Introduction

Institutional investors have long believed that governance risks are reduced by linking management interests with those of shareholders. One of the most effective means to do this is by encouraging management teams to become shareholders of the companies they manage.

Every year, on behalf of its institutional investor Members, CCGG engages with the boards of approximately 30 to 35 of Canada's leading public companies. The discussion is focused on governance matters that are of primary importance to investors. Over the last few engagement seasons, one of the most prominent topics covered during our engagement meetings has been management (executive) share ownership. This increased focus is primarily a result of our observation that several share (equity) ownership policies allow senior management to receive credit for unvested, share-based awards (restricted stock units and performance stock units) for the purposes of satisfying the company's ownership requirements. Giving value to equity-linked investments that management has not yet earned results in an exaggeration of the officer's ownership stake in the company. In many cases, these awards are settled in cash at maturity; thereby limiting the time horizon of the officer's exposure to share price movements. When such unvested awards are relied upon to meet share ownership requirements, the link between management and shareholder interests is weakened.

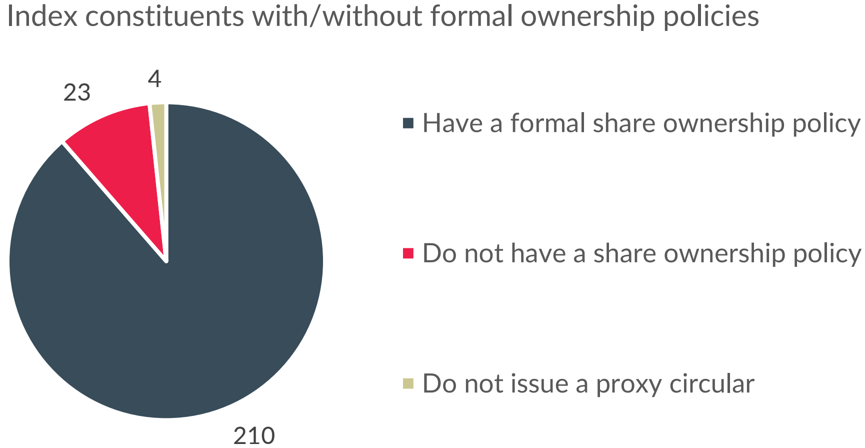
In 2022, CCGG reviewed proxy circular disclosure of the 237 companies included in the TSX Composite Index in order to understand: (a) the structure of share ownership policies across every sector that makes up the TSX Composite Index, and (b) the extent to which CEOs of companies included in the Index rely on unvested compensation awards to meet share ownership requirements.

Our findings based on the above review are set out in the following pages. Within this paper, we also include a set of recommendations that Boards of Directors should consider implementing in order to achieve a stronger link between management and shareholder interests.

