Crisis, What Crisis?

Executive Compensation in the 21st Century

Brief at a Glance

The subject of executive compensation is on the public agenda. Rapid increases in executive pay combined with accounting scandals, the global financial crisis and rising income inequality have put it there.

How has executive compensation design contributed to these phenomena? What role have investors played? And what can responsible investors do to address these challenges?

In Crisis, What Crisis?, Ethical Funds examines how shareholder primacy – a theoretical construct that drives how executive compensation is designed – is taking us down the wrong path and how the stakeholder theory of the firm can get us back on track.
NEI Investments is home to Canada's largest in-house team of responsible investment professionals. This team delivers comprehensive Environmental, Social and Governance (ESG) Services to the managers of socially responsible investments, including NEI Investment's own Ethical Funds.

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Who we are

**NEI Investments (NEI)** has approximately $5 billion in assets under management. NEI is owned 50% by the Provincial Credit Union Centrals and 50% by Desjardins Group. Through its Ethical Funds, it is Canada’s largest provider of socially responsible mutual funds.

The Ethical Funds approach to investing is based on the thesis that companies integrating best environmental, social and governance (ESG) practices into their strategies and operations will build sustainable value for all stakeholders and provide higher risk-adjusted returns to shareholders over the long-term. NEI’s ESG Services team conducts research to support and enhance its company evaluations and corporate engagement work as well as its public policy and standards advocacy. Research is also published in an effort to advance understanding of ESG risks and opportunities among companies, investors and other stakeholders.

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_The paper is all the stronger for their efforts but the opinions expressed here are those of Ethical Funds._
Contents

Executive Summary 5
Summary Recommendations 6
Introduction 7
Shareholder Primacy 8
Stakeholder Theory 17
Recommendations 21
Conclusion 28
Executive Summary

Shareholder primacy is the dominant theory of the firm today and holds that the main obligation of corporations is to benefit shareholders by maximizing share price. Shareholder primacy (sometimes called ‘shareholder value maximization’) shapes the design of executive compensation at public corporations. Executive compensation has been designed to achieve this goal by tying pay to share price.

This practice has contributed to the creation of risk at the level of the firm, financial markets, and the global economy. At the level of the firm, we see a disconnect between levels of executive pay and long-term company performance. At the level of financial markets, we see the creation of incentives that have contributed to excessive risk-taking and the global financial crisis. At the level of the global economy we see growing income disparity, the decline of the middle class and social unrest.

Socially responsible investors are in a unique position to lead the investment industry and turn this situation around. We can begin by embracing the stakeholder theory of the firm, re-initiating conversations about the purpose of the corporation and advancing the executive compensation design features that follow.

Stakeholder theory holds that the purpose of the corporation is to create value for all its stakeholders. The stakeholder constituency will vary by firm and may include employees, customers, suppliers, communities, future generations, regulators, creditors, financiers and investors. While shareholder primacy drives much shareholder thought and executive compensation design, its legal foundations are weak at best. Stakeholder theory, in contrast, has found support in law, management theory and by many people who actually run companies. Managers taking the long view and considering the interests of a broad set of potential beneficiaries can reduce risks, lower costs and exploit opportunities that contribute to the long-term health of the companies they run.

Stakeholder theory is consistent with the fundamentals of socially responsible investment. Over the past two decades, socially responsible investors have contributed to the development of metrics for measuring the ESG performance of public corporations. These metrics capture how well companies are observing stakeholder interests.

Over the past five years, Ethical Funds has been advancing ESG metrics as key components of executive compensation design through research and engagement with companies, regulators, and standards-setting bodies. Some companies have begun to integrate these metrics into executive compensation design, rewarding top managers for improving customer satisfaction, employee engagement, safety performance, or reducing environmental impacts.

A concerted effort by socially responsible investors to extend and broaden these practices will benefit companies and their shareholders. Further, such efforts have the potential to diminish short term risk-taking and restore the notion that companies can, should and do provide long-term sustainable benefits to society.
Summary Recommendations to Investment Institutions

Socially responsible investors should consider adopting a set of actions to address the challenges of executive compensation today. Ethical Funds recommends the following:

1. Stop advancing the myth that “shareholders own the company.” We own securities and have specific rights. We do not command corporate assets.

2. Encourage companies to find ways to benefit all stakeholders, not just shareholders. Guidance on how to identify and engage stakeholders is readily available.

3. Encourage companies to establish specific and measurable environmental, social, and governance (ESG) performance metrics linked to stakeholder interests. These criteria should be placed alongside financial metrics in executive compensation design. Investors should insist on clear and consistent linkages between all performance metrics and the pay rewarded.

4. Acknowledge that not all shareholders are the same. Encourage companies to engage those investment institutions that share an interest in long-term sustainable value creation. This can be demonstrated through public statements of investment philosophy, holding periods and turnover track records.

5. Enhance disclosure of compensation engagements with companies and provide assurance that these engagements are conducted with long-term sustainable value creation top of mind.

6. Accept the legitimate use of discretion by compensation committees in diverging from compensation formulae. But insist that discretion should be used sparingly. Boards should disclose when they have used it, how they have used it, and why they have used it.

7. Exercise your right to vote on executive compensation as proposed by management (“say-on-pay”) and explain your negative votes to the compensation committee of the board so that companies can improve practices.

8. Advocate for the elimination of stock options. Stock options are complex, highly susceptible to manipulation and have the effect of excessively rewarding executives on the basis of a single and questionable performance metric.

9. Engage policy-makers and standards-setters to improve executive compensation practices. Regulators have the potential to improve disclosure and compensation practices. Shareholders have an obligation to help even the playing field for those companies adopting best practices.

