

# SWEET Deals

**Canadian regulators need to do a better job of curbing excessive CEO pay packages... here's how.**

BY STEPHEN SAPP

**E**xecutive compensation has rapidly become one of the most frequently debated topics in business around the world. Interest has been fuelled by the regular revelations of the enormous compensation packages granted to many CEOs as well as growing evidence that the incentives associated with these packages may have played an important role in many recent corporate scandals. It is believed that compensation agreements provided to senior executives exacerbated problems at companies like Enron, Fannie Mae, and Freddie Mac in the U.S., Nortel in Canada, One.Tel in Australia and Parmalat and Vivendi in Europe.

Because compensation packages can influence executives' decisions and thus how firms are governed, it is important to ensure that the design of these contracts receives adequate attention. Even though many have alluded to the important governance role played by executive compensation, the topic has largely been missing from the discussion of corporate governance. To address this concern, the Institute of Corporate Directors Blue Ribbon Commission on the Governance of Executive Compensation in Canada was created in November 2005. The Commission was established to examine the current state of the governance of executive compensation in Canada and to identify best practices to provide a useful framework for addressing the issue in a proactive manner. The goal of the current paper is to provide a brief overview and discussion of the research and the recommendations at the heart of the Commission's final report published in June 2007.<sup>1</sup>

The report relied heavily on a series of extensive

research studies focusing on executive compensation in Canada. A key finding from the research is that executive compensation is viewed as a problem in Canada, but not at the same level as in the U.S. The concerns most frequently expressed were related to the large absolute levels of compensation and their apparent disconnect from firm performance. Because these concerns were felt to originate from the lack of a strong process for determining executive compensation, our research allowed us to identify several areas in need of improvement in the design process for executive compensation in Canada. The report contains recommendations to address these concerns along with extensive examples and discussion of best practices.

The discussion in this paper is as follows. In the next section we discuss the research at the heart of the report. The third section discusses the recommendations and the corresponding compensation analysis process. The final section provides some concluding remarks.

To ensure that the recommendations in the report are consistent with the areas of both perceived and, most importantly, actual concern surrounding executive compensation in Canada, we performed a series of research studies. Our studies used a variety of approaches to investigate executive compensation and provide as broad a perspective as possible on this issue. Specifically, we synthesized the academic and professional literatures on the subject, performed an empirical analysis of compensation and governance at a group of Canadian publicly listed companies, compared the results from our Canadian sample with a matched sample of U.S. firms

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from the S&P500, and interviewed thought-leaders on governance and executive compensation across Canada.<sup>2</sup>

In our synthesis of the existing literature on executive compensation, we characterized the key issues identified by academics in many of the top academic journals within various disciplines (e.g., accounting, economics, finance, law and strategy etc.) and practitioners in many of the top business media outlets around the world (e.g., *Business Week*, *Economist*, *Financial Times*, *Globe and Mail*, *National Post* and *New York Times* etc.).<sup>3</sup> Our study of the academic literature went back to the 1980s when compensation became a significant topic for researchers. Although many theories of executive compensation and corporate governance were identified as early as the 1930s (e.g., Berle and Means (1932)), there were relatively few papers on the topic until the mid-1980s. The major themes of the research in this area revolve around the principle-agent problem and how to improve the alignment of incentives for executives and shareholders. Recent research focuses on potential explanations for the imperfect alignment of their incentives (i.e., the weak pay-performance relationship) especially the impact of various factors on the process by which executive compensation packages are negotiated, most importantly concerns about the independence of those involved.

Although there were significant differences in the specific issues raised by the media around the world from 2000 to 2006, there was a consistency in the essence of the topics. One of the main concerns was, not surprisingly, the increasing level of executive compensation and the impact it has on executives' incentives. The important governance role of compensation is clearly recognized by the in-depth discussions surrounding how executives can influence the size and composition of their compensation packages in both good and bad ways. Some noteworthy examples are the re-pricing and backdating of options, the use of different sources of executive compensation to avoid disclosure rules (e.g., executive pension plans), changes in the recognition of revenues and costs to influence earnings and the impact of such actions on the apparent absence of a relationship between pay and firm performance.