Findings

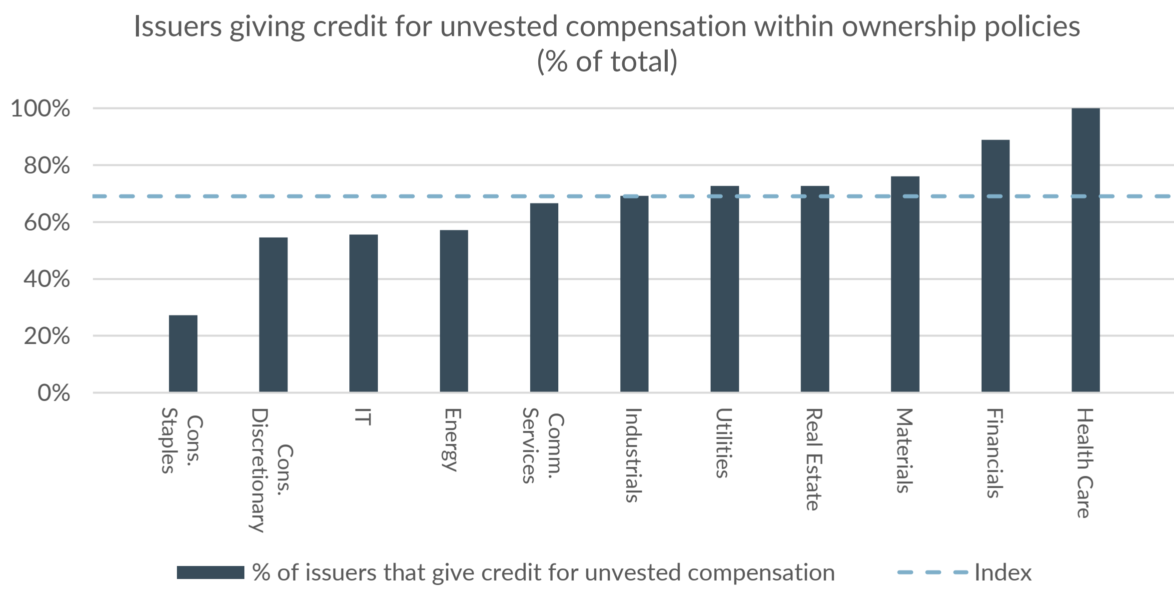
Formal share ownership policies

Based on our review, we found that 210 out of 237 issuers (i.e. 89%) included in the Index have a formal share ownership policy that must be met by one or more members of the senior management team, including the CEO. The vast majority of issuers without a formal share ownership policy were founder-led or family-controlled corporations and, in many cases, CEOs and members of senior management at these companies hold a sizable common share interest, regardless of the absence of a formal share ownership policy.



Inclusion of unvested compensation awards within ownership policies

Of the 210 issuers with a formal share ownership policy, 145 or 69% give value to unvested compensation (primarily restricted stock units and performance stock units) for the purposes of determining compliance with the share ownership policy. The proportion of issuers within each sector that credit unvested compensation awards towards share ownership varies, as shown in the chart below.



Restricted stock units (RSUs) and performance stock units (PSUs) are the most common forms of unvested compensation for which credit is given within share ownership policies. RSUs and PSUs are often called full value instruments because their value is linked to total share value, as opposed to just changes in share price. The final value of PSUs is also linked to company performance indicators, as determined by the Board (one common indicator being Relative Total Shareholder Return).