10. Initiate and participate in serious discussions about placing a cap on executive compensation. The rate of increase in executive pay is not sustainable. The conversation to limit pay must begin now.
Introduction: Design Matters

On May 31, 1916 the Royal Navy engaged Germany’s fleet in the North Sea, near Jutland, Denmark. During the battle, three British battle cruisers – the Invincible, the Queen Mary, and the Indefatigable – received fire, exploded and sank. More than 3,000 men lost their lives. The fleet commander, Vice-Admiral David Richard Beatty, from the HMS Lion turned to his flag captain and commented, “Chatfield, there seems to be something wrong with our bloody ships today.”

Beatty’s phlegmatic remarks notwithstanding, the extreme vulnerability of the battle cruisers had come as a surprise. Later inquiry found that a severe design flaw had allowed German shells to penetrate gun turrets and detonate ammunition stored below deck.

A similar thought occurs to us as we observe the world of executive compensation: there seems to be something wrong with how we pay our top executives. 1 Today, most executives of publicly-traded companies are primarily evaluated on the basis of share price performance and the financial indicators that are believed to drive share price. The most common mechanism to get executives to focus attention on share price is the stock option plan or some other form of equity-based compensation. 2 In both Canada and the United States, equity-based compensation accounts for more than half of what executives get paid. This is a relatively recent phenomenon, one that started in the late 1970s but got real traction in the 1990s. 3 Not surprising, then, when most companies declare proudly that their main purpose is to maximize share price. Maximize share price and you can maximize your pay.

But there’s a problem. Although executive pay has increased, accountability and performance have not necessarily increased with it. Instead, as executive pay has increased, we have witnessed a succession of corporate accounting scandals, a focus on “earnings management” instead of company management and excessive corporate risk-taking. Further, some commentators believe the structure of executive pay has contributed to the ongoing global financial crisis and a level of income polarization that threatens social, economic and political stability. In this context, governance experts, academics, shareholders and politicians are looking at the topic of executive remuneration very closely and coming to the conclusion that there is something deeply wrong with how publicly-traded companies pay top executives.

This brief is more than just an autopsy of past and present practice: it is also a look forward to address the question of how we, as responsible investors, should address the challenge. To do this, we draw upon the work of leading corporate governance scholars to revive an alternative theory of the firm, one grounded in the idea that the purpose of the corporation is to provide a positive rate of return to all its stakeholders.

But we must go beyond merely advocating a theory. We also recommend a series of practical actions socially responsible investors can take to engage companies on their executive compensation practices. We believe a critical mass of investors engaging in this way can help build better companies, stronger communities and create a more sustainable economy.

1 This paper focuses on executives working at public corporations operating under the ‘Anglo-American model’ – corporations that are characterized by dispersed ownership and single-tiered, non-executive boards of directors elected by shareholders and emphasizing shareholder interests. For thirty years, there has been a global trend toward the Anglo-American model in how companies are governed and by extension, in how executives get paid. For a general critique see Thomas Clarke, “A Critique of the Anglo-American Model of Corporate Governance”, Comparative Research in Law & Political Economy Research Paper 15/2009 Vol. 5 No. 3, (2009). For one discussion of how public corporations in Canada differ from their American and UK peers see Randall Morck and Bernard Yeung “Some Obstacles to Good Corporate Governance In Canada and How to Overcome Them”, Research Study Commissioned by the Task Force to Modernize Securities Legislation in Canada, August 18, 2006. In Canada, public corporations are more likely to be controlled by a single controlling shareholder than in the US. See for example, Second Class Investors: The Use and Abuse of Subordinated Shares in Canada, Shareholder Association for Research and Education, 2004. This tendency does not negate the observation that Canadian executives are only slightly less compensated by equity than their American counterparts.

2 See for example, Meridian Compensation Partners, Trends and Developments in Executive Compensation, March 2011 and Equilar “Performance Share Usage Among S&P 500 CEOs Continues to Grow”.

Shareholder Primacy: “The Dumbest Idea in the World”?

Shareholder primacy – the idea that the main obligation of corporations is to maximize share price for the benefit of shareholders – is the dominant philosophy that guides the design of executive compensation plans today. How did we get here?

The answer can be found in the emergence of the public corporation as a significant economic entity in the sixteenth century. Under this form of incorporation, the public company separates ownership of the company, in the form of shareholders, from the managers who run the company on a day to day basis. This separation of ownership and control is identified as a ‘principal-agent problem’.

Adam Smith may have been the first to define this problem as he observed the emergence of the joint-stock company, issuing securities on early public stock exchanges. In The Wealth of Nations (1776) he wrote: “The directors of such companies, however, being the manager rather of other people’s money than of their own”, cannot be expected to “watch over it with the same anxious vigilance” as would owners. As such “negligence and profusion must always prevail in the management of the affairs of such a company”.

“On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy...It is the product of your combined efforts...Your main constituencies are your employees, your customers and your products.”


The debate over how to remedy the agency problem went unresolved until the 1930s. In the U.S., public policy-maker interest in this topic at that time was keen as President Roosevelt began the process of regulating the corporate and investment institutions widely blamed for the stock market crash of 1929 and subsequent Great Depression. Transparency became the essential means by which securities regulators would ensure that shareholders had the information they needed to make informed investment decisions and keep an eye on managers. Sunlight makes the best disinfectant, it was said, and the regulations introduced in the 1930s laid the groundwork for much of the disclosure regulations we see today.
Through the depression, the war years, and then the big boom of the 1950s and 1960s, enhanced disclosure requirements were widely viewed as sufficient. But with the stagflation of the 1970s came the concern that modern corporations, with vast bureaucracies and systems of control, had detached business from their entrepreneurial past. Large corporations had come to resemble the state. Managers were complacent and the economy was flat. This problem was addressed in a paper published in 1976 by economists Michael Jensen and William Meckling. The solution? Make the managers the owners of the corporation by linking their pay to share price in the form of stock and stock options. That way, the interests of executives and shareholders would be aligned. Managers would become more aggressive and entrepreneurial and work as hard as possible to drive growth.

