to the setting executive compensation. It may be that this objective will be reached in an incremental manner but the goal is clear: a compensation system designed by the company's board of directors for the very specific context of their particular company, sensitive to the expectations of all stakeholders and inducing a long-term perspective in the management of the company.

Some key proposals:

- **Corporations should abandon the concept of peer group of companies as a basis for setting the CEO compensation.** This self-imposed requirement is the weakest link in the current system of compensation setting and has led to a marked increase in compensation.
- **No granting of options** (apart from exceptional circumstances such as a turnaround)[2] **The awarding of share units should not be an annual ritual; grants should occur when an executive is hired or promoted, and their level should be reviewed every three years only;** these share units should be exercisable after a number of years, reflecting the particular **investment and management cycle of the company and its industry;** this term could be 1 year, 3 years, 5 years or even 10 years depending on the situation!
- The board must state in the proxy management circular that it has been formally **informed of the ratio between the CEO's compensation and the median compensation within the firm** as well as within the society at large and that **it considers this ratio to be appropriate in the context of the firm, the industry and the values of the surrounding society.**
- Arrangements **in the event of a change of control** should include the following conditions: only options and share units that are exercisable at the time of the bid can be cashed in **but at the share price which prevailed 90 days prior to the public announcement of the takeover bid.**
- The board is responsible for ensuring that executives **will not benefit from an increase in the value of their options or share units directly attributable to the use of financial engineering measures,** such as share buybacks, the sale of assets or other similar measures.

2 It is often argued that start-ups in their development phase often use options as a form of compensation, thereby economizing their precious cash. The argument merits consideration but is not entirely convincing; the entrepreneur/founder can just as easily give some of his own shares (or share units, phantom shares, etc.) to the indispensable personnel.

- **Progress on implementing such proposals would not happen unless the chairs of the board of TSX 60 companies participate in a forum to discuss these issues.** In this forum, proposals such as those offered in this policy paper could be put forth and challenged; proposals which receive broad support could be adopted to provide a new framework for the compensation process at these large Canadian corporations. Such collective positions would serve as a counterweight to the pressures borne by the corporations in isolation.
- **This policy position also calls on institutional funds to become active participants in the solution to the dilemmas, paradoxes and labyrinths that compensation issues have generated.** Canadian institutional investors must clarify their expectations and their understanding of what forms of compensation will, in their view, support a long-term management perspective, which is a stated goal of their investment policies. Their response to this challenge may lead them away from the standard recommendations of proxy advisors.

Introduction

In 2012, our institute published a policy paper which mapped the historical evolution of executive compensation and offered some explanations for the near exponential increase in executive compensation during the years 1990-2010. It was puzzling to observe, for instance, that the ratio between the median compensation of chief executive officers of Canadian companies of the TSX 60 and the average salary in the Canadian private sector surged from 60:1 in 1998 to 140:1 in 2010.

Regardless of the causes[3], this dramatic increase in executive compensation has drawn sharp and unrelenting criticism, much of it justified.

Investors and shareholders were initially enthusiastic about forms of compensation likely to transform senior executives into fanatics of “shareholder value-creation”. However, soon enough, the link between this “extravagant” compensation and the company’s economic performance seemed very tenuous.[4] Stock options, for instance, could produce enormous rewards just as much by accident or mere chance than as a result of a distinctive contribution to shareholder wealth.

The institutional funds, hidden behind the screen of proxy advisors, fueled guerrilla warfare against high compensation deemed insufficiently justified by high performance for the shareholders.

In Canada, the large institutional funds were brought together in the Canadian Coalition for Good Governance (CCGG), an organization that proved fairly effective at influencing boards of directors to adopt better standards of governance, particularly with respect to compensation.

After 2008, the concept of an advisory vote on compensation (“say on pay”) rallied investors, became compulsory in the United States under Dodd-Frank, and created an (illusory) opportunity for shareholders to voice their disagreement and dissatisfaction with executive compensation.

3 A recent text concludes a lengthy examination of all the factors that could explain the continuing increase in the executive compensation of public companies as follows:
“First, executive compensation is likely driven by many factors–boards and shareholders’ attempts to maximize firm value, executives’ attempts to maximize their own rents (perhaps in conjunction with entrenched boards and inattentive shareholders), and institutional forces such as legislation, taxation, accounting policies, and social pressures. No one perspective can explain all of the evidence, and a narrow attachment to one perspective will distort rather than inform our view of executive pay.” (Edmans and Gabaix, July 2017)

4 “*For example, in a 2015 survey of institutional investors by RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University less than half (38 percent) of institutional investors believe that executive compensation is clearly and effectively disclosed in the proxy. Responses are consistently negative across all elements of compensation disclosure. Sixty-five percent say that the relation between compensation and risk is “not at all” clear. Forty-eight percent say that it is “not at all” clear that the size of compensation is appropriate. Forty-three percent believe that it is “not at all” clear whether performance-based compensation plans are based on rigorous goals. Significant minorities cannot determine whether the structure of executive compensation is appropriate (39 percent), cannot understand the relation between compensation and performance (25 percent), and cannot determine whether compensation is well-aligned with shareholder interests (22 percent). Investors also express considerable dissatisfaction with the disclosure of potential payouts to executives under long-term performance plans*” (Baum, Hale, Larcker, Morfit and Tayan, April 25, 2017.

This measure and others led to lengthy and complex texts to explain the ins and outs of the various components of compensation programs. Obviously, the requirement, be it mandatory or voluntary, to give investors the right to vote on compensation increased significantly the influence of the proxy advisory agencies.

Then, these new forms and levels of compensation widened the chasm between the average pay in the company and what executives were paid. Given that much of this "at risk" executive compensation is tied to the stock price and that stock prices react favourably to cost-cutting and outsourcing of jobs to low-cost countries, middle managers and workers understand all too well that senior executives benefit if they succeed in eliminating their jobs. The wealth of executives henceforth moved in sync with the stock market.

Mutual trust, loyalty, the sharing of objectives and pride in the organization, the sense of "being all in the same boat", were slowly but surely eroded, replaced by a calculative greed at the top and cynical disaffection at the bottom.

Finally, and more generally, executive compensation has become a political issue, a cause of social resentment, and a flaw in governance in most developed societies. Regardless of the arguments that are made to explain and justify the considerable sums paid to executives, the glaring disparity of the incomes within society and even within firms, turns this issue, at best, into a rallying cry for those that want a fairer society and, at worst, into a platform for demagogues.

Our observations in 2012 led us to suggest five proposals to correct some of the major pitfalls of compensation practices at the time:

1. Gradually reduce the role of stock options as a method of compensating senior executives, with the ultimate objective of completely eliminating this form of compensation.

2. Governments should eliminate all tax advantages (whether personal or corporate) favouring the use of stock options as a method of compensation.

3. Boards of directors of exchange-listed companies should establish a fair and productive ratio between the total compensation of the chief executive officer and the median income of the company's employees.

4. Boards of directors must remain entirely accountable and responsible for determining the system of compensation for the executive officers. Boards of directors must be sufficiently credible and have enough courage to base the compensation **not just on quantitative but also qualitative** factors which they consider of prime importance for the long-term well-being of the company.

5. Boards of directors should be guided by principles of the following nature: 1. design the compensation based on the specific circumstances of each company; 2. review and challenge the standard approaches to compensation; 3. ensure fairness and balance in compensation within the company.

These recommendations are still relevant and valid now. Our objective in this policy paper is to update the pertinent information, identify compensation issues as they play out in the context of 2016, and propose measures that will elaborate on, clarify and complete the recommendations we made in 2012.

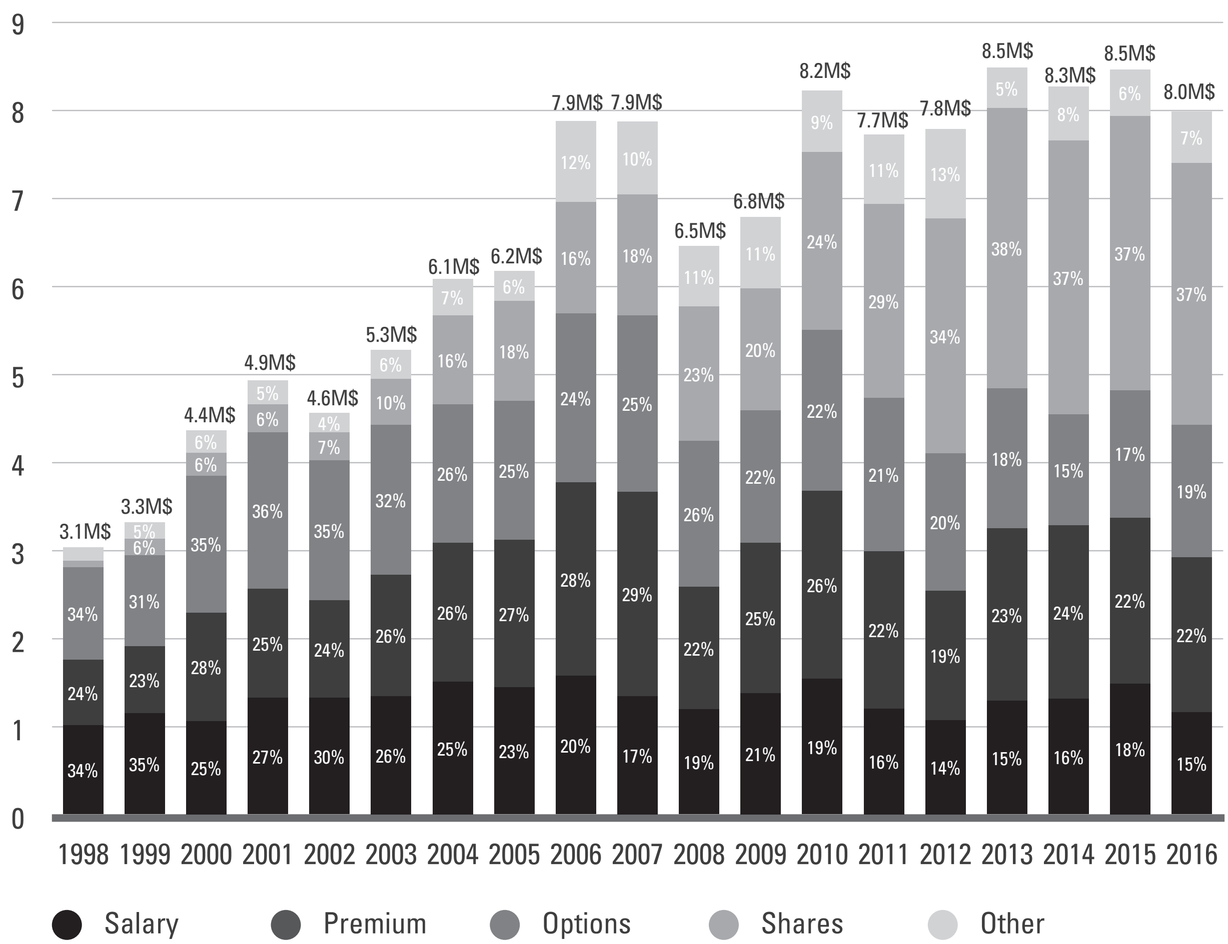
CEO compensation in 2016: Where are we now?

Figure 1 maps out the level and make-up of CEO compensation for corporations in the TSX 60 from 1998 to 2016.

The median total CEO compensation has more than doubled between 1998 and 2007, followed by a 17.7% correction in 2008 and an uptick afterwards. Since 2010 however, CEO compensation has stabilized at about $8 million.

