

Background

CCGG originally issued its Executive Compensation Principles in 2009 to provide enhanced guidance to boards and to promote compensation decisions that are aligned with long-term company and shareholder success. An increased focus by many Canadian boards on compensation structure and the process for compensation decision-making is evident in the improved proxy circular disclosure provided to investors. Recognizing that executive compensation practices and regulatory reporting requirements have continued to evolve, CCGG has refined and updated the original Executive Compensation Principles in this document.

CCGG recognizes that determining and structuring long-term compensation plans is a complex, multi-year process for boards that is constantly evolving. Compensation plans have many objectives measured over a multi-year time horizon, including:

- Ensuring that compensation decisions are highly correlated to long-term performance
- Enhancing the alignment of interests between executives and shareholders
- Mitigating the risk of unintended outcomes or the creation of inappropriate incentives
- Attracting, motivating and retaining top talent

The focus of the following principles is on “pay for performance” and the integration of risk management functions into the executive compensation philosophy and structure.

While proxy disclosure is limited to the top five executives, boards are expected to ensure these principles are used in determining compensation practices throughout the company. The compensation programs for senior executives set the tone and should reflect a company’s overall compensation philosophy and risk profile.

The board and the compensation committee of every public company are responsible for, and accordingly must be actively involved in, establishing and independently verifying compensation philosophy, setting performance measures and assessing performance.

CCGG BOARD OF DIRECTORS

CHAIR

Dan Chornous
RBC Global Asset Management

VICE CHAIR

Donald F. Reed
Franklin Templeton Investments

DIRECTORS

Stephen A. Jarislowsky
Jarislowsky Fraser

Wayne Kozun
Ontario Teachers’ Pension Plan

Larry Lunn
Connor, Clark and Lunn
Investment Management

Brian Murdock
TD Asset Management

John Sinclair
New Brunswick Investment
Management

Rob Vanderhoof
Greystone Managed Investments

Mark Wiseman
CPP Investment Board

CCGG Executive Compensation Principles

PRINCIPLE 1	A significant component of executive compensation should be “at risk” and based on performance
PRINCIPLE 2	“Performance” should be based on key business metrics that are aligned with corporate strategy and the period during which risks are being assumed
PRINCIPLE 3	Executives should build equity in the company to align their interests with those of shareholders
PRINCIPLE 4	A company may choose to offer pensions, benefits and severance and change-of-control entitlements. When such perquisites are offered, the company should ensure that the benefit entitlements are not excessive.
PRINCIPLE 5	Compensation structure should be simple and easily understood by management, the board and shareholders
PRINCIPLE 6	Boards and shareholders should actively engage with each other and consider each other’s perspective on executive compensation matters

PRINCIPLE 1

A significant component of executive compensation should be “at risk” and based on performance

CCGG believes that a large percentage of the total compensation of senior executives should be a reflection of business performance achieved and should be linked to the risks taken during the relevant time period. Performance should be measured on an absolute basis and relative to a fully-considered list of company peers. The pay for performance component should be truly variable and dependent on performance (i.e., be “at risk”), and not be deferred base salary. Performance awards should be based on intrinsically risk-adjusted financial and non-financial measures and should include share-based awards such as Performance Share Units (PSUs) or a mixture of PSUs and time-vesting Restricted Share Units (RSUs), with a greater emphasis on performance as the primary vesting mechanism.

Use of Stock Options

Shareholders generally are discouraging the use of time-vested-only (as opposed to performance-vested) stock options as a significant component of executive compensation, arguing that options may encourage inappropriate risk-taking and lead to unintended reward outcomes that are not well aligned with long-term performance. Another criticism levied at stock options is that they allow management to participate in share performance upside while not suffering any consequences on the downside. In addition, recent research¹ has highlighted the fact that the value of stock options may be quite volatile and often reflective of market-specific rather than company-specific factors.

