Taking Action on Executive Compensation: An Overview

Introduction

Northwest & Ethical Investments L.P.’s approach to investing incorporates the thesis that companies integrating best environmental, social and governance (ESG) practices into their strategy and operations will provide higher risk-adjusted returns over the long term.

Excessive and unjustified pay for top executives has achieved the status of a scandal, and represents one of the most significant challenges to re-establishing investor confidence in capital markets and publicly-traded corporations. This briefing note outlines our position on aspects of this key corporate governance issue, and describes some of our recent efforts to promote good practice.

Issues in Executive Compensation

Linking Executive Compensation to ESG Performance Criteria

We believe executive compensation should be based on pay for performance against sector-specific environmental, social and governance (ESG) criteria, as well as financial performance indicators.

Financial indicators alone provide an incomplete picture of a corporation’s ability to generate long-term value: in a 2004 Deloitte survey of 250 directors and executives, 92% responded that they do not adequately capture underlying strengths or vulnerabilities. Indeed, an exclusive focus on short-term financial metrics can be a disincentive to promoting corporate health: a 2004 study revealed that due to negative market reaction to missed quarterly earnings targets, 80% of executives would give up creating long-term value in exchange for smoother quarterly earnings.

The idea that emphasis on short-term financial metrics – to the exclusion of other measures – can distort incentive mechanisms is gaining currency. A recent McKinsey survey commissioned by the Canadian Coalition for Good Governance found that an overwhelming majority of directors and investors wished to see factors such as sustainable development and customer satisfaction considered in setting compensation.

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1 Some of these activities were carried out by Ethical Funds before the merger that created NEI L.P.
2 Annette Watson/Deloitte In the Dark: What Boards and Executives Don’t know about the Health of Their Businesses [http://www.deloitte.com/dtt/cda/doc/content/dtt_audit_InthedarkFINAL2_101304.pdf](http://www.deloitte.com/dtt/cda/doc/content/dtt_audit_InthedarkFINAL2_101304.pdf)
Yet only a minority of Canadian companies appear to link executive compensation to ESG criteria. As part of our Sustainable Investing Program company evaluations process, we review the compensation practice of companies listed on the TSX Composite Index. Based on our 2008 evaluations, out of some 230 companies we examined, over 70% had no public disclosure on the issue of linking compensation to non-financial indicators. 17% offered some generalized disclosure on the use of non-financial indicators, and a further 7% disclosed that executive compensation was linked to ESG criteria. Only 6% of companies disclosed specific ESG-related targets and compensation plan details.

Say on Pay

We believe shareholders should be enabled to provide input to boards and hold company executives to account through an advisory vote on executive compensation at the Annual General Meeting – “say on pay”. An advisory vote is not binding, but gives shareholders a voice in shaping executive compensation packages, can help improve corporate governance, and, by placing the proper incentives in front of senior executives, can help enhance long term corporate performance.

A company that explains its compensation philosophy and metrics clearly, links pay to performance in a reasonable way, and communicates effectively with investors, will likely find “say on pay” to be a useful engagement tool. For example, Aflac’s advisory vote in its 2008 proxy was supported by 93% of shareholders.


Action with Companies

We take a “dialogic” approach in our engagements with companies: first, we ask questions and listen. This allows us to gain insight into company decision-making procedures, identify internal change agents, and provide them with the information and arguments they need to influence top executives and board directors. If attempts at dialogue are not yielding satisfactory results, we may file a shareholder resolution that will be submitted to a vote at the company’s annual general meeting (AGM). Shareholder resolutions can help raise the awareness of directors, senior executives and other investors on key issues, and often prompt companies to allocate more resources to the concerns raised than would otherwise be the case.

Details of all our shareholder resolutions can be found at https://www.ethicalfunds.com/en/Investor/ChangingTheWorld/DifferencesWeMake/MakingGoodCompaniesBetter/ShareholderResolutions/Pages/default.aspx.

