QUANTUM SHIFTED:

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Making Progress on the EXECUTIVE COMPENSATION ISSUE

NEI

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The discussion about executive compensation has seen a fundamental shift post the global financial crisis of 2008 – within both the media and investment shops trying to find justification between what is paid and what is earned within the executive suite. High profile cases continue to prompt public debate and at times exasperation as the pay gap has grown over time. NEI has been working diligently — and quietly — on the issue of executive compensation for almost ten years, but we have recently begun to shine the spotlight on our work in order to encouraging a wider conversation.

This began in 2012 with the publication of our white paper **Crisis What Crisis?: Executive Compensation in the 21st Century**, in which we challenged the dogma of shareholder primacy and examined its contribution to excessive risk taking at the level of the firm, the financial markets and the global economy. The paper focused on the related issues of the disconnect between pay and performance and the persistent and growing problem of income inequality.

We followed this up in 2013 with engagements (which continue today) with Canada's big banks on internal pay equity, framing excessive executive pay as both a **fairness issue** and a **business risk** and promoting a different approach to pay — equitable compensation that rewards executives who create long-term sustainable value for all company stakeholders, including shareholders.

We have seen positive steps taken as a result of this engagement and in this brief we provide an update on our progress.

YOU GET WHAT YOU PAY FOR:

Excessive payouts for "performance" that is narrowly defined by short-term financial indicators have contributed to accounting scandals, economic crises and income inequality.

EQUITABLE COMPENSATION
DIALOGUE AT CANADA'S BIGGEST BANKS

A DECADE OF ENGAGMENT ON PAY:

Since 2006 we have been engaging through shareholder proposals, dialogue and public policy advocacy to secure say-on-pay at more and more companies, advance the adoption of ESG performance metrics and promote equitable compensation. But say-on-pay is only really meaningful if companies understand why shareholders are voting for or against compensation. So we undertake an annual "Feedback on Pay" campaign, writing to boards to explain our voting decision. Companies tell us that relatively few investors provide this feedback.

Since late 2012, we have been engaging Canada's six biggest banks on **quantum**: how much the top executives are paid. In 2013, the banks agreed to explore the risks of setting quantum by horizontal comparison with executive pay at peer companies, and the potential to add **vertical comparisons:** comparing the compensation of top executives to the pay of other employees in the company or income levels in society as a whole. Several banks disclosed in their 2014 proxy circulars that vertical comparison metrics had been provided to the compensation committee as part of the decision-making process on executive pay. According to the 2015 proxy circulars, all the banks that we engaged have now begun to consider vertical comparison metrics.

We will continue to ask the banks to disclose more detail on their vertical metrics, the trends they reveal, and how this information influences pay. This is important for shareholders like us, who take equitable compensation into account in proxy voting. It would also support development of good practices in this new area of pay governance.

Encouragingly, boards have taken the opportunity to set pay for incoming bank CEOs below that of their predecessors. The quantum is still high, and it remains to be seen if compensation has been curbed for the long term, but reduced use of stock options makes windfall payouts less likely in future, and final pension arrangements will be significantly less generous.

ARE CANADIAN BANK BOARDS RETHINKING QUANTUM?

	Is use of vertical pay comparisons disclosed in the 2015 proxy circular?	Are the actual vertical metrics disclosed?	Was a new CEO appointed in 2014?	How does the new CEO's compensation compare to previous CEO?		
				Salary	Target Total Direct	Final Pension Cap
Royal Bank of Canada (RBC)	"The Human Resources Committee annually reviews select vertical pay ratios to provide context in making recommendations to the board for compensation awards for the President and Chief Executive Officer."	No	Yes	-13%	-11%	-37.5%
Toronto Dominion Bank (TD)	"…the HRC reviewed a report on compensation for front line employees, and compared base salary and incentive outcomes over time for executives and the broader employee population."	No	Yes	-33%	-18%	-46%
Scotiabank	"We enhanced our vertical pay analysis, which forms part of our decision-making process for determining the President and CEO's compensation… Our vertical analysis compares the President and CEO's pay package to the median Canadian family income."	Yes	Yes (2013)	-33%	-25%	-25%
Bank of Montreal (BMO)	Vertical comparisons do not appear in the compensation discussion and analysis, but are mentioned in the rebuttal to a shareholder proposal. "…the Bank also takes into account… the vertical pay ratio of CEO pay to other employees of the Bank…"	No	No	N/A	N/A	N/A
Canadian Imperial Bank of Commerce (CIBC)	"…the MRCC also reviews vertical pay ratios before making recommendations to the Board for compensation awards for the Chief Executive Officer and his direct reports."	No	Yes	-33%	-21%	-56%
National Bank of Canada	The compensation discussion and analysis includes a section on equitable compensation practices. "It is critical for the Board and its Human Resources Committee that Officer compensation be granted in a fair and equitable spirit… …vertical pay ratios are also submitted to the Board for information purposes."	No	No	N/A	N/A	N/A

Source: McDowall Associates (2015) Are the Banks Changing the Compensation of their CEOs?

