Aligning Compensation:

An investor brief on fair pay and income inequality

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The authors would like to thank the following individuals for reviewing a draft version of this document: Laura Campos, Director, Corporate and Political Accountability, The Nathan Cummings Foundation; Michael Garland, Assistant Comptroller - Corporate Governance and Responsible Investment, Office of New York City Comptroller; Julie Gorte, SVP, Sustainable Investing, Impax Asset Management; Delaney Greig, Manager, Engagement and Policy, SHARE; Brandon Rees, Deputy Director, Corporations and Capital Markets, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO); and Catherine Smith, Manager, Proxy Voting Services, SHARE. Organizational affiliations are provided for purposes of identification and do not imply endorsement of the contents of this report by any organization listed above.

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Published by the Shareholder Association for Research and Education, January 2019

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Introduction

The ability for shareholders to vote on a company's approach to executive compensation is still a relatively recent phenomenon in Canada. It dates back to the first adoption of advisory "say on pay" votes at Canadian banks in 2008 following shareholder resolutions filed by SHARE and its clients. Continued shareholder engagement and resolutions has spread the practice of "say on pay" votes to more than 80% of the TSX60 and a majority of the TSX Composite Index.

The focus of shareholder assessments of executive compensation remains fixed on the alignment of compensation with various measures of company financial performance ("pay for performance"), on the theory that a well-designed compensation structure will help incentivize executives to deliver improved company performance. Most often, performance is assessed by returns delivered to shareholders, measured by metrics like earnings per share (EPS) or total shareholder return (TSR, relative or absolute).

This analysis rarely incorporates an understanding of the contribution that the rest of the workforce makes to company performance. If effective compensation is important to attract, retain, and incentivize performance for top executives, isn't it even more critical for employees for whom a pay differential would have a more significant effect in overall income and well-being?

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During the decade in which Canadian shareholders have participated in say-on-pay votes, executive compensation has reached new heights, while workers' wages have stagnated. The average hourly wage has remained "essentially unchanged" since the 1970s when inflation is taken into account.[1] Between 2008 and 2016, the ratio of median CEO pay and the average salary of workers in the private sector in Canada has gone from 120:1 to 140:1.[2]

This growing pay disparity should be a concern for investors. A 2016 study by MSCI found companies with lower CEO-to-average-worker pay gaps outperformed those with higher pay gaps.[3] A separate Harvard Business School study in 2017 found a negative relationship between firm performance and excessive CEO compensation (defined as the portion of compensation that is unrelated to economic factors). This negative relationship was exacerbated in firms where the CEO is overpaid and the employees are underpaid, and in firms with weaker corporate governance, and lower employee satisfaction.[4]

The effects of income inequality extend beyond the firm-level, affecting the growth and sustainability of the economy. A study by IMF economists not only found a strong negative relationship between income inequality and medium-term economic growth, but also, higher levels of inequality were associated with shorter growth periods.[5]

Workforce Disclosure Initiative

In 2017, SHARE began a partnership with Share Action in the UK on a new Workforce Disclosure Initiative (WDI), now backed by investors with over $13 trillion in assets under management. The WDI asks companies to report on a set of specific metrics relevant to positive workforce development and value both within the company itself and throughout its supply chain. The WDI is a positive opportunity to develop not only better disclosure from companies about decent work practices, but to develop better thinking amongst boards and management about the value of their workforce and how to improve workplace practices.

WDi Workforce Disclosure Initiative

Addressing income inequality

Investors who are concerned about growing inequality tend to focus on limiting executive compensation as a remedy. In part this is practical, because thanks to "say on pay" votes shareholders have the ability to influence executive pay; in part it is because investors tend to stay out of "operational" concerns beyond the board and executive level; and in part it is a natural reaction to reports of egregious pay scales and practices at some companies.

But capping executive pay on its own is a limited response to a structural problem. Limiting a few peoples' income at the top end does not guarantee that the dollars saved will be channelled towards measures that improve economic outcomes for the rest of the workforce.

More attention needs to be paid to ensuring that the value that the rest of the workforce provides to a corporation is recognized and rewarded appropriately.

