# 20 Questions Directors Should Ask about **Executive Compensation**

Second Edition

WRITTEN BY
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20 QUESTIONS

# How to use this publication

Each “20 Questions” briefing is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management — and themselves — tough questions.

The questions are not intended to be a precise checklist, but rather a way to provide insight and stimulate discussion on important topics. The comments that accompany the questions provide directors with a basis for critically assessing the answers they get and digging deeper as necessary.

The comments summarize current thinking on the issues and the practices of leading organizations. Although the questions apply to most medium to large organizations, the answers will vary according to the size, complexity and sophistication of each individual organization.

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INSTITUTE OF CORPORATE DIRECTORS

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# Preface

The Risk Oversight and Governance Board (ROGB) of the Canadian Institute of Chartered Accountants (CICA) has developed this briefing to help directors, particularly compensation committee members, fulfill their responsibility for the oversight of executive compensation.

This is a Second Edition of a document originally issued in 2003. It has been substantially revised to reflect the changing environment in which boards of directors, and compensation committees in particular, find themselves operating. This publication complements the publication *20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee*.

Due to the complexity of executive compensation, this publication goes beyond discussing executive compensation only in terms of the board's oversight role, but also explores some of the underlying operational issues in order to give directors a solid basis for assessing the information they receive from management and external advisors. Questions that directors may want to ask are provided following, or as part of the discussion of the issues.

It is important that all directors have a general understanding of executive compensation. Members of compensation committees, as well as those on audit committees will require a greater level of detail. While the level of detail in this document may be more directly relevant to members of compensation or audit committees, it will also provide a solid foundation for all board members.

The ROGB acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, Elizabeth Greville and David Crawford, the authors, Hugh Miller who carried out the editing and the CICA staff who provided support to the project.

**Giles Meikle**, FCA
Interim Chair, Risk Oversight and Governance Board

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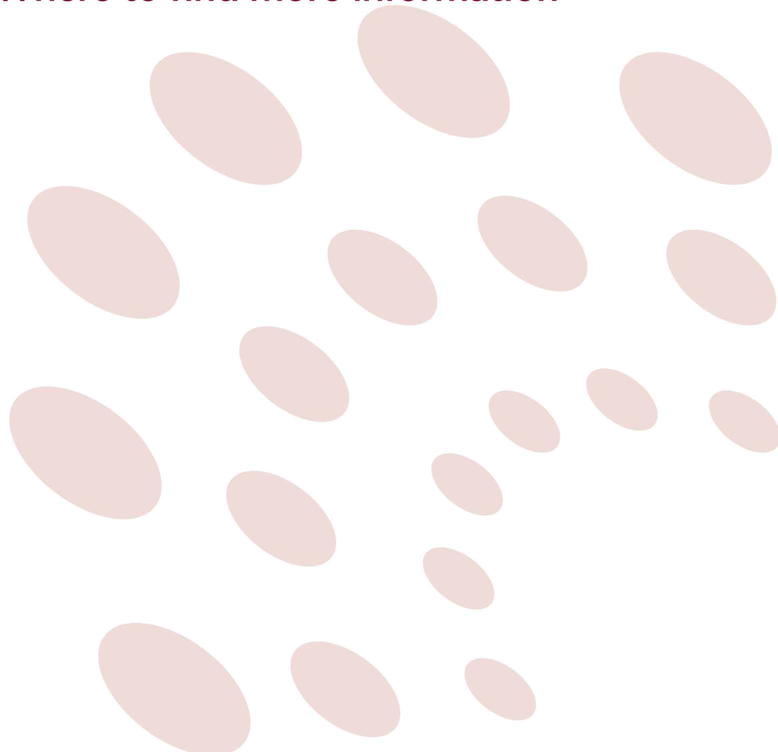

## Questions

1. Does the compensation philosophy support the strategic direction of the organization?
2. Does the board understand and approve the level of risk inherent in the organization’s compensation philosophy?
3. Is the issue of executive compensation integrated into board discussions about risk?
4. How effectively do we engage with shareholders regarding executive compensation?
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13. How do our share ownership guidelines compare to developing best practices and regulatory requirements?
14. Would a clawback policy be an effective way to manage compensation risk in our organization?
15. How will executive benefits such as pensions and perks hold up under scrutiny from shareholders?
16. Are the board and CEO in agreement over the organization’s approach to executive compensation?
17. How effective has our executive compensation program been thus far in terms of motivating and paying for the desired performance?
18. What compensation-related risks have affected our organization or others in our industry?
19. What is the potential payout under the most extreme scenario? Is it justifiable?
20. What risks do we need to monitor on an ongoing basis?

# Introduction

Compensation committees are coming under growing scrutiny because of increasing shareholder engagement, exhaustive pay disclosures, and the significant regulatory and public attention now being given to executive pay.

The role of the human resources and compensation committee is discussed in the document *20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee.* This complementary document, designed for compensation committees, delves deeper to explore some of the technical issues involved in the design and assessment of executive compensation.

Executive compensation is a complex field. This publication aims to suggest questions for directors to ask as they review executive compensation, and also give them a basis for critically assessing the information they receive from management and external advisors. The document provides an in-depth analysis of the elements and issues involved in the design and review of a compensation program, and then provides suggested questions for directors to ask.

## The Role of the Board in Overseeing Executive Compensation

Oversight of executive compensation is one of the key governance responsibilities of the board of directors. The board is responsible for reviewing and approving the company's overall compensation philosophy as well as the elements of the executive compensation program and the related disclosure. The various elements cannot be considered in isolation. The compensation philosophy must be reviewed with an eye to the company's strategy and risk tolerance, as well as the expectations of its shareholders. The elements of the compensation program itself must be reviewed to ensure that they do, in fact, support the principles of the compensation philosophy and that they can withstand scrutiny by shareholders and others.

The responsibility for detailed review of these issues is generally delegated to the compensation committee, which presents its recommendations to the board. Information on the role and mandate of the committee can be found in the document *20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee.*

Ultimately, the board's overriding objective is to ensure that pay is:

- *effective,* in that it achieves the desired goals;
- *responsible,* in terms of value and cost; and
- *defensible,* in that it can be explained and justified to shareholders.

The first section of this document addresses the issues related to the overall review of compensation philosophy and practices. The second section sets out various different components of compensation and discusses how they may be used to further the organization's compensation philosophy, and what issues the compensation committee should be aware of when reviewing the compensation program.

# Part A: Oversight of Compensation

## Approving the Compensation Philosophy

**Compensation Philosophy**
The compensation philosophy forms the foundation for executive pay programs. This philosophy should set out the key principles under which management, the compensation committee and the board set, evaluate and approve compensation.

An effective executive pay program should be designed to:

- align management with shareholder interests,
- pay for the *right* kind of performance, and
- help the organization attract and retain top-performing management.

There are trade-offs between these goals. For example:

- Pressure to maximize or increase a company's earnings faster than its peers often puts stress on enterprise risk and the organization's long-term strategic positioning.
- In the interests of attracting top management, some compensation programs allow significant wealth to be taken out of organizations in good years for performance that may be unsustainable over the longer term.

Pay needs to be balanced in terms of rewarding performance that supports both short-term and long-term shareholder interests, enhances the organization's profitability and long-term health, and is based on prudent enterprise risk management practices. This reflects the fact that the decisions management makes to maximize shareholder value often involve complex interrelationships and trade-offs between maximizing current profitability, optimizing the organization's strategic positioning for long-term profitability, and building financial and reputational strength.

1. Does the compensation philosophy support the strategic direction of the organization?

## Aligning Compensation and Risk

The organization's compensation philosophy must be aligned with its strategic direction and also with its risk tolerance. Management is responsible for taking risks on behalf of shareholders to generate returns commensurate with those risks. It is important to ensure that the degree of risk encouraged by the compensation program is consistent with the organization's overall risk tolerance.

Factors affecting the alignment of the compensation program with the company's risk tolerance include:

- ***Management's incentives -*** If management's incentives can be maximized at the expense of undue risk to the organization, more balance should be provided in terms of measures and/or by deferring some amounts to ensure sustainability of performance.
- ***Leverage of incentives -*** The compensation program's leverage [the degree to which pay varies with performance] should be consistent with the organization's business model and its shareholders' primary goals. For instance, it does not make sense to have leveraged and risky programs when investors want predictable and stable profits.
- ***Product or business risk tails -*** When executives are eligible for significant incentive payments in relation to products or businesses whose risks continue beyond the normal incentive period.
- ***Stewardship role -*** There is a risk involved in rewarding those in stewardship roles, such as the chief auditor or chief risk officer, based on profitability.

This alignment should be reviewed periodically, particularly when changes are made to the design of the compensation program. Organizations may consider explicitly requiring consideration of compensation-related risks in the mandate of the board and/or committees.

