

2011

DAVIES GOVERNANCE INSIGHTS



INSIGHTS



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EXECUTIVE SUMMARY



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We are often asked by our clients how their governance practices compare with the practices of other issuers of comparable size or to help them develop practices that align with those adopted by issuers in the same industry sector. It is important for each issuer to develop governance practices that are appropriate for it – practices that promote effective decision-making in the best interests of the issuer. The size and industry of the issuer is, of course, relevant, but so too are the issuer’s age and stage of development, its culture and the personalities of members of management and the board. However, trends among other issuers can provide a valuable point of reference for boards and management teams of Canada’s public companies in determining which practices are most effective for them.

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For this reason, we have completed an extensive analysis of trends in Canadian corporate governance. The statistics on Canadian corporate governance practices presented in this report are based in large part on our review of the 2011 management information circulars available for 360 of the issuers included in the S&P/TSX Composite Index (the "Composite Index") and the S&P/TSX SmallCap Index (the "SmallCap Index"). Where it was helpful we have highlighted separately the practices of the two component parts of the Composite Index: the S&P/TSX 60 Index (the "TSX 60"), the 60 largest issuers on the TSX by market cap, and the remaining 200 issuers on the Composite Index (referred to as the "Completion Index").

We have supplemented the data we have collected with our expertise in governance and with insights on the background and significance of the trends that emerged from our research.

WHO ARE THE DIRECTORS OF CANADIAN ISSUERS?



The boards of Canadian issuers are predominantly Canadian. The approximately 20% of directors who are not resident Canadians are drawn overwhelmingly from the United States. The next most common jurisdictions to which Canadian issuers look for directors are the United Kingdom and Australia (but the numbers in both cases are quite small).

Canadian boards are also highly independent of management. In fact, the level of independence on most boards far exceeds the independence requirements established by regulators, and recommended by institutional investors and proxy advisory firms. Typically, the only non-independent director on a Canadian board is the CEO. Issuers with controlling shareholders may also have representatives of the controlling shareholder on the board. Under Canadian regulatory standards, these directors are not considered to be independent for most purposes. These standards are currently being re-examined by regulators and by institutional investors.

Directors on both the Composite Index and the SmallCap Index tend to serve on a number of boards. TSX 60 directors typically serve on up to four other public company boards, although not typically on another TSX 60 board.

Women are not typically being invited onto Canadian boards, with the exception of boards of TSX 60 issuers. Eighty-eight percent of TSX 60 issuers put at least one woman forward as a candidate for election in the 2011 proxy season (68% put two or more women candidates forward). However, 57% of issuers on the balance of the Composite Index and 65% of SmallCap Index issuers did not put any women forward. Of the 360 issuers across the Composite Index and the SmallCap Index, only seven are chaired by women. Women are no more likely to be in positions of leadership at the committee level - of the more than 1,500 board committees across both indices, only 53 are chaired by women.

PROFILE OF A TSX 60 DIRECTOR

The most common profile for a director of a TSX 60 issuer is a male in his early sixties. He is a Canadian resident and is independent of management. He serves on two to four other public company boards and has served on his current board for the last eight years. The other public company boards on which he serves are likely not those of TSX 60 issuers.

SUCCESSION PLANNING FOR CANADIAN BOARDS

Directors currently serving on boards of Composite Index issuers have been on those boards for approximately eight years. Those serving on SmallCap Index boards had been serving for approximately seven years. In 2011, there was relatively modest turnover in the boardrooms of Composite Index and SmallCap Index issuers. Roughly three-quarters of issuers on both indices put forward only incumbent directors (i.e., did not put forward any new directors).

A significant majority of Canadian directors are over the age of 60. Among TSX 60 directors, approximately 65% are 60 or over (56% of Completion Index directors and 52% of SmallCap Index directors are 60 or over). It is not uncommon for issuers to have a retirement policy requiring directors to retire from the board at age 70 or 72. **Based on the current composition of Canadian boards and the tenure of their members, we would not expect the level of turnover on Canadian boards to change significantly in the coming years.**

BOARD STRUCTURE

The size of Canadian boards correlates to a number of factors, including market cap and the complexity of the issuer's business. Not surprisingly, larger issuers tend to have larger boards. Virtually all TSX 60 issuers have at least nine members on their boards and it is not uncommon for TSX 60 issuers to have 13 directors or more on their boards. Less than half of issuers on the Completion Index (and less than a third of issuers on the SmallCap Index) have boards of nine or more.