The False Mantra of Shareholder Primacy

Thirty-five years later, shareholder value maximization has become the dominant theory within academia, U.S. law and business school curricula, and in the design of executive compensation.

In academia, victory was declared in 2001. In “The End of History of Corporate Law”, Hansmann and Kraakman assert the achievement of “a widespread normative consensus that corporate managers should act exclusively in the economic interests of shareholders.” This, they wrote, was a function of the economic triumph of the Anglo-American corporate model focused on shareholder value maximization and the failure of other models such as the manager-oriented model that evolved in the U.S. in the 1950s, the state-oriented model dominant in France and Asia and the labour-oriented model of Germany. The emergent consensus had already affected corporate governance practices throughout the world and it was only a matter of time before its influence would be felt in the reform of corporate law as well.

In the U.S., law and business school curricula emphasize shareholder value maximization as the central purpose of the corporation. “Instruction affects views,” a Brookings Institution study notes, and “surveys show that after completing school, students are more likely to see shareholder value as the most important goal of the corporation.”

Finally, in the world of executive compensation, most executives of publicly-traded companies are evaluated on the basis of share price performance and financial indicators that are believed to drive share price including earnings per share, total share return, revenue and operating income. The most common mechanism to get executives to focus attention on share price is the stock option plan or some other form of equity-based compensation such as restricted stock, performance shares and deferred share units.

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8 As noted elsewhere this is a recent phenomenon. In 1976, stock-based compensation represented less than 1 per cent of CEO compensation in large American corporations. In 2011 63% of total executive pay was in equity-based compensation. See Meridian Compensation Partners, Trends and Developments in Executive Compensation, March 2011 and Equilar, “Performance Share Usage Among S&P 1500 CEOs Continues to Grow”, 2012.
The notion of shareholder primacy is a juggernaut. But in the wake of growing concern about corporate performance, market crashes, and income inequality, the challenges to shareholder primacy are beginning to mount. These tend to coalesce around five major points:

1. **Shareholders do not own companies. They own shares.**

Proceeding under the banner of shareholder primacy, investors often act as if we and we alone command the company’s assets, insist that the corporate world revolves around us and deny the different kinds of ownership or stakes that others might have in the well-being of the company.

As noted by Lynn Stout, a leading corporate governance scholar at Cornell University, share ownership brings specific rights (e.g. the right to file shareholder proposals to be included in the company’s information circular). But shareholders do not exercise control over the corporation’s assets. We do not have the right to help ourselves to the company’s earnings. We may receive dividends but that happens only when directors decide to declare them. Any influence we have over the company is made by argumentation (through engagement or proposals) or through director elections. Thus, “while it is perhaps excusable to loosely describe a closely held firm with a single controlling shareholder as ‘owned’ by that shareholder; it is misleading to use the language of ownership to describe the relationship between a public firm and its shareholders.”

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2. Directors are not required to maximize shareholder value; under most circumstances their primary legal obligation is owed to the corporation not the shareholders.

Section 122 (1) (a) of the Canada Business Corporations Act states: “Every director and officer of a corporation in exercising their powers and discharging their duties shall act honestly and in good faith with a view to the best interests of the corporation.”

The Supreme Court of Canada has confirmed Section 122 (1) (a) of the CBCA. In Peoples Department Stores v. Wise, the Supreme Court ruled:

“(I)t is clear that the phrase the ‘best interests of the corporation’ should be read not simply as the ‘best interests of the shareholders’…We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments, and the environment.”

In this and other decisions, the Court has affirmed the existence of a ‘business judgment rule’ which allows directors to consider a broad range of factors in making decisions. They are not, in general, under an obligation to maximize shareholder value. The Court will defer to the business judgment of the directors provided that an appropriate degree of prudence and diligence was brought to bear in reaching a reasonable business decision at the time it was made.

U.S. court decisions have the potential to influence courts in Canada and elsewhere. But even in the U.S., where equity-based compensation has been most aggressively pursued, the legal support for the idea that corporate law requires directors and executives to maximize shareholder value is weak.

The legal foundation for shareholder primacy is most often traced to a single judicial opinion found in the Michigan Supreme Court’s 1919 decision Dodge v. Ford Motor Company. In this case, the Dodge brothers sued Henry Ford for refusing to provide a dividend to minority shareholders. The Dodge brothers wanted the money to expand their competing business and Ford knew it. Ford defended withholding the dividend by claiming he wished to use the money to offer lower prices to consumers and to pay higher wages to his employees. The brothers sued and won. The Court famously stated: “There should be no confusion… a business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”


Peoples Department Stores Inc. v Wise, Supreme Court of Canada, October 29, 2004.

For a legal analysis of the Peoples decision and the Supreme Court of Canada’s decision in the case of BCE vs. 1976 Debentureholders, see Ed Waitzer and Johny Jaswal, “Peoples, BCE, and the Good Corporate Citizen, Osgood Hall Law Journal 47, 2009. Waitzer and Jaswal conclude that while the court did not affirm shareholder primacy it could have gone much further in specifying the duties corporations owe to stakeholders.


Stout argues this case does not set law. Her argument comes in four parts. First, the court’s statement was published in the form of dicta; a statement of opinion that while authoritative is not binding. Second, the case is almost a century old. There has been a lot of corporate law written since 1919. Third, in the U.S., corporate jurisprudence tends to be set in Delaware where judges have become known for their expertise on corporate law. Michigan is not noted for its contributions to this area. And fourth, and perhaps most important, over the past 30 years, the Delaware court has cited Dodge v. Ford on just one occasion – and not on the question of corporate purpose but on the question of controlling shareholders duties to minority shareholders.  