VERTICAL COMPARISONS Done Differently: Focus on the Outcomes

We don't value vertical pay comparisons for their own sake. Our purpose in promoting vertical comparisons is to moderate executive pay and address the risks associated with income inequality. Debate on vertical metrics has focused on the CEO-to-median company worker pay ratio provision included in the U.S. Dodd-Frank Act. We think that's a pity. We are skeptical about how useful this metric will be for investor analysis: there could be significant challenges in making meaningful comparisons between companies in differing sectors or with radically different structures. Worse, it is possible to imagine a situation where the lowest-paid workers could be replaced by outsourced services to drive up the level of median compensation; while in higher-pay sectors such as financial services, the ratio might seem relatively low, reducing the incentive to moderate executive pay.

That's why we've been promoting different equitable compensation approaches and metrics, such as:

- Rate of increase in pay of senior executives compared to other workers
- Maximum ratio for pay differential between succeeding levels in company hierarchy
- Caps on executive pay based on comparison to another employee level deemed significant in the context of the company, or to an income indicator in the wider economy
- Reducing disparity in employee benefits, including medical plans and pension provisions
- Living wage initiatives, setting a floor for pay of the lowest-paid workers within the company

To avoid the risk that a problematic vertical metric could be imposed by regulation, we encourage companies to demonstrate that there are simpler and more effective ways to deliver the outcomes we are looking for: equitable compensation and moderation of executive pay.

FROM THOUGHT TO ACTION:

We shared our perspective on vertical pay comparisons in dialogue with companies and in submissions to the U.S. Securities and Exchange Commission consultations on how to implement the Dodd-Frank provision.

Proxy Voting Done Differently: A Unique Approach to Excessive Quantum

When do we say "NO" on pay?
Many Canadian companies now offer an annual advisory vote for shareholders on executive compensation. We decide how to vote after analyzing the compensation plan from several perspectives. First we look for pay-for-performance: a preponderance of performance-based awards in the plan and actual alignment of compensation to the company's performance. We expect the performance assessment to be based on clearly disclosed metrics and favour plans that integrate strategic ESG factors that drive long-term performance, alongside financial metrics. We also check for pay governance good practices.

We go on to consider whether the quantum of pay is reasonable and equitable:

- C-suite pay equity: A large disparity between the compensation of the CEO and the other executives may indicate an "imperial" leadership situation, interfering with teamwork, creating discontent and threatening orderly succession.

- Horizontal pay equity: Horizontal peer groups of executives in similar roles at other companies are commonly used in setting quantum. We recognize that appropriate horizontal comparisons have value, although there is potential for abuse by including companies in the peer group that are not in the same market for executive talent, or have egregious compensation practices.

- Vertical pay equity: Even if all of our other tests have been met, we will vote against if we consider compensation to be excessive in the wider social context.

How much is too much? As long as pay is linked to performance, is there any need to set an upper limit for executive compensation? The idea of a pay cap is less radical than it might appear, as there are already limiting mechanisms. Cash bonuses are typically limited to a specific multiple of base salary, even if actual performance exceeds the "maximum" level for the performance metrics. No one is concerned that a CEO will stop performing once the maximum bonus is reached.

Some investment institutions state that they will vote against excessive pay, but don't explain how "excessive" is defined. So we have developed an additional guideline, to determine in a consistent way if we should vote against a pay package that is compliant with all our other guidelines, because the quantum is excessive. Our test relates CEO total compensation to the median household income in Canada. We used this metric to reflect our concerns about income inequality, because it relates to the financial well-being of typical Canadian families. No matter what sector they operate in, the pay of all CEOs can be compared to the median household — and we can calculate the ratio ourselves, even if the company doesn't provide equitable compensation disclosure.

We define a high quantum "range of concern" using multiples of the most recently available data for Canadian median household income:

- If CEO total compensation falls in our range of concern, we vote against the compensation package unless we find evidence that the company has adopted the kind of internal equitable compensation practices that we are promoting through engagement.
- If CEO total compensation exceeds the upper limit of our range of concern, we vote against.

Effectively, this sets a cap on the quantum of CEO compensation that we will support.

A WORKABLE METRIC:

In 2014 we shared the draft of our excessive compensation guideline with companies we were engaging on quantum. In its 2015 proxy circular Scotiabank disclosed it had adopted CEO-to-median household income as a vertical comparison metric.

In Conclusion

Executive compensation is a complicated issue, but as investors we see risk when compensation packages aren't aligned with long-term corporate and stakeholder goals. We have a long way to go, but some of the Canadian banks we have engaged have taken the step of using vertical metrics as part of their compensation-decision making process. The success we have had with Canada's big banks has helped build momentum as we take the issue of excessive executive compensation to other sectors.

We recognize that compensation quantum is just one element in a complex of issues contributing to income inequality — but it is one that shareholders have influence over. If income inequality poses systemic risk then institutional investors with holdings across the economy have a duty to respond.

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