CLARKSON
Centre for Board Effectiveness

Clarkson Centre Governance Monitor:

2010 Report on Corporate Governance in Canada

Funded by

Compiled by David Comrie

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What is the Board Shareholder Confidence Index?

Since 2002, the Clarkson Centre for Board Effectiveness (CCBE) has been annually tracking corporate governance practices in Canada of corporations listed on the S&P/TSX Composite Index. CCBE has assessed companies based on their adoption of generally accepted Corporate Governance Best Practices. The resulting output is the Board Shareholder Confidence Index ("BSCI"). (The full methodology and scores are available at http://www.rotman.utoronto.ca/CCBE/details.aspx?ContentID=211)

This year, the top 12 companies on the Board Shareholder Confidence Index are:

Rank	Ticker	Company Name
1	NXY	Nexen Inc.
1	POT	Potash Corporation of Saskatchewan Inc.
3	BMO	Bank of Montreal
3	ENB	Enbridge Inc.
3	IMN	Inmet Mining Corporation
3	KEY.UN	Keyera Facilities Income Fund
7	CP	Canadian Pacific Railway Ltd.
7	X	TMX Group Inc.
9	FTT	Finning International Inc.
9	IAG	Industrial Alliance Insurance and Financial Services Inc.
9	SLF	Sun Life Financial Inc.
9	TRP	TransCanada Corp.

Changes to the Scoring Criteria in 2010

As part of the annual scoring process for the BSCI, CCBE examines the scoring criteria used for the previous year and assesses whether any changes should be made to weightings, whether any new measures should be added or removed. The reason for this is that Corporate Governance is constantly evolving. Every year, new best practices develop and the scoring criteria used by CCBE are adjusted to keep in step with those changes. For 2010, the scoring criteria were adjusted to include a deduction should a company fail to disclose the value of any option gains received by the individual Named Executive Officers during the most recent fiscal year.

Prior to December 31, 2008, companies were required to disclose the aggregate value realized on the exercise of options. However, as of the new compensation disclosure requirements by the Canadian Securities Regulators (CSA) in 2009, the requirement to disclose option gains was removed. CCBE and others believe reporting this information is valuable to shareholders and thus considers the disclosure of option gains a best practice. In collecting our data in 2010, 83.4% of the 199 companies assessed did not disclose the value of option gains. This excludes companies that either had no options exercised during the year or companies that do not have any options outstanding as their option gains would be $0.

The value to shareholders with regards to option gains disclosure is that the original value of option awards disclosed in the Summary Compensation Table is a projected value. This type of projection is frequently inaccurate with regards to the final value of the options when exercised. For example, during the 2009 fiscal year, Ed Clark, CEO of The Toronto-Dominion Bank, was awarded 619,288 options with a grant-date fair-value of $4,700,024. The options were awarded on March 3, 2009. On December 31, 2009, had Mr. Clark been able to exercise those options, the actual value he would have received for those options was $18,467,168. While these options are not currently exercisable and it is also possible for the share price to decrease thus reducing the value of the award, the likely scenario is that the share price will increase over the life of the options making the award even more valuable. Therefore, in order to fully understand the compensation being awarded to CEOs during the year, it is beneficial for shareholders to fully understand the final values of compensation awarded in previous years.

2010 Results

This year, companies have continued to improve overall. Under the scoring criteria applied in 2010 (which includes the application of the new 5-mark deduction for option gains), the average overall score is 57.5 out of 100, which is an increase over the average 2009 score of 56.1 out of 100. If the 2009 criteria are applied to the reported corporate governance practices of the companies in the 2010 study, the average 2010 score improved more than 8% from 2009 to 61.6 out of 100.

The scoring areas where the biggest improvements were seen are Director Share Ownership; Compensation Committee Independence; and CEO Succession Plan Disclosure.

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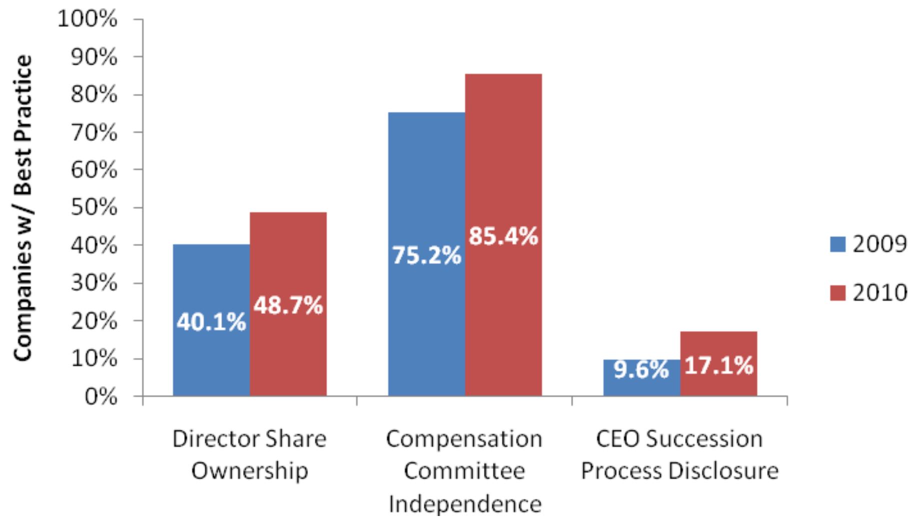