Investor engagement on valuing the workforce

One method of directing attention to the contribution that the workforce makes to corporate revenues and economic growth is to ask companies and investors to better assess and quantify relevant workforce metrics and incorporate them into investment analysis. SHARE's promotion of the Workforce Disclosure Initiative (see box) is intended to support this change in thinking, by developing a systematic effort to identify and disclose the value that the workforce contributes to the company's success.

Another method is to ask that the board of directors develop its own tools to recognize and understand the importance of the workforce for their company's continued success. Typically boards of directors have held to the belief that compensation below the executive level is solely the concern of management. As a first step, therefore, boards should be asked to elevate consideration of non-executive employee compensation and relevant workforce metrics to the board's compensation or human resources committee.

Too often, the primary reference point for boards of directors in developing executive compensation plans is other companies. That is, corporate boards benchmark executive compensation to the amounts paid to other executives. While there is a role for "horizontal benchmarking" (see box) in addressing recruitment and retention issues, its use should be qualified by other data. In particular, the board should situate executive compensation within the pay structure practiced throughout the rest of the company – "vertical benchmarking."

Horizontal benchmarking

It has become relatively standard in North American corporations to use horizontal benchmarking when determining pay packages, targets and parameters for executives. This involves selecting companies with reference to size, industry, competition for talent and the geographical location of operations to create a comparator group. Compensation committees will then look at how these peer companies pay for a similar role to better understand the market competitiveness of pay levels, pay mix, and pay design.

Good horizontal benchmarking can provide useful insights in attracting and retaining talent. On the other hand, poor horizontal benchmarking is likely to contribute to increases in executive pay levels that are unrelated to firm performance.

Some common problems in horizontal benchmarking include the use of:

a) inappropriate size of comparator companies
b) irrelevant sector comparators
c) inappropriate geographical comparators
d) inappropriate target pay levels

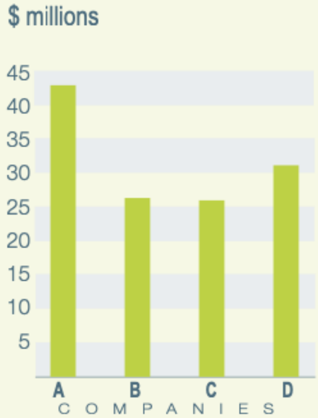
For example, Company A is a Canadian telecommunications firm with a market cap of approximately CA$13 billion. 75% of the companies in its self-selected peer group are significantly larger with almost half the companies in the group belonging to different industries. Further, the base salary for Company A's CEO is benchmarked at the 75th-90th percentile of its comparator group. The resulting high base salary benchmarks also have a multiplier effect on total compensation as many incentive plans set target payouts as a percentage of base salary. Despite being smaller than industry leaders as measured by revenue, total assets, and by market cap (see Figure 1), Company A has the highest total cost of management in its industry (see Figure 2). On average, Company A's total cost of management was 35.57% higher than its three industry leaders.

While setting target pay above the industry average is a clear invitation to escalate executive pay across the market, setting easy or low performance-related pay targets can also have a similar effect. Low targets, especially ones with thresholds at the 25th percentile of their performance comparator group, reward executives even when their firms performed worse than 75% of other companies in their sector. For example in our reference group, Company B's relative total shareholder return (rTSR) compensation threshold is set at the 25th percentile for their performance peer group, and their executives still receive bonuses even if they do not meet their return on invested capital (ROIC) targets as long as their rTSR is at the 55th percentile.[6]

While compensation consultants and boards often rationalize this by explaining that the executive receives a lower bonus for poorer performance, shareholders may wonder why it is appropriate to provide any bonus at all when performance is sub-par.

Comparing the size of company A to its peers

Total cost of management of companies A, B, C & D



Evolution of the law

India was the first country to mandate pay ratio disclosure in its Companies Act, 2013, which requires listed companies to publish the ratio of remuneration of each director to the median employee, as well as a comparison of the percentage annual increase in executive and median employee remuneration – "and justification thereof" – amongst other things.[7]

In the US, vertical benchmarking is now a legal requirement for publicly-traded companies, in the form of a CEO-to-median-worker pay ratio that is disclosed as part of securities filings (Item 402 of SEC Regulation S-K).[8] The purpose of the ratio is "to provide shareholders with a company-specific metric that can assist in their evaluation of a registrant's executive compensation practices."[9] The ratio is limited in its value as a comparative tool because the method used to calculate the ratio may differ between organizations, and the structure of the workforce may vary considerably even between companies in the same industries. However, the ratio does help to define workforce compensation as a relevant question for shareholder analysis, engagement and voting.

