**Corporate Governance and Executive Compensation**

**Learning Outcomes**

After completing this module, you will be able to:

1. Explain why share price maximization is the primary goal of a firm.
2. Discuss how agency costs prevent firms from maximizing their share price, and the actions companies and governments can take to prevent this from occurring.
3. Describe the sources of regulations and guidelines relating to corporate governance and director and executive compensation available from government agencies and non-profit organizations.
4. Identify the legal responsibilities of a corporate director.
5. Assess the corporate governance practices of a corporation.
6. Assess the director and executive compensation practices of a corporation.

**Introduction**

Since the governance problems at Enron and other companies in the early 2000s, there has been a crisis of confidence in the ethics of corporations. Instead of working in the long-term best interests of shareholders and maximizing the company’s share price, senior managers have been more concerned about their stock options plans and all the other executive perks that most investors only dream of.

To address this crisis, corporations aided by an army of consultants have worked feverishly to improve their governance and to design executive compensation systems that are not excessive and encourage management to work in the shareholders’ best interests. Governments too have stepped in to pass legislation that sets higher governance standards and penalizes executives who abuse the investor’s trust. Non-profits like the Canadian Coalition for Good Governance and the Chartered Financial Analyst Institute have published good governance and executive compensation guidelines and strongly advocated them to regulators, industry, and their members.

Managers must understand good corporate governance and executive compensation principles and be able to effectively implement them. Current shareholders, potential investors, lenders, and credit rating agencies are all placing greater emphasis on corporate governance when assessing a firm’s performance.

**1.1 | Goal of the Firm and Agency Costs**

The primary goal of a firm is to maximize the value of its common shares which equals the present value of the future cash flows the company expects to generate. Economics textbooks often say that profit maximization is the main goal, but profits should not be used for three reasons:

* Profit is an accounting figure that can be more easily manipulated than operating cash flows by choosing different accounting policies, practices, and estimates or engaging in fraudulent financial reporting.
* Profit only measures the current period’s performance while share price equals the present value of all future cash flows. Focusing on profit encourages managers to make more short-term decisions like cutting research and development expenditures to raise net income knowing that the company will not benefit from these expenditures for several years.
* Profit does not incorporate varying levels of risk while share price does through adjustments to the discount rate. A firm can raise its profits during good economic times by taking on riskier projects, but investors will not know their effect until the company experiences difficulties in the next downturn.

The goal of share price maximization addresses these problems and forces managers to be more long-term decision-makers.

A company’s share price is determined by two factors which are changes in the future cash flows and discount rate. A falling share price means the future cash flows are deteriorating or their risk level is rising. The value of a stock market index like the TSX/ S&P 300 or S&P 500 is equal to the weighted average price of all shares in that index. These indexes are the primary performance measures for the economy which is why the media focuses so closely on them in their reporting. If markets rise, the economy is prospering because future cash flows are rising or risk levels are falling, but if markets fall an economic slowdown is likely to follow.

A company incurs agency costs when its management and ownership are separate, and the managers hired to run the business do not work in the shareholders’ best interest and maximize the share price. These costs are incurred because:

* Managers are more worried about their job security than pursuing risker, more profitable projects especially if they are close to retirement
* Managers are focused on their pay and perks instead of their performance
* Executive pay is closely linked to a company’s size, growth, and media profile not its profitability
* Boards of directors are not independent of the CEO and have conflicts of interest
* Boards of directors lack the time and expertise to perform their duties
* Auditors are not independent of management
* Shareholders of widely-held companies do not act to reduce agency costs
* Takeover defenses prevent poor managers from being removed

Agency costs are high, and they affect other stakeholders besides shareholders like employees or creditors. Several high-profile corporate bankruptcies in the U.S. (i.e. Enron in 2001) and Canada (i.e. Nortel in 2013) have motivated governments, corporations, and investors to reduce agency costs. Their actions include:

* Improved corporate governance policies and practices
* Greater emphasis on “pay for performance” which links executive pay to achieving specific corporate goals and increasing the firm’s share price
* Enhanced financial reporting and better auditor training and independence
* Rising activism by large institutional investors to address agency problems
* More corporate take-overs by competitors and private equity firms to remove poor-performing managers
* Severance and change-of-control entitlements, also called “golden parachutes,” encourage poor-performing executives to leave and not resist take-overs

Corporate governance and executive compensation are examined in this module. Financial reporting and the auditing process are reviewed in the Module: Quality of Financial Reporting. Module: Mergers and Acquisitions and Corporate Restructuring discusses the role of institutional investors and private equity firms.

* 1. **| Corporate Governance Overview**

In Canada, most large companies incorporate federally under the Canada Business Corporations Act (CBCA) as they can operate in every province. CBCA stipulates the powers and responsibilities of a firm’s board of directors and the rights of its shareholders although many of these regulations can be modified in the company’s articles of incorporation and bylaws if supported by shareholders. Businesses listed on the Toronto Stock Exchange (TSX) or the Toronto Stock Exchange Venture (TSXV), Canada’s large and small-cap exchanges, must follow other regulations in the Ontario Securities Act and the TSX Company Manual.

Until recently, securities regulation in Canada was a provincial jurisdiction where each province had its separate legislation. Most countries, including the U.S. through its Securities Exchange Commission (SEC), have recognized that national securities regulation is more effective given that public companies typically raise funds in several jurisdictions. Despite this, provincial governments were unwilling to give up their authority, although they did agree to form the Canadian Securities Administrators (CSA). This is a national body composed of federal, provincial, and territorial governments that prepares national or multilateral instruments relating to securities regulation. National instruments are adopted and implemented by each province’s securities commission while multilateral instruments are only effective in some provinces. In a November 2018 decision, the Supreme Court of Canada finally gave the federal government the power to establish a national securities regulator but there has been limited progress to-date. The Supreme Court also indicated the federal and provincial governments should continue to work together cooperatively.

**Role of the Board of Directors**

A public corporation’s shareholders elect a board of directors to oversee the company’s operations on their behalf and work in their long-term best interests. The board is the ultimate decision-making authority although most major decisions such as mergers and acquisitions are still voted on by the shareholders. The board’s main responsibilities are to appoint the CEO and senior executives, monitor and evaluate their performance, determine their compensation, and potentially terminate them. It also sets the company’s strategic direction; monitors opportunities and risks; approves the budget including any major decisions such as capital expenditures, raising new capital, organizational restructurings, or new product launches; and authorizes the annual report outlining the company’s performance before it is distributed to shareholders. The CEO and other executives manage the business on a day-to-day, but the board has the right to intervene and overturn them if necessary. Directors must be familiar with the company’s operations to know if it is being managed effectively. The degree of board involvement varies, but the trend is for directors to be more actively involved.

The board elects a chairperson to oversee its activities and enhance its effectiveness. The chair’s responsibilities are to set the agenda for board meetings, ensure directors receive all needed information, preside over board of director and shareholders meetings, and be a liaison between the board and management. All directors are elected by shareholders at the annual general meeting and may be removed at their discretion. Directors are primarily experts from business, politics, academia, and the legal profession but they also include union or employee representatives and those with specific skills in areas such as sustainable development or ethics. Having a diverse board with more varied backgrounds and personal characteristics including gender, age, ethnicity, and geographical location is important, but it is also critical to have directors with extensive industry experience. Boards of larger established companies typically meet eight times a year for a day-long meeting either face-to-face or by conference call. In-person meetings are more common because of the more engaging debate and direct personal contact. The boards of smaller companies meet more often due to their dynamic nature which requires more careful oversight. Special meetings are called to discuss pressing issues between regular board meetings. Strategic planning retreats lasting a couple of days are also held to map out the firm’s direction.

Directors are given notice of the meeting and receive an agenda along with meeting materials well in advance, so they have adequate time to examine the package and contemplate any questions or concerns. The meetings are conducted formally with agendas, quorum requirements, official motions, and minutes that are later circulated to directors for approval. Regular attendance at all meetings is critical to making informed decisions and directors are evaluated on their attendance. No proxies are allowed, and directors are potentially liable for any decisions made in their absence, so it is important they attend. Most issues are decided by the majority, but the firm’s articles of incorporation or bylaws may stipulate that certain motions be supported by more than 50% of directors or even be unanimous.

Much of the board’s work is done through several smaller permanent standing committees composed of directors that make recommendations to the full board for approval. Possible standing committees are the executive, strategic planning, nominating, compensation, audit, finance, risk management, governance, legal, pensions, health and safety, community relations, and ethics and sustainability committees. The executive, audit, finance, nominating, and compensation committees are the most common and the audit committee is mandatory. The executive committee acts between board meetings when it is impractical to call another meeting and may help the board chair in consulting with management. This committee is either elected by the board members or consists of the board chair and the chairs of each of the standing committees. The audit committee oversees the annual audit of the financial statements, while the finance committee supervises the preparation of the yearly budget and raising needed capital. The compensation committee designs the director and executive pay system, evaluates their performance, and determines their compensation. The nominating committee recruits new directors and recommends them to the board and the shareholders for approval.

In addition to standing committees, boards form special committees or task forces for limited periods to address critical matters or achieve specific goals quickly before being disbanded. Advisory councils consisting of outside experts counsel the board on emerging issues or the general strategic direction of the business, but these experts are not directors and have no authority.

**Shareholder Rights**

A corporation is owned by its common shareholders, but their rights are not absolute. The board of directors must hold an annual general meeting of its shareholders. Before the meeting, the board circulates a management information circular which describes the issues to be either voted on or discussed including the election of directors; appointment of external auditors; annual financial statements; management discussion and analysis; director and executive compensation; and other management or shareholder proposals. The board determines the agenda, but regulators require that the circular be detailed enough so shareholders can make informed decisions. Shareholders may require that the board include shareholder proposals in the circular as well even if the board does not support them. Proposals can also be introduced at the meeting, but the chair is normally able to rule them out of order claiming insufficient time was given to examine them before the meeting. If the chair does allow these proposals to be discussed and voted on, the results are usually only advisory which means they are not binding on management. The board may call a special meeting of shareholders at any time to seek shareholder approval of a proposal. Shareholders who own 5% or more of the shares can also call special meetings.