2. Does the board understand and approve the level of risk inherent in the organization's compensation philosophy?

3. Is the issue of executive compensation integrated into board discussions about risk?

## Aligning Compensation and Shareholder Interests

Shareholders are taking a more active role with respect to executive compensation. The board must understand the shareholder base and determine an approach to engage and/or inform shareholders about compensation decisions. Some organizations may find their shareholders' views are relatively uniform, but more often, different shareholder groups have differing objectives.

For example:

- Some shareholders who take a diversified or passive (invest in the Index) approach to investing may look for organizations with better longer-term performance relative to their peers. These shareholders may include pension funds and other longer-term investors.
- Some shareholders focus on a company's absolute performance, as reflected in its share price, and their objective may be to see the organization maximize its share price over a defined term. These investors may include some retail investors, or special situation investors (e.g., merchant banking/private equity).

Cyclical, commodity-based organizations have a particular challenge in aligning management and shareholder interests. For instance, some shareholders may prefer that management moderate cyclical impacts (e.g., aim to be a low cost producer that achieves a certain profit level throughout an industry cycle, and/or hedge or "lock in" commodity prices). Other shareholders may ***want*** significant exposure to commodity price movements as part of a diversified portfolio or as a short-term bet.

Engagement with shareholders occurs in a number of different ways, including:

- Institutional investors engage with boards and compensation committees both directly and indirectly, through shareholder organizations and advisory services.
- Controlling or significant shareholders' views, expressed either through managers or directors, will frequently be part of the process around compensation decisions.
- Some companies have instituted non-binding shareholder votes that allow shareholders to vote on a company's compensation plans as disclosed in its proxy circular (say on pay).

Even with input from shareholders, directors should remember that they are required to exercise independent business judgment in their decision-making.

4. How effectively do we engage with shareholders regarding executive compensation?

## Mechanics of Overseeing Compensation

### Organizational Characteristics

An organization's approach to compensation must take into consideration and reflect the organization's "DNA" – the various characteristics that shape the organization's culture and the way it operates. Some of these factors include:

- ***The way executives are motivated.*** For some executives, maximizing their incentive pay is a critical factor in decision-making. This is neither good nor bad in itself, but needs to be understood. On the other hand, some executives might give little weight to incentives when making business decisions.
- ***Management's risk appetite.*** Independent of pay, management may be naturally risk adverse or have a high tolerance for risk taking. Management teams that are too aggressive may expose their organizations to undue risks, while those that are too conservative may fail to take advantage of opportunities.
- ***The board's competency for assessing performance.*** The greater the board's knowledge of the company's business, strategies and performance, and the industry in which it operates, the better the board will be able to set standards and assess information relevant to compensation.
- ***The effectiveness of the budgeting and/or goal setting processes.*** It is important to consider the organization's budget setting dynamics, including the effectiveness of the process and the comfort level of the board.
- ***The nature of the relationship between the board and the CEO, and between the CEO and other management.*** If relationships are hostile (or, perhaps, quietly hostile) or where pay has become overly important, the board should proceed with caution.

- ***The regulatory regime(s) under which the organization and management operate.*** Compensation programs for organizations in some sectors, such as utilities, telecommunications and financial services, may have to comply with special regulatory requirements.
- ***Shareholder views.*** Shareholders have a keen interest in the pay decisions made by the organizations in which they invest.

5. How well do we understand the organization and the senior management team in terms of motivators, risk appetite and relationships?

## Roles and Responsibilities

Directors must understand the respective roles of the board, the compensation committee, management and external resources. The board plays a 'hands-on' role with respect to the compensation of the CEO and top executive officers, while management is generally responsible for compensation beyond the top executive officers. Many boards delegate much of their detailed work to a compensation committee, although final responsibility rests with the full board.

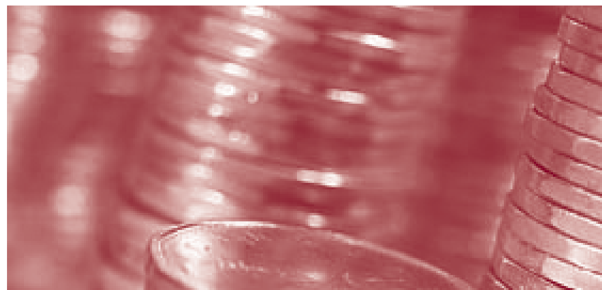
## Use of External Advisors

To discharge its oversight responsibilities, the compensation committee must be able to access outside expertise, which includes having the authority to hire and terminate advisors at the committee's discretion.

In Canada, two main models have emerged under which external advisors provide advice to compensation committees.

- Under one model, the compensation committee and management each retain separate and independent advisors.
- Under the other approach, the compensation committee retains its own independent advisor(s) whose primary mandate and accountability is to the committee; however these advisors may, with the prior knowledge and approval of the committee chair, also assist management on selected projects.

An advantage of the second model is that it can avoid duplicate consulting processes and leverage the advisor's company-specific knowledge and full resources.



The compensation committee should determine the model that is most appropriate for the organization, considering:

- ***The complexity of the organization's business and executive compensation programs.*** Larger, more complex organizations with multiple business lines and compensation programs usually require a broad range of consulting services. In these organizations, management may retain one or more consulting firms depending on the project and required expertise. The mandate of the compensation committee's independent advisor could range from being quite limited to very comprehensive. In a limited role, the committee's advisor might assist in assessing design and pay recommendations to be approved by the committee. A comprehensive mandate, on the other hand, might have the committee's advisor heavily involved in designing, assessing and/or recommending compensation levels and programs.
- ***Significant advisory work beyond the board relationship.*** An actual or perceived conflict of interest may occur if a potential external advisor to the compensation committee works for a firm that has extensive business relationships with the organization. In such a situation, the committee will need to satisfy itself that the advisor's independence is not impaired.
- ***Adversarial relationship between the board and the CEO.*** If this type of relationship exists, separate committee and management advisors should be considered regardless of the size and complexity of the organization and/or its executive compensation programs.

Despite the external advisor's involvement, however, the ultimate responsibility and accountability for these activities remain with the compensation committee and the board.

Table A summarizes the elements of executive pay, the participants involved and their respective roles.

**Table A**

| Executive Pay Elements/Aspects | |
|---|---|
| • Compensation philosophy | • Executive contracts |
| • Competitive benchmarking | – Provisions |
| • Pay structure/mix | – Documentation |
| • Pay level setting | • Severance policies |
| • Annual incentives | • Change in control |
| • Long-term equity & design | • Tax/accounting |
| • Customized business/line programs | • Disclosure and reporting |
| • Retirement program | • Share ownership and trading |
| • Benefits & perquisites | • Claw backs |

| Participants | | |
|---|---|---|
| **Internal** | **Board/Shareholders** | **External** |
| • CEO | • HR Committee Chair | • Compensation consultants |
| • Business Heads | • HR Committee | • Recruiters |
| • Human Resources | • Board Chair | • Law firms |
| • Finance/Accounting | • Audit/Risk Committee | • Accountants |
| • Legal | • Board | • Agents (for executives) |
| • Taxation | • Significant Shareholder | |
| • Risk | • Shareholders | |

| Roles | |
|---|---|
| • Designing/structuring | • Documentation/implementation |
| • Advising/consulting | • Administering/monitoring |
| • Proposing/recommending | • Evaluating (adjudication) |
| • Approving | |

### The Compensation Cycle – Annual Activities

The compensation committee's annual activities and the timing of those activities differ from company to company. In accordance with best practice governance standards, compensation committees often review and assess the information in one meeting and make final major decisions at a second meeting. Table B summarizes the typical activities and the key player(s) usually responsible for each activity.

**Table B**

| Activity | Key Players | | |
|---|---|---|---|
| | Prepare | Assess | Approve |
| **Review and Approve Performance Objectives** | | | |
| Company financial performance | Management | Committee | - |
| The CEO's performance objectives | Committee Chair<br>Committee | External Advisor | Board |
| Performance objectives of Senior Executives | Management | External Advisor | Committee |
| **Governance and Regulatory Disclosure** | | | |
| Update Committee Charter | Committee | External Advisor | Board |
| CD&A for proxy circular | Management | External Advisor | Committee |
| Succession plan | Management | External Advisor | Committee |
| Current market trends | External Advisor | - | - |
| Compensation philosophy | Management | External Advisor | Committee |
| **Review and Approve Compensation Levels and Structure** | | | |
| Analyze and review competitive CEO compensation data | External Advisor | - | Committee |
| Analyze and review competitive executive compensation data | Management<br>External Advisor | External Advisor | Committee |
| Analyze and review competitive Board of Director compensation data | Management<br>External Advisor | External Advisor | Committee |
| Prepare and review tally sheets for compensation of CEO and other executives | Management<br>External Advisor | External Advisor | Committee |
| Recommend, review and approve compensation adjustments for CEO | Committee Chair<br>External Advisor | Committee<br>External Advisor | Board |
| Recommend, review and approve compensation adjustments for Senior Executives and Executives | Management | Committee Chair<br>External Advisor | Committee |
| Review short-term incentive design and projected payouts | Management | External Advisor | Committee |
| Review long-term incentive design and projected payouts | Management | External Advisor | Committee |
| Review share ownership guidelines and executive holding levels | Management | External Advisor | Committee |
| Review and approve long-term incentive grants | Management | External Advisor | Committee |

## Disclosure

The compensation committee is not directly responsible for drafting the compensation disclosure, but it reviews the disclosure and must be satisfied that it properly captures the decisions made by the committee and the board, and the related rationales behind those decisions. Disclosure must meet the Canadian Securities Administrators (CSA)'s expanded disclosure requirements and should be in plain language and provide useful information to investors.

