

2009 EXECUTIVE COMPENSATION PRINCIPLES

Canadian Coalition for
GOOD GOVERNANCE

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BACKGROUND

In 2005, CCGG issued “Good Governance Guidelines for Principled Executive Compensation”, with the following recommendations for boards:

- 1 Build an Independent Compensation Committee - The compensation committee should be composed entirely of independent directors with disclosure of inter-locking directorships.
- 2 Develop an Independent Point of View - The compensation committee must not be solely dependent upon management when developing compensation packages for management and should employ external advisors to provide both perspective and expertise.
- 3 Test Pay to Performance Linkages -The compensation committee should extensively test the linkage of pay to performance to ensure that total pay packages do vary significantly with outcomes.
- 4 Establish Share Ownership Guidelines - The compensation committee should require executives to build and maintain a significant equity investment in the company. Consideration should be given to holding periods beyond retirement.
- 5 Disclose All Facets of the Compensation Regime - The compensation committee should provide complete, accurate, understandable, and timely disclosure to shareholders concerning all elements of executive compensation including any post retirement benefits.

Many of Canada’s leading companies have followed all or most of these guidelines, and the Canadian Securities Administrators now require disclosure of all types of compensation and benefits.

To further guide boards and help encourage compensation decisions that are aligned with long-term company and shareholder success, CCGG has prepared the following “Pay for Performance” principles building on our 2005 guidelines.

CCGG EXECUTIVE COMPENSATION PRINCIPLES

CCGG recognizes that determining and structuring long term compensation plans is a complex, multi-year process for boards that is constantly evolving and never completed. Compensation plans have many objectives, measured over a multi-year time horizon, including:

- Paying for performance to align the interests of executives and shareholders
- Ensuring that compensation does not encourage or reward undue or unmanageable risk
- Attracting, motivating and retaining top talent in highly competitive environments
- Reflecting the realistic and practical market alternatives for executives

The focus of these principles is on “pay for performance” and the effective implementation of risk controls suitable for the particular business by directly linking risk management with the executive compensation structure.

While proxy disclosure is limited to the top 5 executives, boards are expected to ensure these principles are used in determining compensation practices throughout the company, particularly those relating to risk adjusted performance. The compensation plans for senior executives set the tone and should be the end result of the company’s overall compensation and risk plans.

CCGG EXECUTIVE COMPENSATION PRINCIPLES

PRINCIPLE 1 *“Pay for performance” should be a large component of executive compensation*

PRINCIPLE 2 *“Performance” should be based on measurable risk adjusted criteria, matched to the time horizon needed to ensure the criteria have been met*

PRINCIPLE 3 *Compensation should be simplified to focus on key measures of corporate performance*

PRINCIPLE 4 *Executives should build equity in their company to align their interests with shareholders*

PRINCIPLE 5 *Companies should limit pensions, benefits, and severance and change of control entitlements*

PRINCIPLE 6 *Effective succession planning reduces paying for retention*

PRINCIPLE 1

“Pay for performance” should be a large component of executive compensation

CCGG believes that a large percentage of the total compensation of senior executives should be a reward, in addition to their base salary and benefits, for superior risk adjusted performance of the business, in both absolute and relative terms, achieved by their company and relative to the risks taken during the relevant time. The pay for performance component should be truly variable depending on performance (or “at risk”) and not be deferred base salary. “Pay for performance plans” include cash bonuses, stock options, performance based deferred stock units, restricted stock units etc.

PRINCIPLE 2

“Performance” should be based on measurable risk adjusted criteria, matched to the time horizon needed to ensure the criteria have been met

Performance based compensation should be based on successfully achieving strategic goals over a period of time that will usually exceed one year. These goals should be identified in advance, and there should be limited discretion for the board to alter results if goals are not achieved. Payments of performance based compensation should be over the period of time that it takes for results to be known, resulting in a lengthening of the payout period for much of performance based compensation. This allows for a linking of compensation with risk management plans and effective “claw backs” of compensation in cases of poor performance, fraud, illegal behavior or restatements.

Performance Metrics

Typically, the board determines a small number of relevant metrics and develops a compensation plan that is based on meeting the criteria. These measurable corporate “drivers” should be the key strategic goals of the business as determined by the board of directors, capturing a range of dimensions of long term corporate performance. Care must be taken to weight the metrics appropriately to avoid unintended payouts when the company performs poorly but meets some of the metrics. Executives, directors and shareholders must be able to clearly understand the corporate goals that management are incented to achieve.