At the meeting, shareholders elect the directors nominated by the board for a one-year term. Shareholders can nominate their own directors if advanced notice is given and relevant information about the candidates is included in the circular. Each director must be approved by a majority of the shareholders and any unsuccessful director must withdraw. Shareholders can also call a special meeting to remove the directors. During the rest of the meeting, management reviews the information in the circular, answers shareholders’ questions, and votes on any proposals. Under the CBCA, certain important actions such as business acquisitions, sales of assets, new share-based compensation plans involving the issuance of new shares, and changes to the articles of incorporation and bylaws must be approved by shareholders. In some cases, if a shareholder disagrees with a transaction but the majority of shareholders vote in favour, they have the right to have their shares bought out at fair market value. Shareholders can also bring legal action against the board to force them to comply with the company’s articles of incorporation, by-laws, or provincial securities legislation or to stop treating any shareholder in an unfairly prejudicial manner.

Shareholders have considerable rights, but most do not attend the annual meeting because of the time and expense. The board asks for their votes in a proxy solicitation which allows the board to exercise their votes at the annual general meeting in support of their agenda. Other shareholder groups who oppose management may try to compete for these votes by issuing their own shareholder information circulars and proxy solicitations, but management is usually successful because of their skill soliciting proxies and greater financial resources. The exception is large institutional investors who often meet directly with management to discuss their concerns. If they are not addressed, the institutional investors may speak at the general meeting or make a public statement. Private equity firms and activist investors can also press the company for change and even initiate a proxy battle or take-over bid to replace current management.

**History of Corporate Governance in Canada**

The movement to improve corporate governance in Canada began in 1994 with a report sponsored by the TSX entitled “Where Were the Directors? – Guidelines for Improved Corporate Governance in Canada.” The report also called the Dey Report after its committee chair, made 14 recommendations which the TSX adopted as best practice guidelines. Companies listed on the exchange were required to disclose their governance policies and practices in their annual report and provide an explanation of where they varied from these guidelines. The Dey Report was followed by another TSX sponsored report entitled “Five Years to the Dey” in 1999 that found although companies were making progress in approving their governance practices that there were still several important shortfalls. This was followed by another TSX sponsored report in 2001, the “Saucier Report on Corporate Governance,” that recommended changes to the guidelines adopted by the TSX. This report was quickly followed by the Enron bankruptcy in 2001 which exemplified the poor state of corporate governance and financial reporting in the U.S. and other countries. In July 2002, the U.S. Congress passed the Sarbanes-Oxley Act (SOX) which enacted several measures to restore investors’ faith in the financial markets. Given the need to maintain Canadian investor confidence and access to the U.S. capital markets, the Canadian Securities Administrators (CSA) passed several similar national instruments relating to corporate governance and financial reporting. The national instruments relating to corporate governance included:

NI 58-101 Disclosure of Corporate Governance Practises

NI 58-201 Corporate Governance Guidelines

**1.3 | Corporate Governance Guidelines**

NI 58-201 Corporate Governance Guidelines applies to all publicly traded companies in Canada. Companies do not have to adhere to them, but they are required under NI 58-101 Disclosure of Corporate Governance Practices to disclose their governance policies and practices and explain any variations with these guidelines to shareholders. These guidelines are influenced by several unique Canadian factors including the smaller size of the Canadian financial market and the proportionately higher number of small-cap companies. Canada also has a greater concentration of business ownership with a single shareholder, usually the founding family, controlling a higher percentage of companies compared to the U.S. These factors favour a simpler, more flexible corporate governance system than in the U.S., but Canadian guidelines must be stronger so its large domestic companies can access U.S. capital markets. The Multi-Jurisdictional Disclosure System (MJDS) allows firms to issue shares concurrently in both Canada and the U.S. using the same documentation. Canadian firms cross-list their shares in the two countries to access lower-cost capital, reduce issuance costs, and make their shares more marketable for investors.

A summary of NI 51-201 Corporate Governance Guidelines includes:

**Board composition.** A majority of a board’s directors should be independent to provide more objectivity when dealing with management. An independent director should serve as board chair or be appointed as the lead director if that is not possible. The independent chair or lead director should act as the effective leader of the board and ensure the board carries out its duties. The option to have a lead director relates to the practice of having the company’s CEO serve as the board chair. Although common in the past, most companies have discontinued this action with improvements to corporate governance.

An independent director has no direct or indirect material relationship with the company. A material relationship is one that can “be reasonable expected to interfere with the exercise of a member’s independent judgment.” This includes current and former employees or auditors, their family members, individuals who accept consulting or advisory fees from the company, or persons employed by another firm that provides legal, financial, or consulting services. Independent and non-independent directors are also called outside and inside directors. When company executives serve on the board, they are called executive directors.

**Meetings of independent directors.** Independent directors should meet regularly without the non-independent directors or the company’s management.

**Board mandate.** The written mandate should acknowledge the board’s overall responsibility for the stewardship of the company including:

* Ensuring the integrity of the CEO and other executives and that they create a culture of integrity in the organization
* Establishing a strategic planning process and approving a new plan annually
* Identifying the opportunities and risks of the business and implementing an appropriate risk management program
* Succession planning including appointing, training, and monitoring senior management
* Adopting a communication policy to provide equal access to corporate performance information to all stakeholders
* Constructing internal control and management information systems
* Developing corporate governance policies and practices including measures to allow stakeholders to provide feedback directly to independent directors

**Position descriptions.** Written job descriptions should be established for the board chair, the chairs of all board committees, and the CEO. This includes establishing with the CEO the goals and objectives that the firm is expected to achieve.

**Orientation and continuing education.**  All directors should receive a thorough orientation where they examine the role of the board of directors and its different committees, the nature of the business’s operations, the time commitment required, and the skills they are expected to bring to the board. The board should also provide each director with ongoing professional development opportunities to enhance their skills and knowledge of the business’s operations.

**Code of business conduct and ethics.** The board should adopt a written code of business conduct and ethics to promote integrity and discourage wrongdoing. It should apply to all directors, executives, and employees and specifically address:

* Conflicts of interest including defining any transactions and agreements where a director or executive officer is deemed to have a material interest
* Protection and proper use of corporate assets and business opportunities
* Confidentiality of corporate information
* Fair dealing with the issuer’s security holders, customers, suppliers, competitors, and employees
* Compliance with laws, rules, and regulations
* Reporting of any illegal or unethical behaviour

The board must monitor compliance with the code, approve all exceptions, and report any departures to shareholders.

**Nomination of directors.** A nominating committee should be appointed consisting of independent directors only. It must have a written charter that describes its purpose, responsibilities, member qualifications, member appointment and removal, structure and operations, and system for reporting to the board. The committee should have the right to engage and compensate outside advisors as required.

Before nominating new directors, the committee should consider the best size for the board and establish the competencies required by each director as well as the entire board. The qualifications for each new director position will be set to fill any identified gaps in the board’s skill set. Nominees should be selected based on these competencies as well as their personality and other characteristics to build a strong group dynamic. It also needs to consider whether nominees can devote enough time and resources to their position as a director. The nominating committee makes recommendations to the board. Once approved by the board, the nominees are voted on by shareholders at the annual general meeting.

**Compensation committee.** A compensation committee consisting of independent directors only should be appointed. It must have a written charter that describes its purpose, responsibilities, member qualifications, member appointment and removal, structure and operations, and system for reporting to the board. The committee should have the right to engage and compensate outside advisors as required.

The committee sets the goals relevant to the CEO’s compensation, evaluates their performance against these goals, determines compensation based on performance, and makes a recommendation to the board. It makes similar recommendations for the other executives and directors. Finally, it advises the board on what incentive and equity-based compensation plans to adopt and reviews all compensation disclosures made to shareholders.

**Board assessment.** The board, its committees, and directors should be regularly evaluated on their effectiveness. Boards and committees are evaluated against their mandate and charters, while directors are evaluated against their job descriptions and the competencies they were expected to bring to the board.

**Audit committee.** Companies should appoint an audit committee consisting of at least three directors who are all independent and financially literate. The committee should have a charter outlining its responsibilities. Its main duties are to:

* Recommend an external auditor to the board
* Determine auditor compensation
* Directly oversee the auditors work as they prepare the annual audit report and any other audit work
* Resolve any disagreements between the company and its external auditors
* Approve the interim and annual report including the financial statements and management discussion and analysis (MD&A)
* Approve any other public financial disclosures derived from the annual report
* Approve all non-audit work to be performed by the audit firm to reduce any potential conflicts of interest
* Approve company hiring policies relating to the current and former partners and employees of the audit firm to reduce potential conflicts of interest
* Establish procedures to deal with external complaints received by the company about accounting, internal control, or auditing matters
* Establish procedures to allow employees to make confidential, anonymous submission concerning questionable accounting or audit matters

The committee should have the authority to hire outside advisers to assist in the audit review process. The audit committee is required by statute.

**Other Best Practices**

In addition to the guidelines and regulations of the CBCA, CSA, and TSX, several non-profit organizations representing the interests of investors have developed their own recommendations to promote good corporate governance. The two most important publications are:

Building High Performance Boards (2013), Canadian Coalition for Good Governance

The Corporate Governance of Listed Companies: A Manual for Investors (2009), Chartered Financial Analysts Institute

The following is a summary of the recommendations made by these groups.

**Board and committees.** A board’s chair and the majority of its directors should be independent as they are more likely to critically assess management’s actions and make objective decisions that are free of any conflicts of interest. Do not allow the CEO to serve as chair as they will be responsible to call board meetings, set the agenda, and prepare all the discussion materials sent to directors. This will likely be done in consultation with the other executives creating a serious conflict of interest. Even if the CEO is not the board chair but serves as an executive director, they will have a close business and personal relationship with the chair. Executives including the CEO, COO, and CFO should not serve on the board and only be allowed to speak at board meetings when invited. A former CEO of the company should not be allowed to serve as chair either as they will not act independently due to their previous relationship with management and may hamper the board’s efforts to strategically re-direct the company or undo any of that CEO’s past mistakes. Non-independent board members such as suppliers, customers, and business advisors should be appointed sparingly and must recuse themselves from any decisions where they have a business interest. Friends, relatives, business associates of executives and directors, and recipients of company donations should also be excluded.