Figure 1

Levels and composition† of the compensation of chief executive officers of companies on the TSX 60, 1998-2016 (in millions of constant 2016 dollars)



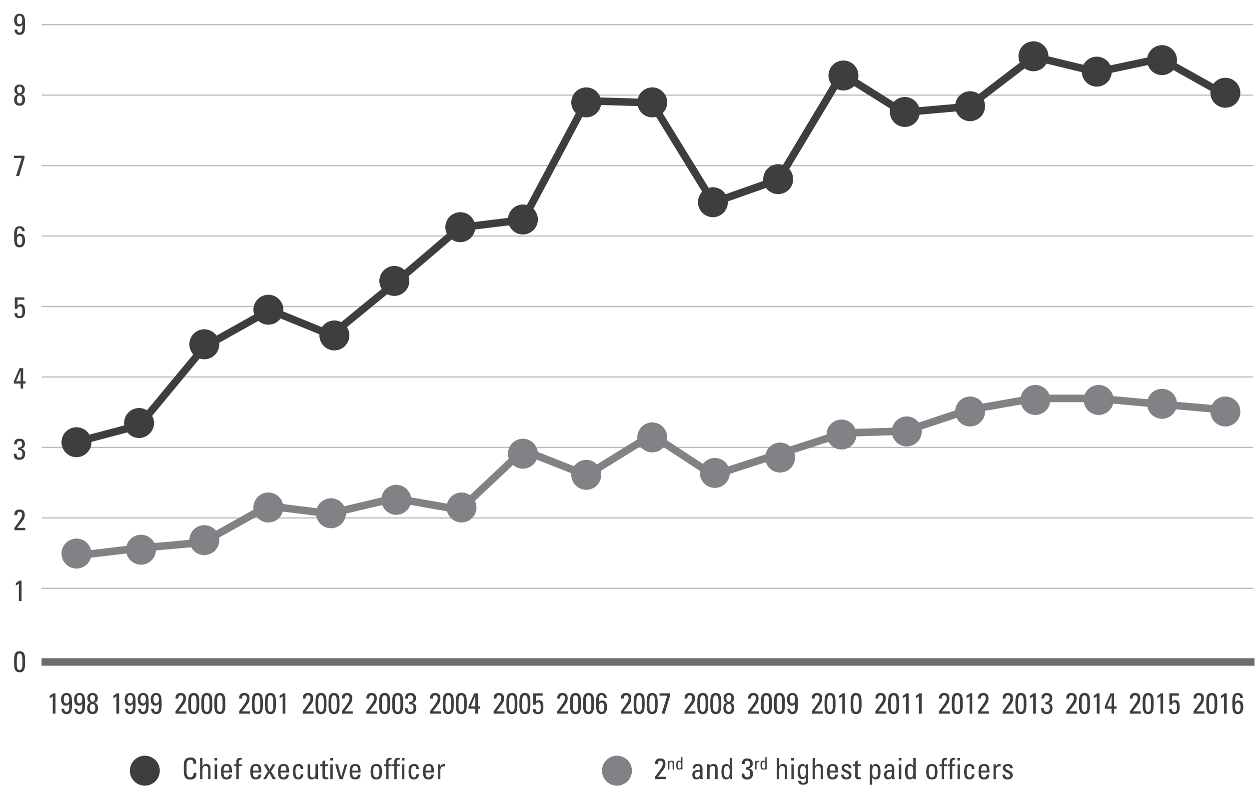
† The level corresponds to the median total compensation, and the composition corresponds to the average of the percentages of each category, so as to maintain a total of 100%.
Source: Proxy Management Circulars filed on SEDAR, data compiled by IGOPP.

By comparing the median compensation of the chief executive officers and the 2nd and 3rd highest paid officers (Figure 2), we observe a significant gap, which is increasing slightly over the years. In 2016, the median of the chief executive officers stood at $8.0M versus $3.5M for the 2nd and 3rd highest paid officers, or 2.3 times higher.

This statistic seems to show a progression in salary inequality in the top echelons of the large Canadian corporations.

Figure 2

Median compensation of Canadian chief executive officers as compared to the 2nd and 3rd highest paid officers, 1998-2016 (in millions of constant 2016 dollars)

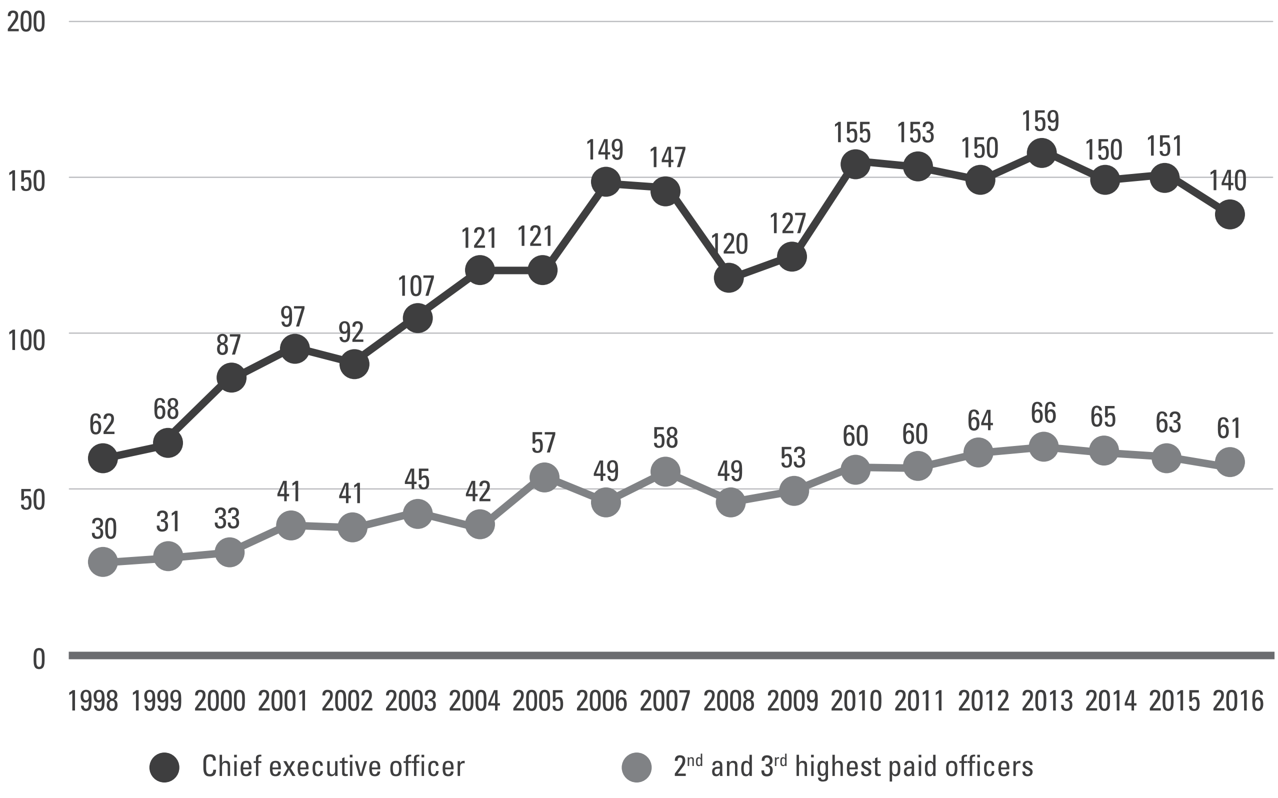


Source: Proxy Management Circulars filed on SEDAR. IGOPP compilation.

Then the ratio between the median compensation of Canadian CEOs and the average salary of workers in the Canadian private sector (Figure 3) increased from 62:1 in 1998 to an apex of 159:1 in 2013, and now stands at 140:1 in 2016. For the 2nd and 3rd highest paid executives, the ratio was relatively stable over the past years at around 60:1

Figure 3

Ratio between the median compensation of executives and the average salary of workers in the private sector, 1998-2016, comparison of chief executive officers/2nd and 3rd highest paid executives



Sources: (1) median compensation of chief executive officers, 1998-2016: from proxy management circulars filed on SEDAR. IGOPP compilation.
(2) total annual compensation per job in the private sector, 1998-2016: Statistics Canada, CANSIM, tables 383-0030 and 383-0033.

In Figure 4, this ratio is compared to the same ratio for U.S. CEOs, which in 2016 was 53% higher as compared with the Canadian ratio.

Figure 4

Median value of the compensation of chief executive officers compared with the average salary of workers in the private sector, comparison of Canada (TSX 60)/United States (S&P 500), 1998-2015 (Canada: nominal CAD /nominal CAD; United States: USD 2000/USD 2000)

Sources (Canada): (1) median compensation of chief executive officers, 1998-2015: from proxy management circulars filed on SEDAR.
(2) total annual compensation per job in the private sector, 1998-2015: Statistics Canada, CANSIM, table 383-0030.

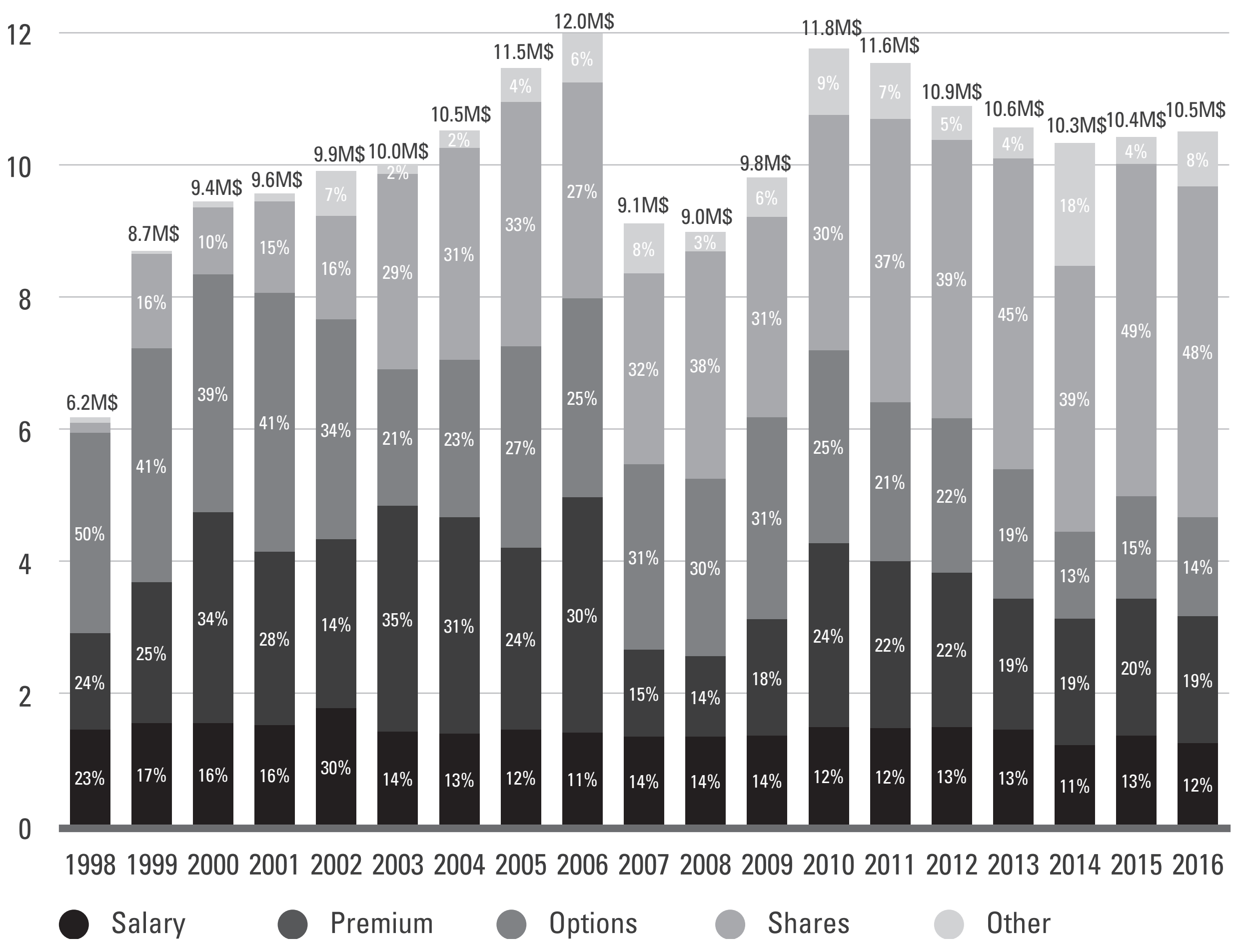
Sources (U.S.): (1) median compensation, 1998-2008: Frydman and Jenter (2010).
(2) median compensation, 2009-2010: GMI (2010, 2011).
(3) median compensation, 2011-2015: Meridian CEO Pay survey 2016.
(4) average annual salary in the private sector, 1998-2015: US Department of Labor, Quarterly Census of employment and wages, 1999-2016.