6. Does our compensation disclosure adequately address the issues of primary concern to our shareholders?

High priority issues for shareholders which disclosure should address include:

- ***Competitive benchmarking:*** If the organization uses third party surveys for benchmarking, does the disclosure identify the benchmarked (peer) companies and explain how the company's target pay was positioned relative to the chosen peers?
- ***Pay/performance linkages:*** Does the disclosure clearly articulate the performance measures and targets used in the organization's incentive programs? Does it explain the process used to evaluate performance and determine the related incentive payouts? If incentive awards are based on qualitative or subjective performance conditions, does the company provide an adequate description and disclose actual results?
- ***Risk-reflective compensation:*** Does the disclosure explain how the structure and design of the compensation program takes into account the company's business risks and supports the creation of long-term value?
- ***Exercise of discretion:*** Does the disclosure explain what role, if any, that committee discretion plays in the final determination of annual and long-term incentive awards?
- ***Clear explanation of decision-making:*** Is there a focused discussion, analysis and insight into the way the compensation committee determines specific incentive payouts, long-term incentive awards, etc.?
- ***Special compensation arrangements:*** Does the description of executive severance or change-of-control payments/benefits provide a clear explanation as to how the required elements were quantified?

**Summary Compensation Table**

One important use of the Summary Compensation Table ("SCT") mandated by the Canadian Securities Administrators as part of compensation disclosure is to allow investors and others to gauge the overall reasonableness of compensation awarded in the fiscal year. This refers to both the absolute and the incremental compensation in relation to performance delivered.

However, care should be taken when using the Summary Compensation Table in the proxy for pay-for-performance analysis. The SCT provides the compensation awarded for the fiscal year – by component and in total. For stock options, the grant date fair value is to be disclosed, and the ultimate payout from this award could range from zero to many multiples of the disclosed award value. For share units, the dollar amounts could reflect:

- straight compensation (time vesting only), or
- a value based on an assessment of individual and/or business performance achieved, and/or
- an at-risk amount subject to future performance.

# Part B: Understanding the Elements of an Effective Compensation Program

## Setting and Evaluating Compensation Levels

7. How can we assess whether the organization's pay practices are both defensible and competitive?

### Competitive Benchmarking

A primary tool for evaluating the reasonableness of pay levels is competitive benchmarking. Through this process, the company collects pay data from other organizations and analyzes that data to make its own compensation decisions. The process involves defining both the peer group and the desired competitive positioning. Compensation committees should pay particular attention to these choices and should also consider the way in which competitive data is used when making pay decisions.

### Defining the Peer Group

To develop an appropriate peer group, organizations typically consider a number of comparator company characteristics, including:

- ***Industry:*** A peer group of organizations in the same industry is particularly important since organizations in the same industry compete directly for talent, employees' skills are most easily transferred within the same industry, and a senior executive's direct industry experience is often critical to the organization's success.
- ***Size:*** The sample may reflect companies with similarly-sized operations or companies whose size is otherwise adjusted for (e.g., through regression analysis).
- ***Geographic reach:*** The sample should ideally reflect geographies from which talent will be recruited or lost (local, national, North American, or international).
- ***Ownership:*** Different ownership structures (public vs. private; autonomous vs. subsidiary; founder vs. career executive) can affect executive positions because of differing accountabilities, the direction that executives receive, and their freedom to act independently.
- ***Diversity of business and organization complexity:*** Organizations comprised of multiple business segments or product lines and ones with operations in multiple countries may require a peer group with similarly diverse characteristics.

Developing an appropriate peer group of Canadian organizations can be challenging, particularly for companies with a small number of direct competitors. Consequently, these organizations may need to go beyond their core industry to develop a peer group. Generally, the more peer companies that can be identified for the comparator group, the more robust the resulting benchmark statistics are likely to be. However, developing an appropriate peer group will often result in a trade-off between the number of peers and the relevance of the benchmark.

Larger, more complex organizations often require multiple perspectives on the market. The multiple sets of data can combine:

- ***Industry/business model comparators – with whom the company competes for business.*** The comparator organizations may vary by business segment, though they should be mainly within the same industry, and may include ones that are headquartered outside of Canada. Comparator companies may also include organizations with a similar business model even if they are outside the company's specific industry.
- ***Talent market comparators – with whom the company competes for talent.*** The comparator companies may extend beyond Canadian-headquartered companies, at least for some roles. They may also represent a range of industries and company sizes beyond direct industry competitors.

If the primary peer group comprises a small number of companies (e.g., less than 10 organizations), having a larger secondary sample may provide a useful additional reference point to inform compensation decisions.

### Using Competitive Data When Making Pay Decisions

Ultimately, when using peer group data, the members of the compensation committee must understand the strengths and any weaknesses that exist with the data in the context of their own business and talent markets. The choice of peers for benchmarking and competitive positioning is crucial and must be done reasonably and fairly.

The source(s) of the market data should also be considered. For example, customized surveys developed through a rigorous data collection process in which jobs are matched to formal benchmark positions usually provide more robust data than informal industry surveys.

Under the CSA proxy disclosure requirements, where benchmark data are used for decision-making purposes, companies must disclose "the benchmark and explain its components, including the companies included in the benchmark group and the selection criteria."

### Defining the Desired Competitive Positioning

Once the most appropriate peer group has been selected, the decision as to where to position the company in relation to its peers is strategically important. A typical market approach, and an accepted "best practice," is for organizations to position each compensation element at the market 50th percentile (i.e., median), and provide actual compensation above or below the 50th percentile depending on actual performance.

In some instances, the desired positioning may be above the 50th percentile – for example, to attract "hot skills." In these situations, it is important that the compensation committee consider and understand the potential implications for pay levels (e.g., targeting above the median may result in a constantly upward moving target) and the other elements of compensation (e.g., the impact on incentive payouts taking into account the degree of leverage and how that compares to market practice).

There is interdependency between benchmarking and competitive positioning, which must be understood before making changes to the compensation philosophy. For example, targeting the 50th percentile of a peer group comprised solely of U.S. companies may have a greater impact on pay levels (particularly long-term incentive compensation) than moving the desired target competitive positioning to the 75th percentile of a peer group of Canadian companies.

### Internal Benchmarks

It is also important to note that competitive data is just one reference point when evaluating the reasonableness of pay levels. Internal factors should also be considered, including individual performance, length of time in the position or organization, the importance of the role to the organization, and the individual's key skills and competencies. Collectively, such measures may count for as much, or even more, than external measures.

8. Do we understand the process used to develop the compensation program? Are we confident in the methods used?

## Selecting Performance Measures

Ensuring that an organization's compensation program is effective in paying for performance requires the selection of appropriate performance measures. Most organizations use a variety of performance measures, each with its own strengths and weaknesses (which is why a combination of measures is often used).

To identify the most appropriate performance measures to use to guide executive compensation, compensation committees should consider the company's business model and the way that success can best be measured for the organization as a whole. The resulting organizational performance metrics or scorecard can then provide the foundation for designing variable and equity compensation.

There are a number of different types of measures which can be used in various combinations:

- External stock market measures
- Internal financial measures
- Strategic and operational measures
- Monitoring-oriented measures

### External Stock Market Measures

External stock market measures include measures such as total shareholder return and share price. These measures are volatile, particularly over the short term, as shares are priced with varying expectations of future business performance.

### Share Price Increase and Absolute Total Shareholder Return

Many executives consider absolute share price performance to be the most significant performance measure. It may be rewarded through:

- Stock options (highly leveraged),
- Share unit grants (less leveraged), and/or
- Incorporation as a specific measure in a performance plan.

A criticism of absolute return is that both strong and weak returns can be the result of general industry or market price movements that are disconnected from actual management performance. On the other hand, absolute shareholder return can be the ultimate goal for many shareholders.