Shareholder primacy advocates also advance Revlon Inc. v. MacAndrews & Forbes Holdings Inc., as a second case demonstrating that the law specifies shareholder value maximization as the purpose of the firm. In this case, the directors of Revlon decided that the company would be sold to a private group of shareholders. The public shareholders would be required to give up their interest and receive cash or other securities in return for their shares. The Delaware Supreme Court held that when a company initiates an active bidding process, the board’s role changes from that of acting in the best interests of the corporation to seeking for shareholders the best possible price for their shares. As Stout notes, “it is only when a public corporation is about to stop being public that directors lose the protection of the business judgment rule and must embrace shareholder wealth as their only goal.”

The business judgment rule prevails in Delaware too – the most business-friendly American court. Case law demonstrates that Delaware courts are generally loath to review the business decisions of directors who have performed their duties in good faith, with prudence, and in the best interests of the corporation. Most famously, in Schlensky v. Wrigley the plaintiff William Schlensky filed a derivate action against Phillip Wrigley to force the installation of lights at Wrigley Field so the Chicago Cubs could play night baseball. By this time (1968) every other major league baseball team had installed lights. The defendant refused to install them for the Cubs expressing concern that night baseball would be detrimental to the surrounding neighbourhood. The court decided in favour of the defendant citing precedent that when corporations operate within the law the court is without authority to substitute its judgment for that of the directors. 

The upshot is that, contrary to executive compensation plans that emphasize share price, the directors of public corporations are not legally required to maximize share value.

15 Stout, The Shareholder Value Myth. U.S. jurisprudence on this matter is something of hornet’s nest. Interested readers should also review Unocal v. Mesa Petroleum another decision of the Delaware Supreme Court that legitimized poison pills to prevent takeovers when it can be shown that there is a threat to corporate policy and that defensive measures are proportional and reasonable. See also Leonard L. Rotman, “Debunking the ‘End of History’ Thesis for Corporate Law”, Boston College International and Comparative Law Review, Volume 33 Issue 2 (2010).
3. Shareholder primacy encourages companies to seek short term profit regardless of long-term consequences.

“Short termism” is defined as the excessive focus of corporate managers on short term results for the purpose of share price manipulation. For non-financial firms, short termism may involve maximizing quarterly profit and stock price by inflating current earnings at the expense of the long-term health of the firm. This can include such practices as decreasing discretionary expenses, under-investing in long-term assets or taking on excessive risk to maximize short term earnings. For financial firms, short termism can also involve investing in assets with hidden risks and taking on excessive debt to bolster short term profits or portfolio returns. It can also include using short term trading strategies that ignore the fundamental value of underlying assets, or using voting rights to pressure firms to provide immediate payback to owners through dividend payouts, stock repurchases, or selling off assets. When firms use these measures to boost stock price it is called ‘earnings management’.¹⁷

Lynn Dallas, of the University of San Diego School of Law, is among a group of scholars who distinguish accounting earnings management from real earnings management. Enron engaged in accounting earnings management when it created a large gain on its books by ‘selling’ its unprofitable broadband venture to a ‘special purpose entity’ that it also controlled, essentially playing a shell game. Lehman Brothers engaged in accounting earnings management when it reported its borrowing as sales thus boosting its earnings in time to please analysts on quarterly earnings calls. While these troubling accounting methods have declined with the passage of legislation in the U.S. (Sarbanes-Oxley), real earnings management has increased. Examples include offering price discounts to temporarily increase sales and reducing expenditures on items such as employee training and research and development to improve margins.¹⁸

How widespread are both forms of earnings management? In a 2005 survey of more than 400 financial executives, it was found that a majority would avoid initiating a positive net present value project if it meant falling short of the current quarter’s consensus earnings estimates. They would do this because they believe that missing an earnings target or reporting volatile earnings reduces stock price.

¹⁷ CFA Centre for Financial Market Integrity/Business Roundtable Institute for Corporate Ethics, Breaking the Short-Term Cycle: Discussion and Recommendations, 2006.

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Financials alone are not up to the task

Most executives and directors believe that a focus on financial indicators alone provides an incomplete picture of a corporation’s ability to generate long-term value.

In a 2004 survey of 250 directors and executives undertaken by Deloitte, 92% responded that financial indicators do not adequately capture the underlying strengths or vulnerabilities of the companies they run. Deloitte followed up in 2007. In that survey 78% said that financial indicators alone do not adequately capture their companies’ strengths and weaknesses. The figure rose to 85% for companies with revenues over $1 billion. Significant percentages of respondents said that senior management needs better information relating to such areas as employee commitment (58%), customer satisfaction (48%), innovation (36%), impact on society (32%), operational performance (32%) and supply chain performance (31%).
4. Shareholder primacy contributed to the conditions that led to the global financial crisis.

The Financial Crisis Inquiry Commission was created in 2009 by the U.S. Congress as a bipartisan panel to investigate the causes of the global financial crisis. The Commission concluded that the financial crisis was an avoidable disaster. It identified the collapse of the housing bubble as the spark that led to the steepest decline in the stock market since the Great Crash of 1929 and the ongoing global financial crisis.

There were, however, pre-conditions that created a tinder-dry environment for that spark. Shareholder primacy was one element in that environment.