- **<u>Director Share Ownership</u> is based on the average ownership of the 1/3 of directors with 3 or more years of consecutive service who own the fewest shares relative to the annual retainer**. In order to achieve full marks, those directors must own shares with an average value of four times the annual director retainer. This criterion helps determine to what extent Directors share the same interests as the shareholders they are representing. The reason for looking only at the bottom 1/3 is that even the directors who own the fewest shares should still be well-invested. If the ownership of the entire board was used, there is the potential that 1 director could own enough shares set the average above the minimum level despite all of the other directors having no ownership. Directors who have been on the board for less than 3 years are excluded so that they have time to accumulate shares.

- **<u>Compensation Committee Independence</u> tracks whether or not a company has a compensation committee that consists of only independent directors**. A fully independent director is less likely to be conflicted when determining the CEO's compensation.

- **<u>CEO Succession Process Disclosure</u> is important because, in the event that the CEO is unable to continue, companies frequently are forced to find a new CEO quickly**. Sometimes this will result in the new CEO being hired from outside the company which can be more costly to shareholders as the incoming CEO will need to be compensated for incentive compensation and pensions forfeited when switching companies. In addition, for an external hire there will be a learning curve where time and effort will be required to familiarize them self with the organization. During this period of orientation, the CEO is learning about the company and not necessarily running the company. A good succession plan will identify internal candidates who are familiar with the organization thus allowing a more seamless transfer of power and reducing the need to hire externally as well as any

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costs associated with hiring outside the company. Companies will often say that they have a CEO Succession Plan but, in discussions with directors, a frequent issue that comes up is that not enough time is spent on CEO succession. In order to ensure that a proper succession plan is in place, CCBE expects companies to disclose the process that has been put in place.

Of the companies that have been assessed this year, there are 150 that were included in last year's study. Those companies have shown improvement overall with the average score increasing to 64.8 from 57.7. The following is a list of the key areas where significant changes have been observed:

Scoring Area	Number of Companies that Improved	Number of Companies that Declined	Difference
Director Share Ownership	59	17	42
Director Share Ownership Increase	40	48	-8
Continuing Education Process Disclosure	35	8	27
Board and Director Skills Disclosure	32	7	25
CEO Succession Process Disclosure	21	2	19
Director Meeting Attendance	19	15	14
Board Independence	17	7	10
Compensation Committee Independence	16	4	12

*Note: Sample set consists of 150 corporations assessed in both 2009 and 2010

Director Share Ownership measures absolute increase in director ownership of company stock. The significant improvement in Director Share Ownership is likely the result of a rebound in the market in the past year. Directors who failed to meet the minimum ownership threshold for 2009 could now be able to meet the necessary level due to increased share price.

Director Share Ownership Increase tracks whether or not board members are annually reinvesting and increasing their investment in the corporation. The implication of the high rate of improvement and simultaneous decline in the Director Share Ownership Increase is related to the way this metric is scored. One mark is deducted for each director who has not increased their ownership since the previous year to a maximum deduction of five marks. This year, 40 companies had at least 1 more director increase their ownership than they did last year. At the same time, 48 companies had at least 1 additional director fail to increase their ownership from 2009 to 2010. However, this is not necessarily an indication that directors are not investing in their companies. On closer inspection, of those 48 companies, 24 of them had only one

additional director who did not increase his or her ownership. Of those 24, 14 of them had received full marks in the previous year. This suggests that on many boards, directors are continuing to invest in the company that they are representing, and while the occasional director or two might not grow their investment in a given year, the overall trend is positive. The fact is that of the 150 companies in the set, 50 of them had all of their directors increase their ownership this year.