Examples of corporate “drivers” or metrics used in performance based compensation plans include single and multi-year financial measures such as GAAP based profitability or returns on capital employed or assets (either on an absolute or relative peer group basis), and non-financial measures such as employee or customer satisfaction, employee safety and environmental records or other specific non-financial strategic measures. Consideration should be given to not only performance in the year, but also to forward looking metrics related to the long term health/value creation ability of the company.

“Pay for performance” compensation should only be paid or vest if the company actually meets or exceeds the measurable performance targets – and not simply due to the passage of time as is common with, for example, stock options.

Link Compensation and Risk Management Plans

Compensation plans should focus on measuring the quality and sustainability of earnings over the long term, and include:

- 1 Adjustments to reflect the risks of the business and actual cash flows over the length of time that the risks are outstanding (i.e. a company should pay bonuses once residual risks have been minimized). For example, bonus pools could be “risk adjusted” using factors such as current and future risks taken in the year, risk adjusted cost of capital employed and/or liquidity requirements.
- 2 Plans should have caps to limit the incentive to take unmanageable risks or to avoid paying for unsustainable performance.

These measures will discourage excessive or unmanageable risk-taking by ensuring that compensation is payable over the time that risks continue to exist, and that compensation is reduced if the risks cannot be managed adequately. These measures will also ensure that management is rewarded for actual long term performance, and that the compensation system does not overly emphasize short term goals. Often, the measurement period is 2-5 years, and extends beyond an executive’s retirement date.

The need to link compensation and risk management plans is particularly relevant for financial services businesses, as well as for companies with multi-year projects or where product liability concerns extend over a number of years.

Scenario Analysis

Boards should formally “stress test” a number of possible scenarios to see how their compensation plan will react to future external and internal events to ensure that there are no windfalls for unsustainable performance. The board should ensure that there will be an ongoing link between compensation and business performance, and that there is significant leverage (subject to reasonable caps) built into the compensation package for exceptional performance vs. “ordinary” performance. This will allow the board to determine the reasonableness of compensation if unexpected or unintended positive or negative events occur, and may lead to “caps” on certain portions of compensation to avoid extreme results.

Payments When Targets are Exceeded or Missed

If performance targets are significantly exceeded, compensation above target levels may be warranted, provided that performance compensation is reduced if performance is below target. In other words, there should usually be some balance between the upside and the downside of performance based compensation. However, with some criteria the negative impact to the company of failing to achieve the target level may be greater than the positive impact of exceeding it (or in some cases, vice versa). If so, consideration should be given to more severe consequences for failure to meet the target than the benefit of exceeding it (or vice versa). As well, there should be caps on payouts for exceeding target levels to avoid large unintended payments.

“Claw backs”

If a company pays a bonus to an executive on the apparent achievement of performance metrics in a particular year, and it later becomes clear that the metrics were not achieved due to fraud or other illegal behavior of the executive, the company generally has the legal right to require the return of the bonus and to cancel unvested compensation rights.

It may also be appropriate to require the return of compensation in the event of a material earnings restatement or other company specific shock that significantly reduces shareholder value where the executive had an active involvement in the issue that caused it. To clearly have this right, the company and the employee should consider entering into an appropriate employment contract.

CCGG recognizes that this is a complex and emerging area, with legal and tax issues, and that each company has different circumstances. CCGG notes that “claw backs” are becoming common place in the US and Europe and have been adopted by some Canadian companies. CCGG will monitor the development of “claw backs” and recommend best practices in the future. However, we note that a properly designed pay for performance plan will often not pay out deferred compensation in circumstances where a claw back might otherwise be employed.

Consider Total Compensation during Tenure

In making annual equity and option grants, boards should be aware of the current value of past equity compensation granted to the executives and whether an extraordinary event unrelated to the performance of the executives has occurred (such as unusual share appreciation in the industry), particularly with time vested options. Boards should also consider the level of exposure to the equity of the company needed to adequately motivate management, balanced with the need to have competitive current compensation and to ensure adequate ongoing pay for performance links.