In 2001, the U.S. ratio reached its highest point at 205 (113% higher than the Canadian ratio at the time). The Canadian ratio broke the 100 level in 2003 and 150 in 2010. This raises the (naive) question: were the Canadian CEOs whose compensation stood at below 100 times the average salary of employees in the Canadian private sector prior to 2003 less competent and less productive at that time?

The chief executive officers of the big six Canadian banks are obviously (?) better paid (Figure 5) with a total compensation of $10.5 million, a significant decrease from the $11.8 million they were paid (at the median) in 2010.

Figure 5

Levels and composition† of the compensation of chief executive officers of the big six Canadian banks, 1998-2016 (in millions of constant 2016 dollars)

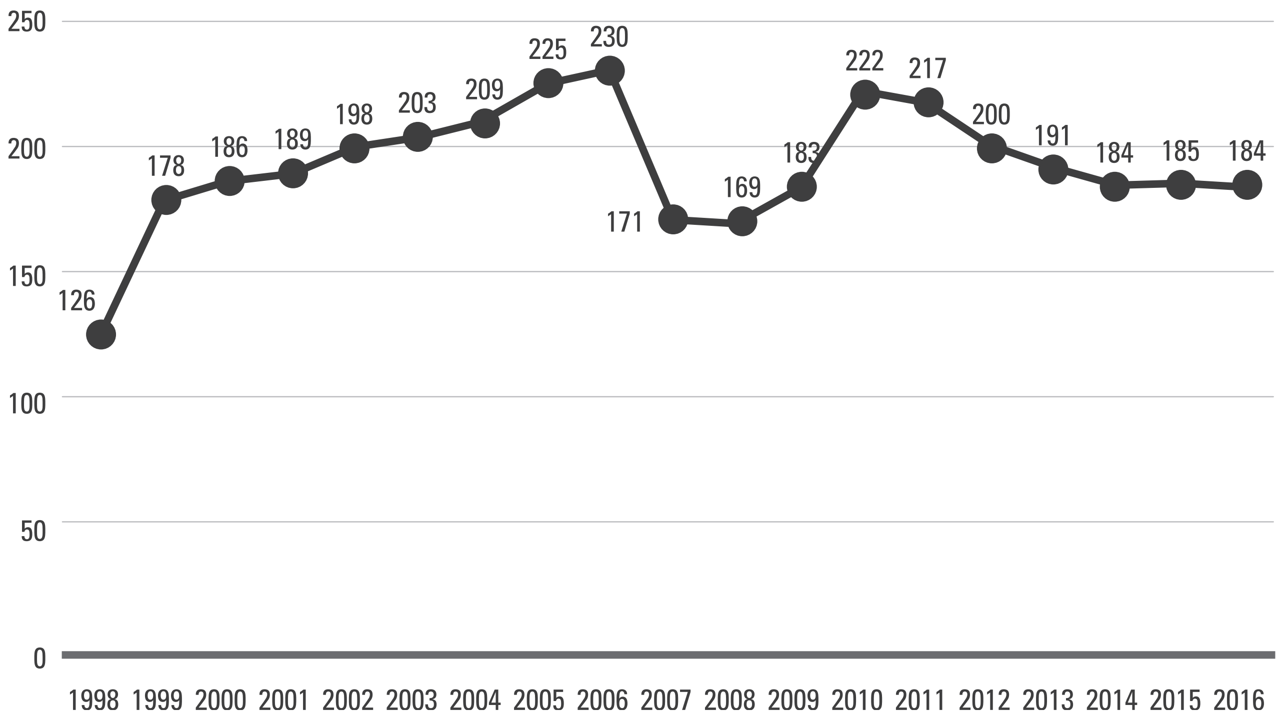


† The level corresponds to the median total compensation, and the composition corresponds to the average of the percentages of each category, so as to maintain a total of 100%.
Source: Proxy Management Circulars filed on SEDAR, data compiled by IGOPP.

The ratio between the compensation of the bank CEOs and the average salary of Canadians is also appreciably higher at 184 in 2016 (Figure 6).

Figure 6

Ratio between the median compensation of the executives of the big six Canadian banks and the average salary of workers in the private sector, 1998-2015



Sources: (1) median compensation of the chief executive officers of the big six Canadian banks, 1998-2015: from the proxy management circulars filed on SEDAR.
(2) total annual compensation per job in the private sector, 1998-2015: Statistics Canada, CANSIM, tables 383-0030 and 380-0033.
IGOPP compilation.

HAVE CANADIAN EXECUTIVES LOST PURCHASING POWER?

Figures 1 and 5 would seem to point in this direction. However, on closer examination, it is clear that executives have traded stock options for share units. Indeed, options, which previously represented approximately 35-36% of total CEO compensation, only accounted for 19% of their compensation package in 2016, while share units soared from 6-7% of the total in the early 2000s, to 37% in 2016.

This phenomenon is even more noticeable for the executives of the big Canadian banks. Options as a percentage of their total compensation dropped from more than 40% at in the early 2000s to 14% in 2016, while the proportion of their compensation in the form of share units rose from 15-16% to 48% in 2016.

Clearly, the fact that the total compensation of CEOs seems stable since 2012, and even decreased slightly, reflects this change in the composition of their compensation. Shares maintain a stable value even if the stock price is stagnating, while options have zero value if the stock price does not move above the exercize price.

WHY THIS SHIFT TOWARD SHARE UNITS?

For senior executives, there are several advantages to this form of compensation, including:

- **Certainty of some cash value even in a down market:** contrary to options, share units retain some value even if the stock price were to drop below their value at the time they were granted. With stock options, should the stock price drop or stagnate, they have zero value.
- **Anonymity and convenience:** share units, which are usually redeemable in cash, do not carry any obligation of insider reporting.
- **Accumulation of dividends:** share units granted as part of a compensation program are eligible for the dividends paid on the shares to which the units are linked. These pseudo-dividends accrue in the account of the executive and may represent a significant return for share units in a high-dividend industry, such as banking.

From the point of view of the corporation, there are also advantages to this form of incentive compensation:

- **No dilution of EPS:** when the underlying compensation program is properly designed, the share units are not included in the number of shares used in calculating *diluted* earnings per share (EPS), but stock options are. Since the EPS is not affected by this form of compensation, it is no longer required or useful to buy back shares to counter the effect of dilution, a practice frequently associated with stock options.
- **Apparent stability or even decrease in compensation:** given the sensitivity to ever increasing compensation, the gradual switching from stock options to share units provides some relief; but in fact, executives have traded some upside for a compensation package with much lower downside risk; the greater certainty of cashing in comes with a somewhat lower total compensation number.
- **Tax considerations:** the gain realized on the exercised stock options becomes a tax deductible expense for the corporation in the United States but not in Canada; on the other hand, *the corporation can*, in general, claim the amounts associated with the awarding of share units, as well as the subsequent gains when they are exercised, as a deduction for tax purposes **both in Canada and the United States**. This feature of share unit tends to lower the after-tax cost of this form of compensation.

Thus, to the question raised earlier “Have executives lost purchasing power?”, the answer is no. They have gained the certainty of cashing in an amount close to what was divulged as their compensation and yet still get to benefit from any rise in stock price. This revised compensation system still carries a powerful incentive to sell the corporation and benefit from the control premium.

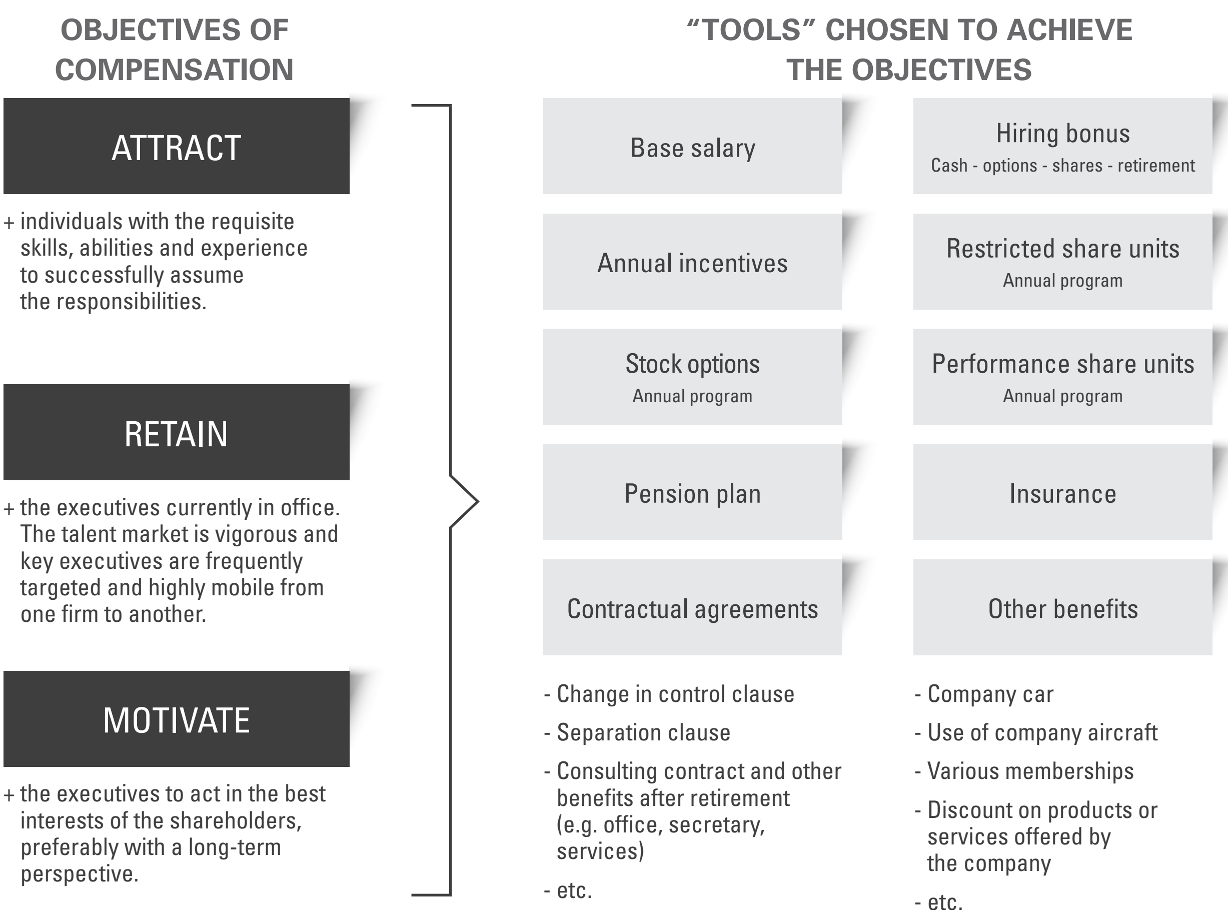
What do we seek to achieve through incentive compensation?

The setting of executive compensation in the contemporary corporation is guided by quasi-universal compensation principles. The levels and forms of executive compensation purportedly seek to achieve three objectives: 1. retain the "talent"; 2. motivate the current office holders; 3. attract, where appropriate, talented executives and managers from other firms.

Over the years, sensitive to the growing pressures on boards of directors to link incentives to performance and to divulge fully all aspects of executive compensation, consultants have proposed complex compensation systems, which in time (and as a result of the small group of consultants advising all companies) have become highly standardized. Figure 7 describes the end result of this evolution in 2016.