Director independence is important, but they also need to be highly qualified professionals who complement the skill sets of the other board members creating a very cohesive, multi-talented unit. Inexperienced directors generally defer to management judgment without challenging their decisions. A director’s career history should demonstrate a commitment to ethical behavior and strong corporate governance; a willingness to regularly attend all meetings, be prepared, and make valuable contributions; an ability to avoid conflicts with their other business interests; and a commitment to on-going professional development and peer and self-evaluation. Companies should limit the number of outside boards that directors and executives serve on so they can devote the necessary time to their duties at the company and avoid potential conflicts of interest. Interlocking directorships where directors serve on more than one board are sometimes encouraged by companies for business reasons. Government regulators prevent directors or executives of competing companies from sitting on each other’s board fearing they will limit competition and raise prices, but they can sit on the boards of customers or suppliers. Term and age limits should be imposed to get the latest ideas and different perspectives and prevent directors from becoming too comfortable with management. Recruiters are having more difficulty finding new directors since SOX because of the greater responsibility, time commitment, and potential for liability.

Boards must supply robust oversight in the areas of strategic planning, risk management, and director and executive recruiting, evaluation, and compensation. They need to ensure there is a strong link between executive pay and performance. Boards should establish a communication policy that promotes frequent and transparent communication with all shareholders especially larger institutional investors. It should give them access to all relevant, material information and an opportunity to express their views about the company’s operations.

A company should carefully consider its optimum board size. If the board is too large, it will not involve all its members equally leading to director apathy and “free-riding,” and defer more decision making to management. Too small of a board will lack the skills needed to direct and counsel management and the resources to do the committee work. The optimum board size and the portion of directors that are independent vary. Start-ups may want smaller boards so they can act more nimbly and may choose a higher proportion of non-independent directors that have the specialized knowledge required or can provide links to the company’s investors, financiers, customers, and suppliers. Large companies need more directors as their operations are more diverse and independent directors are acceptable due to less of a need for specialization.

**Ethical conduct.**  Companies should strongly enforce their code of business conduct and ethics. Avoid conflicts of interest, director interlocks with other companies, and any personal use of company assets. There should be zero tolerance for violations and a strong reporting system with protections for “whistleblowers.” Directors and executives should be watched carefully for cases of insider trading or tipping. Also, monitor company stock repurchases and share price stabilization plans to ensure they are not being used to enrich directors or executives by increasing payouts on their stock option plans.

**Shareholder rights.** Well governed companies have strong shareholder rights which allow investors to fairly and fully participate in the company’s affairs and criticize management without undue pressure or interference. To achieve this, companies can:

**Allow electronic and absentee voting.** Most shareholders do not attend the annual general meeting because of the time and expense. Boards should allow them to participate virtually and vote electronically instead of only accepting votes that are physically cast at the meeting. Shareholders should be able to vote in advance instead of signing over their proxy to management or an opposing shareholder group. Boards need to provide shareholders with enough time before the annual general meeting to thoroughly examine the management information circular.

**Require confidential voting.** Shareholders are more likely to vote if they can do so confidentially free of undue pressure from the board or management. This vote should be conducted by an independent third party who keeps proper records and quickly releases the results to reduce the potential for fraud.

**Implement cumulative voting.** Cumulative voting increases the probability of minority shareholders being represented on the board by allowing them to cast all their votes for one or a limited number of board nominees. For example, if there were 10 board nominees and an investor owned 100 shares, they would receive 1,000 votes. With cumulative voting, they can use all these votes to support one or more nominees increasing their chances of being elected. This is different from majority voting where shareholders vote for each nominee separately and have one vote per share. Some favour cumulative voting because it gives a greater voice to minority investors to question management’s decisions while others feel it is unfair to the majority shareholder. Cumulative voting is not common as boards fear the added scrutiny, but a well-governed company should welcome criticism. They should also consider allocating some board seats to special interest groups such as labour unions or environmentalists. The strength of any democratic institution is measured by how open it is to the opinions of all its stakeholders.

**Do not use multiple share classes with different voting rights.** Shares that limit voting rights fall into one of three classes. These include non-voting shares; restricted voting shares that limit the number of shares in a class that can be voted; or subordinate voting shares that receive only one vote per share while multiple voting shares receive more than one vote per share. Non-voting, restricted, or subordinate voting shares trade at a significant discount to voting or multiple voting shares because of their limited voting rights. Many countries do not permit these types of shares as they treat most investors unfairly, limit a firm’s ability to raise equity capital thus forcing it to rely more on debt, and reduce economic efficiency by enabling a company’s founder to retain control even if they do not possess the skills to effectively manage the business.

**Eliminate supermajority voting.** According to supermajority voting, a motion must receive more than half of the votes, usually two-thirds, to pass. A board may indicate publicly that they require two-thirds support to demonstrate strong shareholder support for an important motion, but more often supermajority voting is used to protect management at the expense of shareholders.

**Provide preemptive rights.**  To change the balance of power within a company in their favour, a board may issue new shares to a shareholder group to increase their percentage ownership. Preemptive rights give all existing shareholders the option to buy a portion of these new shares so they can maintain their ownership percentage. In Canada, preemptive rights are not a statutory requirement but are included in the articles of incorporation or bylaws of most public companies.

**Eliminate staggered elections.** Boards may thwart attempts by shareholders to remove a board by implementing multi-year director terms with varying end dates. Only a few of the directors will stand for re-election each year so it will take much longer for shareholders to replace the board. The preferred practice is to have one-year terms to make boards more accountable although staggered elections do allow more board continuity especially if there is high director turnover. Board nominees should also require 50% plus one of the votes to be elected so each director has the support of over half of the shareholders when there are no competing candidates. All directors must be appointed for a one-year term and be elected by a majority of shareholders in the TSX Company Manual so staggered elections are not an issue in Canada.

**Limit take-over defenses**. The continuous threat of being taken over by another firm pressures management to reduce agency costs and maximize a firm’s share price. Take-over defenses are actions undertaken by target firms to impede a take-over. Sometimes they are used by managers of poorly run companies to protect their positions or a company’s founders to maintain control. In these instances, the defenses are not in the best interest of shareholders. In other cases, managers do not use them to protect their jobs or maintain control, but to “play hard to get” to secure the highest take-over bid possible for shareholders. Take-over defenses should only be used to benefit shareholders. Provincial securities law forbids any take-over defence that is not in the best interest of shareholders.

**Support shareholder proposals.** Shareholders should be able to present proposals at the annual general meeting to nominate board members or take other actions. This allows them to address performance issues when the board is unable or unwilling to do so. A company may allow shareholder proposals, but its by-laws could stipulate that they are non-binding or require a supermajority vote to pass. Proposals need to be binding and require only majority support to be effective.

**Voting on corporate changes.** Shareholders should approve all major decisions particularly those relating to the articles of incorporation, by-laws, acquisition/ sale of business units, corporate governance, executive compensation, or voting rights**.** For example, shareholders could reject a new executive stock option plan because it seriously dilutes earnings per share.

**Voice on director and executive compensation.** Shareholders should have a “say on pay” allowing them to vote on the compensation packages of the CEO, other executives, and directors at the annual general meeting. These votes are becoming more common, but they are almost always non-binding.

**Corporate Governance in Practice**

Regulators and non-profit groups have devoted considerable resources to developing rules and guidelines to improve corporate governance in Canada. Given compliance is often voluntary, it is important to know whether companies are adopting these measures or not. Each year since 1996, Spencer Stuart Board Services has published their Spencer Stuart Board Index which summarizes corporate governance practices in Canada’s largest public corporations. The evidence shows firms are making great strides in areas such as board independence, board diversity, director quality, performance evaluation, and linking pay to performance. Other areas like the number of boards directors serve on, mandatory retirement, and term limits may still need attention. In 2019, Spencer Stuart’s research indicated:

**Board independence.** Eighty-one percent of board members were independent and 75% of firms had two or fewer non-independent directors. Non-independent directors are more concentrated in closely-held corporations.

**Board chair independence**. Eighty-six percent of companies separated the position of CEO and chair, and 72% of CEOs were independent. CEO independence increased from 66% in 2015.

**Director experience.** Thirty-three percent of all new directors have no previous experience as directors. This helps promote greater board diversity, but more thorough director orientation, on-going professional development, and mentorship are essential. Directors with accounting and finance experience are the most in-demand making up 47% of all new directors. Sixty-seven percent have experience in the same sector or industry. Directors with past or current CEO experience are declining due to a lack of supply. Directors with past board experience are declining as companies are focusing on candidates with current industry or sector experience to recruit more women.

**Board chair experience.** Fifty-eight percent of chairs had CEO or board chair experience at another company and 54% had experience in that industry.

**Board turnover.** Seventy-four percent of boards appoint one or fewer directors yearly.

**Ages of non-executive directors.** Seventy-five percent of directors and board chairs are 50 to 69 years of age. Directors over 70 years are declining especially those serving as board chair.

**Gender diversity.** Thirty percent of directors were women in 2019 which increased from 23% in 2015. Of the new directorships, 49% are women and they average 58 years old which is only slightly younger than their male counterparts. The bias towards more men directors in small companies is decreasing. Fifty percent of companies have gender diversity targets. An increasing number of women are serving as board chairs, but more are serving as committee chairs.

**Board tenure.** Fifty percent of all directors serve for less than five years and 75% serve for less than 10 years. Board chair tenures are declining but still, 80% served for over five years, and 60% for over 11 years as a director and a chair.

**Board chair transitions.** The hiring of new board chairs is at a high due to the transition to separate the CEO and board chair roles. Most are selected from current board members and have previous board chair and committee experience.