In our empirical analysis, we examine data on the total compensation of the top five executives at each firm, measures of firm performance, and features of each firm's corporate governance structure from the proxy statements of 416 TSX-listed firms<sup>4</sup> and a matched sample of U.S. firms.<sup>5</sup> Not surprisingly, we find that Canadian CEOs are paid less than U.S. CEOs at comparably sized firms in the same industry. Though the total compensation of both sets of CEOs has been increasing dramatically over the past

six years, the difference between Canadian and U.S. CEOs has persisted and even increased. The only exception is for Canadian firms cross-listed in the U.S.—they provide similar compensation packages to those of their U.S. counterparts. This similarity is likely because these cross-listed firms must compete directly with U.S. firms for executive talent. The mix of compensation of Canadian CEOs is also different from their U.S. counterparts—Canadian firms use more annual bonuses, fewer options and more restricted stock units. Finally, the gap between the total compensation of CEOs and NEOs has been increasing in both countries, highlighting the apparent focus on chief executive compensation.

Examining the relationship between total executive compensation and corporate governance in our Canadian sample, we find that measures related to both internal and external governance systems influence executive compensation. Specifically, we find that factors related to an increase in the ability of the CEO to influence the information received by and the decisions made by directors are related to increased CEO compensation (e.g., when the CEO is the chair of the board, and when there are directors with long tenures). Similarly, we find that factors related to a weakened ability of the CEO to influence the board are related to a decrease in CEO compensation (e.g., ownership by a family or a large shareholder, and the presence of financial experts on the human resources committee). Surprisingly, we find that an increase in the number of independent directors on the human resources committee is related to an increase in the CEO's total compensation but the presence of past CEOs is not. For the options portion of executive compensation, we find that more options are used by firms in which the CEO

has more influence over the board, and firms in which the directors have more experience with options due to their sitting on multiple boards. These results indicate

a clear role for corporate governance in the design of CEO compensation packages and a need to reassess the requirements for directors on the human resources committee (e.g., the definition of independence). Investigating other concerns raised in the literature, we find that the use of comparables in the compensation design process is related to an increase in CEO compensation but, interestingly, the choice of an outside CEO is related to a decrease in the CEO's compensation. Finally, we find a weakly significant negative relationship between performance and compensation. Since these last



two results are the opposite of what one would expect, we examined them more carefully. Interviews with insiders suggest that the lower compensation for outside CEOs could be the result of Canadian firms recruiting CEOs from management below the CEO level at U.S. firms so they can be offered lower compensation. The results for pay for performance are impacted by the large range of profitability of the firms in our sample—our data set includes both healthy and financially troubled firms. This suggests that it is important to reassess how performance is measured—firms may still wish to compensate a CEO well if they are achieving the goals being set for them, even when the firm is doing poorly (e.g., in a turnaround situation).

The final stage of our formal research program was to perform a series of semi-structured interviews with a set of 59 thought-leaders and individuals representing various aspects of the compensation determination process (e.g., CEOs, directors, compensation advisors, institutional shareholders and regulators).<sup>6</sup> The interviews lasted, on average, 60 minutes and provided insight into the findings from the literature review and the empirical analyses. All of our interviewees strongly supported the need for pay for performance; however, they almost unanimously felt that the performance piece was not well implemented in practice. Second, they felt that more detailed disclosure of all sources of compensation was called for, despite the observation that such disclosure coupled with the use of comparators in setting executive compensation had led to increasing pay levels and thus ratcheting. Lastly, they suggested that those involved in the compensation design process need to have enhanced skills and capabilities. Specifically, the members of the human resources committee need to have an enhanced understanding of financial and human resources issues, and executive compensation consultants need to establish standards of professional behaviour. Related to the enhanced capabilities, it was felt that both groups need to be more accountable for their actions and have “independence of thought” to allow them to utilize these competencies in designing effective compensation agreements.

Because of potential differences in concerns based on the individuals’ roles, we separate the interview results according to the level and type of involvement in the executive compensation design process. One of the most interesting observations is that those most directly involved in the process (e.g., CEOs and directors) focused on the design of contracts to ensure pay for performance and the reaction of the media to the disclosure of the resulting compensation packages. Even though our other participants were also concerned about pay for performance, they

were more concerned about the human resources committee being willing and able to implement a true pay for performance package (i.e., a package which both increases and decreases with performance) and the ability of disclosure to increase the accountability of those involved in the process. These differences provide interesting insights into where different individuals think improvements are needed in the executive compensation design process.

Overall the research provided several thought-provoking insights into what areas are important and in need of improvement in the executive compensation design process. Building on these findings, an initial set of recommendations was released in November 2006. In response to these recommendations, there were three major comments. The first was to use guidelines and not detailed prescriptive rules. Guidelines allow firms to modify the recommendations according to the exigencies of their business. Second, emphasis on disclosure alone is not a panacea for good governance. There are conditions under which increased disclosure is advantageous but also conditions under which it could potentially be problematic. Finally, pay-for-performance is crucial but the concept is poorly understood, so the Report should build on the research to provide insight into best practices and help stimulate more discussion in this and other areas of concern for human resources committees.