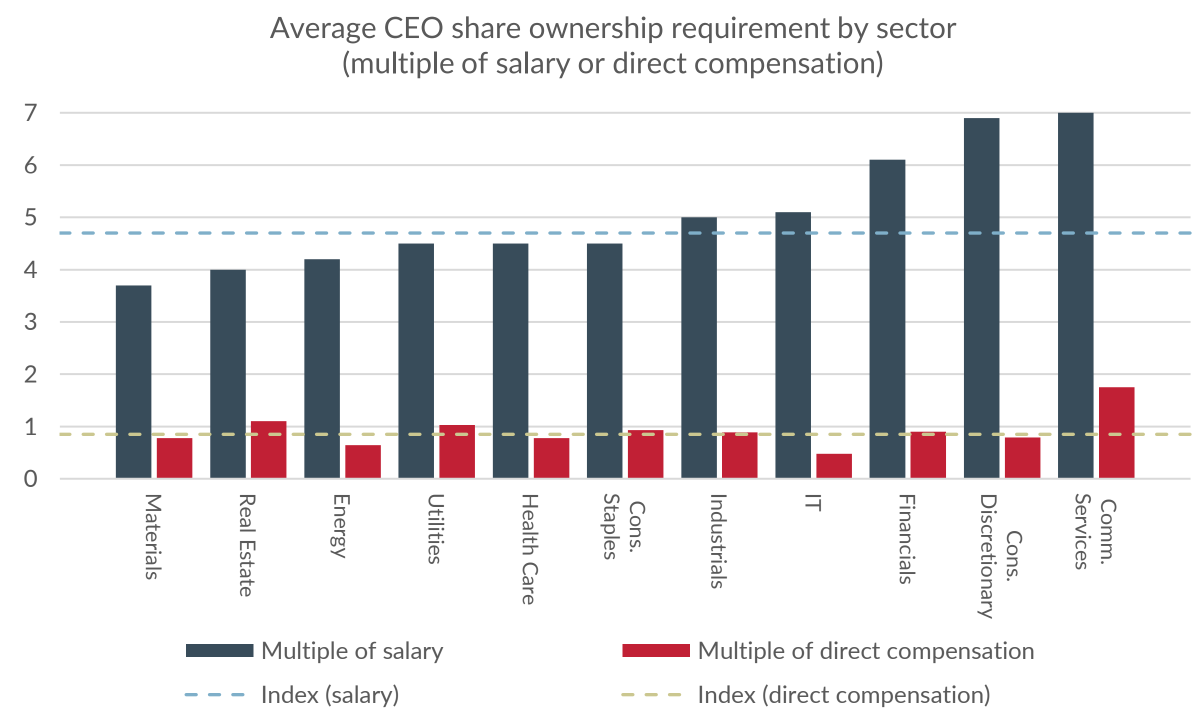
Based on our review, we found that RSUs and PSUs, in the vast majority of cases, vest within three years of being granted and are settled immediately or shortly following vesting. Upon vesting, RSUs are either settled in cash (approximately 40% of Index constituents) or in shares (~60%). PSUs similarly are either settled in cash (~45%) or in shares (~55%) upon vesting. When these awards are settled, other than in a few exceptional situations, there is often no requirement to hold onto the shares that have vested or use cash proceeds to purchase common shares of the company. As a result, management teams have no requirement to build their common share ownership in the company over time or meet their share ownership requirements through common shares of the company, as long as they hold a sufficient number of unvested compensation awards such as RSUs or PSUs. This practice reduces the effectiveness of share ownership policies and weakens the link between management and shareholder interests.

Inclusion of vested options within share ownership policies

Our review also indicated that 13 out of 210 issuers with a formal share ownership policy give credit for instruments such as stock options (which are not full value instruments). When credit was given for options, in almost all cases the value of options was limited to the in-the-money value of vested options.

CEO share ownership requirements

On average, CEOs of the 210 companies with a share ownership policy were required to hold approximately 4.7 times their annual base salaries in common shares, deferred share units, and other vested and unvested share-based awards (unvested RSUs and PSUs primarily). However, when we assessed these share ownership requirements relative to total direct compensation (TDC), the average requirement equated to less than 1.0 times annual TDC granted to CEOs.



TDC includes base salary, cash bonus, stock options and share-based awards. For context, on average, CEOs within the Index had been employed with the company for 15 years and had served in the CEO role for approximately 9 years, providing ample time to build a more meaningful equity or common share interest in the company than that required by the share ownership policy.