Figure 7

Executive compensation: the current approach



These three objectives are generally accepted, rarely questioned:

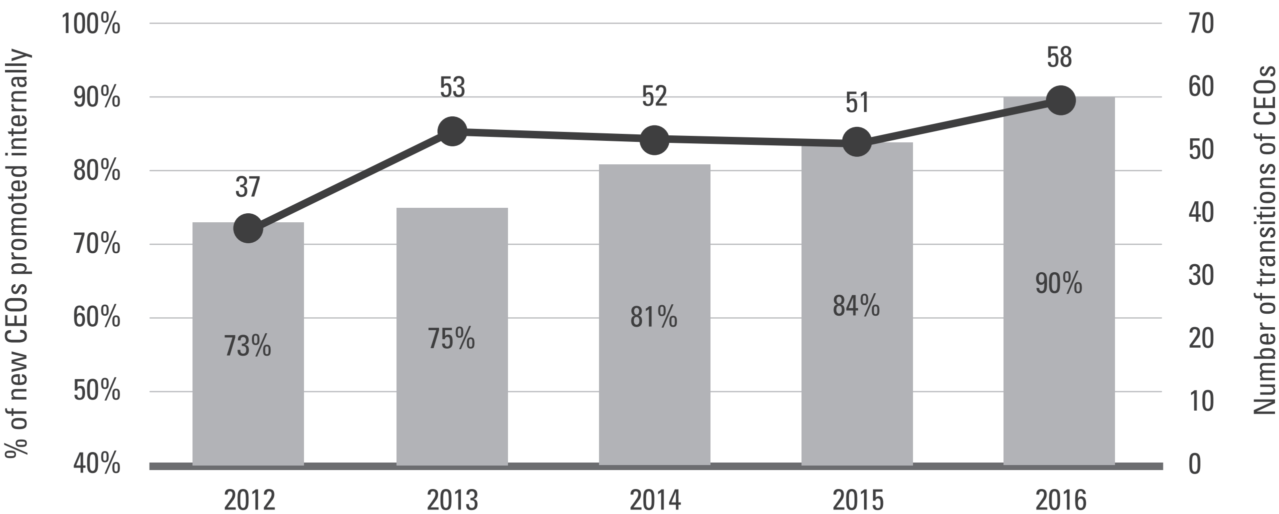
ATTRACT

Apparently, it is often necessary to recruit managers and executives from other companies to fill positions because they have experience and skills that are superior to those available within the company. This may be due to a weakness in the company's succession programs or from a material change in its business model, which requires new skills not available currently within the company.

However, it should be noted that recent trends on the appointment of CEOs indicate a strong preference for internal promotions. As shown in Figure 8, of the 58 new CEOs of companies in the S&P 500 in 2016, 90% came from within the ranks of the company, as compared with 73% in 2012.

Figure 8

Promotions and transitions of CEOs among companies in the S&P500, 2012-2016



Source: Adapted from Spencer Stuart, *CEO Transitions*, 2016.

Then, recruitment of executives outside the company's ranks risks creating an imbalance in management compensation; in order to convince an executive in a senior position with another firm to migrate to the company, the candidate will usually be offered compensation terms that are superior to what executives at the same level in the company currently earn.

RETAIN

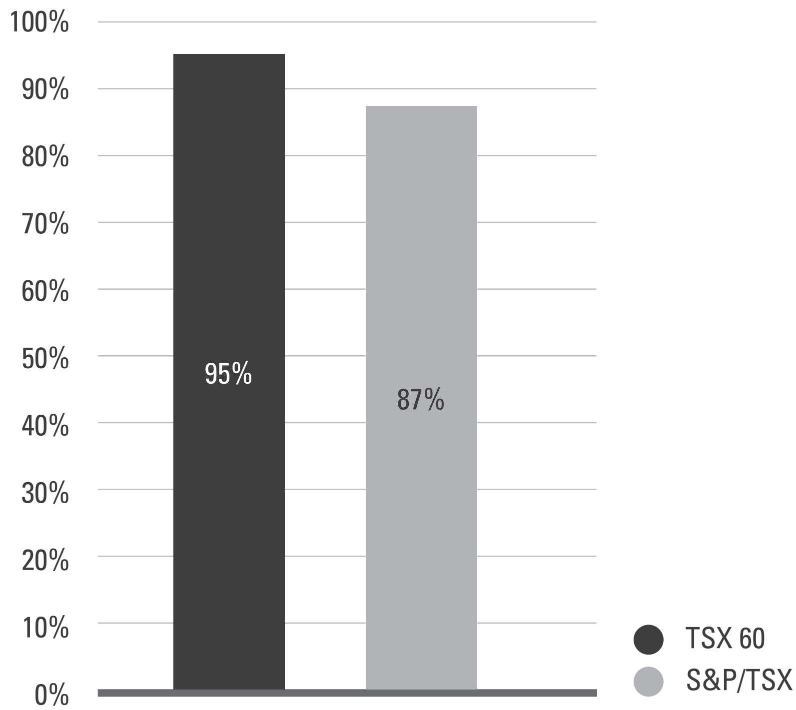
The going assumption here is that management talent is highly mobile from one firm to another, across industries and both locally and internationally. Without a competitive compensation scheme (as compared to firms of a similar size and scope), a talented executive may switch to another firm in order to fully monetize his skills.

To guard against this risk, the firm should compare its executive compensation practices to those of "similar" firms.

As shown in Figure 9, about 95% of the companies in the TSX 60 and 87% of the companies in the S&P/TSX have used at least one group of "peers" to set the level of compensation of their CEO.

Figure 9

Percentage of companies using at least one peer group to set the compensation of their executives



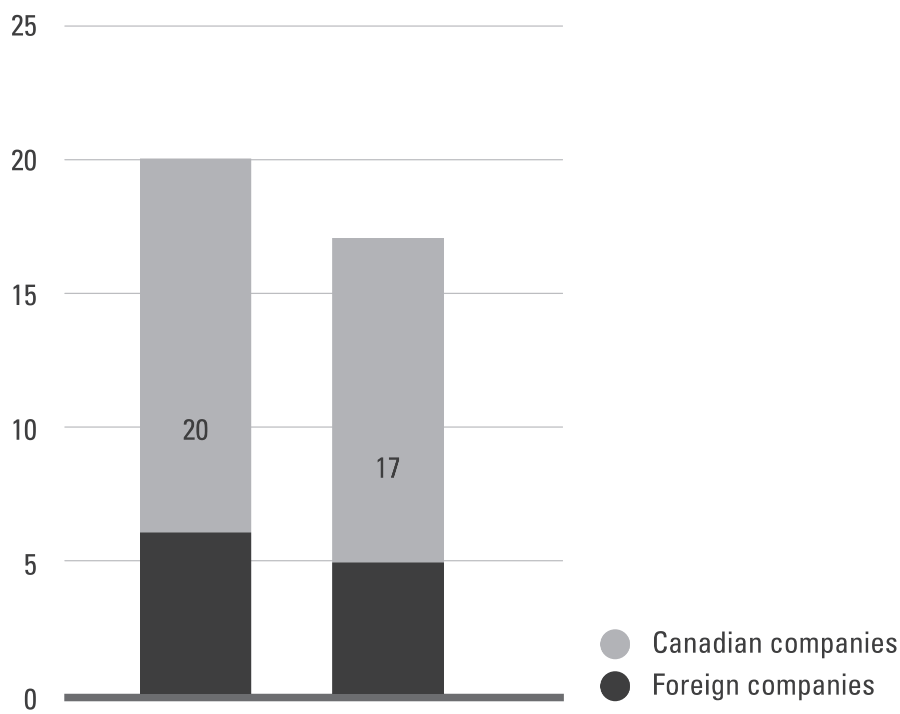
Source: management proxy solicitation circulars filed on SEDAR. IGOPP compilation.

It is interesting to observe (Figure 10) that the companies in the TSX 60 compare themselves on average to 20 firms, including 6 foreign firms.

In reality, it seems quite unlikely that 20 companies on average are truly comparable to any Canadian company; that is, twenty companies operating under the same market contingencies and in competition to attract the same management talent. In actual fact, this process only serves to reassure all parties that management is paid “fairly”, considering the level of compensation of other executives.

Figure 10

Average number of Canadian and foreign companies contained in the reference groups used to determine executive compensation



Source: Management proxy circulars filed on SEDAR. IGOPP compilation.

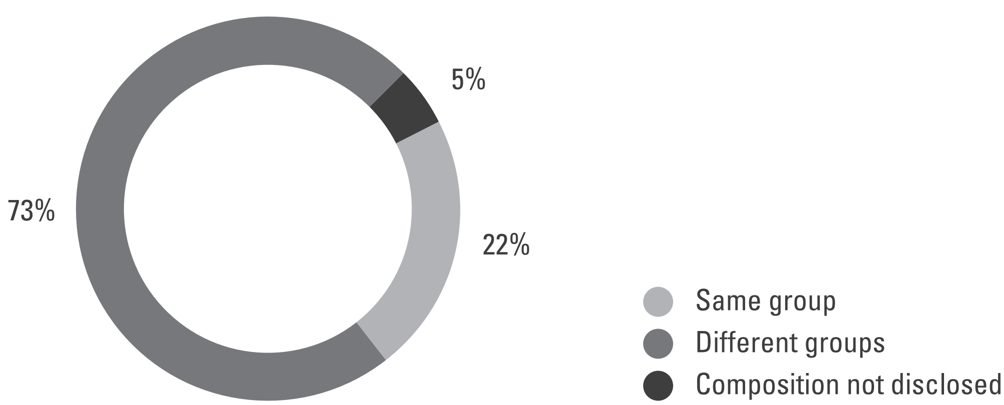
Since incentive compensation is often tied in part to relative performance metrics, companies should, and most do, disclose which companies are considered relevant for performance comparisons. Some 68% of companies on the TSX 60 do disclose the group of «peers» used to assess the performance of their executives, versus 50% of the companies on the S&P/TSX as a whole.

One intriguing point, **73%** of the companies of the TSX 60 choose one group of companies for compensation purposes and another group for performance metrics (Figure 11).

This *modus operandi* clearly reveals that boards of directors (and their compensation consultants) do subscribe to the theory that "management talent" is generic and transportable and, therefore, that it is reasonable to expect that their CEO could be recruited by numerous firms from very different industries. But, when comparing metrics, it seems more appropriate to limit the comparison to firms in the same industrial sector.

Figure 11

Percentage of companies disclosing the use of two groups (one to determine compensation and one to assess performance), according to whether just one group is used in both cases or two different groups are used



Source: Management proxy circulars filed on SEDAR. IGOPP compilation.

The whole process of comparisons with "peers" to set compensation is based on a doubtful premise, namely that management talent is generic and transportable from one firm to another, from one industry to another, without difficulty. This assumption is empirically questionable. The number of dismal failures following the recruitment of crossovers for the position of CEO led to a nearly universal rejection of this practice[5]. It became apparent that the deep knowledge of the business, the industry, its culture and business model were more important than the so-called "generic" and transportable skills such as leadership and experience managing a firm in other industrial sectors.

5 Of course there are exceptions. A CEO will occasionally move from one company to another *within the same narrowly defined industry*. One can point to the example of Hunter Harrison, who became CEO of CP after having been the CEO of CN, two companies in the highly concentrated railway industry in which Harrison worked for his entire professional life. In such rare situations, the recruitment of an outsider executive may prove profitable.

The statistics show that out of 1,800 CEOs chosen from 1993 to 2005 in the United States, less than 2% originated from another firm (Clifford, S., 2017, p.191). In 2016, as Figure 8 shows, 90% of the 58 new CEOs of companies on the S&P 500 were promoted internally (Spencer Stuart, CEO Transitions, 2016). For the TSX 60, seven new CEOs were appointed in 2016, five of whom were internal promotions. (Source: IGOPP, 2017)

An extensive review of studies bearing on this issue reaches the following conclusion:

"The evidence of negative or insignificant returns associated with an external succession strategy is contrary to what would be expected, given theories of competitive markets for executive talent. If CEOs were distinguished from one another by only a certain general talent factor, firms should benefit from the larger pool of talent available when their boards decide to pursue external successors. Presumably, strong, independent boards stand to benefit from such an external strategy when the expected talent of outsiders exceeds that of insiders. To the contrary, the empirical evidence suggests a negative expected benefit from going outside rather than pursuing an internal succession strategy, despite the ability to access an enhanced talent pool. In the aggregate, CEOs appear to be most effective only when they have made significant investments in firm-specific human capital" (Elson and Ferrere, 2013)

MOTIVATE

According to the dominant theory, incentive pay is an essential tool to align motivation with the long-term interests of the corporation and its shareholders. However, this alignment is complex because of individual calculus, opportunistic behavior and the inherent uncertainty of all economic activity. How should motivations be channeled towards the interests of the corporation? How to ensure that incentive compensation truly reward performance and not merely luck and happenstance? How to channel the behavior and decisions of corporate executives for the long-term benefit of all the corporation's stakeholders?