One of the board structures that is intended to promote the independence of the board from management is the separation of the positions of CEO and chair. Where these positions have not been separated, a lead director is often appointed to bolster the independence of the board from management and, in some cases, from

AVERAGE SIZE OF BOARDS

TSX 60

12

COMPLETION
INDEX

9

SMALLCAP
INDEX

8

a major shareholder. Approximately 60% of issuers on the Composite Index have a non-executive chair (i.e., have separated the positions of CEO and chair). Of those that have not, about two-thirds have lead directors. On the SmallCap Index, a little more than half have separated the positions of CEO and chair. Of those that have not, only about half have a lead director.

In camera meetings of the directors who are independent of management are another approach to supporting the independence of the board from management. The vast majority of issuers (87% of the Composite Index and 85% of the SmallCap Index) disclosed in their 2011 circulars that they hold *in camera* meetings of directors who are independent of management at each regular meeting of the board.

BOARD COMMITTEES

Boards of public companies are only required to have one committee under Canadian law - the audit committee. However, virtually all issuers on the Composite Index and the SmallCap Index have a compensation committee and a governance and nominating committee. In some cases, issuers combine the compensation committee with the governance and nominating committee. The audit committee must by law be fully independent and, in most cases, the compensation committee and governance and nominating committee are also fully independent, even though not legally required in Canada.

Of course, many issuers have other committees as well. Environmental, health and safety committees are common among certain issuers, including those engaged in the mining sector. Reserve committees are common in the energy sector. Issuers in the financial sector will typically be required by their governing statutes to have conduct review committees.

Executive committees have become very uncommon. Less than 15% of TSX 60 issuers and 6% of issuers on the Completion Index have executive committees. The move away from executive committees reflects trends both towards boards that are smaller than they were 15 years ago, and efforts to be more inclusive of all directors in board decision-making.

When it comes to risk oversight, some issuers assign responsibility to a committee (usually the audit committee or a risk committee). This is quite common among TSX 60 issuers, but other issuers on the Composite Index, as well as SmallCap Index issuers, reserve risk oversight to the full board. Oversight of strategy is almost always dealt with by the full board (as opposed to by a committee) across the Composite Index (including the TSX 60) and the SmallCap Index.

AVERAGE RETAINERS

TSX 60	COMPLETION INDEX	SMALL CAP INDEX
DIRECTOR \$140,310	DIRECTOR \$47,278	DIRECTOR \$34,476
CHAIR \$357,890	CHAIR \$112,189	CHAIR \$83,687

DIRECTOR COMPENSATION

Directors typically receive a combination of retainer and meeting fees, although some issuers pay their directors a flat fee (with no additional payment for meeting attendance). Directors who travel a significant distance may also receive a travel fee and in some cases receive additional payments for taking on additional *ad hoc* responsibilities on behalf of the board.

Most TSX 60 directors receive retainers of at least \$50,000 per year, with a significant percentage receiving more than \$100,000 per year. Meeting fees, where paid to TSX 60 directors, average approximately \$1,600 per meeting. The vast majority of directors of issuers on the Completion Index and the SmallCap Index receive \$50,000 or less in annual retainer payments and \$1,100 and \$1,000 (respectively) in meeting fees, where paid. Chairs (other than chairs who are also the CEO) generally receive a higher retainer than do other members of the board. Most TSX 60 chairs received at least \$250,000 and a few earned as much as \$550,000 or more. Chairs of issuers on the Completion Index and the SmallCap Index typically receive annual retainers of \$150,000 or less. Committee chairs usually receive an additional retainer. Chairs of audit committees often receive committee chair retainers that are higher than those paid to chairs of other committees. In other cases, this is also the case for chairs of compensation committees.