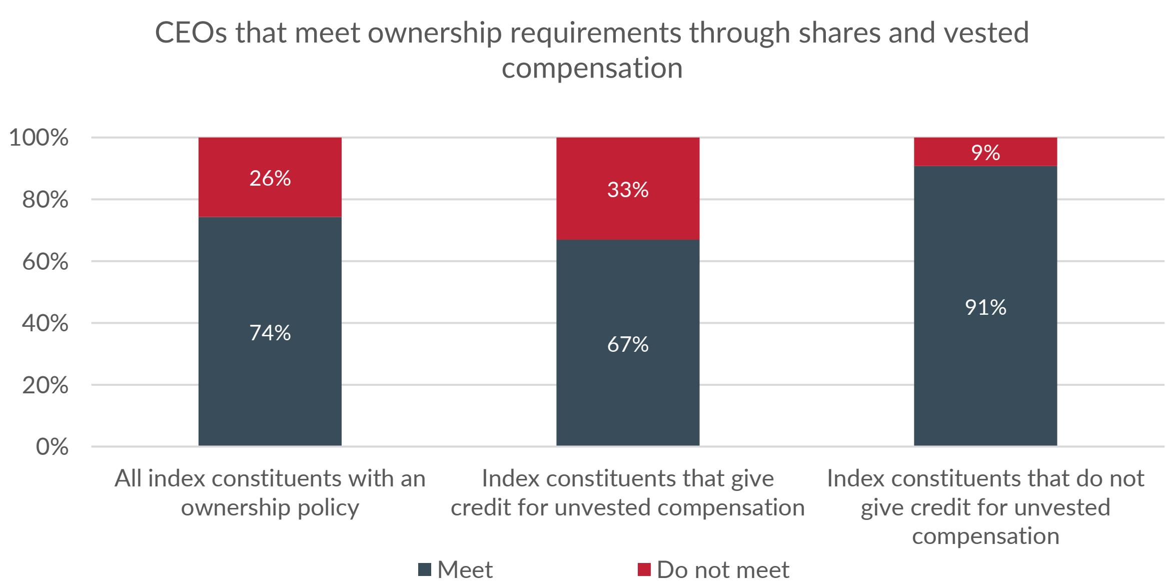
There was no material difference in the level of ownership required by those issuers who do not give credit for unvested awards as compared to those who do (i.e. the required level of ownership did not increase with the inclusion of unvested awards).

CEO reliance on unvested compensation to meet share ownership requirements

Most CEOs in the Index met their share ownership requirements through common shares and vested, full value awards (such as deferred share units) alone. However, a meaningful number (54 out of 210 CEOs subject to a share ownership policy, or 26%) did **not** meet their share ownership test by owning a sufficient number of common shares and vested, full value awards. Of note, 50% of these 54 CEOs **did** meet their share ownership requirements as per the company's share ownership test, which gave credit for unvested, full-value awards such as restricted stock units and performance stock units held by the officer.

The overall tenure of these 54 CEOs with their respective firms ranges from less than one to 34 years (average 8 years) and they have held the position of CEO for less than one to 15 years (average 3 years). In our view, sufficient time was available in most cases for these CEOs to own a greater common share interest in the company.

Amongst issuers that give credit for unvested compensation in share ownership, the percentage of CEOs that do not meet their respective requirement through common shares and vested compensation is materially higher, as demonstrated in the chart below (middle bar). This lends credence to the suggestion that the structure of share ownership policies can have a direct impact on the extent of an officer's common share ownership.



Median CEO common share ownership across sectors

The following table shows that most CEOs across major[1] sectors not only meet the median share ownership required for their sector through common shares alone but significantly exceed this median requirement. This raises a question whether, given the level of CEO common share ownership across every sector, credit still needs to be given to CEOs within share ownership policies for unvested compensation awards.

Median CEO Common Share Ownership and Requirement by Sector

Sector	*Multiple of base salary owned*	*Multiple of direct compensation owned*	*Multiple of base salary required*	*Implied multiple of direct compensation required*
Information Technology	52.61	5.02	5.0	0.48
Materials[1]	6.92	1.37	3.0	0.72
Utilities	3.68	0.72	5.0	1.02
Energy[1]	9.90	1.37	4.0	0.62
Real Estate	25.19	3.31	3.0	1.00
Health Care	1.02	0.23	5.0	1.01
Consumer Staples	16.05	3.58	5.0	1.04
Industrials[1]	8.19	1.21	5.0	0.78
Financials[1]	7.63	1.09	5.0	0.87
Consumer Discretionary	51.08	4.94	5.0	0.74
Communication Services	1.78	0.38	6.0	1.16
Index	**8.19**	**1.35**	**5.0**	**0.77**

Our review also showed that, on average across the Index, common shares represent 56% of total CEO equity ownership (which includes common shares, DSUs, PSUs and RSUs but does not include stock options). However, when credit is given for unvested compensation awards within share ownership policies, 48% of total CEO equity ownership is comprised of common shares. Once again, this supports the premise that the structure of share ownership policies can directly influence the extent of an officer's common share ownership.