**Board size.** Boards average 11 members with larger companies having two additional members than smaller firms. The number of large boards is declining.

**Board committees.** Large companies have an average of four committees and small companies have an average of three. Firms are reducing the number by combining committees. The three most common committees are audit, governance and nominating, and human resources and compensation.

**Board and committee meeting attendance.** Boards meet an average of eight times a year with larger companies meeting slightly less often than smaller firms. There is an average of five meetings of each committee per year with little difference between committees. Attendance is near perfect averaging 98% at the board and committee levels which has remained constant since 2015.

**Board and director evaluations.** All companies evaluate board, committee, and director performance with several using outside consultants. Fifty-five percent evaluate committee chairs and 71% evaluate the board chair. Sixty-one percent used both peer and self evaluations.

**Election of directors.** Nearly all companies use majority voting with one-year terms to elect directors.

**Overboarding and interlocking directorships.** Only a third of companies set a formal limit on the number of boards a director can serve on (i.e. overboarding) which averages four. Most other firms have informal limits and directors typically must receive the approval of the board chair. Each request is reviewed on a case-by-case basis and only two of their directors are typically permitted to serve together on another company’s board (i.e. interlocking directorships).

**Mandatory retirement and term limits.** Sixty percent of companies have a mandatory retirement age and/or term limit which are usually 72 years and 15 years of continuous board service. The remaining firms do not have such policies and instead rely on the director evaluation process.

**Share ownership.** Ninety-seven percent of companies have director share ownership requirements. They typically must hold common shares or DSUs equal to three times their annual retainer which can be accumulated over five years. Twenty-five percent of companies require executives to take all their compensation in the form of equity until they meet the share ownership requirement. Ninety-three percent allow directors to substitute equity for any cash payments received.

**Shareholder advisory votes.**  Eighty-three percent of firms hold a non-binding “say on pay” vote for director and executive compensation.

**Director pay practices.** Total director compensation averages CAD 234,000 per year. Annual retainers average CAD 199,000, committee fees average CAD 6,000, and board or committee meeting fees average CAD 2,000. Seventy-three percent of companies use retainers only to simplify their pay systems. Fifty percent of companies have fixed committee meeting fees, but the rest have variable fees with the audit committee having the highest fee. Added compensation is usually given for attending special meetings, serving on special committees, and travel. Total pay consists of 50% equity on average and has grown by 3.8% per year over the last five years.

Pay practices are typically reassessed every one-to-two years and most firms use a peer group to set director compensation levels. Fifty percent of companies use the same peer group for executive compensation. Pay is significantly higher at larger companies and varies by industry with the resource, communications, media, and technology industries being the highest.

**Board chair compensation.** Chair compensation averages CAD 409,000 with 50% taken in common equity. Eighty-seven percent receive an annual retainer only which may be either an all-inclusive retainer or the director retainer plus a chair retainer. Chair pay is significantly higher at larger corporations. Non-independent chairs are paid considerably more than independent chairs and received more of their pay in cash. Chair compensation has grown at 2.3% per year.

**Committee chair compensation.** Eight-two percent use variable committee chair retainers instead of fixed retainers. Audit committee retainers are the highest averaging CAD 25,000 followed by the human sources and compensation committee at CAD 20,000 and the governance and nominating committee at CAD 15,000.

**Corporate Governance Ratings**

Since the Enron crisis, corporate governance has become an important consideration when equity analysts, lending institutions, and credit rating agencies evaluate a firm’s performance. Businesses have made great progress in improving governance, but the level of success varies between companies. Analysts need to quickly assess the quality of governance at specific firms. To serve this need, financial information providers offer corporate governance ratings.

Institutional Shareholders Services (ISS) is the leading proxy advisory firm globally recommending to institutional investors how to vote the shares in their portfolios. These shares must be voted in shareholders’ best interests for institutional investors to meet their fiduciary responsibilities. As a byproduct, ISS supplies Governance Quality Scores (GQS) for businesses that assess over 230 factors classified into four categories and 20 sub-categories.

**Exhibit 1: CQS Categories and Sub-categories**

|  |  |
| --- | --- |
| **Board Structure** | **Compensation/Renumeration** |
|  Board composition |  Pay for performance |
|  Composition of committees |  Non-performance based pay |
|  Board practices |  Use of equity |
|  Related party transactions |  Equity risk mitigation |
|  Board controversy |  Non-executive pay |
|  Diversity |  Communication and disclosure |
| **Shareholder Rights and Takeover Defenses** |  Termination |
|  One-share, one-vote | **Audit & Risk Oversight** |
|  Take-over defenses |  External auditor |
|  Meeting and voting-related issues |  Audit and accounting controversies |
|  Other shareholder rights issues |  Other audit issues |

In Canada, scores in each category are classified into deciles compared to other companies in the TSX/S&P 300. ISS supplies a GQS score ranging from 1 (i.e. low-quality governance) to 10 (i.e. high-quality governance) for each category and an overall score. ISS also offers more a comprehensive Environmental, Social, and Governance (ESG) rating that measures a business’s societal and sustainability impact.

**1.4 | Responsibilities of Directors**

Corporate directors have legal responsibilities under common law. These include:

**Fiduciary duty.** Directors must act honestly and in good faith with the best interests of the corporation in mind. Normally this means working in the shareholders’ best interests, but sometimes the long-term interests of the firm or the interests of minority shareholder groups and other stakeholders such as creditors, employees, or the community take priority. Even if the director is elected by a specific group of shareholders, creditors, or employees, their fiduciary responsibility to the corporation is paramount. Executive directors such as CEOs have the same responsibility to the corporation as independent directors. Even with subsidiaries and closely-held corporations that are controlled by a single shareholder, directors must act in the corporation’s best interests.

**Duty of care.** Directors must show the care, diligence, and skill that a reasonably prudent person would in similar circumstances and devote adequate time to critically examining all issues. Directors are not expected to have firsthand knowledge of a company’s operations and can rely on the information provided by management including the financial statements unless they have grounds to question their accuracy. The board must be able to promptly access all information needed to monitor the affairs of the company. Directors can delegate their duties or seek the input of qualified advisors such as accountants or lawyers, but the final responsibility for decisions rests with the directors.

**Business judgment.** Directors should apply reasonable judgment in decision making with the honest belief that they are acting in the corporation’s best interests. Courts are hesitant to challenge the appropriateness of directors’ actions or impose their views if directors considered all reasonable alternatives and acted in good faith free of any conflicts of interest.

**Confidentiality.** Directors must keep confidences and not use any information acquired as a result of their position for personal gain. They must not trade in the company’s securities while in possession of material non-public information (i.e. insider trading) or disclose this information to others (i.e. tipping).

**Conflict of interest.** Directors should avoid conflicts of interest. Any conflicts should be disclosed, and directors or related parties should not attend meetings or vote in any matter if they have a material interest in a proposed contract. If any conflicts are discovered, the contracts should be set aside, and any profits refunded. Directors may serve on multiple boards, but they must avoid conflicts of interest between firms.

Directors can be held liable for the actions of the company giving them a strong incentive to fulfill their obligations. A due diligence defence can be used to avoid liability if they can demonstrate they took appropriate actions such as thoroughly reviewing relevant information; making all necessary inquiries; consulting experts; putting appropriate policies, procedures, and control systems in place; and following them carefully. Besides a director’s obligations under common law, some federal and provincial statutes impose extra responsibilities on directors and expose them to greater liability. These statutes relate to corporate, securities, employment, environmental, pension, and tax law. Most statutes allow a due diligence defence but not all, so directors must have adequate directors’ and officers’ liability insurance to reimburse them for any losses or legal costs. Intentional illegal actions are not normally covered under these policies.

**Professional Designation**

The Institute of Corporate Directors (ICD) is the professional organization for directors in Canada. With over 15,000 members and 11 chapters across the country, it improves confidence in Canadian organizations by strengthening director performance through education, advocacy, and applied research.

ICD in partnership with the Rotman School of Management at the University of Toronto has developed Canada’s leading Directors Education Program (DEP). This is not an entry-level program but is aimed at existing directors at public and private corporations, Crown corporations, public institutions, co-operatives, and large not-for-profits organizations who want to become more effective directors. To be accepted to the program, applicants must have experience as for-profit company directors, preferably as an independent director and not an executive director. Those who have worked with boards in a professional role but have not served as a director may also be considered. Applicants need to have a track record of highly successfully executive or professional experience along with sound business judgment and demonstrated leadership abilities. References from ICD members and DEP graduates who are free of conflicts of interest attest to the applicant’s suitability for the program and potential for success.

The ICD-Rotman DEP focuses on corporate governance in for-profit, publicly-traded companies. It consists of four modules taught over 12 days facilitated by leading academics, experienced directors, and experts in the field. The modules include:

Module 1 – Guiding Strategic Direction and Risks

Module 2 – Monitoring Financial Strategy, Risks, and Disclosure

Module 3 – Guiding Human Performance

Module 4 −Assessing Enterprise Risk and Directing Extreme and Unique Events

Upon completing the ICD-Rotman DEP, candidates must take the following steps to earn the ICD.D designation:

* Be a current member in good standing with the ICD and sign the ICD’s Member Code of Conduct
* Successfully pass the ICD.D online examination
* Successfully pass the ICD.D oral peer examination given by two ICD examiners
* Sign the ICD.D Designation Agreement, which requires directors with ICD.D to commit to a minimum of 14 hours of ongoing governance education annually

In addition to the NEP, ICD also offers the ICD-Rotman NFP Program for leaders of not-for-profit organizations as well as Board Oversight of Technology, Board Dynamics for Executives, and other short courses and private training in corporate governance. Graduates of the ICD-Rotman NFP Program are not eligible for the ICD.D designation.