Compensation consultants have vied with each other in imagination and innovation to devise compensation programs that supposedly cope with these issues, but in reality they have had limited success and certainly increased the complexity of compensation programs.

Over time and under pressure from institutional investors, regulators and especially proxy advisory agencies, compensation programs have converged toward a standard model of compensation.

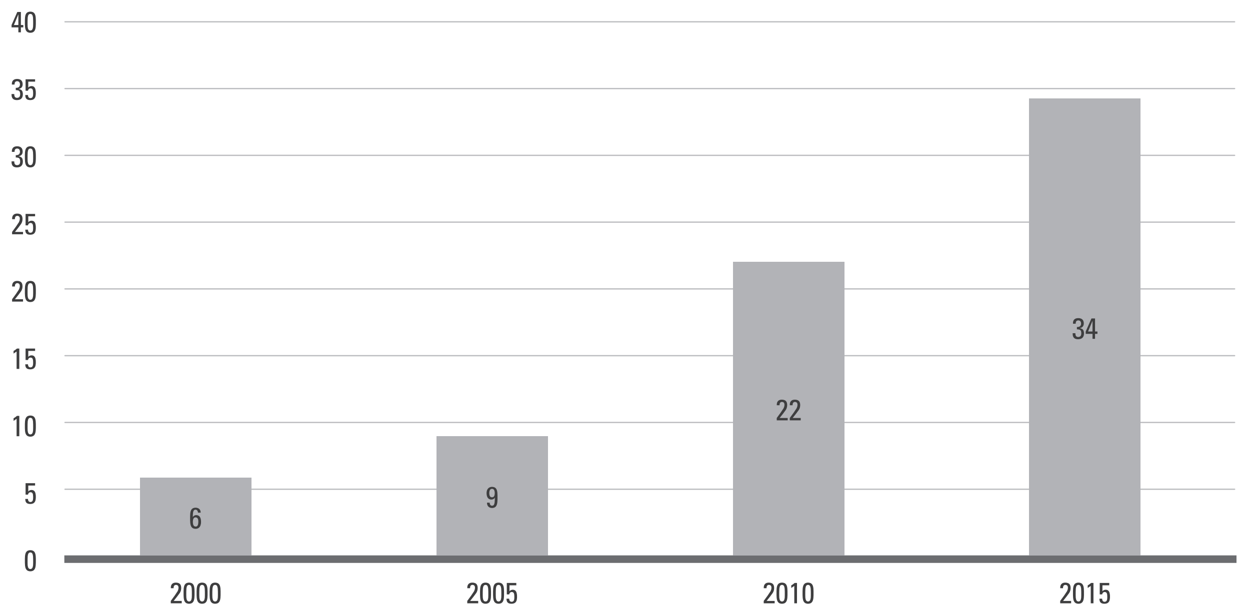
These developments have given rise to two phenomena:

1. The description and disclosure of compensation systems have become longer, more detailed, and indeed labyrinthine.

The average number of pages required to describe executive compensation in the management proxy circular has quintupled in barely 15 years. (Figure 12)

Figure 12

Average number of pages devoted to compensation in management proxy circulars of the 50 largest companies by market capitalization (May 2016) that were also going concerns in 2000.

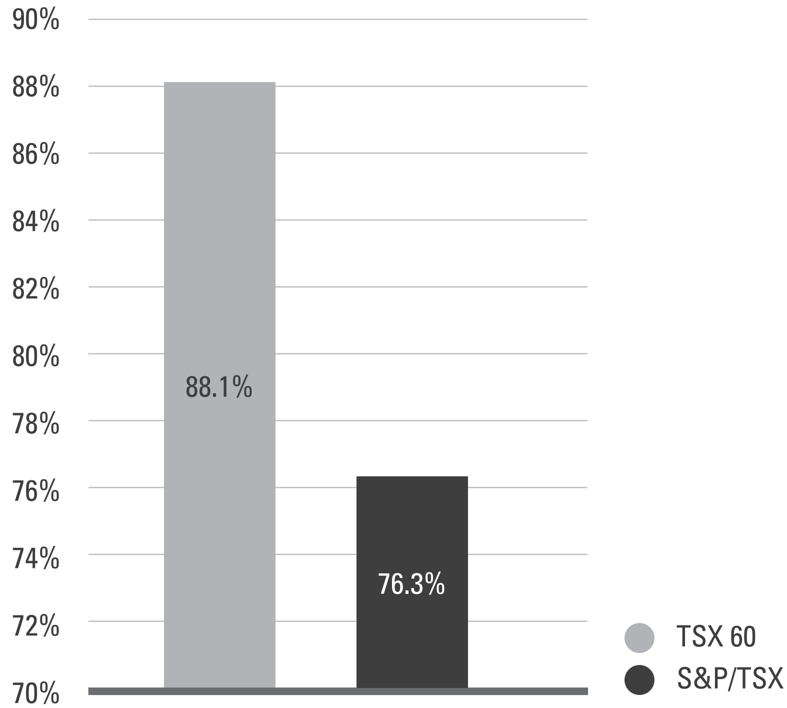


Source: IGOPP compilation.

Most boards of directors of listed companies call upon consultants to develop their compensation policies and programs (Figure 13).

Figure 13

Percentage of boards of directors of TSX 60 and S&P/TSX companies who retained the services of compensation consultants in 2015.

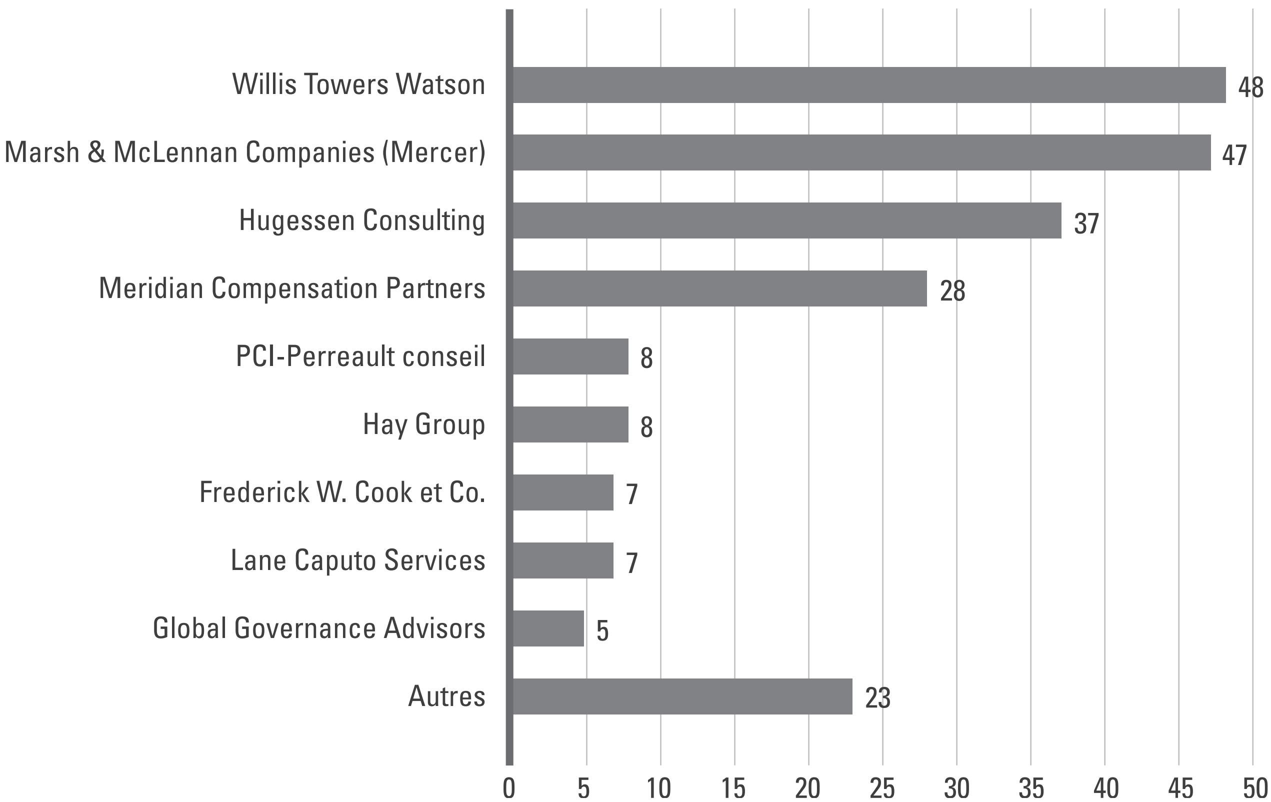


Source: IGOPP compilation.

Generally speaking, a small number of consulting firms take the lion’s share of this market, as shown in Figure 14.

Figure 14

Number of S&P/TSX companies, according to the consultant company, retained by boards of directors in 2015



Note: More than one consultant may be hired by the board of directors every year.

Source: IGOPP compilation.

2. **The ministrations of consultants and the pressures of proxy advisors have resulted in a standardized, convergent process for setting executive compensation.** This process leads to *yearly* packages which combine salary, bonuses, stock options, restricted stock grants, performance share units, retirement benefits. The full assemblage will also include formal contracts covering change-of-control situations, termination conditions, etc.

Only the quanta of the compensation package vary from firm to firm. As we showed above, the "market" value of the executive is determined by comparisons with a group of companies deemed to be sufficiently similar in their size and complexity to play the role of a quasi-market for CEO talent.

The Human Resources/Compensation committes and the board must determine the level of compensation against the median (or more often the 70th or 90th percentile) compensation of executives at the set of companies selected as «comparables». It is obvious that the effect of this practice is to increase the median substantially from year to year and, thus, overall compensation as well.

Through a careful selection of these «comparable» companies (including U.S. companies in the group for Canadian CEOs!), the board is assured of setting a compensation package that will please their executives.

As long as a high percentage of this compensation is "at risk", this conventional program should satisfy the expectations of the investors as well as the dictates of pproy advisory agencies and others. Therefore, the company will most likely receive a large percentage of positive say-on-pay votes from shareholders.

But straying from the dominant, standard model of compensation will expose the board to criticism and some negative votes.

"At-risk" compensation

The so-called "at-risk" compensation should be understood to mean that the amount that will actually be earned is variable depending on stock price and/or the achievement of performance targets. In the current context of compensation, only the base salary is not considered "at risk". Therefore, as shown in Figures 1 and 5, the "at-risk" compensation exceeds 80% of total compensation, which is considered the best argument in defence of high levels of compensation, although this is largely sophistry.

Here is the concrete reality for a typical company in 2016:

- The *annual incentive premium* represents 22% of the CEO's total compensation; this premium is tied to quite detailed and weighted annual targets; note that this premium can vary between 0% and 150% of the CEO's salary depending on the results against targets; but the probability of 0% incentive is nil as the history of past premiums paid shows that it was never the case (and most often there is a floor in place). It would be more appropriate to consider only a part of the premium at risk; for example, what would be the incentive premium on meeting 75% of the targets versus 100%.

- "Long-term" incentive compensation represents 63% of the total and is broken down as follows:
    - *Deferred share units* (50% of the CEO's long-term compensation); these units are acquired *after a term of three years subject to no other conditions (and fully benefit from the accrual of dividends at the rate paid to shareholders);* how can it be claimed that the total amount is at risk? Is it plausible that the stock price in three years could be zero? Of course, the cash value of this long-term incentive depends on the stock price, but is the total amount really "at risk"?
    - *Performance share units* (25% of the long-term compensation); these units are subject to a performance targets (let's say cash flows) over three years; here again, the CEO may earn from 0% to 125% of the units granted at the end of three years. The probability that the performance actually achieved will result in zero units earned is very low. Again, only part of the value of these performance units is really «at risk».
    - *Stock options* (25% of the long-term compensation); these options are acquired after a term of three years and subject to no other conditions (except that the holder must be in the employ of the company at the time of their acquisition). Clearly, the value of stock options could be zero should the stock price fall below the exercise price for a lengthy period of time. The value of stock options reported as compensation is based on models which attempt to account for this risk, whether it be Black-Scholes-Merton, the binomial lattice method or Monte-Carlo simulations[6].