Where stock options are used, they should be de-emphasized in favour of other forms of equity-linked compensation and serious consideration should be given to introducing performance-vesting provisions. Performance-vesting provisions are a means of mitigating the risk of rewarding executives for share performance clearly driven by factors beyond management’s control (for example, a booming commodity market). Boards also should be mindful of minimizing the dilutive impact of a stock option program.

¹ See example on pp. 39-40 of Professor Yvan Allaire’s 2012 policy paper entitled *Pay for Value: Cutting the Gordian knot of Executive Compensation*, published by the Institute for Governance of Private and Public Organizations (IGOPP).

PRINCIPLE 2

“Performance” should be based on key business metrics that are aligned with corporate strategy and the period during which risks are being assumed

Performance-based compensation should be based on successfully achieving strategic goals over the short, medium and long term. These goals should be identified in advance, and the board should be allowed to use its informed judgment to alter payouts to ensure that compensation reflects the performance of the business, both in absolute terms and relative to a fully-considered peer group. Payments of performance-based compensation should be aligned with the period of time over which results are achieved and the related risks are assumed.

Performance Metrics

The board should determine a number of relevant performance metrics and develop a compensation plan that is linked to achieving those metrics. The board should be actively engaged in setting performance goals, determining the appropriate level of stretch and assessing performance against the company’s goals. The metrics should include broad corporate financial metrics as well as individual and/or corporate measures key to managing risk. Chosen performance metrics should also reflect the key strategic goals of the business as determined by the board, capturing a range of dimensions of long-term corporate performance. Companies should disclose these larger strategic goals and explicitly show the linkage between strategy and the chosen performance metrics. 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 is being incented to achieve.

Examples of metrics used in performance-based compensation plans include single and multi-year financial measures (both on an absolute and on a relative peer group basis), and non-financial measures appropriate to the company, such as Environmental, Social and Governance measures, corporate sustainability measures or other specific non-financial strategic measures. Such measures should reinforce an expectation of ethical behavior within the company. Consideration should be given both to performance in the year and to metrics measured over longer periods and related to the long-term viability of the company.

Performance-based compensation should be paid only if the company actually meets or exceeds the measurable performance targets and achievement of performance targets should be a significant component in the vesting of equity awards.

Link Compensation and Management of Business Risks

The board should integrate the company's enterprise risk management program into its compensation plans. Compensation plans should reward appropriate risk-taking consistent with the risk profile of the company as presented to shareholders. Compensation plans should also focus on maintaining the quality and sustainability of earnings over the long term. The time period over which compensation is paid should be aligned with the period in which performance is achieved and the associated risks are assumed.

Variable compensation components should include caps to ensure an appropriate sharing of value between management and shareholders and to limit the incentive to take excessive risks in order to achieve short term, unsustainable performance.

Scenario Analysis

Boards should formally "stress test" compensation plans to ensure that rewards are appropriate in different scenarios and that there are no windfalls for unsustainable performance. The board should ensure that there is an ongoing link between compensation and business performance, and that there is significant leverage (subject to reasonable caps) in the compensation package to reward exceptional performance. Stress testing allows the board to determine the reasonableness of compensation if unexpected or unintended positive or negative events occur and to adjust the design of compensation plans to avoid extreme results.

Quantum

In determining the overall quantum of compensation to award, boards often place significant emphasis on the relative positioning of total compensation against a list of industry peers on the basis that talent retention is the primary concern. While these external considerations are important, overreliance on these factors can lead to ever-increasing compensation levels unrelated to performance, particularly where total compensation is specifically targeted at percentile ranges beyond the median of the peer group. Similar concerns also have led some boards to grant substantial awards even during periods when corporate performance has not met expectations. Absent extenuating circumstances, quantum of compensation awarded should be determined within the context of the organization as a whole and justified primarily by performance. Consideration also should be given to the realized value of previous award grants in determining current compensation levels. Boards should reassess regularly how effective the compensation program has been at achieving the company's strategic objectives.