The financial services industry relies on effective and efficient regulation to function. Shareholders require information to ensure efficient markets and oversee the governance of corporations. Households require safe and secure deposit-taking institutions to protect their savings. Homebuyers and small businesses need to be properly assessed for credit risk.20 But prior to the crisis, relentless lobbying efforts by corporations obstructed the development of regulation designed to protect stakeholder interests.21 Over a period of several decades legislation separating commercial and investment banking was repealed and anti-predatory lending laws in several states were rolled back—both critical pre-conditions leading to the crisis. Thirty years of deregulation and the failure of credit rating agencies to provide the red flags, short-termism, a desire for share price maximization and a culture of greed all contributed to a setting that invited the crisis. As noted by the Financial Inquiry Commission that setting included:

- The explosion of risky subprime lending and securitization, unsustainable house prices, widespread predatory lending practices, increases in household mortgage debt and exponential growth in financial firms’ highly profitable proprietary trading activity.

- Dramatic failures of corporate governance and risk management at financial institutions deemed to be ‘too big to fail’. Too many banks took on too much risk, with too little capital and too much dependence on short term funding. Leverage ratios of the five largest investment banks in the U.S. were as high as 40:1 and the leverage was often hidden in opaque derivatives products and off balance sheet entities.

- A systematic breakdown in accountability and ethics. Lenders made loans that they knew borrowers could not afford. Loans contained in financial products sold to investors often did not meet the underwriting standards of the financial institutions packaging and marketing these products.

The commission concluded that compensation systems of the financial services industry “too often rewarded the quick deal, the short-term gain without proper consideration of the long-term consequences. Often those systems encouraged the big bet – where the payoff on the upside could be huge and the downside limited”.

This was foreseen. As early as 2003, the National Association of Corporate Directors recommended that public corporations decrease their reliance on stock price as a performance measure and recommended that companies use both qualitative and quantitative measures in compensating executives for performance. In 2007, in advance of the financial crisis, the Research and Development Committee of the Committee for Economic Development, a distinguished panel of business, academic and policy leaders criticized the reliance on short term financial results rather than long-term value and stability. The panel concluded that decision-making based primarily on short-term considerations “damages the ability of public companies and therefore of the U.S. economy to sustain superior long-term performance”.

5. Executive compensation design based on shareholder primacy is contributing to income polarization and brings risk to the global economy.

Income inequality is increasing. Executive compensation is one of the primary causes.

In 1980, CEOs of large U.S. companies received an average of $624,966 in annual compensation or 42 times the pay of typical factory workers. By 2010, large company CEO pay had risen to $10.8 million or 315 times the median workers’ pay. Further, statistics show that income disparity has reached levels not seen since the Great Depression. In 2008, the top 0.1 per cent of wage earners took in more than 10 per cent of the personal income in the U.S. and the top 1 per cent took in more than 20 per cent.

Who are these people? The largest single chunk of the highest-income earners are executives and other managers in firms. According to economists John Bakija, Adam Cole, and Bradley T. Heim, executives and financial professionals today account for about 60 per cent of the top 0.1 per cent of income earners. Further, executives and financial professionals now account for 70 per cent of the increase in the share of national income going to the top 0.1 per cent between 1979 and 2005.

In Canada, the picture is similar; though slightly less stark. According to the Conference Board, in 1995, the average pay of Canada’s highest paid 50 CEOs was $2.66 million, 85 times the pay of the average worker. In 2010, the average pay of the highest paid 50 CEOs rose to $8.38 million, 255 times the average worker.

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26 Mackenzie, Hugh, Canada’s CEO Elite 100, Canadian Centre for Policy Alternatives, January 2012.
Similar to the U.S., as the Canadian economy grows, most gains have gone to a very small group of ‘super-rich’. The richest 1 per cent of Canadians – the 246,000 people whose average income was $405,000 – took home almost a third of all growth in incomes from 1998 to 2007. The growth in income is not due to the assets they own; rather, it is mostly coming from remuneration, suggesting that high executive pay is driving at least part of this growth. At the other end of the spectrum, the poor have gotten poorer on a relative basis. The gap between the real average income of the richest group and the poorest grew from $92,300 in 1976 to $117,500 in 2009. The rate of increase in income inequality has been greater in Canada than in the U.S. since the mid-1990s.27

This trend is not unique to Canada and the U.S. According to both the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF), income inequality is on the rise in most countries. Of total world income, 42 per cent goes to those who make up the richest 10 per cent of the world’s population. Just one per cent goes to those who make up the poorest 10 per cent.

**High Pay in the U.K.**

In the U.K., an independent High Pay Commission found that “the pay gap” between bosses and the average employee has grown dramatically. In 2010 alone, the commission found that as economic growth slowed, executive pay in the FTSE 100 rose on average by 49% compared with just 2.7% for the average employee. The Commission has concluded “excessive pay damages companies, is bad for our economy and has negative impacts on society as a whole.”28

Why does this matter? Evidence shows that sustained economic growth is possible only when its benefits are widely shared. According to the IMF, rising income inequality is destructive to growth, bringing political instability, fewer public policy options in the face of economic shocks and an inability to invest in education and entrepreneurial activity. In a test of which variables contribute to durable economic growth, income distribution is a more important driver than trade openness and robust political institutions.29

In the World Economic Forum’s 2012 survey of 469 experts from industry, government, academia and civil society severe income disparity tops the list of 50 global risks identified. In the words of the WEF, the “seeds of dystopia” are being sown as income inequality contributes to “declining economic conditions jeopardize[ing] the social contracts between states and citizens.”30

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28 High Pay Commission, Cheques With Balances: Why Tackling High Pay is in the National Interest, November 2011.
The rise and fall and rise of stakeholder theory

Stakeholder theory suggests that the purpose of the corporation is to provide a return to stakeholders. In order to succeed and be sustainable over time, directors and executives must keep the interests of employees, customers, suppliers, communities, shareholders and future generations going in the same direction. Innovation to keep those interests aligned — rather than trading off the interests of stakeholders against each other — ought to be the main goal. By managing for stakeholders companies will provide broad societal benefits, create value for shareholders and other financiers and ensure the efficient allocation of resources.31

The idea that corporations have a social purpose beyond maximizing shareholder value can be traced back to the creation of the first joint stock companies. In Canada, the Hudson’s Bay Company received its corporate charter in 1670 not to maximize shareholder return, but rather, for the purposes of trade and settlement in the Hudson Bay region of North America and for exploration toward the discovery of the Northwest Passage to Asia.

