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Public Finance

CEO Pay: Are Shareholders Getting Value For Money?

Shareholder votes on executive compensation have taken centre stage at annual meetings this season. While there have been a few high-profile "no" votes (CIBC and Barrick), "yes" votes are the norm. Firms that effectively communicate the alignment between C-level suite pay and shareholder value are winning the vote, sometimes in opposition to proxy advisory firm recommendations—Goldcorp is a case in point.

Executive Compensation: How CEO's Rank
3 Highest Pay Increases

Company	1-year Change in Pay	Shareholder Return
Liberty Global	248.2%	40.5%
Freeport McMoRan	125.1%	18.6%
Aetna	174.9%	50.3%

Even as market participants assert themselves against prescriptive voting, proxy advisory firm ISS will likely apply its U.S. equity plan scorecard to Canadian issuers in 2016—a score of 53 is required for a positive recommendation. And Canadian regulators are keenly watching reaction to the SEC's pay-versus-performance recently proposed disclosure requirement. Given that two-thirds of pay at large companies in the U.S. is pegged to performance where say-on-pay advisory votes have been mandatory since 2010 (still only voluntary in Canada), have these measures better aligned executive pay with shareholder return?

A 2013 survey by Hay Group of 300 large U.S. companies reveals little correlation between the median CEO pay, which increased 5.5% to $11.5 million, and the group's 34% median shareholder return (share appreciation + dividends).[i] By this measure, CEOs were vastly underpaid relative to what shareholders reaped. However, as compensation specialists well know, a single year comparison is hardly a fair measure of a CEO's contribution, especially since current year pay reflects historical performance, typically 3 years. Yet, the survey also shows that only 3 of the highest paid CEOs led companies in the 10% of shareholder return over a 3 year period.

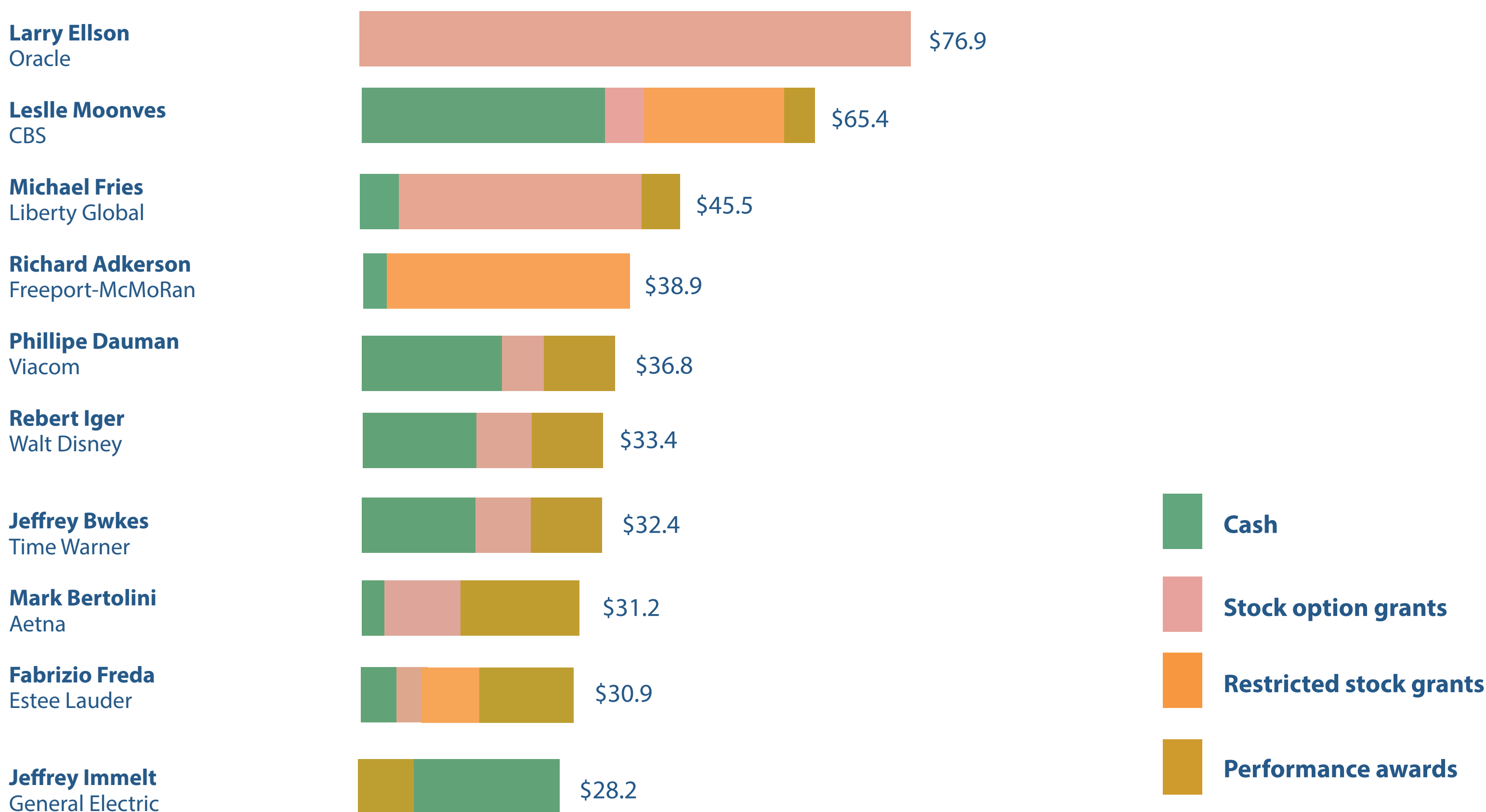
Size Matters:
Change in CEO Compensation Relative to Company Market Capitalization[2]