Thus, for this company (and most others), *long term means three years*[7] and the compensation is "at risk" as soon as the amount eventually earned is *variable*. Would it not be more appropriate to only consider a part of the annual premium and a part of the units that are subject to performance criteria as being at risk? This at-risk part could be determined on the basis of past results for these types of incentives.

Even if 100% of these three components (annual incentive premium, performance share units and stock options) were labeled as being "at risk", the result would only be that **53%** of this CEO's compensation is at risk (22% plus (50%x63%)) and not **85%**, as the company claims. Maybe it would be fairer to declare that 85% of the compensation declared for the CEO is **variable** and could result in an actual compensation that is well above or below the amounts attributed for this year.

6 These models only provide an approximation of the value of the options. The choice of method for valuing stock options is a complex subject that is not within the scope of this policy paper.

7 In fact, this definition of long-term is largely attributable to the tax rules applying to share unit plans payable in cash. So as not to be considered a deferred salary for tax purposes, the payment in cash for such share units must made no more than three years after the date they were granted.

Obviously, this sort of compensation, renewed every year, results in an enormous accumulation of wealth for the executives.

It should be noted furthermore that the compensation reported annually is not equal to the amounts cashed in during a particular year. To determine the latter amount, one must know whether the performance objectives initially set (sometimes two or three years earlier) have actually been met (or surpassed). In fact, the amounts cashed in during the past year must include the exercise of stock options and the value of share units. This information is available in the company's reports but is difficult to assemble.

For instance, the valuation of share units depends on their nature: are they earned through the strict passage of time or subject to some internal or external performance targets etc. The computations for determining the value of share units at the time of grant are rarely explicit. It is certainly not our intention to lenghten the texts on compensation in the annual circular, but the reader should be informed of the process for determining the amounts shown in the case of share units (subject or not to performance conditions).

Some companies do divulge that they use a probability estimate that performance targets will be met (for example, a company in the TSX 60 multiplies the gross value of performance-linked incentives by 0.75, which is what the compensation consultant has assessed as the probability that the executives will achieve all of the targets). Do other corporations follow a similar procedure without disclosing it?

Measures of performance

The performance metric most often and increasingly used as target for variable executive compensation is *total shareholder return (TSR)*, as demonstrated in Table 1. Some 70% of the TSX 60 corporations use that metric as their primary performance target in 2015. Indeed, this result may also be a testimony to the influence of proxy advisory agencies, first and foremost ISS, which have championed relative TSR as a metric of choice.

Relative TSR may represent an acceptable compromise in coping with the difficulty of setting long-term performance targets and objectives (3 years or more) that are not impacted by changed industry circumstances, by mergers and acquisitions, by international commodity prices, by technological changes, etc. Thus, TSR, relative to a group of firms in the same industry, seemed a reasonable target, one likely to please investors of all stripes. Obviously, the notion of *the same industry* proved to be problematic, especially in Canada. (Marsteller, Ellerman, and Brindisi, March 2017)

Table 1

Percentage of TSX 60 corporations using certain performance criteria for the compensation in shares of their CEO, 2011-2015

Performance criteria	2011	2012	2013	2014	2015
Total shareholder return (TSR)	60%	58%	63%	66%	70%
Measures specific to the industry	24%	22%	33%	25%	26%
Earnings per share measures (EPS)	22%	24%	22%	23%	18%
Qualitative measures	14%	22%	20%	21%	16%
Return on invested capital	14%	18%	20%	17%	12%
Cash flow measures	12%	12%	14%	8%	11%
Return on equity	16%	16%	16%	13%	9%

Source: Management proxy circulars filed on SEDAR. IGOPP compilation.

Share buybacks and compensation

Of course, TSR and EPS as performance targets may incite management to resort to various means of achieving the targets, including some form of financial engineering such, such as share buybacks, asset sales, etc.

Share buy-backs have a dramatic positive effect on earnings per share and return on equity, both of which tend to boost the stock price for a short period of time, alhough weakly correlated with the company's long-term performance[8].

8 For a demonstration of this fact, see the IRRCi Research Report, 2014)

In fact, a recent research paper has concluded that:

Vesting equity is positively associated with the probability of a firm repurchasing shares, the amount of shares repurchased, and the probability of the firm announcing a merger and acquisition (M&A). When vesting equity increases, stock returns are more positive in the two quarters surrounding both repurchases and M&A, but more negative in the two years following repurchases and four years following M&A…. This paper shows that the impending vesting of equity may lead CEOs to take myopic actions – actions that boost the short-term stock price at the expense of long-term value.

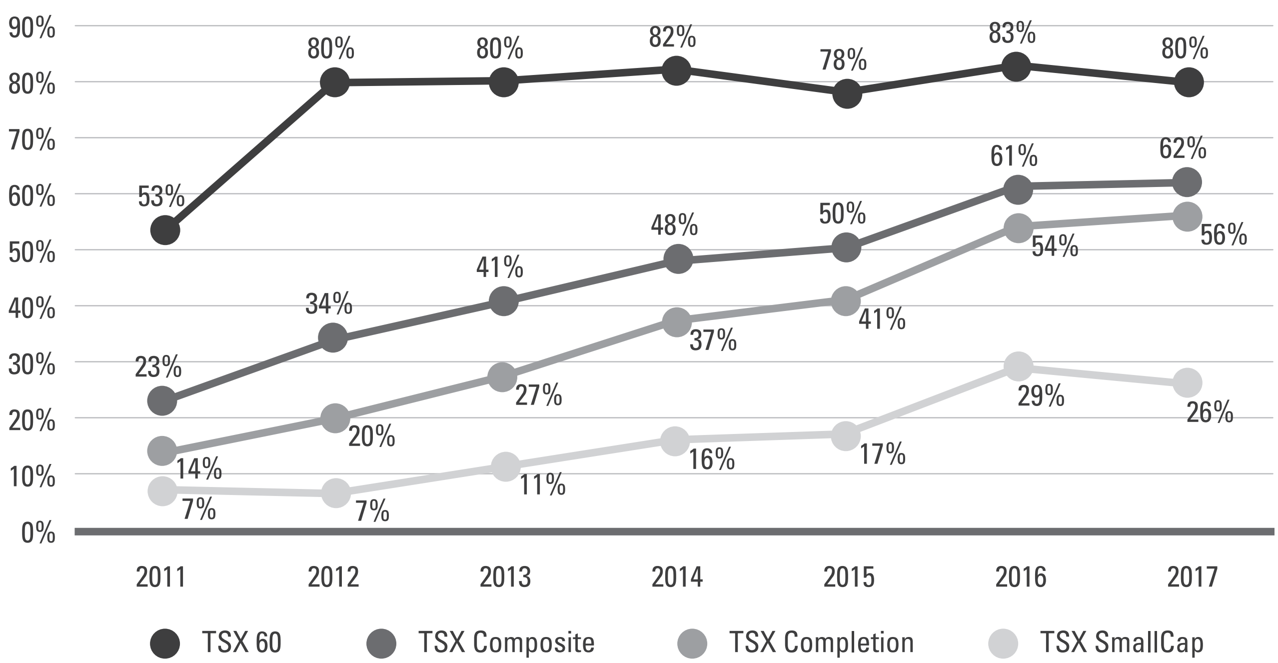
(Edmans, Fang, and Huang, 2017)

Say on pay

The concept of advisory votes by the shareholders on compensation ("say on pay"), which has been mandatory in the United States since 2010, has spread to Canada. As a result, by 2017, nearly 80% of companies in the TSX 60 and 62% of companies in the S&P/TSX had adopted this practice (Figure 15).

Figure 15

Percentage of companies in the TSX 60 and S&P/TSX that held an advisory vote on the executive compensation policy, 2011-2017



Source: Davies Ward Phillips & Vineberg LLP. Governance Insights 2017 (October 2017).

In 2016, as in previous years, shareholders have voted by a large majority in support of executive compensation policies with a median positive vote of 94.2%, only four companies with 20% or more of negative votes and only one company with a majority of negative votes (Eldorado Gold Corporation).

Table 2

Percentage of positive votes on compensation for senior executives of companies in the TSX 60 in 2016

Average	Median	Maximum	Minimum
90.71%	94.20%	98.27%	43.13%

Source: Reports of voting results filed on SEDAR, data compiled by IGOPP.

These results are hardly surprising and may be deceptive for two reasons:

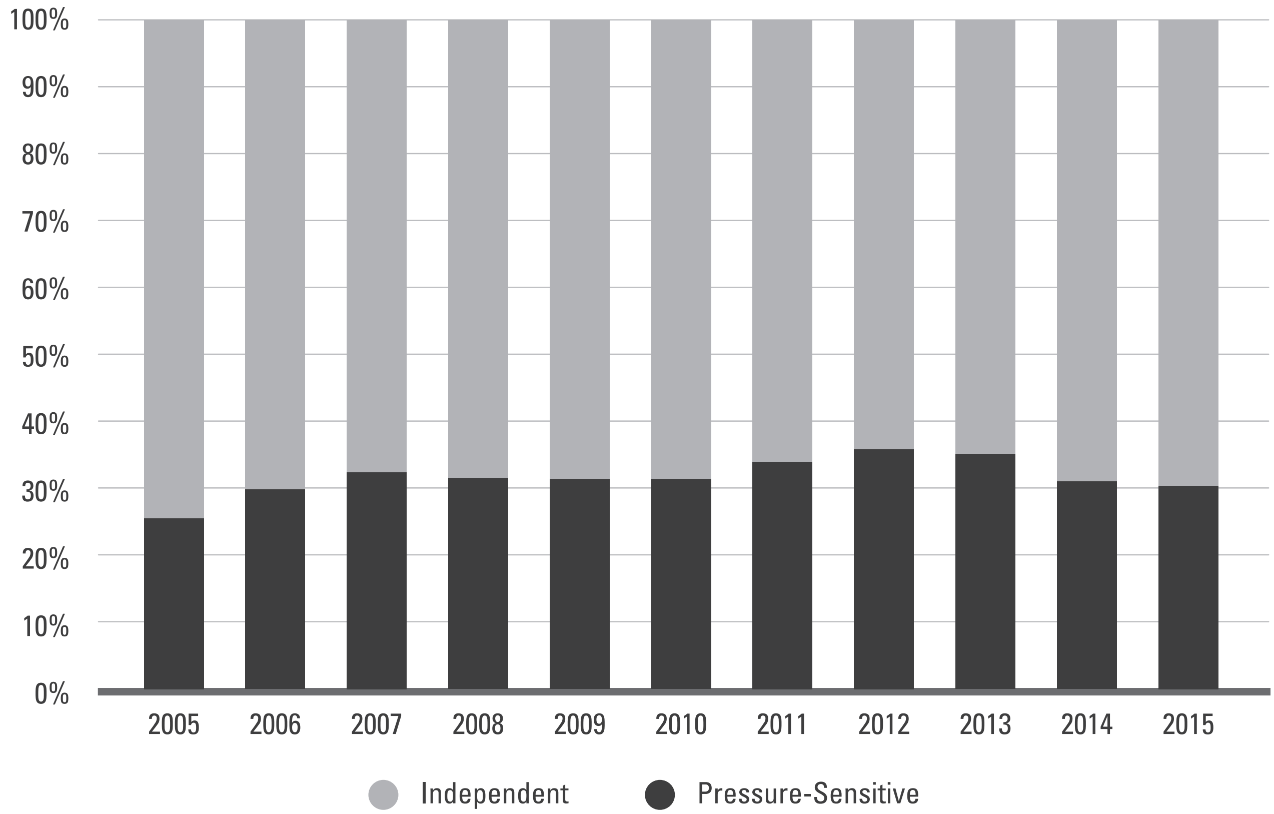
- The proxy advisory agencies make recommendations annually on the compensation standards which companies should adopt. Because of their influence, and the risk associated with a negative vote, listed corporations, as we have argued repeatedly in this policy paper, tend to adopt compensation practices that satisfy the dictates of these agencies, thereby contributing to a reassuring uniformization of compensation-setting policies and processes.
- There is great inertia and a significant bias in favour of a positive vote. Indeed, insofar as "wealth managers", mutual funds and index funds[9] feel obliged to exercise this voting right but have neither the time nor the interest to carefully assess all aspects of compensation, they will defer to the advice of ISS/Glass Lewis (assuming they are subscribers to their services) or simply vote for management. Then, nearly a third of Canadian institutional investors are considered to be susceptible to pressures that can be exerted on them by large corporations (see Figure 16).

