CCGG Review of Executive Share Ownership Policies

The Canadian Coalition for Good Governance ("CCGG") recently published a report on executive share ownership policies with recommendations to create stronger links between management and shareholder interests. CCGG also surveyed share ownership practices at TSX Composite issuers.

This update summarizes CCGG's recommendations and the key findings from their survey. We have also provided views on how companies might consider CCGG's guidance and some suggested principles for enhancing share ownership policies, while mitigating some of the challenges with CCGG's approach.

CCGG places greater emphasis on the investor perspective and recommends changes designed to increase executive ownership of actual shares. While we agree with the goal of aligning executives' interests with shareholders', we think a more measured approach can achieve this goal with fewer risks and unintended consequences.

CCGG's Recommendations

CCGG believes that directors should encourage greater common share ownership by senior management and recommends five approaches Boards can take to achieve this objective:

- Ownership requirements should continually build an officer's economic interest over time. Two approaches are:
  - — Shift from an ownership requirement with a defined threshold to an annual share purchase requirement (e.g., require executives to purchase 15-20% of their Total Direct Compensation ("TDC") in common shares annually).
  - — Require executives to use a portion of proceeds from cash-settled equity awards to purchase common shares, or retain a portion of shares from the settlement of any share-based awards.
- Ownership requirements should be expressed relative to TDC, rather than base salary, to reflect ownership that is meaningful in the context of the executive's total compensation.
- At least 75% of the ownership requirement should be met through common shares. Institutional investors do not view equity-based compensation as equivalent to common shares. After a reasonable period (where equity-based awards have vested and paid out), 100% of share ownership should be in common shares.
- If equity awards are considered, only: (i) vested, full value awards required to be held until retirement (i.e., vested deferred share units ("DSUs")); and (ii) vested restricted share units ("RSUs") and performance share units ("PSUs") settled in shares, or cash-settled with a requirement to purchase shares on the open market, should be considered. Stock options (vested or unvested), and unvested RSUs and PSUs should not be included.

- Ownership policies should value securities at either market value (CCGG's stated preference) or at cost. Valuing securities at the higher of market value or cost does not align with shareholder interests as executives have both a floor value (when share prices fall), and upside (when share prices increase), unlike shareholders.

CCGG Survey Findings

- 89% of TSX Composite constituents have a formal share ownership policy. The majority of issuers without a formal policy were founder-led or family-controlled, with senior management inherently owning sizable equity.

- Of the companies with a formal policy, 69% consider unvested RSUs and PSUs, and 6% consider vested in-the-money options, in determining compliance.

- On average, CEOs are required to hold ~4.7× their base salary in common shares, DSUs, and other vested and unvested share-based awards. This translates to less than 1× TDC, on average.

- On average, companies in the communication services, consumer discretionary and financial sectors had the highest CEO share ownership requirement (~6-7× of salary), while companies in the materials, real estate and energy sectors had lower holding requirements (~3.5-4.5× of salary).

- 13% of CEOs in the survey relied on unvested compensation to meet requirements. 74% met their requirement through holding common shares and vested, full-value awards.

- The structure of ownership policies appears to impact the level of CEO common share ownership. Empirically, CEOs did not meet their requirement through common shares and vested compensation if the ownership policy considered unvested compensation.

- The survey found that median CEO common share ownership exceeded the ownership requirement across major sectors[1]. This led CCGG to ask the question whether there is a real need to count unvested equity awards in assessing compliance with share ownership requirements.

Meridian Commentary and Suggested Principles

Executive share ownership guidelines exist for two complementary reasons:

1. To align executives with shareholders

2. To support appropriate risk taking by executives.

While ownership of common shares by executives is highly desirable, fully adopting the CCGG guiding policies may, for all but the longest tenured executives, mean that most of their net worth is tied to company equity. While this creates an ownership mentality, it may promote inappropriate risk taking (either overly risky or risk adverse behaviors), which could decrease shareholder value.

Meridian has suggested a framework and principles to evolve share ownership policies from current "market practice" to better align executives with investors, while mitigating the less practical aspects of CCGG's recommendations and supporting appropriate risk taking.

[1] Major sectors are those that represent at least 10% or more of total Index constituents.

The five principles suggested below address key design features of share ownership policies to evolve policies to “best practice”.

1. How to test value of ownership against requirements

- Many Canadian companies use the higher of cost or market to assess compliance with ownership requirements. This is different than the U.S., where dominant practice is to use market value.

- Compliance would ideally be met using the market value of equity holdings and equity-based compensation, as this is most aligned with investor experience.

2. What counts towards ownership

- There should be a balance between counting unvested equity-based compensation toward fulfillment, and requiring a portion of ownership in common shares. This balance should acknowledge that: (i) share units (whether vested or unvested) are economically equivalent to common shares, in the hands of the recipient; and (ii) allowing executives to fulfill their guidelines based solely on equity-based compensation usually means that they get a “reset” with each year’s equity compensation award, irrespective of how well the share price has performed.

  Below are some principles that are aligned with the goal of enhancing alignment between executives and investors:

  — Requiring a moderate minimum percentage (for example, 25%) in common shares is a reasonable starting point—this is not currently majority market practice in Canada.

  — Purely time-vested share units (and PSUs, where performance criteria have been met) should be counted towards the balance of the ownership requirement.

  — PSUs with a risk of a zero payout should generally not be eligible. However, companies that have a materially higher than market weighting to PSUs in the long-term incentive mix should consider whether it is reasonable to count some portion of unvested PSUs.

  — Stock options (whether vested or not) should not be included.

3. Time to achieve requirements

- Most ownership guidelines require compliance within five years. A better approach could be to eliminate the ‘artificial’ deadline for compliance, but require executives who exercise options or redeem share units to retain common shares with all, or a portion, of the net after-tax proceeds, until compliance is met (or if share units are cash-settled, use proceeds to purchase shares).

  — This increases real share ownership over time and ensures that executives are actively progressing towards achieving their common share ownership.

  — This demonstrates strong alignment with shareholder interests and avoids disclosure that executives are not in compliance with the policy at the end of a specified time period.

4. Post-employment holds

- The share ownership level should be retained for a year following resignation or retirement. This supports long-term decision making, particularly as executives near retirement, and provides an incentive to support a smooth transition to an executive’s successor.

5. Other considerations

- Companies could implement treasury-settled share unit plans, which allow executives to retain their vested share units for the long-term on a tax-deferred basis following vesting. This would enhance the economic alignment with shareholders.

- Disclosure of actual common share ownership levels for each executive in the proxy annually (separate from equity-based compensation), and its contribution to meeting share ownership (what gets measured gets managed).

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