> "Companies should develop a set of fair pay principles. These principles should cover the company's approach to living wage across their business and supply chain, to equal pay, and to executive pay..."
>
> – PWC UK, 2016

In the UK, beginning in January 2019 listed companies with more than 250 UK employees will need to disclose and explain annually the ratio of their CEO's total annual remuneration to the median remuneration of their UK employees, as well to the 25th and 75th percentiles of their UK employee population.[10] UK companies must also report on "how pay and employment conditions of employees of the company and of other undertakings within the same group as the company were taken into account when determining directors' remuneration."[11]

Israel has gone a step further, setting an upper limit on compensation in its financial sector of 2.5 million shekels (CA$905,000) a year, or no more than 44 times the salary of the lowest worker at the company.[12]

In Canada, there is no regulatory requirement related to workforce pay disclosure, ratios, or outright caps on executive pay. While Canadian securities and corporate law often adopts practices from the US or the UK, Canada has yet to adopt mandatory "say on pay" votes (as is required in both the US and the UK) and has not entered into any rule-making process related to executive pay ratios or workforce disclosure.

In the absence of regulation

Boards of directors are, of course, not limited to what is required of them by regulators. Just as boards in Canada have voluntarily adopted "say on pay" votes even while regulators have failed to require it, they may voluntarily adopt measures that help them benchmark their executives' pay against compensation and incentive practices throughout the company.

The idea is gaining acceptance. A 2016 report from PWC, for instance, recommended that:

> "Companies should develop a set of fair pay principles. These principles should cover the company's approach to living wage across their business and supply chain, to equal pay, and to executive pay in the context of pay in the wider workforce and society. Remuneration Committees need clearer principles to deal with the difficult questions of fairness and responsibility in relation to executive pay, which go beyond simple market competitiveness."[13]

In 2014, six Canadian banks released a report by Meridian Compensation Partners looking at the question of horizontal benchmarking in the Canadian financial sector. The report was commissioned in response to shareholder proposals filed by NEI Investments.[14] The consultants concluded that

> "Committees should evaluate the consistency of executive pay actions with those proposed by management for the rest of the company. For example, salary increases provided to executives

should be compared to the merit budget for the rest of the organization. Likewise, Committees can assess the payout from executive bonus plans to those for other employees. These evaluations can provide Committees with insight into how the Company's resources are being shared at different levels of the organization."[15]

A more recent report from the Institute for Governance of Private and Public Organizations in Montreal recommended:

> "The board must state in the proxy management circular that it has been formally informed of the ratio between the CEO's compensation and the median compensation within the firm as well as within the society at large and that it considers this ratio to be appropriate in the context of the firm, the industry and the values of the surrounding society."[16]

Yet the uptake for fair pay policies remains limited, and where it does exist it is not routinely disclosed to investors. Voluntary efforts to enact vertical benchmarking have been pursued in Canada by some of the banks, notably RBC, National Bank,[17] and CIBC (which benchmarked pay structures to a living wage analysis in 2016).[18] However, to date few Canadian companies have followed in their footsteps.

Continued shareholder efforts have therefore focused on expanding the use of vertical benchmarking and fair pay assessments amongst banks and other financial sector companies. In the US, for example, shareholder proposals filed by institutional investors at 11 companies in 2017 and 2018 asked that the compensation committee of the board of directors take into consideration the pay grades and/or salary ranges of all classifications of company employees when setting target amounts for CEO compensation, and to describe in the company's proxy statements how it complies with the requested policy. The proposals resulted in agreement to incorporate the practice at most of the companies approached.