Named executive officer share ownership

While we did not formally collect data on share ownership for officers other than the CEO, in our experience named executive officers other than the CEO are less likely to meet share ownership requirements through common shares and vested, full-value awards such as deferred share units alone when credit is given for unvested compensation awards such as restricted stock units or performance stock units within share ownership policies. The situation is exacerbated when these unvested awards are settled in cash as opposed to shares.

[1] Major sector – representing at least 10% or more of total Index constituents.

Effective share ownership policies

We believe that Boards of Directors should encourage greater common share ownership amongst officers of the company. The following recommendations provide Boards with a range of alternatives which would support this objective and strengthen management alignment with shareholder interests.

1. Establish share ownership requirements that continually build an officer's economic interest over time.

    a. One such approach would be to shift from an ownership requirement with a defined threshold to an annual share purchase requirement. For example, requiring CEOs and NEOs to annually invest a minimum of 20% and 15% respectively of their TDC in common shares is a reasonable share purchase expectation. This requirement would lead to share ownership levels that approximate 1.0 times and 0.75 times TDC for CEOs and NEOs respectively 5 years after appointment and 2.0 times and 1.5 times TDC for CEOs and NEOs respectively 10 years after appointment to their role.

       Another avenue would be to require NEOs to either: (a) use a portion of the cash proceeds received upon vesting of any cash-settled share-based awards to purchase common shares of the company, or (b) retain a portion of shares they receive upon settlement of any share-based awards. While such requirements are not prevalent in Canada, we note that some public issuers in the United States require CEOs and other NEOs to retain at least 50% of net after-tax shares received from settlement of equity-based compensation awards until retirement.

2. Establish and express share ownership requirements relative to TDC, rather than base salary.

    a. In many cases, base salary is the smallest component of TDC and, on average, represents only 21% of TDC for all Index issuers. Consequently, and as highlighted in our research, the vast majority of share ownership policies have threshold requirements tied to base salary that ultimately equate to less than 1.0x TDC. If the purpose of the threshold requirement is to define an ownership stake that is meaningful in the context of the NEO's own economic circumstances, then we believe the relationship between the threshold requirement and TDC is important to highlight and disclose.

3. Require CEOs and other officers to meet a majority of their ownership requirements through common shares alone.

    a. While they may serve other purposes, equity-linked instruments (such as RSUs and PSUs) are generally not regarded by Institutional investors as being equivalent in nature to common share holdings. We believe it is reasonable to expect 75% or more of share ownership requirements to be met through common shares alone. Ideally, 100% of share ownership requirements should be met through common shares after a reasonable time has passed and most share-based awards and options granted during an officer's anticipated tenure at the company have vested and paid out.

4. If credit is to be given for compensation awards within share ownership policies, such credit should be limited to awards that have vested, are full value in nature, and which must be held until retirement. For example, deferred share units (DSUs) are full value awards that often need to be held until retirement and, therefore, credit may be given under share ownership policies for vested DSUs.

    a. Stock options, which are not full value awards and therefore, do not track total shareholder return, whether vested or unvested should not be included in an officer's share ownership test.

    b. Credit should not be given for unvested RSUs or PSUs within share ownership policies until such awards vest. Upon vesting, credit should be given for awards that are either: (a) settled in shares which must be held, or (b) in cash that must be invested to purchase common shares of the company on the open market.

5. Share ownership policies that determine the value of securities held by officers at the higher of market value or acquisition price do not align well with shareholder interests. This accommodation gives officers the benefit of a floor value, in the event that share prices fall, while at the same time giving officers the opportunity to enjoy any upside when share prices increase following an officer's purchase of common shares. We believe a more appropriate policy would consistently value securities at either market value (our preference) or at acquisition price.

Feedback

CCGG welcomes any feedback from issuers or institutional investors on this report. Please feel free to contact us at:

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