As early as 1916, J. Maurice Clark wrote about the need for an “economics of responsibility, developed and embodied in our working business ethics.” 32 A debate ensued about the role of the public company among corporate governance theorists, particularly in the wake of the stock market crash of 1929. And, for a period of several decades, the notion that corporations owed a duty to society was the victor: Emerging from the economic stress of the Great Depression, through World War II and extending to the boom period of the 1950s and 1960s many corporations acknowledged their purpose in providing employment, fighting a war and accepting their role as a major driver of the economy beyond profit-making. This acknowledgment contributed to a broad acceptance of a social contract between corporations, labour, and government. E. Merrick Dodd of Harvard University and a leading corporate governance theorist of the time argued that “public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function”.33

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Why didn’t it stick?

Part of the critique of early notions of stakeholder theory was grounded in the fuzziness of its conception and practice. Beyond stating corporate social responsibility generally, there were legitimate questions of where corporate obligations ended and the duties of the state began. Milton Friedman’s classic article “The Social Responsibility of Business is to Increase Profits”, published in The New York Times Magazine 1970 criticized the “analytical looseness” attached to the notion that “businesses have social responsibilities”.

What’s changed?

Structures, Tools, Standards, Services

Friedman may have had a point back in 1970 about the lack of rigor attached to the concept of corporate social responsibility. Though the debate about the social purpose of the corporation had been waged over the centuries, it is true that in 1970 there was little in the way of guidance for executives seeking to ensure stakeholders would benefit from corporate activity. There were no tools for systematically identifying stakeholders and little thought had been applied to how to establish the boundaries of the corporation and its social obligations.

That criticism has now been addressed. With the assistance of the socially responsible investment industry, the concepts of corporate social responsibility and stakeholder theory are beginning to re-emerge as mainstays of management strategy. Significant efforts have been made to identify and categorize stakeholders. While the stakeholder constituency will vary by firm, it generally includes customers, employees, suppliers, communities, future generations (or the environment), regulators, creditors, financiers and investors.

Forty years after Friedman, new principles to guide corporate relationships with stakeholders have been established. From codes of conduct for labour practices, to guidance for observing human rights, to best practice standards for boards of directors, companies now have specific guidance on how to draw the boundaries and establish policies, practices and compliance mechanisms for their own operations and for their suppliers. Executives and directors now have at their disposal a robust set of tools for identifying and working with stakeholders.
United Kingdom Companies Act, 2006

In the UK, the Companies Act, 2006 introduces a new statutory duty of loyalty that requires directors to “promote the success of the company for the benefit of its members as a whole” and in doing so, take account of a range of statutorily prescribed considerations including:

(a) the likely consequences of any decision in the long-term,
(b) the interest of the company’s employees,
(c) the need to foster the company’s business relationships with suppliers, customers and others,
(d) the impact of the company’s operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct,
(f) the need to act fairly as between members of the company.

Among the most important of these are:

• AA 1000 Stakeholder Engagement Standard – sets out procedures to allow organizations to identify and engage stakeholders using a structured and auditable standard. The AA 1000 SES has been developed in consultation with companies, policy makers, civil society and representatives from standards-setting bodies. The AA 1000 Standard provides a basis for designing, implementing, evaluating and assuring the quality of stakeholder engagement.

• Global Reporting Initiative (GRI) – the world’s premier reporting standards on matters related to corporate sustainability. The foundation of the GRI’s reporting process is a definition of materiality. It urges companies to report on topics and indicators that reflect the organization’s significant economic, environmental, and social impacts or that would if disclosed substantively influence the assessments and decisions of stakeholders.

• ISO 26000 – provides a harmonized global guidance document on social responsibility intended for use in both the public and private sectors. The guidance was developed by the International Organization for Standardization. ISO is the world’s largest developer of international standards leading a network of national standards institutes in 163 countries. Over the past several decades, ISO has established a large number of international standards, including ISO 9000 (quality management) and ISO 14000 (environmental management systems).

In addition, in the years since Friedman dozens of consultancies have emerged to help companies identify and work with stakeholders. The global consulting firm Deloitte, for example, places the stakeholder concept within a risk management framework and has developed tools and services for their clients. These are intended to provide a structured process for stakeholder engagement planning, design, implementation, monitoring and reporting. The Hay Group, a global management consulting firm with a focus on executive compensation, has published advanced and rigorous guidance on ‘sustainable remuneration’. The guidance can help directors and executives to establish stakeholder-related metrics and re-think how compensation can be designed for the long-term.36

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Redesign and Recommendations

When ships of war were first armoured in the late nineteenth century, sea battles were short range. Shells followed a low trajectory, hitting the gun ports located along the sides of ships. For that reason, the heaviest armour was always placed there. But by the time World War One broke out, ships had been fitted with long range guns. At Jutland, German shells fired from much greater distances followed a high trajectory and rained down on the poorly-armoured decks of the British battle cruisers. Those ships blew up. But with this realization and soon after the Battle of Jutland, the British began to redesign and retrofit their ships.

Executive compensation is in need of a redesign. Shareholder primacy – and the executive compensation models that go with it – must be replaced by the idea that the purpose of the corporation is to provide long-term sustainable value to all its stakeholders. Executives should be incentivized to take the long view and consider the interests of a broad set of potential beneficiaries. In doing so, they can avoid conflict and costs, as well as embrace opportunities that provide for the long-term health of the companies they run.