In Canada, shareholder proposals filed by the Mouvement d'éducation et de défense des actionnaires (MÉDAC) have also asked certain companies to take up the practice of vertical benchmarking.[19]

Fair pay is in the investor interest

We believe there is merit in boards of directors commissioning fair pay assessments when developing executive compensation practices, and we believe investors should reward companies that adopt the practice. The implications are twofold:

- For boards, fair pay analysis will provide a useful grounding for executive compensation that gives the board more tools in negotiating with executives and counteracts the tendency to escalate pay solely in relation to pay levels at other firms.
- The implication for executives is even clearer: if the board benchmarks an executive's pay against the method by which other employees are compensated, the executive will now have an incentive to ensure that the practices that promote effective recruitment, respect, retention and reward are in place for employees throughout their company.

Improving pay ratio disclosure

Recognizing that mandated CEO-to-median-worker pay ratio disclosures do not, on their own, provide a complete picture of a company's approach to decent work, a group of institutional investors with more than US$3.3 trillion in assets under management (including SHARE) wrote to the boards of every S&P500 company in the US in November 2018 asking them to supplement reporting related to the mandated pay ratio disclosure with breakdowns of full and part time employment status, tenure and experience, compensation mix, and alignment between CEO pay practices and those for other employees.[20]

SHARE's work

1. **ENGAGE:** SHARE approaches companies within sectors that are highly dependent on a motivated workforce and/or known to have low pay or other incentive-related issues within the workforce, with a three-pronged approach:

    1) We ask companies to measure and disclose appropriate workforce-related metrics that help to value the contribution that workers make to the success of the company, such as the Workforce Disclosure Initiative;

    2) We ask boards of directors to take into consideration the pay grades and/or salary ranges of all classifications of Company employees when setting target amounts for CEO compensation, and to describe in the Company's proxy statements how it complies with the requested policy.

    3) We ask management to address specific practices that contribute to inequality and precarious work such as poor shift scheduling practices and/or gender pay gaps.

2. **VOTE:** When voting proxies for our clients, SHARE analyzes executive compensation as a share of revenues and other corporate indicators, and uses pay ratio data (where available) or other measures of median worker income as a check against excessive disparities. We vote consistently for shareholder proposals that address rights at work including freedom of association and collective bargaining, and for proposals that ask firms to evaluate and address gender and racial pay gaps.

3. **ADVOCATE:** On behalf of shareholders, we advocate publicly and in meetings with government officials and regulators for reforms that protect and empower workers, address income inequality and gender pay gaps, and protect workers' retirement savings.

SHARE's impact-oriented shareholder engagement, proxy voting and policy advocacy programs are focused on achieving changes in corporate policy and practice that not only mitigate risks at the company level, but also contribute to building a sustainable, inclusive and productive economy upon which long-term investment incomes depend.

Endnotes

[1] https://www150.statcan.gc.ca/n1/pub/11-630-x/11-630-x2015006-eng.htm

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[3] https://www.msci.com/www/research-paper/income-inequality-and-the/0337258305

[4] https://www.hbs.edu/faculty/Publication%20Files/18-007_182aaa61-979e-4f84-ac61-d7e3837779d6.pdf

[5] https://www.imf.org/external/pubs/ft/sdn/2014/sdn1402.pdf

[6] rTSR: compares the total return of a stock to an investor, to an external comparator group. (See: https://www.investopedia.com/terms/t/tsr.asp)
ROIC: a metric calculated to assess a company's efficiency at allocating its capital to profitable investments. (See: https://www.investopedia.com/terms/r/returnoninvestmentcapital.asp)

[7] http://ca2013.com/197-overall-maximum-managerial-remuneration-and-managerial-remuneration-in-case-of-absence-or-inadequacy-of-profits

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[11] UK: The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, 2008 No. 410 SHEDULE 8

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[13] PWC. *Time to Listen*. July 2016. (available at: pdf.pwc.co.uk/time-to-listen.pdf)

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[18] https://www.cibc.com/content/dam/about_cibc/investor_relations/pdfs/quarterly_results/2018/proxy-circular-2018-en.pdf, page 12

[19] For Example: https://share.ca/share-proposals/compensation

[20] https://www.wsj.com/articles/u-s-companies-asked-to-disclose-more-about-their-workers-11544720521

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