### Relative Total Shareholder Return

Relative Total Shareholder Return (TSR), which considers share price performance and the value of reinvested dividends, is viewed favourably by institutional shareholders. Nevertheless, making it an effective and fair measure poses challenges:

- Peer group selection
  - Finding an appropriate peer group is difficult for many Canadian companies with few direct comparators.
  - Differences in industry/business segment and geography can impede a true assessment of management's relative performance.
  - The relative financial strength of companies can influence relative total shareholder return. Even two companies in a seemingly similar industry can have dramatically different exposures, such as to commodity prices, foreign currency or general market movements. For example, a company that is profitable throughout an industry business cycle is likely to underperform in improving industry conditions and outperform in deteriorating industry conditions compared to companies whose profits are more sensitive to industry conditions.
  - M&A activities can force changes in the peer group, undermining consistency and compounding adjudication challenges.
- ***Varying sensitivities to uncontrollable variables.*** Even companies in the same industry can have varying sensitivities to variables such as commodity prices and foreign currencies.
- ***Starting and ending pricing conditions.*** Problems can be created when using discrete time periods since measurement is very dependent on the starting and ending relative pricing conditions of stocks (note: this may be partially offset by averaging the starting and ending prices).
- ***Clusters and influence on upper and lower quartiles.*** The year over year distributions of return across the peer group can be volatile. For example, the peer group returns may be tightly clustered one year, but more variable the next, making the degree of out-performance and/or underperformance over a given measurement period somewhat random.

Many of the above challenges are magnified over the short term. For instance, a five-year relative total shareholder return is a more meaningful measure than a one-year relative total shareholder return.

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**Best Practice:**
Consider measuring relative total shareholder return by the spread above or below the median (or average) rather than the percentile or rank. Using the median (or average) focuses on the most stable component of the peer group's return, which reduces some of the randomness of the outcome.

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## Internal Financial Measures

Internal financial measures include measures such as profitability or cash flow. These measures may have time interdependency issues or be affected by balance sheet adjustments that can, in turn, significantly impact the income statement. For example, the transition to International Financial Reporting Standards may affect the suitability and interpretation of financial measures.

### Profitability Measures

Although some businesses find using profits to capture and measure organizational success is fairly straightforward, challenges with these measures include:

- ***Discrete time period problems*** (time-interdependencies) in that enterprise value is based on multiple years of profit and cash flow.

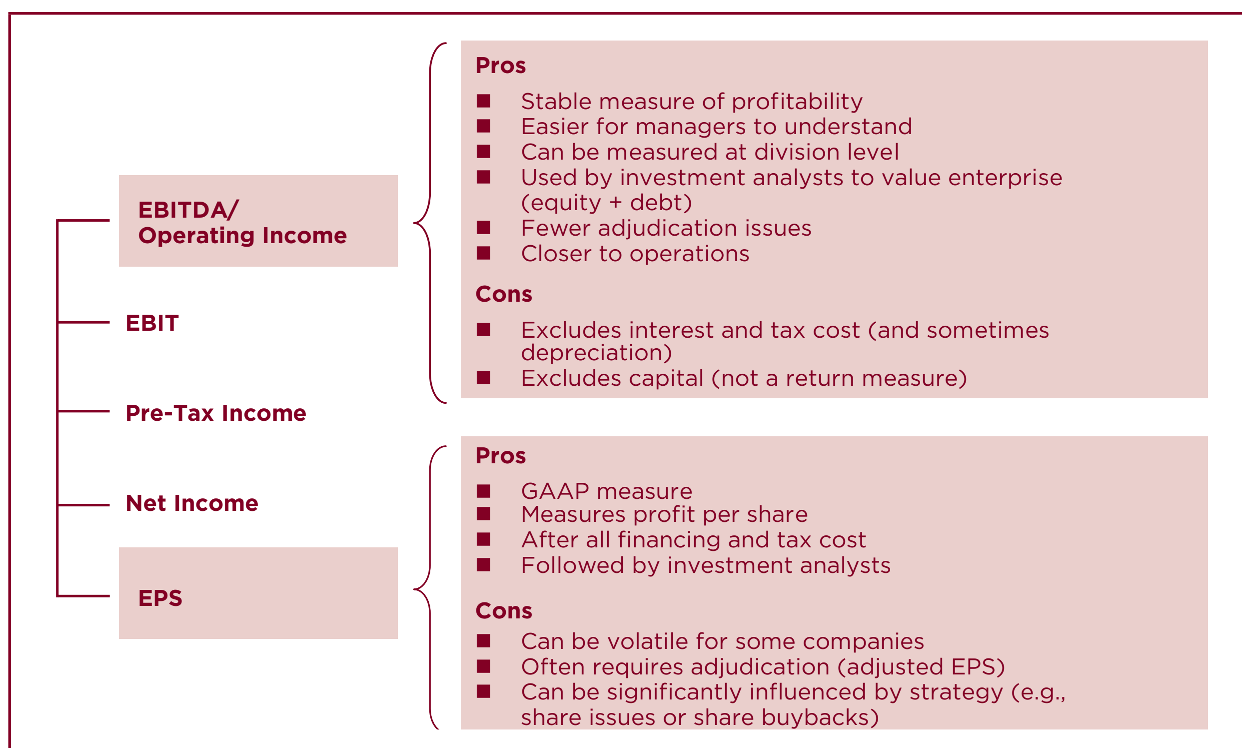
- ***The underlying revenues and expenses that determine profitability measures include components with differing attributes***:
  - Ongoing/sustainable changes have a multiple effect on value (e.g., a $10 million increase in profit may result in a $100 million increase in firm value – 10 x PE ratio);
  - One time changes (e.g., gains, losses, contingencies, reserve releases), often have a very real impact on value but do not (and should not) have a multiple effect;
  - Some expenses are arguably more like investments (e.g., R&D, technology spending) and may also be one time in nature; and
  - Certain accounting rules can make it difficult to use net income or EPS as an incentive measure (e.g., amortization of intangibles, foreign currency adjustments, asset write-ups or impairments, etc.).

It can also be difficult to operationalize a measure in an effective way. Although the creators of the measures often come from finance, the users cover a range of disciplines and roles. A regional manager, for example, may have greater understanding and control over EBITDA, but be unable to relate to a more complex measure such as economic profit.

These issues make it particularly difficult for boards – one step removed from the detail – to adjudicate the actual performance that is achieved. Similarly, there can be transparency issues for other stakeholders who only have access to annual reports and related shareholder communications.

Table C compares the pros and cons of EBITDA versus EPS as a measure of profitability.

**Table C**



### Financial Return Measures

Financial return measures, such as return on equity (ROE) or return on invested capital (ROIC), arguably offer a more complete measure of profitability. However, these measures also have their shortcomings:

- The current level of return may be the result of strong and/or weak performance factors. For example: a high ROE could be due to very strong profitability performance or the result of very poor historical performance that has led to a deterioration in the equity level.
- A reference point is needed to ensure a meaningful comparison to the company's historical performance, its goals going forward, and/or its relative performance compared to peers.
- Managers have little control over equity over a short period of time. Care should be taken to avoid undue complexity.

## Strategic and Operational Measures

These include measures such as market share, efficiency, or business mix. These measures can complement financial measures, but they may dilute the incentive's focus.

## Monitoring-Oriented Measures

These types of measures may relate to factors such as debt ratings, capital strength, reliability, safety, or environment. Although these measures are important to track, they are often only important when they deviate from expectations.

### Illustrative Approach to Facilitate a Holistic Assessment of Performance

- Formula-based incentives that are driven by limited measures cannot encompass the company's long-term financial health/value creation ability.
- An initial assessment is based on hard "primary" measures. Specific targets continue to be set for these measures.
- Other secondary measures are determined at the beginning of the performance period and are also considered. The resulting assessment may lead the compensation committee to make an upward or downward adjustment to the final incentive payout.

*Primary Measure(s)*

| Standard | Factor |
|---|---|
| Threshold | 0.0x |
| Target | 1.0x |
| Maximum | 1.5x |

*+ or -*

*Performance Modifier*

| Secondary Measure(s) | Adjustment |
|---|---|
| Poor | -0.50 |
| Acceptable | 0.0 |
| Strong | +0.50 |

## Setting Performance Standards

In setting or evaluating standards, there are numerous reference points, particularly for publicly traded corporations. While the starting point is normally the annual budget, this can be tested or set based on:

- The company's long-term business goals;
- Analyst expectations (consensus EPS forecasts);
- A reasonable performance improvement over previous years;
- Performance standards implied in other measures (e.g., what level of EPS is needed to meet the organization's return on capital goal?); and
- Cost of capital.

Directors should have a reasonable understanding of the factors that need to be considered when setting performance targets. For instance, a target based on budget should be re-affirmed by considering the organization's long-term performance goals and analyst expectations. Similarly, a timeless standard, such as 10% ROE, might be given "a reality check" by considering budgets and performance versus prior year.

In assessing the performance range (standards) and payout curve, it is useful to consider the underlying assumptions concerning the probability of achieving the performance standards.