**1.5 | Executive and Director Compensation**

An effective executive compensation system is critical to aligning the interests of management and shareholders to minimize agency costs and maximize shareholder value. The price of a company’s shares equals the present value of their future cash flows, so executive compensation needs to be highly correlated with long-term performance. Pay systems that reward short-term profits at the expense of long-term success are detrimental. These systems must also be competitive with other firms in the industry, so the company can attract, motivate, and retain high-quality managers in a competitive global market for executive talent.

There have been major improvements to corporate governance in Canada since the Dey Report was published in 1994 and the realization by directors that they can be held accountable for a lack of proper oversight. Boards of directors now play a much more active role in a company’s management setting its strategic direction, selecting the right CEO, counselling management as they work to achieve the firm’s goals, and evaluating executive performance. With this more active involvement comes the need for higher director compensation, but as with executives, director pay systems must maximize shareholder value by rewarding long-term performance. This is difficult for directors as they are tasked with building their own compensation plans leading to potential conflicts of interest.

CCGG recognizes how important effective executive and director compensation is to promoting good corporate governance. Improved monitoring of executive performance by boards and shareholders and strong penalties for those who attempt to mislead investors are essential, but nothing is more important than giving executives and directors the proper financial incentives to maximize shareholder value. CCGG has published two reports on how to design effective executive and director compensation systems.

Executive Compensation Principles (2013)

Director Compensation Policy (2017)

**CCGG Executive Compensation Principles**

Principle 1 – A significant component of executive compensation should be “at risk” and based on performance.

Principle 2 – Performance should be based on key business metrics that are aligned with corporate strategy and the period during which risks are assumed.

Principle 3 – Executives should build equity in the company to align their interests with those of shareholders.

Principle 4 – A company may choose to offer pensions, benefits, and severance and change-of-control entitlements. When such perquisites are offered, the company should ensure that the benefit entitlements are not excessive.

Principle 5 – Compensation structure should be simple and easily understood by management, the board, and shareholders.

Principle 6 – Boards and shareholders should actively engage with each other and consider each other’s perspective on executive compensation matters.

**Executive Compensation Systems**

CCGG recommends that a significant portion of executive compensation be at risk and based on performance. This means their pay is variable and dependent on attaining specific performance goals or metrics established by the board of directors. These include quantitative and qualitative, company-wide and individual goals that must be achieved over the short, medium, and long term. Metrics are expressed in absolute terms or relative to the performance of their industry peers and should be intricately linked to achieving the firm’s goals as set out in its strategic plan. Companies should disclose to shareholders the linkages between their different performance and strategic goals. There must be a balance between both short-term and long-term performance.

Companies need to provide executives with compensation packages that are competitive with their peers at other firms, but this should not be the overriding issue. The primary concern is whether executives are meeting expectations and achieving the firm’s strategic goals. Performance-based compensation should only be awarded if executives meet or exceed the target. Boards should be very reluctant to provide any exemptions or substitute other forms of compensation if they are unsuccessful. Retention bonuses are sometimes awarded to retain promising managers who are having temporary difficulties, but these payments should be infrequent and disclosed to shareholders in the management information circular.

Compensation should be timed to match the period over which performance occurs and any risks are assumed. If this is not done, executives may take on additional risk or engage in financial manipulation to enhance short-term performance and increase their pay. Boards must carefully monitor executives so the risks they assume are consistent with company policy and earnings are high quality and sustainable. Caps may be placed on compensation to discourage these risky or dishonest practices. Recoupment or clawback policies should be used to reclaim bonuses or unvested compensation if it is later discovered that an executive failed to achieve a performance metric due to an earnings restatement or a firm undergoes a change that significantly reduces its value.

Boards should have the ability to adjust executive compensation, so it is reasonable, and shareholders participate fairly in any gains. Pay plans should be stress-tested in different economic and business scenarios. Any plan needs to avoid overpaying or underpaying managers for unexpected changes in performance such as a major stock market rally that is not sustainable. The board should consider any appreciation in the executives’ previously awarded stock options or grants to determine if their current compensation is appropriate.

Executive compensation systems can be quite complex. The CCGG recommends that compensation committees simplify them so they are easily understood by the board and executives and can be explained to shareholders who must ultimately judge their effectiveness. No CEOs from other companies should be allowed to sit on the compensation committee as this creates a conflict of interest as those CEOs will directly benefit if the company is used as a peer benchmark for their compensation.

Compensation committees frequently retain outside consultants to assist them. These consultants have a thorough knowledge of industry best practices and can help establish a benchmark of industry peers to determine the appropriate type and level of compensation. To be effective, these consultants should report directly to the compensation committee and remain independent of management. The compensation committee and board must not become overly reliant on consultants as ultimately only the board is responsible to design an effective performance-based compensation system.

**Elements of Executive Compensation**

**Salary and bonus.** Executives normally receive an annual base salary plus a bonus. The based salary is usually determined by benchmarking against the salaries of comparable companies in the industry. Salary is more influence by the firm’s size and industry than the manager’s experience and success, so it is poorly linked to performance. The bonus is typically based on an accounting measure such as earnings per share (EPS) or earnings before interest and taxes (EBITDA) over a single year. Using a weighted average of multiple quantitative and qualitative measures is preferred as they provide a more broad-based indication of performance. The minimum threshold to earn a bonus is typically set low, but the bonus rises to a predetermined maximum as performance improves. Large bonuses are preferred to large salaries as they are variable and fluctuate with the manager’s performance, while salaries are fixed and not performance related.

Using accounting measures such as EPS or EBITDA to calculate the annual bonus has two major drawbacks. Executives can inflate their annual bonuses by manipulating accounting profits. Recognizing revenue prematurely, capitalizing expenses that are normally expensed, or reducing discretionary costs such as research and development, advertising, or training will all increase profits in the current year. If an executive feels that they are unlikely to reach their profit goal this year, they can do the opposite to make their profits and bonus higher in the following year.

Some boards feel that if a firm is profitable its executives are creating value for shareholders. This is not true because although net income includes interest expense which fairly compensates debt holders, there is no deduction for the cost of common equity. If net income is insufficient to meet both the cost of debt and equity, then a firm is not adding value. Residual income (RI) is an alternative profit measure that includes both these costs.

RI = NOPAT – (Invested capital) (WACC)

NOPAT = Operating income (1 – Tax rate)

Invested capital = Total assets – Current liabilities (Excluding current portion of long-term debt)

Net operating profit after tax (NOPAT) is a firm’s after-tax profit before deducting interest expense. Invested capital is the investment made by the debt and equity investors. The weighted average cost of capital (WACC) is the weighted average cost of debt and equity financing which is the return that fairly compensates investors for risk.

RI is also referred to as economic value added or EVA®. EVA is a registered trademark of Stern Stewart & Company, a U.S.-based consulting firm that publishes a set of adjustments to NOPAT and invested capital that provides a more accurate RI measure. EVA is widely used now, but when it was first introduced by Stern & Stewart, it was considered revolutionary as firms realized their profits had to be greater than both the cost of debt and equity to be successful. RI can be used to evaluate an entire company or a business unit making it a useful tool for evaluating lower-level managers.

Some companies allow executives to convert all or a portion of their bonuses into deferred share units (DSUs). Each DSU gives the executive the right to one share plus extra DSUs equivalent to any cash dividends paid in the future. DSUs are paid out to the executive in cash or actual shares upon their resignation, retirement, or death. Companies offer DSUs to increase executive share ownership which provides an added incentive to maximize the firm’s share price. Companies frequently match executive purchases of DSUs up to a specific level to increase the rate of conversion, but these units do not vest immediately. DSUs also provide executives with additional tax advantages compared to buying common shares.

**Retirement plans.** Many companies offer Supplemental Executive Retirement Plans (SERPs) to attract and retain top executives. In Canada, the Income Tax Act limits the size of registered pension plan benefits to approximately CAD 160,000. SERPS allows companies to provide pensions above these limits to better compensate high-paid executives. A typical SERP set up as a defined benefit plan provides a pension equal to 2.0% of salary or salary plus bonuses times the number of years of service to a maximum of 35 years. These plans are frequently a concern to shareholders as this is not a performance-based award and the compensation committee may not be acting independently of management. The committee may give a benefit of more than 2.0% per year or provide bonus years for when executives did not work at the company. CCGG recommends that SERP benefits are reasonable and service not be awarded for years executives did not work. If additional years are provided, this should be disclosed along with the rationale in the management information circular.

**Benefits and other perquisites.**  Employees often receive an array of health and welfare benefits such as drug and dental coverage, eye care, medical supplies, and paramedical services such as physiotherapists or chiropractors as well as long-term disability and life insurance. Executives usually receive additional perquisites or perks because of their high position such as a driver, personal chef, a company jet, stays at 5-star hotels or company-owned apartments when travelling, charitable donations made on their behalf, club memberships, private boxes at sporting events, theatre tickets, free parking, use of a vacation home, tuition assistance or loans to purchase company stock. A payment is not classified as a perquisite if it is directly related to the performance of the executive’s job. These benefits may be needed to entertain clients or justified based on cost or personal security grounds, but the CCGG recommends the compensation committee not allow them to become excessive. This is important to protect shareholders and not raise the suspicions of the media, regulators, or rank-and-file workers.

**Severance and change-of-control entitlements**. Executives can be terminated with or without cause. Those terminated without cause must be given reasonable notice or an equivalent amount of severance or termination pay instead of notice. This amount varies with the executive’s length of service, position, level of compensation, and age. Executives can also receive change-of-control payments if they are terminated when a company is taken over by another firm. Termination also includes constructive dismissal resulting from a downgrade in position or a reduction in pay. These payments help to ensure that an executive does not oppose the takeover to protect their own position and will work in the best interest of the shareholders to negotiate the highest take-over premium possible. To receive a change-of-control payout, a “double-trigger” requirement must typically be met. This means another party must purchase more than 50% of the company and the executive is terminated without cause within a fixed period after the acquisition. CCGG recommends that severance and change-of-control entitlements be reasonable and approximately equal. The board should not provide accelerated vesting for any deferred compensation except for change-of-control entitlements as this is beyond the manager’s control. All severance and change-of-control provisions should be disclosed to shareholders in the management information circular.