Payments When Targets are Exceeded or Missed

If performance targets are significantly exceeded, compensation above target levels may be warranted, provided that compensation is similarly reduced in the event that performance is below target. In other words, there should be symmetry or balance between the upside and the downside of performance-based compensation. In some cases, the negative impact to the company of failing to achieve a performance target may be greater than the positive impact of exceeding it. If so, consideration should be given to more severe compensation consequences for failure to meet the target relative to the benefit of exceeding it.

Recoupment Policies

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, the company should ensure it has a specific right to require the return of the bonus and to cancel unvested compensation awards. This result typically is affected through a formal recoupment or “clawback” policy in the company’s code of business conduct.

It also may be appropriate for boards to require the return of compensation previously awarded to an executive in the event of a material earnings restatement or other company-specific change that significantly reduces shareholder value. CCGG notes that recoupment policies are becoming commonplace in the U.S. and Europe and have been adopted by a number of Canadian companies.

Despite the usefulness of such policies, it generally is preferable to align payouts with the period in which risks are realized and to use intrinsically risk-adjusted economic efficiency measures and equity based compensation, rather than to rely on a recoupment policy.

Consider Realized or Current Value of Past Compensation Awards

In determining annual equity-based awards, boards should be aware of the current or realized value of past equity-based compensation granted to the executives and should disclose this information annually in the company’s proxy circular. Particular consideration should be given to instances where extraordinary events unrelated to the performance of the executives have led to unintended pay outcomes. Companies should also include a “lookback” table in the circular that compares the disclosed value of compensation awarded in past years with the realized and current value of those same awards.

Allow for Board Discretion

When performance metrics are used to determine the degree of vesting or the amount of an award, the board should be very hesitant to provide “exemptions” or substitute other forms of compensation (e.g. retention bonuses) when one or more metrics are not met in a particular year. In cases where performance metrics used indicate that a substantial payout is warranted, boards should consider the extent to which the performance may have been favourably impacted by factors outside of management’s control and in such instances boards should not hesitate to consider downward adjustments to award levels. The board should maintain the ability to use informed judgment to alter awards in unusual or unanticipated situations. If such discretion is used, the board should fully disclose in the company’s proxy circular the fact that it has exercised its discretion and the reasons why it has done so.

PRINCIPLE 3

Executives should build equity in the company to align their interests with those of long-term shareholders

In order to align the interests of long-term shareholders and management, executives should be required to hold a significant portion of their net worth in shares (or share equivalents such as deferred or restricted share units, but excluding options) of the company while employed and ideally for a period of time after cessation of employment. Consideration also should be given to requiring an executive to hold some or all shares issued on the exercise of stock options (other than as may be required to pay taxes related to the option exercise). The requirement to build equity is often stated as a multiple of base pay or total compensation, with both the multiple and absolute value increasing with the level of an individual’s seniority within the organization.

If there is a significant sustained drop in the company’s share price, the board should not directly or indirectly “re-price” stock options. Option exercise prices are not increased when share prices rise, and they should not be reduced when share prices drop – this tenet is considered fundamental to aligning the interests of management with the interests of long-term shareholders.

Hedging and Monetization

Companies should prohibit directors and executives from directly or indirectly hedging or monetizing the value of shares held in the company, as such actions reduce the alignment with shareholder interests that these programs are intended to create. In instances where the board allows an individual to hedge or monetize some portion of his or her holdings on an exception basis, the rationale for granting the exception and the financial impact on the individual’s overall share holdings in the company should be fully explained in the proxy circular and in the appropriate regulatory filings.

PRINCIPLE 4

A company may choose to offer pensions, benefits and severance and change-of-control entitlements. When such prerequisites are offered, the company should ensure that the benefit entitlements are not excessive.