- *Threshold.* The minimum level of performance required to reach the threshold performance level. This should be set at a level that is reasonably likely to be achieved, balanced with shareholder tolerance. A threshold that results in a zero payout should be set lower than one that results in, for example, a 50% of target payout.
  - Rule of thumb: attainable 85% to 90% of the time.
  - Note: some plans are structured to provide a bonus (e.g., 33% of target) for achieving threshold ("cliff plans"), while others start with a "0" bonus at threshold. All things being equal, the higher the bonus opportunity at threshold, the more difficult it should be to obtain.
- *Target.* The performance level that would warrant a target bonus payout.
  - Rule of thumb: attainable 60% of the time.
- *Maximum.* An outstanding level which, if met, would justify a maximum bonus payout for that measure.

Setting thresholds and maximums (boundaries) can be challenging. Generally, the less predictable the measure, the wider the incentive zone (between threshold and maximum) should be. Conversely, when a measure is relatively predictable, the incentive zone should be quite narrow. Ideally, there should be a reasonable likelihood that the performance will normally fall within the incentive zone.

The greater the potential maximum bonus (e.g., 2 x target versus 1.5 x target), the more difficult the standard should be to attain.

9. Do the performance measures and standards selected accurately capture the performance that pay should be linked to?

## Evaluating the Incentive Structure

Directors must satisfy themselves that the organization's incentive structure is appropriate and that the full range of potential payouts is reasonable relative to the applicable performance levels and total compensation.

There are often two competing philosophies underpinning annual incentives:

- One approach suggests that incentives should be focused on limited measurable goals set in advance, with compensation committee discretion to be avoided.
- Under the other approach, incentives rest on a comprehensive assessment of performance, including any risks associated with the quality and sustainability of earnings over the longer term.

Ultimately, the most critical elements for the board and compensation committee to understand and be comfortable with include:

- The performance the bonus program is rewarding, and what may be missing;
- The effectiveness of the program to incent, focus and/or reward strong performance;
- The full range of possible performance levels and resulting formula payouts (not just the expected pay for expected performance); and

- The related costs of the program under each performance scenario.

In assessing the design of the annual incentives, directors may find it helpful to use the following process:

1. **Determine the best financial measure(s) and standards to use over a one year period. Consider various measures of profitability and cash flow.**

   Performance is easier to assess in some organizations than others. One of the more challenging areas to address is the balance sheet impact on profitability since there are adjustments to profitability that are largely a result of non-cash accounting changes to the balance sheet. A financial services company, for example, may have write-downs, recoveries, gains and losses in a given year. Although these elements are very important to consider when determining annual bonuses, they often do not lend themselves to a formula-driven profit-related payout line. Moreover, these challenges will increase under IFRS accounting when a greater number of write-downs, recoveries, gains and losses is expected.

2. **Assess any critical areas of performance in order to provide a more complete assessment of performance and to address any significant risk areas.**

   There may be potential issues with the profitability measure itself or a need to go beyond profitability in order to effectively measure the organization's success and long-term financial health. For example, there may be critical strategic and operational measures that should be included when assessing performance.

   For cyclical businesses, annual profitability may be disconnected from controllable performance. Despite that, annual profitability may be important since it represents an ability to pay. Therefore, an appropriate balance should be struck in terms of paying for controllable performance and the company's ability to pay the incentive.

   Examples of measures that may complement profitability include:

   - The value and quantity of reserves (e.g., for mining, oil and gas);
   - Earnings quality, debt ratings, capital adequacy, financial strength;
   - Health and safety, environmental, stakeholder relationships;
   - Customer satisfaction;
   - Managing product risk (e.g., liability tails that could create losses in the future);
   - Maintaining or enhancing competitive positioning (which can be line of business and/or regional specific);
   - Maximizing the efficiency of operations; and
   - Performance relative to competitor organizations or other peers.

   These measures are effectively measures of shareholder value protection (sustainable performance/risk) but they do not readily lend themselves to predetermined weighting or formulae. The relative importance of some of the measures often cannot be properly assessed until the end of the performance period and may, in fact, only become important when they fall outside a certain boundary.

3. **Test the incentive approaches to find the optimal balance between focus and comprehensiveness.**

   Some of the key issues to consider when determining the most appropriate design of the incentive program include:

   - ***The appropriate number of measures.***
   - ***The way focus will be maintained when additional important measures are included.***
   - ***Whether any governors or caps will be formally incorporated into the incentive.*** For instance, the board may want the option to not pay any bonus if profits are below a certain level, or may want to consider capping the incentive to deal with significant windfall situations.
   - ***Whether a subjective element should be incorporated*** and, if so, if it is to be discretionary/ad hoc or a deliberate and transparent adjustment. While incentive plans built on a formulaic approach make it easier to measure performance and determine awards, experience shows the difficulty in setting financial and operational business goals in a volatile economic environment. Directors should be aware that CSA disclosure rules require companies to explain when the directors have applied judgment, including the related circumstances and the type of information that they considered.

4. **Consider the need (if any) to hold back or defer a portion of the incentive to ensure that compensation is commensurate with the performance that has been achieved.**

   To help better ensure that incentives are paid for performance that is sustained, the board may require that a portion of the award be deferred or "banked." Generally, the more levered and aggressive the annual incentive opportunity and the more problematic the one year performance period, the stronger the argument for deferral. The quantum of the long-term incentives and the degree to which long-term performance is being measured should also be considered.

10. Does the board understand the complete range of potential payouts under the incentive structure, and are we satisfied that they are reasonable?

## Using Long-Term and Mid-Term Incentives

Directors must assess whether the organization's incentive structure appropriately integrates the goals of pay-for-performance, shareholder alignment, and management engagement. Medium and long-term incentives are designed to motivate management to look beyond the immediate and the short term (the current year) and to reward management for performance over a longer time horizon. It is important that such rewards be tied not only to performance, both corporate and individual, but also to a careful assessment of the balance between performance and risk.

While the terminology for share unit plans is used interchangeably, this publication uses the definitions in the table below.

| LTI Vehicle[1] | Description |
|---|---|
| **Longer Term Equity** | |
| Stock Options | The participant receives a target award (e.g., as a percentage of salary) that vests over time; the participant receives the incremental gain between the exercise price and share price. |
| Longer Term RSUs[2] or PSUs[3] | These are similar to RSUs and PSUs, except that the settlement is longer term (e.g., five years). |
| DSUs[4] | These are similar to RSUs, except that the settlement does not take place until after employment is terminated (e.g., retirement). DSUs are viewed by shareholders as being akin to ownership. The most common application is for management to allocate a portion of annual bonuses to DSUs until retirement. |
| **Mid-Term Incentives - Three Year Cash Performance Plan** | |
| Cash | The participant receives a target award (e.g., as a percentage of salary) that can be adjusted up or down based on the achievement of set performance criteria. |
| **Mid-Term Incentives - Three Year Equity Plan** | |
| RSUs Time Vesting | The participant receives a target award (e.g., as a percentage of salary) that vests based solely on time. |
| RSUs Performance Driven | The participant receives a grant that is based on performance (grant size can be based on corporate or individual performance). After the grant, awards vest based on time. |
| PSUs Performance Contingent | The participant receives a target award (e.g., as a percentage of salary) that can be adjusted up or down based on the achievement of set performance criteria. |

1 "LTI" (Long-Term Incentive) includes any incentive plan with a performance cycle greater than one year.
2 "RSUs" – restricted share units
3 "PSUs"- performance adjusted share units
4 "DSUs" – deferred share units

## Long-Term Incentives

During the 1990s, stock options with fairly consistent terms and conditions were the most popular form of long-term incentive. Over the last decade, various types of full value shares (e.g., restricted share units, performance adjusted share units and deferred share units) have grown in prevalence, and today most large cap companies maintain two long-term incentive plans. While options have remained fairly uniform in the way they are designed and structured, the new full value share plans can vary dramatically in risk and leverage. Even within the same industry, the spectrum of risk may vary from just time and ownership-related risk (e.g., share units vesting solely with the passage of time) to significant risk and leverage (e.g., no units vesting if relative total shareholder return is below median).

## Mid-Term Incentives

A mid-term incentive is typically a three-year award settled in cash or shares, which may have time vesting and/or performance adjustments associated with it. The most common form of award involves share units, whereby one unit notionally reflects one common share. There are a range of designs, including:

- ***Time vested restricted share units (RSUs).*** A grant of units is settled at the end of three years, subject to ongoing employment. The value of the award effectively increases or decreases in the same manner as real ownership. For dividend- paying shares, dividend equivalents are usually provided in the form of additional RSUs.
- ***Performance adjusted share units (PSUs).*** The number of units is adjusted by a performance factor. Performance is measured prospectively and the performance factor is normally based on a financial measure (e.g., EPS) and/or a stock market measure (e.g., relative total shareholder return). For dividend-paying shares, dividend equivalents are usually provided.
- ***Combinations of above.*** Share units are adjusted by a modifier (e.g., 0.5 x to 1.5 x) with a guaranteed portion.
- ***Performance driven share units.*** An award of RSUs or PSUs where the grant is adjusted in part by the prior year's performance (last year's performance influences this year's grant size).