**Long-term incentives (LTIs).**  These share-based compensation awards are normally the largest component of executive compensation, usually accounting for well over half of executive pay, and are crucial in aligning the interests of executives with those of shareholders. By emphasizing long-term share price maximization, they help reduce agency costs and increase shareholder value. The main forms of long-term incentive pay include:

**Executive stock options (ESOs).** ESOs are a share-based compensation plan that gives an executive the right to buy a specified number of their employer’s common shares at a fixed exercise price following a predetermined vesting schedule. ESOs may vest immediately but this usually occurs gradually in parts or at the end of the agreement. The exercise price is set at or above the current share price, so the ESOs are initially worthless or “underwater.” The company expects an executive will work to increase the firm’s share price over time. Eventually, it should rise above the exercise price and the executive will realize a profit when the options are exercised, and the shares are sold.

When examining ESOs, there are several important dates and periods. The grant date is when the options are issued to the executive. The vesting date is when an employee earns the right to the options. The service or vesting period is the time between the grant date and vesting date and is the time over which the executive earns the compensation and the company recognizes the cost. The exercise date is when the options can first be converted into common shares which is on or after the vesting date. Executives who choose to exercise their options after the exercise date will benefit from any further share price appreciation until that time. Most ESOs have a term of up to 10 years after which the options expire.

ESOs appear to be an excellent way to align the interests of management and shareholders, but there are several serious issues. First, stock options have unlimited upside potential if the share price rises above the exercise price but no downside risk if it falls below it. This encourages executives to incur excessive risk and manipulate the company’s financial statements to raise net income without fear of losing money themselves. By deceiving investors about the firm’s actual performance, they can raise the share price and earn a greater return on their options. This deception will eventually be discovered, but by then the executives have exercised their options, sold the shares, and left the company with their ill-gotten gains. Managers also engage in “front running” where they exercise their options and sell the shares just before the company announces bad news causing the share price to fall. A related practice is “pump and dump” where executives exaggerate their company’s performance to inflate the share price before exercising their options and then selling their shares. Some companies are extending vesting periods beyond when managers leave the company or retire to make them longer-term thinkers and prevent these types of abuses. Others are considering various risk measures when evaluating an executive’s performance.

Second, some ESOs features diverge from the principle that a significant part of executive compensation should be based on performance by allowing plans to be adjusted in response to lower pay.

**Re-pricing.**  The exercise price is lowered during the vesting period after a decline in the share price, so the executive is motivated to stay at the firm and continue to perform. Alternatively, re-pricing may encourage executives to take on more risk to earn higher profits knowing they will be protected if a project fails.

**Doubling-up**. More options are granted during the vesting period to compensate for a declining share price or a price that is not rising as quickly as executives expected. Again, this may be necessary to retain and motive important managers.

**Back-dating options.** The start date is reset to when the company’s share price was lower to justify a lower exercise price.

**Re-load features.** Executives lock-in profits over the life of an option contract. The exercise price is increased, and any profits earned are not lost if the share price later declines.

**Evergreen options.** These options have an unlimited term so there is not a strong link between an executive’s pay and performance.

Third, general increases or decreases in the stock market are not due to the actions of executives, so ESOs do not effectively link pay with performance. An executive may be doing an excellent job keeping a struggling company solvent, but their stock options will likely be worthless providing them with little reward for their efforts. Another executive may make several major strategic errors but still receive a large payout on their ESOs simply because the stock market is booming, or the firm is a weak company is an otherwise strong industry with rising share prices. These problems can be addressed by only awarding options if the executive achieves certain performance goals such as a specified return on equity or by offering:

**Premium-priced options.** The exercise price is set at a high level, so executives are only paid for superior performance.

**Index options.** Executives are only rewarded if they outperform a stock index such as the S&P 500 which incorporates general stock market movements.

Fourth, ESOs may substantially dilute earnings per share or the ownership stake of specific shareholders causing them to lose control or influence in the company. This can be addressed by using capped stock options that reduce the number of options issued by limiting an executive’s payout. Also, boards can stipulate that shares issued as part of an option plan have to be matched by an equal number of stock repurchases leaving the number of outstanding shares unchanged. Finally, the options can be settled in cash using stock appreciation rights (SARs). SARS operate the same as stock options except instead of having the executive buy shares at the exercise price and then re-sell them for a profit, the company provides a cash payout equal to the difference between their market value and exercise price, so no new shares are issued.

Fifth, some executives try to monetize or hedge their stock options to protect themselves against a decline in the company’s share price. Monetize means to exercise the options and sell the shares while the executive is still employed with the company. Hedge means to issue a protective put, another type of stock option, that pays out if the company’s share price falls. Monetizing and hedging negate the alignment of management and shareholders’ interests that ESOs created.

Sixth, stock returns include both the stock price appreciation and the dividend yield. ESOs only receive the stock price appreciation, so executives might reduce the dividend to help grow the company even if there are no positive net present value projects.

Finally, private companies have difficulty using stock options because their shares do not trade publicly. This can be solved by using a “phantom” stock plan where the share price is estimated using the different business valuation models examined in Module: Business Valuation. The same approach could also be applied to divisions within a larger public company using tracking shares. These shares are created when a company’s operations are divided into business units and a share price is estimated for each unit based on its profits. These share prices are used to construct separate stock option plans for each business unit that better measure performance compared to a stock option plan that is based on the company’s overall share price.

**Restrictive share units (RSU).** RSUs are a share-based compensation plan where executives receive a specified number of their employer’s common shares following a predetermined vesting schedule if they remain employed for a designated period. Once vested, employees receive the shares or are given an equivalent amount of cash. Whether the RSU is equity-settled or cash-settled depends on how concerned the company is about its cash position, share price dilution, or loss of control. For example, an employee received a grant of 10,000 RSUs that vests equally over the next five years if they remain with the company. The employee would receive 2,000 shares or an equivalent cash amount at the end of each year. If they leave earlier or are terminated, the remaining shares are forfeited. Since the contract specifies the number of shares to be issued, the employee also benefits if the share price rises which provides an added incentive. Some RSUs have accelerated vesting provisions where shares vest more quickly due to superior performance or if the company is acquired by another firm. This feature is important if employees are concerned about being terminated when new owners take control. A vesting period of three to five years is normal.

**Performance share units (PSU).** These compensation plans are like RSUs except the share grant only vests if a specified quantitative or qualitative performance goals are met such as achieving a certain EBITDA or completing a new product launch. PSUs are preferred to RSUs because vesting is dependent on performance.

Stock options were once the predominant form of long-term pay, but they are quickly being replaced by RSUs and PSUs. Stock options encourage risky behavior and are worthless if a company’s share price falls below the exercise price. RSUs and PSUs still retain considerable value if the share price declines so they continue to motivate employees. There is also less share price dilution with RSUs and PSUs since fewer shares must be issued to supply the same reward and both plans are usually cash-settled. If RSUs and PSUs are issued, they are not included in diluted EPS until they are vested while stock options are included when they are first granted.

CCGG recommends placing greater emphasis on PSUs or a mixture of PSUs and RSUs in long-term pay systems. Executives should be required to hold a significant portion of their personal wealth in actual company shares or PSUs and RSUs. This minimum investment is expressed as a multiple of base pay or total compensation. The multiple and amount invested usually grows as the executive’s tenure of employment increases. If stock options are used, they should contain performance requirements, limit the impact of dilution, and have no re-pricing provision. Monetizing and hedging should be forbidden for stock options, RSUs, and PSUs. The board may grant exceptions in special circumstances, but these should be given sparingly and disclosed to shareholders.

**CCGG Director Compensation Policy**

Principle 1 – Independence and Alignment with Shareholders

Director compensation systems, like those of executives, should be aligned with the interests of shareholders to minimize agency costs and maximize shareholder value. Pay must be high enough to attract qualified directors, but not so high as to comprise their independence and objectivity. Directors must be willing to oppose actions that are not in the shareholders’ best interests and resign from the board if necessary. If compensation is too high or based on company performance, directors may become captive of management or be encouraged to take on additional risk or manipulate earnings, just like executives, to maximize short-term gains. CCGG recommends that directors use their compensation to acquire an equity stake in the firm, so they are focused on shareholders’ long-term interests.

Principle 2 – Reflect Expertise and Time Commitment

A director’s compensation should reflect their knowledge, skills, experience, level of responsibility, and time commitment as well as the size and complexity of the company. Directors may receive a fixed annual retainer or a smaller retainer plus a fee for each board meeting attended. Extra fees are also paid for special meetings or serving on committees. The company should have a policy on when special meetings are justified and disclose it to shareholders. Executive directors should not receive additional compensation for serving on the board.

Directors should be reimbursed for all reasonable travel expenses and educational costs, and boards should carefully monitor these expenditures for abuse. Directors’ and officers’ liability insurance is necessary to protect directors from any lawsuits by stakeholders, so they feel secure in fulfilling their duties. They should not receive any of the benefits or perquisites that are provided to executives. External consultants may be used to identify industry best practices and benchmark the type and amount of director compensation at comparable companies. The board must not become overly dependent on these consultants who must work independently of management.

Principle 3 – Compensation May Vary for Different Directors

Director compensation should vary depending on the responsibilities and time commitment of each director. There should be no difference in pay for directors in similar roles to promote group cohesion. Serving as a board chair, lead director, or committee chair warrants higher compensation as does serving on a busier committee such as the audit committee or a special committee.

Principle 4 – Shareholding by Directors

Directors should purchase an equity stake in the company upon joining the board and add to that investment over time. The minimum investment should be set equal to some multiple of each director’s annual compensation and they should have to hold that investment for a minimum of one year after resignation or retirement from the board. Directors should be required to use their director fees to purchased shares or cash-settled RSUs if the company does not want to issue additional shares. ESOs should be avoided as they encourage short-term decision making. None of the RSUs should have vesting or performance provisions that might prevent the director from acting independently. Directors should not be able to monetize or hedge their positions to ensure the continued alignment of directors’ and shareholders’ interests.