Pensions

Some companies provide retirement allowances to their executives above statutory pension maximums (usually called Supplementary Executive Retirement Plans or SERPs) based, for example, on average cash compensation (using salary only, excluding bonuses) in the five years before retirement and on the number of years worked at the company. 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 total pension entitlement is reasonable in the context of the business and does not amount to additional non-performance linked compensation. This position is consistent with the view taken by Canada Revenue Agency that supplemental pensions should be reasonable. Except in unusual circumstances, “bonus years worked” should not be granted, as pensions should be earned only for years actually served. If “bonus years worked” are awarded, the board should disclose this fact and the reasons why it has done so in the company’s proxy circular.

Termination Payments

In Canada, if there is no specific 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 amount of compensation in lieu of notice a court will award for a termination without cause varies within a range depending on factors such as length of service, position, compensation level and age. If a company has a written employment agreement with an executive, it should ensure that the termination provisions are reasonable and are not overly generous in order to avoid “pay for failure”.

Investors are concerned if an executive is terminated due to poor individual or corporate performance and receives a large payment on termination. Often in these circumstances the executive also is paid unvested deferred compensation. Companies should ensure that employment arrangements with executives provide only reasonable payments on termination and that unvested deferred compensation is forfeited on termination.

Change of Control Provisions

It is common for the employment contracts of senior executives to include financial provisions intended to ensure that executives are neutral on a change of control and motivated to act in the best interests of shareholders.

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 following the change of control. The definition of “change of control” used to trigger entitlements should be restricted to the legal definition (i.e. a change in control of more than 50% of outstanding votes) and should be fully disclosed to shareholders. Severance payments on a termination after a change of control should be substantially the same as are payable on a normal dismissal without cause, although it may be appropriate to provide for accelerated vesting of deferred compensation in this circumstance.

PRINCIPLE 5

Compensation structure should be simple and easily understood by management, the board and shareholders

Compensation plans have become very complicated: they often have multiple components incorporating different time horizons, objectives and metrics. CCGG recognizes that a variety of programs may be needed to pay for performance over the appropriate risk time horizons and that tax constraints are a relevant consideration. While a certain level of complexity may be unavoidable, the compensation structure should be simple and easily understood by the board and management, and the board must in turn clearly explain the key elements of the compensation structure and the process for determining variable compensation awards in sufficient detail in order that shareholders can understand it and can consider whether the approach to compensation is appropriate.

Use of External Consultants

Boards often will engage the services of an external consultant to assist in designing compensation programs or to identify an appropriate peer group for compensation benchmarking purposes. When external consultants are retained by the board, the board, as a governance *best practice*, should ensure that the consultant is independent of management. In any event, while the input received from independent compensation consultants may provide valuable assistance to the board, it does not necessarily validate the approach to executive compensation nor does it reduce the board’s responsibility to ensure that compensation decisions are appropriate and closely aligned with performance.

PRINCIPLE 6

Boards and shareholders should actively engage with each other and consider each other's perspective on executive compensation matters

Regular shareholder engagement provides the opportunity for boards to hear the perspectives of investors on a range of matters. CCGG recommends that companies hold an annual 'Say on Pay' advisory vote, which is an effective means of soliciting direct feedback from shareholders on the company's approach to executive compensation. While the vote is non-binding, the board should take the results of the vote into account, as appropriate, when considering future compensation policies, procedures and decisions and in determining whether there is a need to significantly increase their engagement with shareholders on compensation and related matters. The board also should ensure that detailed voting results on the 'Say on Pay' advisory vote are fully disclosed, for the benefit of all shareholders.

In the event that a significant number of shareholders oppose the 'Say on Pay' resolution, the board should consult with opposing shareholders in order to understand their concerns and review the company's approach to compensation in the context of those concerns. Boards also should follow up with shareholders on any significant year-over-year declines in support for its 'Say on Pay' resolution, regardless of the overall level of support achieved. Shareholders who intend to vote against a 'Say on Pay' resolution or have major issues with the company's approach to executive compensation should contact the board to discuss their concerns. The board should disclose to shareholders as soon as is practicable a summary of the significant comments relating to compensation received from shareholders in the engagement process and an explanation of any changes to the compensation plans made or to be made by the board or why no changes will be made.