Mid-term incentives may also be calibrated around a target dollar amount. For instance, a three year performance plan may have a target award of $100,000 (instead of being calibrated as a target number of share units). This approach can lead to more focused incentives (by removing market noise) and may be particularly useful for business unit management.

## Assessing Risk

When designing mid-term incentives in combination with stock options or other long-term incentives, it is necessary to consider pay-for-performance and retention – effectively risk/leverage. Factors to consider in order to understand the risk/leverage of a longer-term incentive include:

- ***The number and mix of longer-term incentives.*** Combining stock options and share units can provide less risk. While stock options provide time diversification (with up to the full term to exercise), share units provide retention elements and/or performance measurement diversification (but no time diversification).
- ***The risk/leverage of the share unit plan.*** Share unit awards can range from straight grants with only time vesting; performance vesting on some, but not all, units; to performance vesting on all units.

There is an emerging trend whereby the risk/leverage for grants made to the broader participant group is lower than for the senior executive team. Some of the aspects that influence the risk and leverage of the plan include:

- ***Performance measurement interdependencies or diversification.*** This is an issue both within a plan and across multiple plans. For instance, a performance share unit plan that uses both profitability and total shareholder return measures will tend to be less risky than one that relies on a single measure (assuming the performance targets themselves are equally challenging).
- ***Performance zone width.*** The performance incentive zone is the range of performance outcomes for which incremental increases in performance will result in incremental increases in bonus awards. Wider zones increase the likelihood that the participant will be "in the game" during the performance period and, in turn, increase the retention aspect of the plan. The zone width should be balanced with investor tolerance in terms of setting an appropriate performance threshold.

11. Does the use of mid and long-term incentives appropriately balance risk and reward, shareholder alignment and management engagement?

## Stock Options

Stock options raise a number of competing issues, and the responsibility of directors is to assess how well the organization's stock options program aligns with its business model and shareholder interests.

An advantage to stock options as an element of compensation is that they provide a reward for the increase in share price, which is an objective and external measure of the company's value, especially when compared to most alternatives that often require significant board adjudication. Stock options are also well understood by participants, have fixed and often conservative accounting costs (i.e., expected future payouts can be significantly above the fixed grant date accounting charge), and they are tax effective for Canadian participants.

On the other hand, a drawback to options is that they generally fail to create shareholders, as the act of exercising is normally the act of selling. Often, the shares acquired on exercise are sold immediately to finance the exercise price and taxes on the gain as well as to lock in the gain. There have also been situations where the option holders reaped significant gains despite the fact that the underlying increased share prices were not sustained. It has also been suggested that a high number of accumulating options may motivate executives to either produce strong short-term results or inflated expectations so they obtain significant rewards for increasing the share price, or to maintain the stock options' in-the-money position.

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Stock options with very low grant date fair values (in relation to the underlying share price) should be treated with extra care. The compensation value disclosed in the Summary Compensation Table is based on grant date "fair value." Companies with high dividend yields and low share price volatility often have very low grant date values. While the grant date fair value may be within a reasonable range, the number of options awarded may result in too much pay being leveraged to share price increases. In fact, very low option grant date fair values should be a warning that options may not be the most appropriate equity vehicle.

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In assessing stock options, it is particularly important to:

- Determine how well the option structure promotes alignment between participants and shareholders, given the organization's financial characteristics and risk profile. For instance, options work better for companies whose investors desire growth and less well for organizations whose investors prefer stable low risk returns and high dividends.
- Consider whether conventional options (vesting solely on time) or performance options (vesting on both time and performance conditions) are more appropriate.
- Consider alternative or complementary forms of long-term incentives and understand the strengths and weaknesses of each.
- Understand both the competitive positioning of long-term incentive programs, and the expected and possible future wealth scenarios that could be generated.
- Consider possible ways the design of the stock option itself could be improved, for example by:
  - requiring longer and/or tougher performance vesting,
  - ensuring that the gain is based on longer-term shareholder value creation,
  - requiring part of the shares acquired on option gain to be retained as ownership, particularly where the gain is significant, and
  - reviewing treatment of options in change-of-control provisions to ensure their appropriateness.

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Be careful not to incorporate too much risk in stock option programs since options are already inherently risky. Adding performance conditions to options, such as performance vesting, can help guard against windfalls being created by general stock market movements. However, rarely will a performance condition guard against a very large option gain. In fact, in some situations, a larger option grant may be awarded to offset the performance condition (and provide the same grant date value) with an end result of even larger option gains.

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Retention ratios partially address the criticism that executives cash out their stock options at opportune times. Requiring executives to retain a percentage of the net shares on option exercises (i.e., retain shares left after paying the exercise cost

and taxes) is also a form of deleveraging for the executive. Instead of having, for example, 10,000 options, the executive may have 2,500 shares after exercise. Although the dollar value is the same, the risk is reduced from a more leveraged in-the-money option position to an ownership position.

12. How could the design of our stock options be improved in order to improve alignment between management and shareholders or manage risk?

## Share Ownership Guidelines

Executive share ownership is an important mechanism that helps align executives' objectives with those of the company's shareholders and reinforces the importance of management effectively representing the interests of shareholders. Today, most S&P/TSX 60 companies have put share ownership guidelines in place.

### Setting Share Ownership Guidelines

In setting guidelines, it is important to consider the wealth that the executives have realized (or may realize) from the company's longer-term incentive programs as well as their need to be able to diversify their investment portfolios. The greater the wealth creation opportunity, the higher the required ownership level should be.

Guidelines typically range for 3 x to 5 x salary for the CEO and 1 x to 3 x salary for other executives, with executives being given up to five years to comply.

### Assessing Compliance With Guidelines

When setting the company's share ownership guidelines, the compensation committee should also specify the types of shares and share equivalents that may count towards satisfying those guidelines. Qualifying equity may include some or all of the common shares owned outright and/or purchased through an employee stock purchase plan, plus share equivalents such as vested deferred share units and unvested restricted and performance share units.

While some companies allow the in-the-money value of vested (but unexercised) stock options to be included in qualifying equity, this is not considered a best practice from a governance perspective.

In assessing compliance with the guidelines, an emerging practice is to determine the value of the shares and share equivalents using the higher of the current market value of the common shares and the value at grant/acquisition.

To further reinforce the importance of complying with ownership guidelines, some compensation committees reserve the right to require that the net proceeds (after cost of shares and related taxes) from the settlement of long-term incentive awards are to be delivered in shares until the executive's guideline is met.

More recently, and in light of the continued attention that regulatory/advisory bodies and institutional shareholders are giving to executive ownership, some companies are considering features such as:

- ***Retention ratios:*** These ratios are aligned with the Canadian Coalition for Good Governance (CCGG) risk management principles and require that a portion of share-based award gains be held for a specified period (e.g., one to two years), or until retirement even if the share ownership requirements have otherwise been met. The ratios may be implemented with stock option plans and/or other forms of equity-based compensation.
- ***Post-retirement equity holding requirements:*** Senior executives (especially the CEO) are typically required to maintain equity ownership for at least a year after retirement to help ensure the decisions they make while in office are aligned with shareholders' interests.

### Other Implications Arising From Share Ownership Requirements

Changes to insider trading rules have led to more timely and transparent disclosure processes and the board should satisfy itself that the spirit of these rules is being followed. In addition, the board should consider whether supplementary guidelines are required to govern the way executives may manage the risks associated with personal investment portfolios that are heavily weighted to company shares. Issues that the supplementary guidelines may address include:

- the circumstances under which an executive is permitted to sell shares; and
- whether executives are permitted to use financial instruments to change the risk/reward characteristics of their ownership or option positions (e.g., the hedging instrument an

executive may buy to remove the downside risk of executive share ownership).

13. How do our share ownership guidelines compare to developing best practices and regulatory requirements?

## Clawback Policies

Compensation committees should consider whether to put in place a clawback policy as a means of managing the potential risk of paying for performance that was not delivered. Institutional and other shareholders are increasingly pressuring companies to implement such policies. The concept of clawbacks first arose in the U.S. with the Sarbanes-Oxley Act's requirement that incentive payments or stock-based profits be recouped from CEOs and CFOs in the event of an accounting restatement due to misconduct.

On July 21, 2010, the U.S. enacted the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, which mandates the Securities and Exchange Commission to establish rules to require listed companies to develop and implement a policy regarding clawbacks and erroneously awarded incentive-based compensation. The policy must apply to all current and former executive officers, and clawbacks would be triggered by an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws.[1]

Even prior to the Dodd-Frank Act, voluntary clawback policies had already been adopted by many Fortune 100 companies in the United States, and they are also becoming more prevalent in Canada.