Change	2007-2009	2009-2011
Market Capitalization	-17%	+19%
CEO Compensation	-28%	+22%

Another measure of shareholder return, increase in market capitalization (equity + debt), and CEO pay have moved in lock-step—both have increased 6 fold over 23 years—and the correlation held up well during the financial crisis and the recovery that followed.[i] This suggests that the market is fairly efficient in linking pay to this measure of shareholder return. But whether pay levels of S&P 500 CEOs are justified by their contribution to firm value is still an open question, an issue that we explore in our next article.

Top Earners

The 10 highest-paid executives last year were awarded nearly $420 million in compensation, much of it in cash or stock options, which are making a comeback. a breakdown of each CEO's pay.



Source: Proxy analysis by Hay Group **The Wall Street Journal**

How to obtain best price execution when settling equity compensation plans in the open market

As a broker who executes trades for equity plans on behalf of issuers and participants, we carefully follow developments in share-based compensation because these changes affect our ability to provide best price execution.

A shift from time-based to performance-based vesting of equity awards increases the uncertainty as to when trades might occur and a large block needs to be sold. The timing of buy orders is also increasingly uncertain as companies adopt more flexible equity plan settlement options (treasury issuance, open market buys or cash) to balance the interests of shareholders concerned with dilution with those of employees for whom the realized value of an award depends on settlement type and market conditions.

With restricted share units (RSUs) that vest only according to a predetermined schedule, employees tend to sell them immediately because they are fully taxable at vesting, so we can plan ahead to identify a potential buyer of a large block. Similarly, if we are privy to a stock option vesting schedule, we can engage executives in discussions as to whether they anticipate exercising in-the-money options.

Equity Awards in Canada[6]

- 34.6% of Canadian companies granted performance-based equity awards in 2013, up from 24.7% in 2009
- Canada lags in granting performance equity awards which were used by 68.9% of U.S. firms
- 75% of Canadian long-term equity performance awards provide RSUs and 4.9% options
- Potential dilution from equity grants at 2.87% has been fairly stable over the last 5 years

Measuring CEO Performance: Isolating CEO Contribution from the Effects of QE and Brand Value

The SEC's proposed measure of executive pay relative to shareholder return (share price appreciation + dividends) is already widely used. Explaining why and how executive pay tracks or deviates from shareholder return, as stipulated in the SEC proposal, will require companies to isolate executive contribution from market factors, such as quantitative easing, that has provided a rising tide for more than 5 years. Can this be done with any reasonable degree of precision?

To mitigate the impact of systematic factors on executive pay, the SEC proposes that large-caps benchmark shareholder return against a peer group. Some companies already scale payouts to peer group medians, such as the S&P 500 for large companies and the Russell 2000 for small-caps. For example, a CEO may earn 150% of a stock grant or option at the end of a 3-year period if the company's shareholder return has been in the top 3rd of a peer group over the same timeframe. Some companies require a minimum shareholder return or at least a positive one for executives to earn any payout, which may result in no performance pay in bear markets.

"I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will."— Warren Buffet

Refinements in measuring shareholder return have been proposed, such as establishing the cost of capital as a hurdle rate to steer CEOs away from greasing returns with excessive debt that comes due after they are long gone.[i] This would better align incentives with shareholder interests than requiring CEOs to hold company stock in retirement for arbitrary periods of 1 or 2 years.

Holding periods don't solve the problem of excessive pay and create an asymmetry between CEOs and shareholders who can vote against a pay proposal and subsequently sell stock while the CEO continues to bear the risk of ownership. Such were the actions of one institutional investor at Barrick where John Thornton was required to buy and hold company stock purchased with his much disputed $11.9 million signing bonus.[ii]

In addition to market factors, many companies link pay to business performance, such as return on equity, a more direct measure of CEO contribution. But if the SEC prevails in requiring companies to compare executive compensation to market performance, business targets may decrease in importance.