Here are our recommendations:

1. **Stop advancing the myth that “shareholders own the company”**. We own securities and have specific rights. We do not command corporate assets.

   While shareholders have unique rights recognized in law they do not command the company’s assets. The continuing assertion of ownership is inaccurate and frames discussions with companies in a way that can only narrow the focus of directors and executives. Shareholders must place their perspectives within a broader framework.

2. **Encourage companies to find ways to benefit all stakeholders, not just shareholders**. Guidance on how to identify and engage stakeholders to improve strategy and operations is readily available.

   Shareholders should recognize, protect, and use our rights responsibly while also encouraging companies to adopt formal mechanisms for hearing stakeholder concerns and ensuring that they too benefit from corporate activity.
Many leading companies already engage stakeholders in a regular and structured fashion through employee engagement, community liaison committees, or stakeholder panels. These companies make use of guidance documents, industry initiatives and global consultancies to inform this work.

3. Encourage companies to establish specific and measurable ESG metrics linked to stakeholder interests. These criteria should be placed alongside financial metrics in executive compensation design. Investors should insist on clear and consistent linkages between all performance metrics and the pay rewarded.

ESG compensation metrics should be tailored to reflect companies’ specific stakeholders and will vary from industry to industry, company to company. Guidance for stakeholder mapping and identifying ESG metrics are readily available. Financial metrics – including share price – should be retained. Companies need healthy financials to prosper and shareholders are legitimate stakeholders too. Inattention to share price can do harm to other forms of financing and invite hostile takeover bids.

Whether the metrics are financial or ESG, companies must disclose the basis and process for calculating total compensation awarded. Companies tend to provide an overview of their compensation philosophy and the amounts awarded, but do not disclose the calculation linking one to the other. An explanation of how the compensation figures are generated should reveal the structure of compensation including the metrics, targets, results and the weights underlying the business performance factors.

**CN Rail and Health & Safety**

In 2007, Ethical Funds filed a shareholder proposal asking CN Rail to detail the ESG objectives used to evaluate performance in the executive compensation context, with specific reference to safety performance targets. The proposal was filed because despite poor safety performance during the year, the CEO had received the maximum payout possible under a plan that was supposed to take this indicator into account. Following our proposal, the company began to take steps to enhance both safety performance and the linkage of safety to compensation. Having resumed our dialogue with the company in 2011, we saw further encouraging progress in CN Rail’s compensation disclosure in the 2012 proxy circular, which included linkages to specific key safety metrics. In 2012, CN Rail was one of the few companies holding a “say-on-pay” vote where we were able to support the executive compensation package.
4. Acknowledge that not all shareholders are the same. Encourage companies to engage those investment institutions that share an interest in long-term sustainable value creation. This can be demonstrated through public statements of investment philosophy, holding periods and turnover track records.

Shareholders who engage companies should have a substantive positive interest in the corporation with a shared objective of long-term sustainable value creation. This means that responsible shareholders should be working with companies to diminish the rights of predatory investors with highly leveraged positions but no long-term commitments to the corporations in which they invest. In confronting these institutions, responsible investors should be calling for leverage limitations, broader disclosure of net positions, enhanced voting rights for investors holding shares for minimum periods (as is done in France) or time-based vesting of voting rights and other regulations to decrease the ability of such funds to push public corporations into risky business decisions.37

5. Enhance disclosure of engagement with companies and provide assurance that these engagements are conducted with long-term sustainable value creation top of mind.

Socially responsible investors should disclose clear decision-making procedures and policies with regard to the governance and executive compensation of investee companies. Shareholders should pay attention to the specific situation of the company concerned rather than the formulaic application of engagement strategies such as template letter-writing and shareholder proposal-filing. Decision-makers should be appropriately resourced and meet relevant standards of skill and experience. Delegation of engagement processes does not absolve agents involved in the investment process from their responsibilities. They should be able to justify to beneficiaries specific actions taken on their behalf.

Engaging companies is a right but it is also a responsibility. Shareholders should adopt and disclose codes of conduct for their engagement programs and consider signing on to the International Corporate Governance Network’s Statement of Principles on Institutional Shareholder Responsibilities and the Canadian Coalition for Good Governance’s Principles for Governance Monitoring, Voting and Shareholder Engagement. To the extent that these principles reference shareholder primacy, responsible shareholders should engage coalition members and advocate revisions.

6. Accept the legitimate use of discretion by compensation committees in diverging from compensation formulae. But discretion should be used sparingly. Boards should disclose when they have used it, how they have used it, and why they have used it.

At times, the use of discretion is essential to attain a fair and reasonable result. The board does have a fiduciary duty to exercise informed judgment and cannot abdicate that duty to reliance on a formula. But discretion should not be used arbitrarily. When it is used, shareholders should request disclosure of full and well-reasoned arguments for rewarding executives.

7. Exercise your right to vote on executive compensation as proposed by management (“say-on-pay”) and explain your negative votes to the compensation committee of the board so that companies can improve future practice.

Advisory votes on executive compensation, or say-on-pay, offer shareholders a non-binding vote on companies’ compensation plans. In the U.K. and U.S., these votes are mandatory for most publicly listed companies. But say-on-pay votes are still voluntary in Canada. Shareholders have few opportunities to publicly provide feedback to the companies they own. They should take advantage of this mechanism to express their views on proposed executive pay packages. Pension fund investors, unlike mutual funds, are not required to disclose their proxy voting activity. In spite of this, pension fund investors should disclose the rationale for their votes at least in high profile cases.
8. Advocate for the elimination of stock options, with the exception of start-ups and other cases where companies may not have the resources to attract the talent they need. Stock options are complex, susceptible to manipulation and have the effect of excessively rewarding executives on the basis of a single and questionable performance metric.