Shareholders are entitled to vote on key issues affecting companies – such as appointing auditors, amending articles of incorporation, electing board directors, and shareholder resolutions – at the AGM. Most shareholders do not attend the AGM or vote their shares directly. Shareholders that want their views represented will
usually instruct another individual or institution (a “proxy”) to vote on their behalf: hence the term “proxy voting”.

We devote a great deal of effort to ensuring that the proxies owned by our investors are voted in accordance with our annual Proxy Voting Guidelines. The guidelines set out in detail the basis for deciding to support or oppose resolutions on ESG issues, including executive compensation, and can be viewed at https://www.ethicalfunds.com/SiteCollectionDocuments/docs/proxy_voting_guidelines.pdf

Our Proxy Voting Activity Report, which shows how we voted proxies for each company in our portfolios, and why, can be accessed at https://www.ethicalfunds.com/en/Investor/ChangingTheWorld/DifferencesWeMake/MakingGoodCompaniesBetter/Pages/ProxyVoting.aspx.

**Linking Executive Compensation to ESG Performance Criteria**

In April 2006 we wrote to all companies on the TSX Composite Index, asking them to take steps to link executive and director performance evaluations and compensation plans to the achievement of long term environmental, social, and governance (ESG) objectives, and to disclose this to investors. Only 24 out of some 280 companies contacted responded to the request, and only a few agreed to consider the idea.

In 2007 we filed a resolution with **Power Financial** asking the company to explain how the compensation regime linked to ESG considerations. In 2005 Power Financial’s CEO was ranked the most overpaid executive in 2005 by the *National Post*, based on average annual compensation of $76 million over three years despite the company underperforming financial sector peers over that period4. Our proposal obtained 8.8% support at the AGM, which translated to 26% of minority shareholder votes, as the Desmarais family controls over 66% of Power Financial’s shares.

In 2007 we also filed a resolution with **Canadian National Railway**, asking the Board of Directors to ensure that the CEO’s compensation accurately reflects the environmental, health, and safety record of the company. We filed this proposal because, despite CN’s declining safety performance during the year, the CEO had received the maximum payout available under a compensation plan that was meant to take into account this indicator. We asked the company to disclose the rationale for this award. Our proposal received 7.84% of the total votes cast at the AGM. In 2008 we continued to engage CN on ensuring appropriate executive compensation while improving safety performance. CN’s Chief Safety Officer provided assurances

on improving safety performance, and the Chair of the Executive Compensation Committee assured us that more attention would be paid to the pay linkage going forward. The next year, the CEO received no bonus.

**Say on Pay**

In September 2007 we again wrote to all companies on the TSX Composite Index, this time asking them to allow shareholders to express their opinion about executive compensation through a “say on pay” advisory vote at the AGM, and to disclose their reasoning if they did not intend to do so. Forty out of 260 companies contacted responded to our request, and some put the idea to a vote of their board of directors or compensation committee. However, none of the companies actually implemented “say on pay” at that time.

With Walden Asset Management, we co-filed a “say on pay” resolution in 2007 with Proctor & Gamble. An agreement was reached to withdraw the resolution, as the P&G agreed to participate in a roundtable discussion among leading corporations and investors to consider the merits of the “say on pay” practice.

With Christian Brothers Investment Services, in 2007 we co-filed a shareholder resolution with Cisco Systems asking the board of directors to adopt a “say on pay” advisory vote. Almost half of Cisco shareholders – 48% - supported the resolution. Because Cisco has not acted on this signal from shareholders, in 2009 we and Christian Brothers have co-filed a further “say on pay” resolution.

With Calvert Asset Management, we have co-filed a “say on pay” resolution with Microsoft Corporation in 2009.

As well as filing and co-filing proposals ourselves, we have also supported the efforts of our colleagues at Meritas, SHARE and MÉDAC (le Mouvement d’éducation et de défense des actionnaires) by voting for “say on pay” shareholder resolutions they have filed with the major Canadian banks over the past several years.