Limit Board Discretion and Disclose When Used

Once performance metrics are determined and agreed to, a board should be very hesitant to provide “exemptions” when one or more metrics are not met in a particular year, subject to the ability of a board to exercise discretion in unusual or unanticipated situations. If discretion is used, the board should fully disclose how and why it did so in the annual proxy circular.

PRINCIPLE 3

Compensation should be simplified to focus on key measures of corporate performance

Compensation plans have become very complicated with multiple parts, often using different time horizons, objectives and metrics. Compensation structures should be simplified to focus the attention of executives on the primary measurable metrics that

drive corporate performance on behalf of shareholders over the long term and that are weighted appropriately.

CCGG recognizes that a variety of programs may be needed to pay for performance over the appropriate risk time horizons, and that there are Canadian and other tax constraints that must be considered. That said, many existing compensation plans could be simplified so that executives, boards and shareholders more clearly understand the incentives being provided to management.

PRINCIPLE 4

Executives should build equity in their company to align their interests with shareholders

In order to align the interests of shareholders and senior executives, executives should be required to hold a significant portion of their net worth in shares (or share equivalents such as DSU's and RSU's, but excluding options) of the company while employed and for a period of time after leaving. Consideration should also be given to requiring an executive to hold shares issued on the exercise of stock options (other than as may be required to pay taxes related to the option exercise), and to prohibit or limit hedging or pledging of equity positions.

The requirement to build equity is often stated as a multiple of base pay or total compensation, increasing with the level within the organization as set by the board. In certain cyclical industries, it may be appropriate for the board to permit executives to sell down their positions during market highs, while requiring that there be a minimum shareholding kept at all times, or to have flexibility at times of market declines.

If there is a significant sustained drop in the company's share price, the board should not (directly or indirectly) "re-price" stock options on the theory that this is needed to retain executives. Option exercise prices are not increased when share prices rise, and they should not be reduced when share prices drop – this is the cost of the use of stock based pay for performance.

PRINCIPLE 5

Companies should limit pensions, benefits, and severance and change of control entitlements

Pensions

Some companies provide retirement allowances to their executives above statutory pension maximums (usually called SERP's) based, for example, on total cash compensation in the five years before retirement (salary plus cash bonuses) and the number of years worked at the company. On occasion, boards award bonus "years worked" as an incentive to attract mid-career executives. Except in unusual circumstances, bonus "years worked" should not be granted, as pensions should only be earned for years actually served.

Boards should impose an annual limit on SERP payments on retirement (often expressed as a dollar amount or as a percentage of base salary) to ensure that the pension is reasonable in the context of the business and is not disguised additional non-performance linked compensation.

Termination Payments

In Canada, if there is no express contractual provision, employment can be terminated by an employer "without cause" by providing "reasonable" notice to the employee or the payment of "compensation" in lieu of notice (so called "severance"). "Cause" has been very narrowly defined by the courts. The notice a court will award varies within a range depending on factors such as length of service and age. Companies should have written rights on termination of employment that match the common or civil law entitlements and do not provide overly generous arrangements to executives.

It is of concern to investors that an executive can be terminated due to poor corporate performance yet receives a large severance settlement. Often in these circumstances the executive is also paid deferred compensation (which is in many cases a large amount)

to which he or she is legally entitled. Companies are encouraged to consider amending employment arrangements to reduce or eliminate severance payments and the entitlement to deferred compensation if an executive is terminated for failing to deliver agreed upon corporate targets.

Change of Control Provisions

It is common to provide senior executives with “change of control” contracts to provide extra severance payments and to accelerate unvested compensation when their company is sold. These are commonly seen as a way to retain executives during a difficult and uncertain time. In the past, many of these provisions allowed an executive to trigger payments and vesting acceleration following the “change of control event”.

Any change of control provision should have a “double trigger” requirement, meaning that (1) an actual legal change of control has occurred, and (2) the executive has been terminated by the company (including by way of constructive dismissal through a downgrade of pay and/or responsibilities) during a specified time period after the change of control. As a result, severance payments made after a change of control should be substantially the same as are payable on a normal dismissal without cause.

PRINCIPLE 6

Effective succession planning reduces paying for retention

Comprehensive succession planning —a key function of every board of directors – will help to ensure a deep pool of senior talent. Effective succession planning can also reduce the need to pay for retention or external hires, reduce turnover and the resulting cost of disruption and can help to manage the compensation expectations of other senior executives and replacements.

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