At this stage, there is no uniform approach to voluntary clawback policies. Their effectiveness remains largely untested, and they continue to raise issues regarding fairness and enforcement. Nevertheless, regardless of legislative action, formal clawback provisions are emerging as a governance best practice.

14. Would a clawback policy be an effective way to manage compensation risk in our organization?

[1] Note: at the time of writing, no deadline was specified in the *Act* as to when the SEC rules must be put in place.

When developing a clawback policy, some of the key issues to consider include:

- ***Who the policy will cover:*** Will it apply to just the CEO and CFO or to a broader group of senior executives?
- ***Circumstances that would trigger recoupment:*** Events that may trigger a clawback include fraud, gross negligence, intentional misconduct, material restatement of accounts and other events.
- ***Compensation elements impacted by the policy:*** Executive compensation typically consists of different elements. The policy should identify the elements covered by the recoupment policy, such as cash bonuses; payments from vested RSUs or PSUs; proceeds received from stock option exercises; other compensation elements.
- ***The compensation recovery time period:*** For example, the recovery of awarded performance-based compensation might be limited to amounts paid within three years prior to the date a restatement is disclosed.
- ***Documentation of the policy:*** Recoupment policies may be documented in different ways, such as by board policy, in executive contracts, or incorporated into annual or long-term incentive plans. When documenting the policy, it is important to consider the legal implications for existing employment terms and conditions.
- ***Enforcing the policy:*** Who will be responsible for monitoring and enforcing the recoupment policy: the board, compensation committee or another group?

### Alternatives to Clawbacks

One of the most difficult challenges of a clawback policy relates to the way that funds will be recovered from the affected executive. Months or years may have passed since the compensation was awarded and the executive will generally have paid taxes on the remuneration and may no longer be with the company. In part for this reason, some organizations, particularly in the financial institutions sector, are considering and/or adopting alternatives or supplements to clawback policies. Many, for example, have implemented bonus banking structures under which a portion of an otherwise earned incentive is held back until it is clear that the requisite performance was delivered. Under another variation, the organization requires executives to forfeit outstanding unvested awards instead of subsequently attempting to recoup previously paid amounts.

# Other Benefits

## Pensions

Directors must ensure that they understand, and are comfortable with, the pension and post-retirement benefits that executives are entitled to over time. A significant amount of compensation can be derived from post-retirement arrangements, particularly through supplementary executive pension plans. There are two main types of pension plans:

- ***Defined benefit:*** The member is promised a specified formula benefit based on earnings and service, e.g., 2% of the average of the best three years' pensionable earnings for each year of company service.
- ***Defined contribution:*** The member's benefit is based on the pension that can be provided from contributions and related investment earnings accumulated over the individual's career.

Under defined benefit plans, it is not unusual for extra credited service and/or enriched formulae to be included in the pensions of the CEO and other senior executives. In this area, a seemingly small change to the pension can add a significant compensation value (cost). It is therefore important to understand the manner in which defined benefit pensions increase in value and become payable under a range of termination and retirement scenarios (for instance, would the accumulated pension amounts be reduced or unreduced, and are the pension payments immediate or deferred in the event of early retirement?). Boards should also be aware that institutional investors and other shareholders are increasingly critical of enhanced executive pensions.

To help ensure that executive pension programs are being managed prudently, the compensation committee should consider whether:

- caps on pensionable earnings or pension payable are warranted (e.g., limit pensionable earnings to salary only or salary plus partial or target annual bonus)
- there are any circumstances under which additional service credits should be provided (e.g., to accommodate late career hires).

## Perks

Benefits and other perquisites should be periodically reviewed to ensure that a valid business need exists for them, particularly for perquisites such as company cars and club memberships, and that they are market and cost competitive. In addition, policies and/or guidelines should be put in place to ensure the appropriate application and/or use of items such as:

- Car programs
- Company airplanes
- Company purchased or expensed travel and accommodations
- Business and/or recreational clubs
- Spousal and family benefits
- Enhanced medical and health benefits
- Post retirement benefits
- Financial and tax planning services

The compensation committee should also monitor the way in which these policies or guidelines are applied.

15. How will executive benefits such as pensions and perks hold up under scrutiny from shareholders?

# Special Circumstances

## Change of Control

Directors should ensure that they understand and feel comfortable with compensation that may be payable on a change-of-control.

Change-of-control provisions enable executives to focus on the goal of maximizing shareholder value with less need for them to be concerned with their future role in the company after a change of control takes place. These provisions can be incorporated within various elements of the compensation program (e.g., stock option, pension or benefit plans). They may also be found in executive contracts or as part of a separate policy.

The key elements of a change-of-control arrangement include:

- ***Change of control definition.*** A "multi-part" definition is typical and may include the acquisition of a certain portion of the common shares or assets of the company, a major change in the board's composition, a shareholder-approved merger or consolidation, and/or a discretionary determination by the board.

- ***Triggering mechanism.*** Different triggering mechanisms are used to determine the conditions under which severance and other compensation may be payable:
  - *A "single trigger"* requires only a change-of-control to take place
  - *A "double trigger"* requires both a change-of-control and the executive to be terminated (including constructive termination – change in status and/or compensation)
  - *A "walkaway" or delayed resignation clause* enables an executive to receive change of control protection without having to prove that he or she faced adverse job consequences (often contingent on serving for an agreed-upon transition period, typically six to 12 months). Walkaway clauses are closely scrutinized in today's corporate governance environment and, therefore, should be reserved for special circumstances, such as retaining key talent who would be integral to a successful transaction/transition.
- ***Application of triggering mechanism.*** Different triggering mechanisms are typically used for different types of compensation that may be payable upon a change of control:
  - *Severance* is generally payable based on a double (versus single) trigger due to pressure from shareholders and governance bodies.
  - *Equity-Related Compensation.* Stock options are traditionally vested on a single trigger. An emerging best practice for both stock options and full value share plans is for them to be vested on a double trigger (with the compensation committee having the discretion to modify this arrangement based on the circumstances of the applicable transaction).

It is important that boards and directors understand that, in the event of a takeover, the optimum balance must be sought and found between fairness to individual executives and fairness to the merger. On the one hand, if some employees are not needed post-merger, or are needed only in less responsible, less remunerative roles, they should be treated responsibly and equitably. On the other hand, a desirable merger from a shareholder perspective must not be unfairly impeded by compensation policies that encourage employees to terminate their employment. This applies especially to those who are essential, even critical for ongoing success, thus jeopardizing the chances of the merger occurring or succeeding.

## Severance

Severance agreements take several forms. Some are contained in employment contracts, others are stand-alone general purpose severance agreements, and some apply only in a change-of-control situation.

The severance formula is normally based on a multiple of salary and annual bonus. Benefits and perquisites may also continue during the severance period. In a few situations, severance agreements also include compensation in consideration of foregone future long-term incentive award opportunities. The board should be sure that it clearly understands and is satisfied with the aggregate resulting remuneration on a "walk-away" amount.

Severance practices are increasingly scrutinized in the current economic environment, particularly with the enhanced disclosure requirements and shareholders' aversion to paying when there has been underperformance. The following are some emerging best practices:

- The severance formula on a change in control should be the same as on termination without cause. This suggests that if a CEO of a large Canadian company is currently entitled to severance of 3 times compensation (salary plus bonus) on a change of control and 2 times compensation on termination without cause, then the 2 times multiple should apply in both situations.
- The bonus inclusion in the severance formula should be capped at the lesser of target or the 3-year average actual bonus.
- Severance entitlements should be subject to a sunset provision after the executive has served for a sufficiently long period.

In its 2009 Executive Compensation Principles, the CCGG advocates a link between severance and performance. However, because this concept may be difficult to operationalize, a possible outcome may be minimal severance under any circumstance. (In the U.K., for example, severance is generally limited to a one times multiple.)

# Critical Review of Compensation

## Reviewing Executive Contracts

Increasingly, CEOs and other senior executives have employment contracts that cover items such as pay levels, stock option grants, pension enhancements, perquisites, change-of control and severance agreements. The board is responsible for reviewing these contracts to ensure they are appropriate and reasonable.

While it is preferable that these contracts be structured by the company, they may also be structured by the executive's agent or by counsel acting strictly as implementers and/or independent advisors. Regardless of who structures the contract, the board should satisfy itself that an executive contract is responsible before approving it. As leaders and role models in corporate governance, CEOs should also be comfortable that their compensation is consistent with strong governance practices.

16. Are the board and CEO in agreement over the organization's approach to executive compensation?

## Back-Testing and Stress-Testing

The board should periodically back-test and stress-test the organization's total compensation and its pay features and programs. Back tests are a historical analysis to determine whether executive pay has worked as intended. This may include assessment of the link between pay received and organizational performance over a certain period, perceived effects of incentive pay on executive decision-making, and review of any unintended consequences of the organization's compensation programs.