Directors also typically receive some form of share-based compensation, whether in lieu of cash retainer and meeting fee payments or in addition to those payments. It is unusual for directors of larger issuers to receive stock options, although it is more common among smaller issuers. Directors of Composite Index issuers most often receive deferred stock units.

AVERAGE CEO CASH COMPENSATION

TSX 60

COMPLETION INDEX

SMALLCAP INDEX

\$2.88

MILLION

\$1.37

MILLION

\$1.22

MILLION

Almost all TSX 60 companies require their directors to hold a certain number of shares of the issuers. This is also the case for about 69% of the Completion Index, but only 44% of the SmallCap Index. Typically, directors are able to count their share-based compensation (such as DSUs) towards their holding requirement.

CEO COMPENSATION


CEO compensation has been a particular focus of the media and the investment community. In Canada, we have not experienced the extremely high pay levels that have attracted so much commentary in the United States and other jurisdictions. Much of the discussion in Canada focuses on the link between performance and compensation.

The average cash compensation (salary plus bonus) for CEOs of TSX 60 issuers in 2010 was \$2.88 million, of which approximately 37% was comprised of base salary and 63% was bonus. CEOs of other issuers on the Composite Index averaged \$1.37 million in cash-based compensation (40% base salary and 60% bonus) and CEOs of SmallCap Index issuers averaged \$1.22 million (37% base salary and 63% bonus).

In addition to base salary and bonus, CEOs are typically awarded some form of stock-based compensation, which may be subject to time vesting, performance vesting or both. The vast majority (approximately 80%) of TSX 60 CEOs received stock-based compensation that was subject to performance-based vesting. Only 51% of issuers on the Completion Index and the SmallCap Index did the same. There was a fairly significant difference in the use of options, phantom stock units (RSUs and DSUs) and to a small extent, SARs across the Composite Index and SmallCap Index.

Almost all TSX 60 companies require their CEOs to hold a certain number of shares of the issuer. This is the case for only 47% of the Completion Index and 30% of the SmallCap Index. Typically, CEOs are able to count their share-based compensation (such as RSUs) towards their holding requirement.

Most issuers on the Composite Index and the SmallCap Index contract with their CEOs to provide them with certain payments upon a change of control. Almost all change of control arrangements are “double trigger”. More specifically, only 2% of issuers on the Composite Index and 6% of issuers on the SmallCap Index offered single-trigger change of control arrangements. The change of control payments typically range from 200% to 250% of the executive’s cash compensation.



Majority voting can give investors a meaningful voice in the election of individual directors to the boards of the issuers in which they have invested.

SHAREHOLDER DEMOCRACY ISSUES

The term “shareholder democracy” is currently being used in the context of the several issues that have been high on the investor agenda, particularly, shareholder engagement with directors, “say on pay” and majority voting. There are two other issues that directors should consider in the context of shareholder democracy. One is the role of the proxy advisory firms; the other is the overall effectiveness of the proxy advisory system.

Say On Pay

Say on pay refers to an advisory vote by shareholders on the executive compensation philosophy and practices of the issuer for the previous fiscal year. In the 2011 proxy season, more than half of the TSX 60 issuers put say-on-pay resolutions to their shareholders. That is likely to increase to at least two-thirds in the 2012 proxy season, based on the issuers who have already committed to adopting say on pay in 2012.¹ The remainder of the Composite Index has been much slower to embrace say on pay, with only 14% of the Completion Index putting a say-on-pay vote forward in 2011 and another 1% having committed to doing so in 2012. **The issue has barely hit the radar screen of smaller issuers. Only 7% of issuers on the SmallCap Index have adopted say on pay and none have disclosed in their circulars that they intend to do so in the 2012 proxy season. With one or two exceptions, shareholders strongly supported the executive compensation of Canadian issuers.**

¹ These issuers include Canadian Natural Resources Limited, Canadian Oil Sands Limited, Cenovus Energy Inc., Inmet Mining Corporation, Penn West Petroleum Ltd., Shoppers Drug Mart Corporation and Yamana Gold Inc.