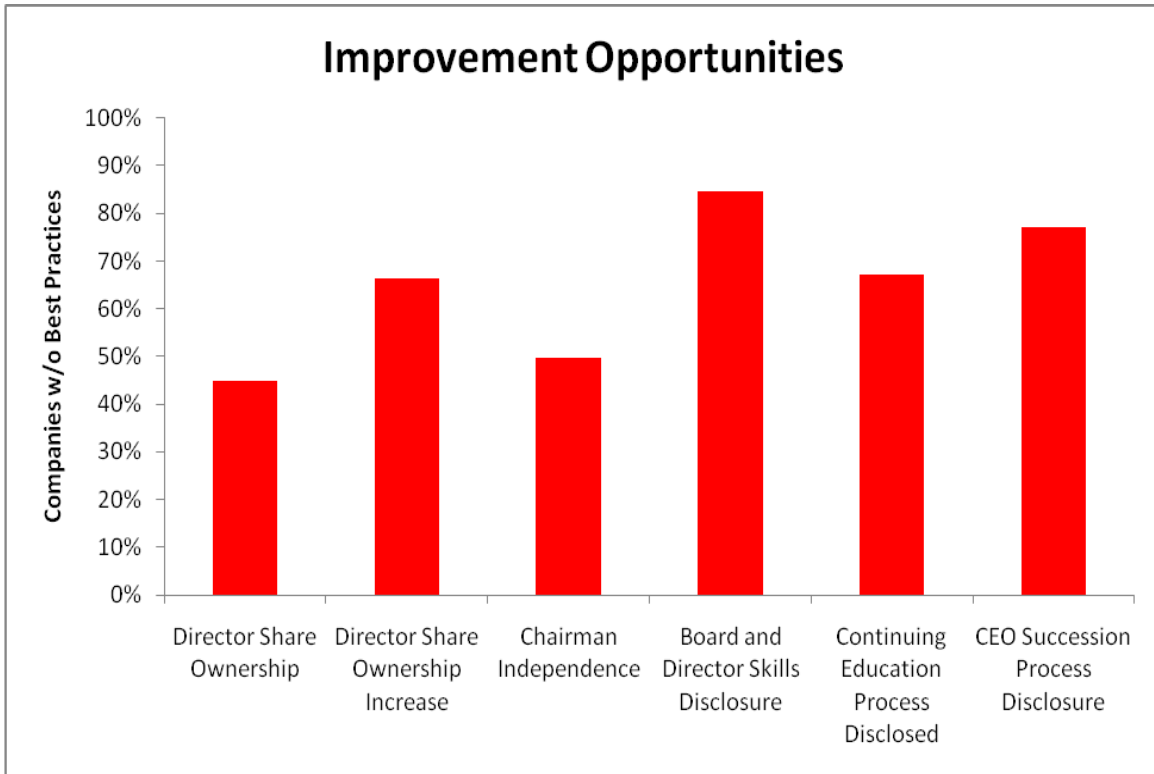
Continuing Education Process Disclosure, Board and Director Skills Disclsoure and CEO Succession Process Disclosure measure the quality of the information communicated to shareholders on these important aspects of governance. Companies are either doing a better job of disclosing processes already in place or have recognized the importance of these corporate governance elements and have included them into their overall governance practices.

Director Meeting Attendance indicates whether or not directors who are unable to fulfill their duties as a director through meeting attendance are being re-elected. Directors who are unable to attend at least ¾ of board meetings or ¾ of any of the main committee meetings are considered to have poor attendance. A majority of companies award their directors an annual retainer. The expectation is that those directors will represent the shareholders at meetings. If a director is failing to attend a significant number of meetings, then they are unable to contribute the expertise and experience for which they are being retained.

Board and Committee Independence measures the percentage of directors who are fully independent. A fully independent director is less likely to have conflicted interests and will be able to be more objective. This is one of the more exciting changes. Companies are continuing to see director independence as an important and relevant issue in the boardroom and are striving to improve it to the point where even the independence definition applied by the Clarkson Centre, which is stricter than most, is finding the independence in the boardroom to be increasing.

Overall

Overall, corporate governance is continuing to improve in Canada, but there are still several areas where the number of companies exhibiting best practices is much lower than we would like to see. Some of the areas that have shown the most improvement are also areas where there is currently a low rate of best practice adoption (such as Director Share Ownership, Director Share Ownership Increase, etc.). The table below illustrates some key areas where there is still significant room for improvement.



Two very positive things to take away from this year's project is the improvement in the number of companies that now have fully independent compensation committees and the number of companies that have disclosed some of the financial metrics they consider when determining the CEO's bonus. In 2009, 75% of companies had a fully independent compensation committee. This year, that number has increased to 85%. This improvement suggests that boards are recognizing the importance of an independent compensation committee. Improved compensation committee independence reduces the risk of conflicts of interest arising while determining the CEO's compensation, allowing the committee to remain objective and continue to oversee the interests of shareholders. Similarly, improved compensation disclosure provides clarity to shareholders. In 2009, only 78% of companies disclosed at least one performance metric used to determine the CEO's bonus. This year, that number has increased to 83%. Clear disclosure on the link between performance and compensation is reassuring to shareholders and further suggests to shareholders that there is proper oversight by the board and the compensation process.

Because of the recent scrutiny in CEO compensation, CCBE expects to see continued improvement in areas around executive compensation. Increased clarity in compensation disclosure will improve understanding of compensation matters for shareholders and allow them to make more informed decisions, particularly with the rise of "Say on Pay" votes.