9 For example, the large index funds managed by Blackrock and Vanguard claim to be proactive and to take a position on compensation issues; however, because Blackrock is itself a public company subject to the same context as other corporations, some investors claim Blackrock has a possible conflict of interest because of the large compensation package for their own CEO; they cite as evidence that Blackrock votes with the management on "say-on-pay" in 99% of cases (whereas the average for 200 funds is 89%). As for Vanguard, the review we conducted of hundreds of shareholder proposals for the S&P 500 companies shows that Vanguard voted with management in more than 98% of cases; the only exceptions appeared for proposals aimed at eliminating multiple voting shares or proposing to give investors access to proxies for the nomination of directors. *We found no cases in which Vanguard voted against management on compensation in 2016.*

Since these shareholders collectively hold a significant percentage of the shares of large corporations, their quasi-automatic vote in support of management tends to camouflage the level of discontentment of other shareholders and make it nearly impossible to obtain a majority of negative votes.

Figure 16

Distribution as a percentage of Canadian investors between pressure-sensitive institutions† and other institutions



†Asset managers and bank-affiliated insurance companies are classed as pressure-sensitive (Chen et al, 2007)

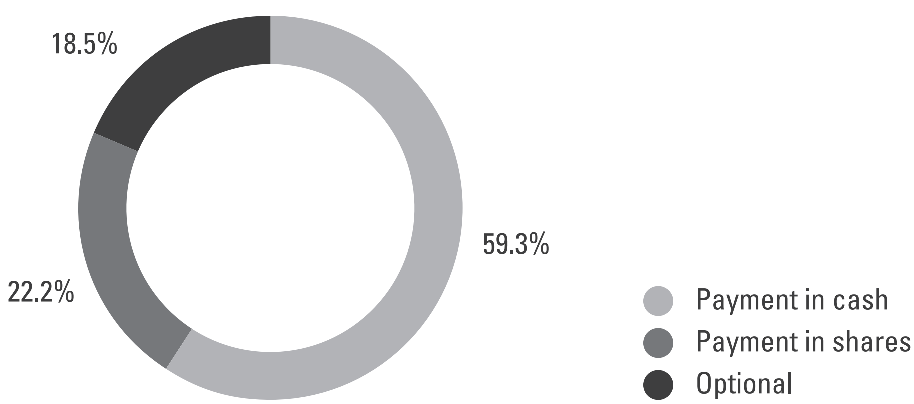
Source: Craig Doidge, Alexander Dyck, Hamed Mahmudi and Aazam Virani. Collective Action and Governance Activism (August 2017). Rotman School of Management. Paper No. 2635662.

Types of share units

Regardless of the nature of the programs, the share units can eventually be either cashed or transformed in actual shares, as noted in Figure 17.

Figure 17

Percentage of companies in the TSX 60 according to the method of payment of the main allocation plan based on the shares of the chief executive officer, 2015 (excluding companies not offering such a plan)



Source: IGOPP compilation.

Thus, the majority of plans are paid in cash to the holder at the time of exercise[10] (or at the end of the specified period, as the case may be). In 18.5% of cases, the beneficiary has the choice between payment in cash or shares. It should be noted that where the plan provides for a payment in shares (or where the executive has that option), shares will be purchased on the market in 50% of the cases or shares will be issued from the treasury in other cases, therefore resulting in a dilutive effect associated with this variant of the plan.

10 So as not to be recorded as a deferred salary for tax purposes, the payment in cash for such share units must made **no more than three years after the date they were granted.**

The taxation and accounting treatment for various types of share units are rarely simple. (See Crawford and da Silva, 2014 for a discussion). The tax treatment may differ depending on the terms and conditions chosen by the corporation at the time the share units are granted: are they based on a performance metric or not, redeemable in cash or not, are there restrictive conditions as to the time of exercise, etc.?

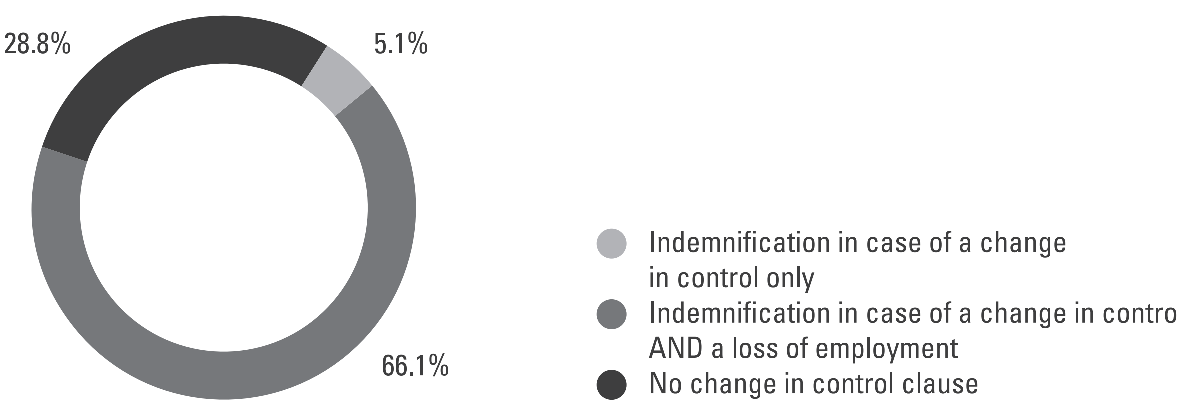
Change-of-control clauses

Some 71.2% of the companies in the TSX 60 have adopted a contractual arrangement that protects management in the event of a change in control (Figure 18). In most cases, this arrangement is triggered by the combination of a change in control of the company **and** the fact that the company's executives are not retained by the new controlling shareholder.

The definition of what constitutes a change in control seems simple enough: a group/a fund/another company acquires more than 50% of the company's shareholder voting rights. However, the change-of-control clauses in the employment contracts of senior managers sometimes give a broader and more flexible meaning to this notion, e.g. "at least 20% of the shares have been acquired by one person or several persons acting together", or "a change is made in the majority (more than 50%) of the directors of the Corporation during a 12-month period".

Figure 18

Percentage of companies in the TSX 60 according to the type of clause contained in the contract of the chief executive officer in case of a change in control, 2015



Source: Management proxy circulars filed on SEDAR - IGOPP compilation.

Table 3 shows some interesting statistics about these change-of-control arrangements. The CEO of a TSX 60 corporation, where such an arrangement has been adopted, will, on average, receive $17.8M if the company were to change to a new controlling shareholder, or 2.8 times the total annual CEO compensation. However, this amount underestimates the true value of this change of control arrangement as it does not factor in the substantial increase in share price that would result from a takeover of control.

Table 3

Statistics on indemnification in the event of a change in control for companies in the TSX 60 (2015)

Total average indemnification (n=41)	17.8M$
Average proportion of the indemnification attributable to the share-based components of the compensation (n=36)	50%
Total indemnification/total compensation multiple (n=41)	2.8x

Source: Management proxy circulars filed on SEDAR- IGOPP compilation.

As 50% or some $8.9 million of the average total indemnification is made up of share-based incentives, the actual value of the indemnification would be much higher were an offer to acquire control of the company made and accepted.

In addition, if there were stock options held by the CEO with an exercise price below the stock price at the end of the financial year, these would not be included in the indemnification number of Table 3 disclosed by the corporations in the event of a change in control. Of course, the substantial premium that would be offered to acquire control may well make these options "in the money".

A sound practice would call for disclosing the number of options held at an exercise price below the share price at the end of the year to provide a fuller estimation of the CEO's potential indemnification in the event of a change in control. Other arrangements should also be adopted to reduce this obvious incentive to sell the corporation. We shall return to this issue in our recommendations.

Clawbacks

Table 4 reports that 86.4% of the companies in the TSX 60 have adopted a clawback provision for the chief executive officer, but only 29% specified the period covered by the provision.

Table 4

Statistics on clawback provisions for the chief executive officer of companies in the TSX 60 (2015)

Percentage of companies with a clawback provision	86.4%
Percentage of companies with a clawback provision disclosing the period covered by the provision	29.4%
Average period covered by the provision	2.0 years

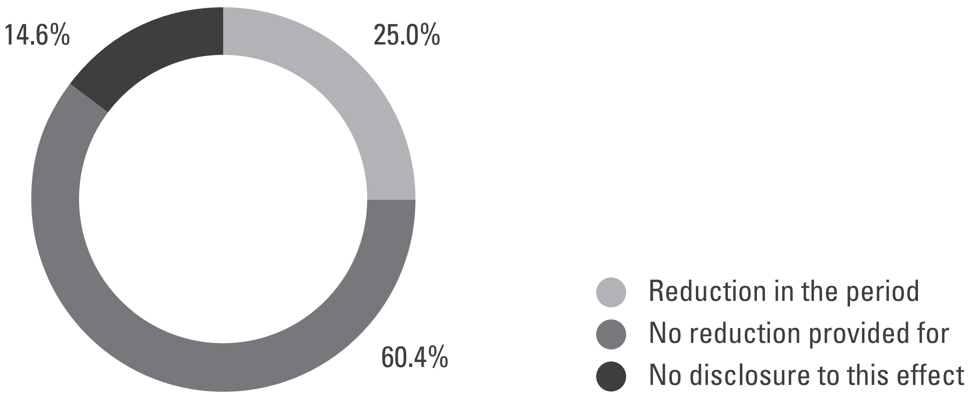
Source: Proxy management circulars filed on SEDAR-IGOPP compilation.

Other interesting facts

Thus, only 25% of the companies in the TSX 60 with a stock option plan provide for a shortened period for acquiring these options upon the chief executive officer's retirement (Figure 19).

Figure 19

Percentage of companies in the TSX 60 having a stock option plan according to whether or not they provide for a reduction in the period of acquisition of options upon the chief executive officer's retirement



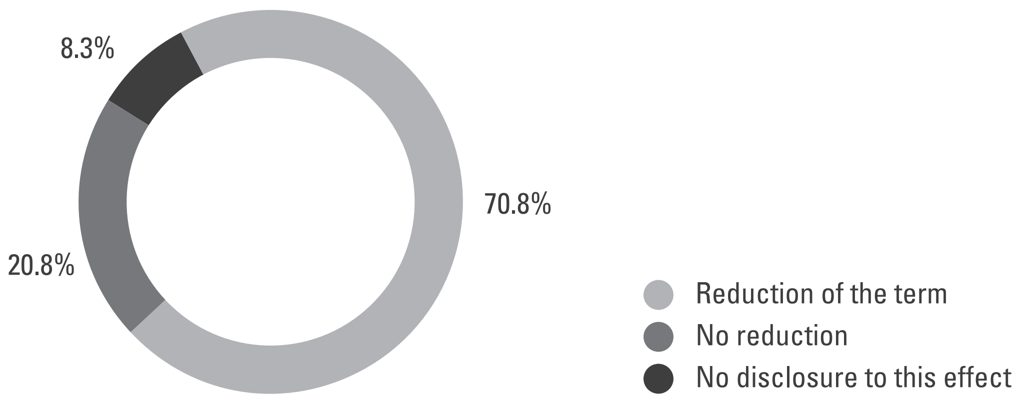
Source: IGOPP compilation.

However, 71% provide for a shortened life for the options upon the chief executive officer's retirement[11] (Figure 20).

11 The options held by the CEO (and other executives) at time of retirement have a shorter life than normal, so they must be exercized sooner.

Figure 20

Percentage of companies in the TSX 60 according to whether they provide for a reduction, or not, in the term of the options upon the chief executive officer's retirement



Source: IGOPP compilation.