Principle 5 – Minimize Complexity and Ensure Transparency

Director compensation plans should be simple, so they are easily understood by directors and shareholders. The rationale for the plan, the process used to develop it, and the reason for any changes should be disclosed to shareholders in the management information circular.

**1.6 | Research Results**

Companies are strengthening their corporate governance and executive compensation systems, but it is questionable whether these measures are improving performance. Current research does not show a positive correlation between corporate governance ratings and financial performance as measured by return on equity, sales growth, operating profit margin, or other metrics. Research on executive compensation finds that pay continues to rise faster than stock prices.

It is not surprising research results are inconclusive given that so many factors influence a firm’s financial performance. In the past, companies focused on greater director independence, separating the CEO and board chair positions, and linking executive pay and performance. Other experts feel boards need to become more involved in the management of businesses particularly in the areas of strategic planning and risk management to help the CEO chart a more profitable path. More active executive committees, improved director qualifications, greater board diversity, less overboarding, and fewer interlocking directorships should also help.

Companies must continue to enhance their corporate governance and executive compensation systems in hopes of having a material impact on performance. Even if a strong correlation is not found, good governance and executive compensation are critical in preserving public confidence in the financial markets.

**1.7 | Corporate Governance and Executive Compensation at CN Rail**

Canadian National Railway (CN) is Canada’s largest railway with 24,000 employees and over 20,400 miles of track stretching across Canada and south through the U.S. Mid-west to the Gulf of Mexico. The company generated revenues of CAD 15 billion and net income of CAD 4.2 billion in 2019 moving primarily bulk commodities but also automobiles and other intermodal freight.

CN must supply shareholders with a summary of its corporate governance and director and executive compensation policies. This information was last circulated in CN’s 2020 Management Information Circular. As discussed, NI 58-201 Corporate Governance Guidelines applies to all publicly traded companies in Canada. Companies do not have to adhere to these guidelines, but they are required under NI 58-101 Disclosure of Corporate Governance Practices to disclose their governance policies and explain to shareholders why they varied from these guidelines. The specific disclosures required are outlined in NI 58-101F1 Corporate Governance Disclosure. This instrument was recently amended to include information on board renewal including term limits as well as hiring policies, employment targets, and participation rates for women at the board and executive levels.

NI 51-102F6 Statement of Executive Compensation requires companies to disclose any direct and indirect compensation paid to their directors, CEO, CFO, and next three highest-paid executives. This must include a detailed description in plain language of the director and executive compensation plans and the rationale for their design.

CCGG’s publication “Model Say on Pay Policy for Issuers” recommends that boards hold a vote on director and executive compensation at each annual general meeting so shareholders can express their satisfaction with the company’s approach. These are advisory votes that are not binding on management, but the board needs to use them as an opportunity to gather valuable feedback. The results of the vote and any feedback should be disclosed to shareholders. If there is significant opposition, the board should meet with the dissenting shareholders to discuss their concerns. The board should disclose all changes made in response to the feedback or provide a rationale for why no actions were taken. The level of shareholder support needs to be monitored over time so any decline can be examined even if most shareholders voted for the proposals.

CN is an excellent example of best practices in corporate governance and executive compensation and the disclosures companies must make to shareholders. CN’s 2020 Management Information Circular is available in the investor relations section of the company’s website or through the System for Electronic Data Analysis and Retrieval (SEDAR) sponsored by CSA. In addition to this information, CN also has a Corporate Governance Manual which gives a more detailed description of its corporate governance practices. NI 58-101F1 Corporate Governance Disclosure and NI 51-102F6 Statement of Executive Compensation can be obtained from the website of one of the provincial securities regulators. The “F” in the designation stands for “Form” which is an actual form to complete or instructions on the specific information that must be provided.

**Corporate Governance Highlights**

* The company exceeds the requirements in CSA’s NI 58-201 Corporate Governance Guidelines and NI 58-101 Disclosure of Corporate Governance Practices. It is dually listed on both the TSX and NYSE, so its governance practices also follow the TSX Company Manual, U.S. Securities Exchange Commission regulations, and SOX. These practices are described in its Corporate Governance Manual.
* Twelve of 13 directors are independent as defined by CSA. The CEO is an executive director but is not the board chair.
* Position descriptions are prepared for the board chair, committee chairs, and CEO. Board standing committees include the audit; finance; corporate governance and nominating; human resources and compensation; environment; safety and security; and strategic planning committees which are composed of independent directors only. The pension and investments committee and the donations and sponsorship committee are composed of a mixture of directors and executives. Each committee reports to the board and has a charter outlining its responsibilities.
* The board met 10 times in 2019, and the committees met as few as two times for the donations and sponsorship committee and eight times for the finance committee. The board collaborates with the company’s corporate secretary and executive to schedule meetings and set agendas. Meetings involve an open exchange of information and in-depth presentations by management on critical business issues. After each board meeting, the independent directors meet in-camera without the executive director and other managers present. The committees regularly communicate with executives about the areas they oversee. Director attendance was 100% at all board and committee meetings in 2019.
* The code of business conduct governs the behavior of all directors, executives, managers, employees, and any other consultant, agent, supplier, or business partner who works on the company’s behalf. The code ensures they act ethically; avoid conflicts of interest; effectively use and protect all business assets and opportunities; keep company information confidential; and not engage in any unlawful activities. The corporate governance and nominating committee updates the code regularly and provides training to all employees. Each director, executive, and manager must annually attest that they are adhering to the code and disclose any direct or indirect conflicts of interest in an annual questionnaire. Directors cannot be involved in a discussion or vote on a matter in which they have a conflict. An ombudsman gives a confidential, neutral, and informal way to solve ethical problems internally and they report to the board each year. The company also offers a hotline for employees to confidentially report any accounting or auditing concerns directly to the board chair. Exemptions from the code of business conduct can be granted by the board but none have yet been approved.

* Risk management is the responsibility of the board and its committees who receive regular presentations and reports from management. The major risks include general economic conditions; foreign currency; capital investments; information technology and cybersecurity; environment; existing operations such as labour disputes; regulatory changes; tax legislation; and health and safety regulations. The audit committee is responsible to ensure the company’s enterprise risk management program (ERM) is effective. The purpose of the ERM is to identify, assess, monitor, and mitigate important business risks throughout the organization.
* The chair and the corporate governance and nominating committee develop a competency matrix to determine any gaps on the board. This helps them identify new directors or decide if existing directors should be re-nominated. The competencies include sales/marketing, finance/accounting, legal, strategy, human resources, engineering/environmental, transport industry/safety, and public policy. Gender, age, and length of board tenure are also considered. Directors are selected based on how they fit in the competency matrix and their qualifications, experience, financial skills, business judgment, and group dynamics. The governance and nominating committee keeps an on-going list of potential directors to help in succession planning. Before being nominated, the chair and CEO meet with each director to determine if they are willing to serve, have any conflicts of interest, and can devote enough time to be effective. Once elected, directors must report any change in employment that may affect their suitability for the board.
* The company recognizes the importance of board and executive diversity in supplying the latest ideas and perspectives and improved management oversight. Their policies focus on recruiting more women, aboriginal peoples, visible minorities, and persons with disabilities, but the overriding principle is selecting the best candidate possible for the position. Currently, 38% of board members are women but there is no representation from the other groups.
* To help renew the board, directors cannot be nominated after their 75th birthday without board approval and no director can serve more than 14 years. The chair can serve up to eight years and each committee chair up to five years. Directors who are CEOs or senior executives at other companies are limited to serving on two boards. Other directors can serve on up to five boards. Directors must receive approval from the nominating committee to serve as a director at another company where one of the company’s directors already serves. No more than two directors can serve as a director at the same company. Directors must report all their board directorships and any case where they have been asked to serve on a board. The board may confer the title of director emeritus to former directors who have made a significant contribution to the company’s success. These directors are invited to shareholders’ meetings and other corporate events, but these positions carry no power or compensation other than expenses.
* The performance of the board, all its committees, the board chair, each committee chair, and the directors are assessed annually using a questionnaire that includes a self-assessment. The chair meets one-on-one with each director to confidentially discuss the results. Either the chair of the corporate governance and nominating committee or the chair of the human resources and compensation committee meets with directors to discuss the chair’s performance. The board chair and committee chairs then report to the board on ways to improve board and committee performance. The board can also hire an independent advisor to conduct a peer assessment of individual directors. Again, the chair discusses the results with each director separately.
* New directors attend an orientation where the leadership team describes the nature and operation of the business, its organization structure, and each of its different functions including finance, corporate services, marketing, operations, technology, human resources, and investor relations. The chair discusses the board’s role and the contributions each director is expected to make based on the competency matrix. A directors’ handbook is circulated that includes important information about the business including the corporate governance manual, code of conduct, board and committee charters, committee chairs and members, director assessment practices, important policies and procedures, safety information, financial statements, regulatory information, and the CN Investor FactBook. New directors are invited to attend different management events such as the annual business planning meeting, the annual sales meeting, or meetings with analysts and investors hosted by investor relations. They are also encouraged to visit company facilities across North America.
* All directors engage in ongoing professional development activities such as the ICD-Rotman DEP program; presentations, seminars, and conferences facilitated by outside experts on governance and operational issues; discussions with executives and operational managers; and visits to company facilities or those of suppliers or customers.
* The company actively engages with its different stakeholders particularly investors, aboriginal groups, and the community. It communicates with shareholders, analysts, institutional investors, and shareholder advocacy groups supplying up-to-date financial information during conference calls, roadshows, analyst conferences, and company visits. It participates in aboriginal community initiatives, provides employment and business opportunities, and educates managers on the role of business in the Truth and Reconciliation Commission’s Final Report. It collaborates with communities on safety and environmental issues and supports the volunteer work of its employees and pensioners.