Majority Voting

Majority voting can give investors a meaningful voice in the election of individual directors to the boards of the issuers in which they have invested. Three elements are necessary for majority voting to satisfy this objective.

The first element is the abolition of slate voting in favour of votes for individual directors. Slate voting has been almost completely eliminated among TSX 60 issuers. Among Composite Index issuers more generally, the vast majority (87%) have also moved to individual voting for directors. The trend is also strong among SmallCap Index issuers, with 80% having eliminated slate voting in favour of allowing their shareholders to vote for each director individually.

The second element is disclosure of the results of the votes for each director (i.e., the percentages cast for and withheld). In 2011, 88% of TSX 60 issuers reported the percentage results for their director elections. This practice was lower among the rest of the Composite Index issuers; only 59% of issuers on the Composite Index (other than TSX 60 issuers) reported percentage results. Almost half the of issuers on the SmallCap Index (48%) followed this practice.

The third element is establishing some consequence for a director from whom a majority of votes has been withheld - ultimately leading to resignation. Almost all TSX 60 issuers disclose that they have a policy dealing with the resignation of a director if he or she receives a majority of withhold votes. This is the case for a little more than half of the Completion Index and about a third the SmallCap Index.

Shareholder Proposals

Canadian corporate law permits shareholders to propose certain business to be put on the agenda of a meeting of shareholders. During the 2011 proxy season in Canada, 72 proposals were made to 25 issuers. Of these, 20 were withdrawn. Only two of the proposals that were put to a vote at shareholder meetings succeeded; a proposal to European Goldfields Limited to adopt majority voting, and a proposal to CIBC regarding the facilitation of shareholder abstention in proxy voting.

Proxy Voting Issues

The proxy voting system in Canada is sufficiently flawed in its design and operation to raise legitimate questions about the quality of the shareholder vote in Canadian public companies. The proxy voting system has come under significant criticism in the last year or so. In October 2010, Davies released a

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SHAREHOLDER
PROPOSALS

MADE TO

25

ISSUERS

ONLY

2

ACTUALLY
APPROVED

discussion paper describing the issues with reliability of the proxy voting system in Canada.² We are delighted that this paper has supported broader discussion among stakeholders and participants in the proxy voting system, including several roundtables and conferences (including one sponsored by RBC Dexia and one sponsored by the Canadian Society of Corporate Secretaries.)

In 2011, the OSC solicited comments on whether action needs to be taken with respect to the proxy voting system in its OSC Staff Notice 54-701. The vast majority of the comments submitted in response to this staff notice support a review of, or significant changes to, the proxy voting system in Canada.

From an issuer perspective, one of the major issues of concern is the influence of proxy advisory firms. This influence (actual or perceived) comes from the fact that certain institutional investors provide proxy advisory firms with standard voting instructions. To the extent that institutional investors adopt the recommendations of a proxy advisory firm (in whole or in part), the concern arises that the proxy advisory firms have become setters of corporate governance standards. Institutional investors object strongly to the suggestion that they simply rely on the recommendations of a proxy advisory firm. While they may take those recommendations into account, institutional investors take responsibility for the way in which the votes are cast.

The complexity of the proxy voting system in Canada often makes it difficult to isolate the source of the problems.

In addition, issuers are concerned that proxy advisory firms do not always analyze their public disclosure accurately or do not take into account the nuances or particular circumstances that apply to a particular issuer. The result can be, from the issuers' perspective, that votes are being influenced by analysis that is inaccurate or otherwise deficient.

In our view, the influence of proxy advisory firms will continue to be a prominent issue in Canadian governance discussions in the next few years. Suggestions that proxy advisory firms be regulated tend to falter when the specifics of such regulation must be set out. The forum for a meaningful discussion among issuers, institutional investors and proxy advisory firms has yet to emerge.

For more information, visit our shareholder voting website at www.shareholdervoting.com

² The Quality of the Shareholder in Canada Vote is available on the Davies website (www.dwpv.com) or at shareholdervoting.com.