Proposals on executive compensation

Boards of directors are, and must remain, responsible for the setting of executive compensation policies and programs that are fair, balanced and conducive to achieving the long-term goals of the corporation.

However, it is claimed that, in too many instances, boards of directors did not acquit themselves very well of this responsibility and have thus contributed to a gradual loss of their legitimacy, particularly since the dramatic events of 2008.

Anytime a governance system loses its legitimacy, competing actors seek to replace it or to curtail its power. Thus, institutional funds, the "activist" funds of all stripes as well as governments have sought ways and means to strip away some of the board's legal and historical authority and responsibility, particularly in the domain of executive compensation.

The manifestations of this trend are multiple:

- Shareholder vote on compensation, the first of a non-binding nature but soon maybe, of binding character.
- Beginning in 2018 in the USA and soon in the United Kingdom, the obligation to divulge the ratio of the CEO's compensation to the median salary in the company :

  As with say-on-pay, which was made mandatory by the Dodd-Frank Act but remained voluntary in Canada, the American legal obligation to divulge the CEO pay ratio (also called for in Dodd-Frank) *should not be imitated* in Canada.

  Indeed, this information requires careful contextual interpretation, does not account for different industrial contexts (for instance the retail industry versus merchant banking) and will likely generate sensational coverage.

  If the divulgation of this ratio were likely to embarrass and lead to notoriety, then companies will resort to all means to reduce their ratio and not necessarily by cutting down on CEO compensation. Measures taken could take the form of subcontracting to an outside supplier all clerical jobs in the company[12] or, if as in the UK the ratio were to be computed only for employees in the country, moving some jobs abroad could be considered; these decisions may not be in the best long-term interest of the company and its various stakeholders.

Attempting to foresee all possible complications, all possible situations, the SEC has produced a long and complex document to establish how companies are to compute this ratio. In spite of the SEC's claim that the divulgation of this ratio *"should be designed to allow shareholders to better assess a particular registrant's compensation practices and pay ratio disclosure rather than to facilitate a comparison of this information from one registrant to another"*, it is obvious that this divulgation will result in comparisons across companies and overall ranking, with a good dose of opprobrium splashed on companies at the head of the list.

Obviously, as American companies are forced to comply (however Canadian companies listed on a U.S. exchange are not subjected to this divulgation), boards of Canadian companies will be pressured to make public this information and numerous shareholder proposals to request divulgation of this information will be submitted to a vote.

Nevertheless, as a key principle of this policy paper is that boards of directors must reassert their incontrovertible responsibility for matters of compensation, we put forth a proposal (Proposal 9) which is respectful of this principle but does call upon boards of directors to be fully accountable for the sensitive issue of income disparity within the company and within society.

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12 Indeed, this move is so probable that the SEC had to pre-empt its effect by including some provision to the effect that personnel so moved had to be included for the computation of median salary!

These singular developments and the lingering difficulty of cutting the Gordian knot of executive compensation have resulted in most boards of directors sailing between Scylla and Charybdis on compensation issues.

On the one hand, they are subject to pressures from investors and proxy advisors seeking to ensure that executive compensation is "reasonable" and, especially, that it is largely "at risk" and tied to shareholder return and quantitative measures of performance. Civil society and governments are also concerned with the deleterious effects of high compensation, but for different reasons.

On the other hand, boards of directors must meet the expectations of senior management and deal with the risk, whether real or not, of losing key persons if some of these executives felt that the board is too parsimonious and that other corporations would be more appreciative of their talent.

Most boards of directors have opted for a prudent approach that consists of recommending the compensation system which has now become the standard and the norm, designed in large part by a small number of compensation consultants and adopted widely.

This "prudent approach" makes sense in the circumstances where boards of directors are targeted individually, have to respond on a case-by-case basis, and have no collective forum in which they can take positions, and when appropriate, to collectively resist the pressures from investors and other stakeholders. In short, boards of directors have no organization, no association and no "coalition" to bring them together, as the Canadian Coalition for Good Governance does for large institutional investors.

PROPOSAL 1

Would it not be useful for the chairs of the board and of the HR/compensation committees at the TSX 60 companies to participate in a forum to discuss these issues.

Progress on implementing such proposals would not happen unless the chairs of the board of TSX 60 companies participate in a forum to discuss these issues. In this forum, proposals such as those offered in this policy paper could be put forth and challenged; proposals which receive broad support could be adopted to provide a new framework for the compensation process at these large Canadian corporations. Such collective positions would serve as a counterweight to the pressures borne by the corporations in isolation.

Without an organized, continuous forum of Chair persons, the institutional funds, proxy advisory agencies and other stakeholders will continue to interfere haphazardly in the compensation decisions of the boards of directors; the Canadian government, attentive to the moods of citizens on these issues, aware of governmental actions in the USA and in the UK and impatient with the slow pace of change, could be tempted to enact legislation governing the executive compensation of public companies.

PROPOSAL 2

Institutional funds must become active participants in the solution to the dilemmas, paradoxes and labyrinths that compensation issues have generated. Canadian institutional investors must clarify their expectations and their understanding of what forms of compensation will, in their view, support a long-term management perspective, which is a stated goal of their investment policies. Their response to this challenge may lead them away from the standard recommendations of proxy advisors.

PROPOSAL 3

Boards of directors must remain entirely accountable and responsible for establishing the system of executive compensation **designed for their specific company and in accordance with the particular investment cycle for their industry**. Boards of directors should link incentives **to quantitative and qualitative performance factors** that they consider of prime importance for the **long-term** well-being of the corporation. Boards are responsible for determining the indicators, metrics and performance objectives that are appropriate **for their specific company**, ensuring that those objectives are sufficiently demanding, and determining the degree to which they have been met.

PROPOSAL 4

The board should link variable compensation **to long-term**[13] **qualitative, quantitative and predominantly internal performance measures** (EVA, economic profit, return on economic assets[14], environmental measures, workplace safety, and performance for other stakeholders, including society at large).

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13 Flammer and Bansal (2014), having studied the impact on compensation linked to long-term measures, conclude as follows: "*We find that return on assets (ROA), net profit margins (NPM), and sales growth all increase in the long run. Interestingly, all three measures decrease in the short run. This pattern suggests that managers invest in long-term projects that are costly in the short run, but pay off in the long run*"
For empirical support for the measures proposed above, such as EVA and the return on economic assets, see the IRRCi Research Report, 2014)

14 It is important to note that this measure is insensitive to share buybacks or off-balance sheet financing provided that the economic assets are defined as the working capital (excluding cash and short-term investments) plus the long-term economic assets.

PROPOSAL 5

It is urgent to abandon the concept of peer group of companies as a basis for setting the CEO compensation. This self-imposed requirement is the weakest link in the current system of compensation setting and has led to a marked increase in compensation. Corporations should, where applicable and relevant, use control groups for purposes of comparing certain performance parameters but **not as a kind of "quasi-market" for talent.**

PROPOSAL 6

In the event the corporation has adopted a say-on-pay vote or is subject to such a vote, the board should be required to explain which adjustments will be made **when this consultation results in 20% or more of negative votes**. This percentage takes into account the inertia in the system described above.

PROPOSAL 7

Arrangements **in the event of a change of control** should include the following conditions: only options and share units that are exercisable at the time of the bid can be cashed in **but at the share price which prevailed 90 days prior to the public announcement of the takeover bid**. Other financial conditions for the executives who are let go, through no fault of their own, as a result of the change of control **should not amount to a sum greater than twice their average salaries and incentive premiums** over the past three years.

PROPOSAL 8

No granting of options (apart from exceptional circumstances such as a turnaround)[15] and **the awarding of share units should not always be an annual ritual; grants should occur when an executive is hired or promoted, and their level should be reviewed every three years only;** these share units should be exercisable after a number of years, reflecting the particular **investment and management cycle of the company and its industry;** this term could be 1 year, 3 years, 5 years or even 10 years depending on the situation!

15 It is often argued that start-ups in their development phase often use options as a form of compensation, thereby economizing their precious cash. The argument merits consideration but is not entirely convincing; the entrepreneur/founder can just as easily give some of his own shares (or share units, phantom shares, etc.) to the indispensable personnel.

PROPOSAL 9

The board must state in the proxy management circular that it has been formally informed of the ratio between the CEO's compensation and the median compensation within the firm as well as within the society at large and that **it considers this ratio to be appropriate in the context of the firm, the industry and the values of the surrounding society.**

PROPOSAL 10

The board is responsible for ensuring that executives **will not benefit from an increase in the value of their options or share units directly attributable to the use of financial engineering measures,** such as share buybacks, the sale of assets or other similar measures; the quantitative performance metrics on which incentive compensation is based should not give a weight of more than 25% to total shareholder return (TSR) or growth in earnings per share (EPS).

PROPOSAL 11

It is strongly recommended that the Canadian Securities Administrators endeavor to reduce the length of the explanatory texts on compensation. **Thus, it is suggested that disclosure of information on compensation focuses on the following requirements:**

- As required by Regulation 51-102 (Table 4.1 and 4.2) of the Canadian Securities Administrators, corporations should indicate, every year, for the 5 top executives, the market value of the options or share units awarded over the past three years **by showing how this value was arrived at and the assumptions underpinning the calculation.**
- They should show the value of stock options if, at the time of their vesting, the stock price should be **one or two standard deviations[16] above the exercise price.**
- Show the value of the share units if, at the time such shares could be cashed in, the share price **had risen or fallen by one and two standard deviations above or below the price at the time the units were awarded.**

16 Standard deviation is a statistical measure of the price volatility of the corporation's share over the past three years; this measure is already used to determine the value of stock options using the Black-Scholes-Merton or binomial lattice method.

- Indicate, every year, the total amount **in cash** actually received by these five executives, from all sources, during the last financial year; this information may be compiled from information already provided but it is a long and complex process; that information should be provided in a simple summary table.
- The concept of **"at-risk" compensation** should be replaced with the more accurate concept of **"variable compensation"**.
- The corporation should explain the **clawback provision** as well as the situations that make a clawback legitimate for a period of two years, even after the executive's departure to another corporation or to his or her retirement.
- Upon an executive's retirement or departure for any reason, **no option or share should continue to vest after his or her departure**; as for the shares and options that were vested at the time of his or her departure, the outgoing manager **must cash them in within one year of the date of departure**.

PROPOSAL 12

Some tax rules should be revised so as to remove some dysfunctional impact, such as the treatment of gains on stock options as capital gains, or the rule which provides that share units paid in cash cannot have a term of more than three years.

Conclusions

This policy paper makes an urgent case that the current, standardized processes for setting executive compensation in publicly listed corporations are deeply flawed.

This ritualized process, indeed reassuring by virtue of the large number of firms abiding by it, fails to take into account the very particular character or business model of each corporation, the specific nature of its industry, the time horizon of its strategy implementation, the drivers of its value-creation. It locks corporations in a mold of compensation devised by consultants, generating large compensations, yet satisfying critical observers; but it does not achieve what compensation programs should aim for.

This standardized process of setting compensation rests largely on false assumptions and empirically dubious hypotheses: high inter-firm mobility of management talent at the top, the transferability of management skills from one company to another, from one industry to another, «at risk» compensation as a motivator of high performances; an underestimation of the role of luck in producing large incentives; a well-selected peer group of companies representing a sort of quasi-market from which to set the value of the corporation's CEO and other executives, etc.

Boards of directors of large publicly listed corporations must devise some mechanism, some forum to address in a concerted manner the issue of how to change this system. Their legitimacy and credibility hinge on their finding some collective way forward.

This policy paper puts forth a number of proposals which would go a long way towards a new approach to the setting executive compensation. It may be that this objective will be reached in an incremental manner but the goal is clear: a compensation system designed by the company's board of directors for the very specific context of their particular company, sensitive to the expectations of all stakeholders and inducing a long-term perspective in the management of the company.

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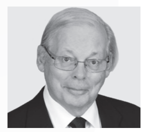

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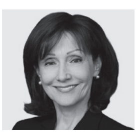

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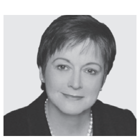

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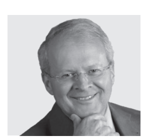

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