Can even the best evaluation system really isolate CEO contribution to shareholder return, especially at large companies whose business success is largely attributable to brand value built over time? Warren Buffett, who last year described Coke's CEO compensation as "excessive", has said "I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will." Buffett has high praise for the talent of Coke's CEO, but he obviously believed that he could get it at a lower price and he did: Coke now ties more executive pay to performance and reduced share-based compensation.[i]

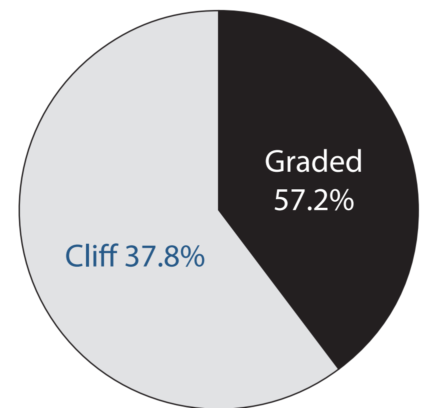
Buffett seems to be expressing in a folksy way that CEOs at large firms tend to be the best of the best, but are also better able to extract rents, consistent with the finding that growth in market capitalization tracks CEO pay increases.

But if RSU and option vesting schedules are contingent on meeting market or business targets, it is more difficult to know ahead of time when these awards will vest—they may not vest at all if targets are missed or vest only partially, and some may be subject to accelerated or extended vesting to provide incentive sweeteners. Providing any information to select outsiders as to the likelihood of business targets being met ahead of a public release would run afoul of securities regulations.[i]

How do we deal with the uncertainty as to when and how much stock might be traded to settle equity awards?[ii]

Graded Vesting: First, many performance-based awards establish milestones when a portion of the award vests, typically one-third per year over 3 years. While we are not privy to whether business targets are achieved ahead of public release, graded vesting reduces market impact compared to cliff vesting—vesting of the entire award at the end of a multi-year period. It is also important for us to know if vesting dates are not the same as payout or settlement dates—employees may be subject to post-vest holding periods.

Canadian Stock Award Vesting Schedules?



Coordinated Trading: We can assist issuers in coordinating the trading of their stock so that buy and sell orders may be matched. For instance, an issuer who is engaged in a Normal Course Issuer Bid may have an opportunity to purchase a naturally occurring block if RSUs vest during this period.

Automated Share Disposition Plans: We can set up automated share disposition plans to enable executives to sell shares whenever the performance criteria are met and awards vest, irrespective of blackout dates.

Shareholder activism is likely to accelerate the trend toward equity grants linked to performance. Whereas traditional options and RSUs vest automatically on a predetermined schedule, awards that are contingent on business and market targets require monitoring and communication between the issuer, plan administrator and broker to ensure best execution and efficient settlement.

Personal Finance

The burdens of wealth in the middle years: a successful career and equity compensation

In our January issue, we introduced our series on how to integrate equity compensation into a financial plan based on life stages. We demonstrated the benefit to 24-year old Jessica of her company's ESPP: with her employer's 50% matching contribution and tax savings from contributing shares to her RRSP, Jessica could afford to participate even with her modest means. In this issue, we catch up with the mature Jessica–a prosperous executive whose diligent savings and company's success have brought upon her the burdens of wealth: the risk of loss and taxes.

Jessica has benefited from participating in her company's ESPP in 3 ways: her employer's matching contribution, share price appreciation and reinvested dividends which, much to her surprise, provided almost 1/3 of overall returns. In the intervening years, she has acquired several stock options with staggered maturities, some of which are in-the-money. She also participates in her company's defined contribution pension plan in which she holds a portfolio of mutual funds. She visits her financial planner who zeros in on two issues: diversification and taxes.

. What is the ratio of her exposure to company stock (stock holdings + in-the-money vested and unvested options + RSUs) to her total investments? She advises Jessica to compare this ratio to her risk tolerance to determine whether stock should be sold to bring the two in line.

. Is Jessica relying on her options or company stock to achieve a specific financial goal? If so, is she close to achieving it?

. What is the sensitivity of her company's business to economic shocks (value-at-risk)? If the stock is highly sensitive, Jessica might consider exercising in-the-money vested options if she needs the money in the near future.

"Separate your view of where the stock is headed from your unique needs". – Stockoptr.com

Jessica determines that, although her company's stock is fairly stable in good times and bad, using her accrued gains to fund her children's education who will soon be off to college would greatly assist in giving her a head-start on retirement savings. Her next step is then to determine the tax cost of selling shares and exercising options.

Did you know?

The gain from sameday exercise and sale of public company stock options is taxable as employment income, not as a capital gain.

Many employees are mislead into believing that option exercise results in a capital gain because they are entitled to a 50% tax deduction in most cases.

The distinction is important because capital losses cannot be deducted from the gain realized from exercising stock options.

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350 Bay Street, Suite 800
Toronto, ON
M5H 2S6
www.globalmci.com

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