Paying CEOs with options has the tendency to incentivize excessive risk-taking. It has also been responsible for dramatic gaps between CEOs and other executives in the same company, leading to imbalances of power, poor morale and weakened succession planning. Options are also highly susceptible to manipulation through the timing of good or bad news and other earnings management techniques. That said, there may be special circumstances in which options can be used appropriately and effectively such as in the case of early stage companies that do not have the cash flow necessary to pay executives appropriately.

9. Engage policy-makers and standards-setters to improve executive compensation practices. Regulators have the ability to improve disclosure and compensation practices. Shareholders have an obligation to help level the playing field for those companies adopting best practices.

Proxy voting, shareholder advisory votes on compensation and engagement can be effective in providing companies with investors views and effecting change. Investors can also seek regulatory changes to raise mandatory requirements for companies.

Investors have many opportunities to share their views on optimal executive compensation practices with governments, regulators, and other standard-setters.

Engaging Policy-Makers
In 2007 Ethical Funds submitted comments to the Canadian Securities Administrators on their proposed Statement of Executive Compensation. Ethical Funds praised efforts to increase executive compensation transparency and disclosure and encouraged greater accountability for compensation committees. Ethical Funds also encouraged the Canadian Securities Administrators to strengthen the regulations requiring companies to link performance, compensation and ESG factors over the long-term.

In 2009 and 2010, Ethical Funds provided feedback to the Canadian Coalition on Good Governance on its draft Executive Compensation Principles. Ethical Funds recommended including linking pay to ESG criteria, encouraging independence in the compensation decision-making process, and promoting greater accountability to shareholders through say-on-pay. The same year, Ethical Funds submitted comments to the Canadian Securities Administrators on the proposed revision of its Corporate Governance policy and reporting requirements. Amongst other issues, Ethical Funds highlighted the importance of ensuring independence of compensation committees.
Ethical Funds Proposals on Executive Compensation

(Excluding say-on-pay proposals)

2012 season
Coca Cola – Link Executive Compensation to ESG Objectives
Laurentian Bank – Disclose Metrics Used for Executive Compensation
Royal Bank – Demonstrate Pay for Performance

2011 season
Laurentian Bank – Disclose Metrics Used for Executive Compensation
Scotiabank – Demonstrate Pay for Performance
TD Bank – Improve Linkage of Compensation to Performance

2010 season
Goldman Sachs – Establish Independent Panel to Review Executive Compensation
Potash Corporation – Demonstrate Link between ESG and Financial Performance and Executive Compensation

2007 season
CN Rail – Link Executive Compensation to ESG Success
Power Financial – Link Executive Compensation to ESG Performance

In 2010, Ethical Funds submitted comments on the International Corporate Governance Network’s Corporate Risk Oversight Principles. Those comments stressed that a critical component of board oversight was ensuring that executive compensation is aligned with corporate strategy. The same year, Ethical Funds once again provided comments on the Canadian Securities Administrators’ proposed changes to the Statement of Executive Compensation. Ethical Funds again suggested they require better disclosure on how companies link ESG performance to compensation.
10. Initiate and participate in discussions about placing a cap on executive compensation. The rate of increase in executive pay is not sustainable. The conversation to set limits on pay must begin.

The topic of placing caps on executive compensation is now on the table. In the chart below we take the two year average increase in executive pay of 21.5 per cent and compound annually for 10 years. Under this business as usual scenario average CEO pays increases from $5.8 million in 2011 to $41 million in 2021. It is clear to us that extrapolating the increases seen in recent years is not sustainable. At some point this trend must stop.

![Projected Growth in Average CEO Compensation (Russell 3000)](http://www.guardian.co.uk/business/2012/may/02/american-ceos-pay-rise)

Ethical Funds favours companies establishing compensation constraints but we have yet to specify ratios or quantum. The socially responsible investment community should initiate a serious discussion on this issue. Investors should begin to engage companies, regulators, and standards-setters in this debate.
Conclusion: We have met the enemy...

The Pogo comic strip ran for decades starting in 1951 until the death of its author Walt Kelly in 1973. The most famous Pogo quotation “We have met the enemy and he is us” was published on the first Earth Day in 1970. In this strip, Pogo remarks upon the capacity of humans to destroy the beauty and pleasure of the “forest primeval”.

On the matter of executive compensation in the early part of the 21st century, we suggest that shareholders, by insisting that our concerns should be paramount, have played a significant role in advancing incentives that damage us all. By endorsing shareholder primacy and simplistic assertions of how executives ought to be paid we are not only damaging long-term value creation for all corporate stakeholders but we are also contributing to income polarization and social strife. We are contributing to the weakening of our economy, our society and the companies we invest in.

Socially responsible investors have an opportunity to play a key role in reversing this trend. Many of us have been framing our actions in stakeholder terms for several years. Some of us have begun to take on the task of putting a spotlight on executive compensation. More needs to be done. We need to make sure we advance a stakeholder concept of the firm and we need to apply the time and effort necessary to analyze, respond and advocate for appropriate incentives at both the level of the firm and with standards-setters and regulatory bodies.

Most ambitiously, we need to initiate conversations about how companies can formally integrate the views of all stakeholders and we need to put the subject of limiting executive compensation through pay ratios or other mechanisms on the policy agenda.

But all this must be done with care and with an eye to potential unintended consequences. Executive pay and human incentives are not simple topics and cannot be addressed properly by the simple goal of maximizing shareholder value. As Plato suggests in The Statesmen, “A perfectly simple principle can never be applied to a state of things which is the reverse of simple”.
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