17. How effective has our executive compensation program been thus far in terms of motivating and paying for the desired performance?
18. What compensation-related risks have affected our organization or others in our industry?

Stress tests involve determining potential payouts under a wide variety of conditions, taking into account multiple variables and both routine and extreme scenarios. Compensation committees should consider the alignment between potential payouts, the underlying performance, and the expectations of shareholders. This can help the board to understand and ensure it is comfortable with the compensation that would be provided under a wide range of circumstances. Such tests are particularly valuable for helping ensure the board fully understands the effect of incentives, equity programs and contractual event provisions (e.g., change-of-control provisions).

19. What is the potential payout under the most extreme scenario? Is it justifiable?

## Risk Mitigation

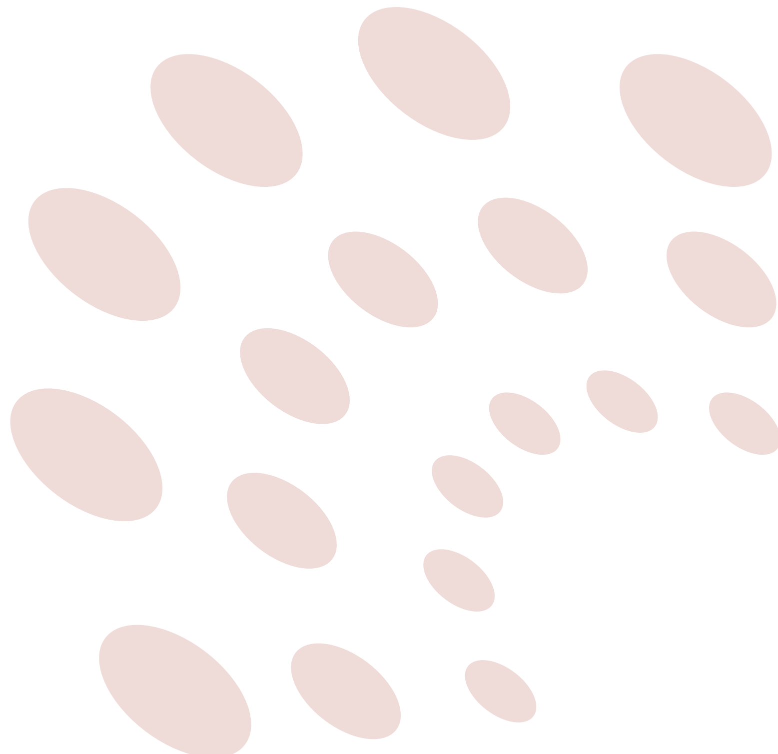
In order to mitigate the risks associated with executive compensation, boards should consider requiring organizations to take some or all of the following steps:

- Clearly articulate the company's philosophy on aligning pay with risk
- Develop processes, internal assessment policies and control procedures, which include engaging chief risk officers
- Require additional reporting of incentive design and actual payouts at the board/compensation committee level for higher risk situations
- Conduct scenario testing both forward and backwards
- Implement formal incentive caps, where appropriate
- Re-examine performance metrics and peer groups
- Implement clawback policies and minimum deferral features on incentives
- Lengthen vesting periods on options and share plans
- Require post exercise hold periods on options during employment and post retirement
- Increase share ownership guidelines, and extend beyond employment
- Modify compensation arrangements for control functions (such as risk) to encourage independence

20. What compensation risks do we need to monitor on an ongoing basis and how do we mitigate them?

## Conclusion

Executive compensation will almost certainly remain a "hot button" issue for boards of directors for some time to come. Compensation committee members will need to be aware of and respond to changes in best practices, regulatory requirements and shareholder views. Directors and compensation committee members who are prepared to conduct a stringent review of executive compensation programs and are able to relate compensation to issues such as strategy and risk will be of great value to their boards, the organizations they serve, and their shareholders.



# Where to find more information

## CICA Publications on Governance*

### The Director Series

#### The 20 Questions Series

20 Questions Directors and Audit Committees Should Ask about IFRS Conversions (Revised ed)
20 Questions Directors Should Ask about Building a Board
20 Questions Directors Should Ask about CEO Succession
20 Questions Directors Should Ask about Codes of Conduct (2nd ed)
20 Questions Directors Should Ask about Crisis Management
20 Questions Directors Should Ask about Crown Corporation Governance
20 Questions Directors Should Ask about Director Compensation
20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance
20 Questions Directors Should Ask about Executive Compensation
20 Questions Directors Should Ask about Governance Assessments
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20 Questions Directors Should Ask about Internal Audit (2nd ed)
20 Questions Directors Should Ask about IT
20 Questions Directors Should Ask about Management's Discussion and Analysis (2nd ed)
20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing
20 Questions Directors Should Ask about Risk (2nd ed)
20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee
20 Questions Directors Should Ask about their Role in Pension Governance
20 Questions Directors Should Ask about Special Committees
20 Questions Directors Should Ask about Strategy (2nd ed)

#### Director Briefings

Climate Change Briefing — Questions for Directors to Ask
Controlled Companies Briefing — Questions for Directors to Ask
Diversity Briefing — Questions for Directors to Ask
Long-term Performance Briefing — Questions for Directors to Ask

#### Director Alerts

The ABCP Liquidity Crunch — questions directors should ask
Executive Compensation Disclosure — questions directors should ask
Fraud Risk in Difficult Economic Times — questions for directors to ask
The Global Financial Meltdown — questions for directors to ask
Human Resource and Compensation Issues during the Financial Crisis — questions for directors to ask
New Canadian Auditing Standards — questions directors should ask

*Available at www.rogb.ca.

## The Not-for-Profit Director Series

### NPO 20 Questions Series

20 Questions Directors of Not-for-Profit Organizations Should Ask about Board Recruitment, Development and Assessment

20 Questions Directors of Not-for-Profit Organizations Should Ask about Fiduciary Duty

20 Questions Directors of Not-for-Profit Organizations Should Ask about Governance

20 Questions Directors of Not-for-Profit Organizations Should Ask about Risk

20 Questions Directors of Not-for-Profit Organizations Should Ask about Strategy and Planning

Liability Indemnification and Insurance for Directors of Not-for-Profit Organizations

### NPO Director Alerts

Pandemic Preparation and Response — questions for directors to ask

Increasing Public Scrutiny of Not-for-Profit Organizations — questions for directors to ask

New rules for charities' fundraising expenses and program spending — questions for directors to ask

### Other Publications

Accountants on Board — A guide to becoming a director of a not-for-profit organization

## The CFO Series

Deciding to Go Public: What CFOs Need to Know

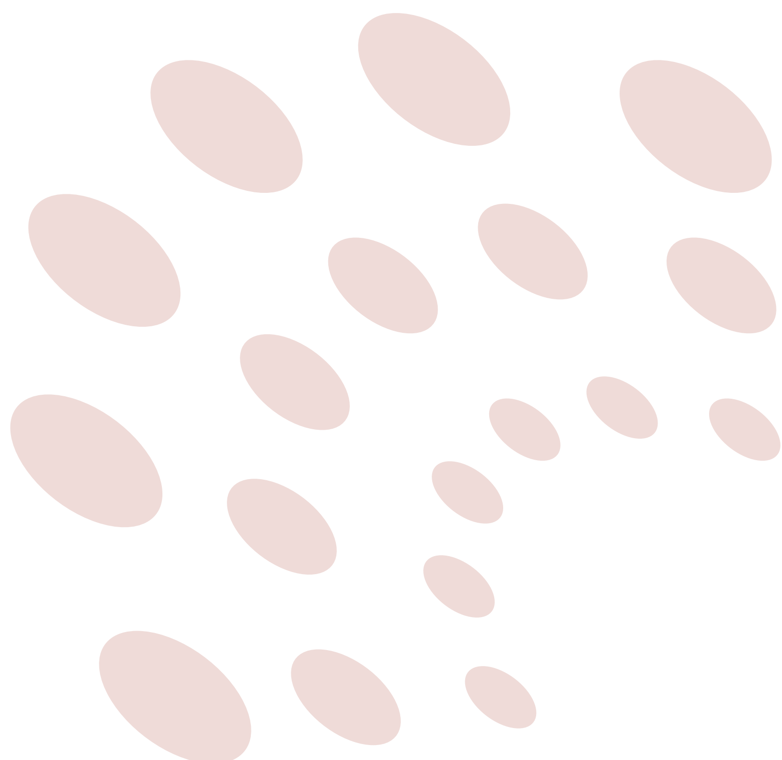
Financial Aspects of Governance: What Boards Should Expect from CFOs

How CFOs are Adapting to Today's Realities

IFRS Conversions: What CFOs Need to Know and Do

Risk Management: What Boards Should Expect from CFOs

Strategic Planning: What Boards Should Expect from CFOs



*Available at www.rogb.ca.

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