**Executive Compensation Highlights**

* The goal of the compensation system is to motive executives to reach the company’s short and long-term profitability targets and long-term strategic goals and maximize shareholder value. Most pay is variable and long-term which is consistent with the principle of paying for performance. Compensation is also competitive so the firm can attract, retain, and motive an outstanding management team. The system has a variety of risk mitigation features to ensure executives act appropriately in the shareholders’ best interest.
* Executive compensation has five components: base salary, annual incentive bonus (AIB), pension benefits, perquisites, and LTIs. All payments are in USD to simplify comparisons with U.S. companies. The cost of management ratio shows total executive compensation was 0.7% of net income in 2019.
* An executive’s salary is based on an economic outlook for the coming year and the median salaries of a comparator group of companies. For the CEO and executive vice-presidents, the comparators are five Class I Railways including Union Pacific, CSX, Norfolk Southern, and Canadian Pacific. The current policy is to match the median salary of this comparator group. Base salary is then adjusted using an assessment of the individual’s leadership skills, sustained individual performance, responsibility, and growth in their role as well as any retention and succession planning concerns.
* AIB is calculated as a percentage of an executive’s base salary and then adjusted for the company’s and individual’s performance. Initially, the CEO receives a bonus equal to 140% of base salary, executive vice-presidents 80%, senior vice-presidents 65%, and vice-presidents 50 to 60%. This target bonus is then broken down into corporate financial, corporate safety, and individual components, and multiple performance measures are used to calculate a performance factor for each component.

**Exhibit 2: Performance Components, Measures and Weights**

|  |  |  |
| --- | --- | --- |
| **Corporate Financial Performance (70%)** | **Corporate Safety Performance (10%)** | **Individual****Performance (20%)** |
| Revenues (25%) | Accident ratio (50%) | Operational and service excellence (25%) |
| Operating income (25%) | Injury ratio (50%) | Organic development and acquisitions (25%) |
| Diluted earnings per share (15%) |  | Employee engagement and effectiveness (20%) |
| Free cash flow (20%) |  | Stakeholder and regulatory engagement (10%) |
| Return on invested capital (15%) |  | Safety culture (20%) |

 For the corporate financial component, the CEO’s bonus is calculated as:

Annual based pay × 140% × 70% × Corporate Financial Performance Factor

The bonuses for each of the components are summed giving the total AIB.

Targets for each of the performance measures are determined annually based on the business plan. There are no guaranteed minimum payouts and they are capped at 200% of the target bonus for each component. Given their importance, no AIB is given if the company does not meet its corporate financial performance objectives. Multiple components and performance measures supply a more balance compensation system than relying on fewer factors. The company plans to drop the diluted earnings per share and return on invested capital performance measures in 2020 as they are redundant due to the high correlation with the other measures.

Executives can convert up to 100% of their AIB into DSUs to increase their level of share ownership. The company matches up to 25% of investments and these extra RSUs vest over four years beginning on the deferral date.

* Executives participate in the company’s registered defined contribution and defined benefit pension plans which are supplemented by SERPs. The registered defined benefit plan provides a pension equal to 2% of an executive’s average base salary and AIB over their best five years of employment times their years of service up to a maximum of 35 years. An unreduced pension is available at 55 years and no bonus years are awarded. Registered plan benefits vest immediately but SERP benefits only vest if the executive has worked at least two years for the company and does not retire before 55 years.
* Executive perks include an annual physical exam, club membership, company-leased vehicle, parking, financial counselling, and tax services. A corporate aircraft is available for business purposes only. It may be used for personal reasons in exceptional circumstances, but all costs must be reimbursed.
* LTI program is composed of 45% ESOs and 55% PSUs. The board and the human resources and compensation committee determine the size of the annual grant based on an assessment of each executive’s individual performance plus retention and succession planning concerns. ESOs vest over four years at a rate of 25% and have a 10-year term. The exercise price is the closing share price on the grant date. The vesting period is being increased to five years in 2020 to give executives more long-term incentive.

PSUs vest over three years but executives need to meet two performance targets to be rewarded. Seventy percent of PSUs require that they achieve a specified average rate of return on invested capital (ROIC) over the life of the agreement conditional upon also reaching a minimum share price in the last three months of the vesting period. ROIC equals NOPAT divided by invested capital which should exceed the WACC if the company is generating residual income for its shareholders. Thirty percent of PSUs are awarded based on the company’s share price appreciation over the vesting period including dividends relative to the share prices of two equally weighted comparator groups consisting of 1) selected Class I Railways, and 2) S&P/TSX 60 companies. The number of PSUs awarded varies from 0% to 200% depending on the company’s performance and are settled in either cash or equity. The board plans to reduce the weight of ROIC PSUs to 60% and increase relative share price PSUs to 40% in 2020 to better align payouts with share performance.

* All ESO, PSU, and SERP agreements have confidentiality, non-compete, and non-solicitation provisions. Executives must adhere to these provisions for two years after the cessation of employment to receive vested ESO, PSU, and SERP benefits. They cannot disclose confidential company information; engage in a competing business; solicit or accept business from any customer, supplier, or distributor; hire or engage company employees; profit from any business opportunity learned about while employed by the company; or take any action that may be detrimental to the company’s business interests.
* Executives cannot hedge the value of their company shareholdings or engage in any transactions involving publicly-traded options. Boards may claw back any executive compensation due to a restatement of earnings caused by an executive’s gross negligence, intentional misconduct, or fraud. They may also require executives to repay compensation earned in the last 24 months regardless of whether there was an earnings restatement if gross negligence, intentional misconduct, fraud, theft, or embezzlement occurred.
* Executives who are terminated for cause or resign forfeit their AIB and SERP and all their ESOs and PSUs are cancelled. They do receive vested DSUs and registered pension benefits. Executives who are terminated without cause receive a severance package consistent with current legal standards along with a prorated AIB and all vested DSUs, registered pension plan, and SERP benefits. PSUs are paid out on a prorated basis if the performance conditions have been met and all vested stock options must be exercised within three months. If there is a change in the control and the employee is terminated without cause or resigns for good reason within two years, they are treated the same as an employee who is terminated without cause. Good reason (i.e. constructive dismissal) is when an executive must relocate their office or home more than 100 kilometers outside of their current location or they are assigned substantially different duties and/or terms and conditions of employment.
* New executives must meet a minimum shareholding requirement within five years and maintain it during their employment. CEOs need to hold their shares for one additional year to discourage short-term decision making at the end of their tenure. This requirement is expressed as a factor of the executive’s base salary and was nearly doubled in 2019.

**Exhibit 3: Minimum Shareholding Requirement**

|  |  |
| --- | --- |
| **Position** | **Factor of Base Salary** |
| CEO | 8× |
| Executive vice-presidents | 5× |
| Senior vice-presidents | 4× |
| Vice-presidents | 2.0× to 2.5× |
| Senior management | 1.5× |

Only common shares and vested DSUs can be used to meet the requirement. Vested or unvested stock options or unvested PSUs are not eligible.

* Risk mitigation features are built into the compensation system to prevent abuses and encourage executives to maximize long-term shareholder value. These include:
* Performance measures are reviewed annually to ensure they are still relevant.
* Compensation can be altered at the board’s discretion due to market factors or other extenuating circumstances.
* Pay plans are stress-tested regularly to see if payouts are reasonable in different economic and business scenarios.
* A proper balance between fixed and variable and short and long-term compensation creates a strong link between pay and performance.
* Multiple performance measures reduce the risk of relying on too few indicators.
* ESOs and PSUs vest over three to five years stressing long-term performance.
* Overlapping vesting periods for LTIs result in more consistent behaviour.
* PSU performance measures include a minimum share price requirement to ensure both executives and shareholders benefit together.
* AIB and PSUs payouts are capped at pre-determined maximums with no payment if performance targets are not met.
* Executives are members of the defined benefit pension plan which curbs excessive risk-taking when investing the plan assets
* Compensation can be clawed back due to questionable financial practices.
* Change-of-control entitlements are only paid if an executive is terminated for good reason reducing the cost to shareholders.
* Executives do not have written employment contracts giving the board more discretion when dealing with performance issues.
* An executive’s minimum shareholding requirement cannot be hedged.
* Executives must follow confidentiality, non-compete, and non-solicitation requirements after ceasing employment to receive LTI and SERP payouts.
* Independent outside executive compensation consultants are used to design, review, and test compensation plans.
* Every employee can invest 1% to 10% of their gross pay into the Employee Share Investment Plan (ESIP) each pay period. The company matches 35% of the first 6% invested but these extra contributions do not vest for one year. Over 80% of employees and 100% of executives take part in this plan.

**Director Compensation Highlights**

* Director compensation is set by the board of directors on the advice of the corporate governance and nominating committee aided by outside advisors. The goal is to attract the most qualified professionals possible, remain competitive with U.S.-based companies, and reward directors fairly considering their workload, time commitment, and responsibilities. Director compensation is compared against three peer groups: 1) Class I railroads in the U.S. and Canada; 2) Canadian firms with similar revenues and market capitalizations; and 3) S&P 500 companies.
* The board chair and each director receive an all-inclusive, flat cash and stock retainer with no added compensation for attending meetings or travel costs. Having a flat retainer is easier to administer and consistent with most companies. The chair’s retainer is more than double that of the directors. Directors who serve on a committee or as a committee chair receive an added cash retainer. Committee chair retainers are higher for the audit and human resources and compensation committees, but all committee members are paid the same regardless of the committee they serve on. Executive directors do not receive any extra compensation.
* For the stock portion of a director’s retainer, shares are either purchased directly by the company on the open market or they are awarded DSUs. DSUs are paid out in shares upon the director’s departure from the board. Extra DSUs are granted instead of any dividend payments each year.
* Directors need to achieve a minimum shareholding requirement in shares or DSUs worth five times their annual retainer within five years of joining the board and maintain it throughout their tenure. They must take 50% to 100% of their annual retainer in shares or DSUs until the requirement is met and 0% to 100% subsequently. Currently, 80% of all compensation is paid in shares or DSUs.
* Directors cannot monetize or hedge the minimum shareholding requirement over their tenure and must continue to hold 50% of it for two years after they leave the board.