## RECOMMENDATIONS

Although many of the recommendations contained in the report are consistent with the guidelines proposed by the Securities and Exchange Commission (SEC) in 2006 and the Canadian Securities Administrators (CSA) in 2007, the Report extends the discussion in many dimensions. The research suggested the need for accountability of those involved in the determination of executive compensation, and the need to align executive pay with organizational performance. Consequently, the recommendations include a well-developed process that discloses the role of those involved to increase the accountability of those involved to all important stakeholders.

Improved accountability does not, however, have to imply increased liability, as feared by many of our informants. By focusing on the disclosure of a logical process, we build on many recent judicial decisions to help manage director liability. Business judgment and the use of a process by the board were upheld in *Disney versus Michael Ovitz* (Delaware Supreme Court (2006)), even though the ruling identified many problems with the process.<sup>7</sup> Similarly in the case of *People’s versus Wise* in 2004, the Canadian Supreme Court highlighted the importance of a logical process in making

business decisions.<sup>8</sup> Consequently these verdicts highlight the value of a logical process in making significant business decisions. Disclosing the process and the identity of those involved will increase their accountability for their actions, but will not necessarily increase their liability.

Concerns were frequently raised that all individuals involved in the process must be independent, that is, not beholden to management and able to objectively evaluate all aspects of the proposed executive compensation plan. Our concept of independence builds on the results of our research and differs from that of the CSA and SEC. We believe it is necessary that the human resources committee be able to objectively view the often-competing information they have to deal with. Consequently, we are less concerned than the regulators about the involvement of representatives of the family in family-controlled companies (e.g., having family members or their surrogates on the human resources committee) or individuals with very specific knowledge. The directors should have certain competencies such as significant financial understanding and human resources knowledge (i.e., understanding what it takes to motivate, retain and groom executives).

We propose a process that contains a series of inter-related steps:

- Obtaining an in-depth understanding of the business model, strategy and goals of the firm.
- Developing appropriate executive performance metrics (both quantitative and qualitative) to support the business model, strategy and goals.
- Determining the appropriate weighting for each performance metric and developing relevant targets.
- Assessing what it takes to motivate an executive with respect to compensation given the mobility of executive talent and other job elements.
- Evaluating whether or not the total compensation arrangement is in accordance with the performance targets and aligns the executive's incentives with the firm's business model and objectives.
- Objectively stress-testing the entire plan to see if it is fair to the CEO, the firm and investors.

At the end of the process, we also suggest that the final compensation packages be debated at the level of the board of directors and voted on by the board.

Following these steps should ensure a thorough investigation of the relevant issues to ensure the alignment of the compensation package with the goals of the firm. The process is general enough to allow the necessary judgment and ingenuity to enter into the process and provide the proper balance between the art and science of executive

compensation. The report also considers best practices and key issues to provide the human resources committee with an enlarged tool set in designing their compensation packages.

Overall the report discusses how good governance can come from independent, confident and diligent directors on the human resources committee following a strong process to design executive compensation packages. A century ago, Justice Brandeis (1914) stated that “sunlight is the best disinfectant; electric light the best policeman.” He recognized that exposing facts to the light of day is the best way to mitigate problems. Since we cannot control the sun but we can control electric lights, he recommended selected disclosure as a means of policing businesses. In a similar fashion, our recommendations centre on an increase in the disclosure of both the compensation design process as well as the outcome. By following a logical process and disclosing the details of this process, we believe increased scrutiny will result in improved executive compensation practices that address the concerns raised in our research and are therefore fair to all stakeholders—the CEO, senior management and the firm's suppliers of capital, especially its shareholders.

Our focus on process and discussion of the relevant issues at each stage of the process allow our recommendations to go beyond the current CSA and SEC proposals. Our recommendations increase the stature of the human resources committee as human capital becomes the most important type of capital for firms. Given the important role of executive compensation in the steering of the firm and its ability to fulfill its business strategy, the human resources committee needs to be viewed as a crucial governance committee. With this added stature, however, comes added accountability and expectations. ■

## ENDNOTES

1. For a detailed discussion, please refer to the full report available for download at [www.icd.ca](http://www.icd.ca).
2. The complete results from the analysis can be found in Sapp (2007).
3. The results from the complete analysis can be found in Sapp, Bryant and Cotte (2007).
4. Walt Disney Co. Deriv. Litig., No. 411, 2005 (June 8, 2006).
5. People's Department Stores Inc (Trustees of) versus Wise 3 S.C.R. 461, 2004 SCC68.

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