**Action on Policy and Standards**

Some issues go beyond the performance and disclosure of one company: sometimes a change in the rules is needed to improve disclosure or performance across a whole sector. Therefore we often raise our voice in consultation processes on regulations and standards relating to corporate sustainability and governance, including executive compensation.

**Submissions to CSA**

The Canadian Securities Administrators (CSA) brings together provincial and territorial securities regulators to design policies and regulations to govern Canada's securities industry. We often participate in CSA’s consultations with stakeholders on policy development, as the changes made impact all Canadian listed companies in our portfolios.
In June 2007 we submitted comments to the CSA on the proposed Form 51-102F6 - Statement of Executive Compensation. We welcomed this initiative to increase the transparency of executive compensation packages, improve disclosure for investors and create greater accountability of board compensation committees, but we also called for a long-term perspective in assessing performance, and for linkage of compensation to ESG criteria.


In May 2009 we wrote again to the CSA to comment on its proposed revision of Corporate Governance policy and reporting requirements. Amongst other issues, we highlighted the importance of ensuring independence of compensation committees.


Submissions to CCGG

We were among the earliest members of the Canadian Coalition for Good Governance (CCGG), a coalition of institutional shareholders to promote good governance practices in the companies they own. CCGG consistently engages on behalf of its members on executive compensation issues. Although its principles and recommendations are not mandatory, they are taken into consideration by Canadian companies.

In 2007 we wrote to CCGG to point out that its proposed position on the advisory vote on executive compensation could be interpreted as opposing “say on pay”. In 2009 CCGG amended its position, recognizing the role of “say on pay” within the process of company-shareholder engagement.


In March 2009 we provided feedback to CCGG on its draft Executive Compensation Principles. We recommended inclusion of three additional concepts: rewarding executives for long-term sustainable performance by linking pay to ESG criteria; encouraging independence in the compensation decision-making process; and promoting greater accountability to shareholders through “say on pay”. CCGG released the Principles in June 2009. We were encouraged that the Principles advocate for pay based on both short- and long-term company performance, and on
indicators including relevant non-financial measures such as employee or customer satisfaction, safety, and environmental record.


Moving Forward on Compensation

Over the past year, across the global economy, we have witnessed the negative consequences of excessive reliance on short-term financial indicators as the primary means for assessing the health of corporations. We have also seen an unprecedented wave of shareholder anger against excessive and inappropriate executive compensation, reflected in record support for “say on pay” shareholder resolutions. In the face of such support, a growing number of companies in Canada and the US have agreed to adopt the advisory vote on executive compensation on a voluntary basis. As this practice becomes more widespread, attention will shift to the question of making “say on pay” compulsory, as it is in some jurisdictions, including the UK. In the US, the Obama administration has lent its support to legislation for mandatory “say on pay”, as well as other proposals for reform of compensation regimes.

Emerging issues in executive compensation may include the disparity between top executive pay and that of average workers. According to a 2009 study by the Canadian Centre for Policy Alternatives, the average compensation of the 100 highest-paid CEOs in Canada in 2007 was just under 259 times that of the average employee. In this context, we noted with interest, and supported, a 2009 resolution at German photovoltaic company SolarWorld to cap executive compensation at 20 times that of average employee compensation. This proposal was put forward by the company itself – not by shareholders. While the proposed cap is close to the existing ratio in Germany, a mandated cap goes beyond current practice. We saw this initiative as an indicator of strong corporate commitment to self-regulation and financial accountability.

Although we have seen some progress, there remains much scope for improvement. We will continue to work on current compensation issues, and to explore new aspects of this area of corporate governance.

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6 Hugh Mackenzie, Jan 2009, Banner Year for Canada’s CEOs, CCPA Growing Gap Project http://www.growinggap.ca/files/Banner%20Year%20For%20CEOs.pdf