Gallagher McDowall Associates
ARTHUR J. GALLAGHER

Looking Forward in Executive Compensation:

New Designs for Better Results

ROBERT LEVASSEUR
DOMENICO D'ALESSANDRO

SEPTEMBER 16, 2016

15GBSDCN#

What We Will be Talking About Today

- A quick review of the current state of executive compensation in Canada and the USA:
  - Regulatory changes
  - Current trends
  - Are stock options as evil as they are made out to be?
- Examination of TSX 120 companies that have introduced novel approaches to the delivery of executive compensation. AKA: “Outliers:”
  - A review of issues these designs address
  - Outlier examples
- New approaches to measuring performance for executive compensation purposes:
  - Is the current obsession with relative TSR healthy?
- Should you be considering changes?
  - Checklist for compensation professionals in assessing your circumstances

LET'S TALK ABOUT EXECUTIVE COMPENSATION

Pressures and Influencers of Executive Compensation

1. Disclosure: Magnitude of executive compensation has triggered the CEO Pay Ratio issue.
2. Regulatory: Proposed US rules in the financial sector may herald longer term variable compensation. Shifting the compensation mix even more into medium and long term incentives.
3. Governance: Boards are reacting to the homogeny in EC structure created by proxy advisors, such as ISS and Glass Lewis.
4. Public opinion: Severance packages that reward for failure continue to face scrutiny, yet difficult to prevent.
5. Performance Management: The use of TSR as the dominant EC performance. This results in equity value being the primary, if not the only, measure being used to assess executive performance.
6. Long Term Incentives: The emergence of real equity as LTI currency.

The CEO Pay Ratio in the US *

- Compensation of CEOs of 350 companies in the S&P 500 averaged out to a **331X** ratio relative to US average annual worker pay.
- Yet, there are more than 27 million private firms in the US.
  - The 248,760 employees identified by the US bureau of Labour Statistics as CEOs in 2013 reported average pay at $178,400.
  - That's a multiple of **5X** annual worker pay.

* Source: Mark J. Perry, *American Enterprise Institute, 2014*

US Financial Sector Regulator Proposals

- Beginning April 21, 2016, 6 US Regulators jointly published a series of proposed rules for financial institutions with assets in excess of $50 billion.
- The purpose of the regulations is to lengthen the time period over which incentive-based compensation must be deferred and placed at risk of both reduction and potential full recovery:
  - 40% to 60% of *all* incentive compensation must be deferred for 3 to 7 years from original grant date. Recovery period can be even longer.
  - *All* unvested awards must be subject to forfeiture, downward adjustments and cancellation.
  - *All* vested incentives must be subject to claw-back (whether previously paid out or not) by employees, former employees in cases of fraud, misconduct or intentional misrepresentation.

Headlines You Never See

CEO Forfeits Stock Options

Pay Day! Company Boss
Cashes in Whopping $9,200 SOP Grant

Underwater Stock Options Record Beaten :
John Smith's Awards Worthless
For More Than a Decade!!!

Stock Options are not evil and can be used effectively: Just Know What You've Signed up For…

- Stock options continue to be viewed with suspicion by the governance "experts" and regulators
  - Yet stock options are the most tax effective vehicle for the participants, and allow them to choose when to exercise over a long period of time

- The popular media usually misrepresents stock options when reporting their grant value as if they were actual "cash in the bank": not true
  - Option leverage can be spectacular *or* they can be worthless

- Multiple grants over a period of years add to their complexity

- Equity-based compensation is betting on the company's future success

- "Market theory" suggests eventual alignment of share price with profits
  - *However,* in reality operational success and share price are not always neatly aligned, especially over a CEO's increasingly short tenure and the typical 3 year PSU

- Stock Options are not that liquid
  - Blackout periods and inquisitive Analysts limit the liquidity of these vehicles, especially for CEOs and CFOs.

Proxy Advisory Group: ISS

What they say vs. What they do

What they say

- "ISS does not advocate that companies use TSR as the metric underlying their incentive programs"
- "Maintain appropriate pay-for-performance alignment with emphasis on long-term shareholder value"
- ISS' P4P methodology "comprises and initial quantitative screen and routine qualitative assessment"
- "TSR measurements – even over the long term – are sensitive to the endpoints of the periods being measured."

What they do

- ISS primarily uses a company's relative TSR to assess its quantitative performance: "TSR, which is objective and transparent, is the primary metric ISS utilizes in evaluating pay and performance alignment"
- Relative TSR is measured on a mid-term (3 year) basis, not on a longer-term basis
- ISS also looks at
  - the CEO's pay in the most recent year relative to the median pay of the peer group CEOs, and
  - the CEO's pay history over the past five years relative to the company's absolute TSR

Proxy Advisory Group: Glass Lewis

What they say vs. What they do

- "We generally prefer that at least a portion of medium or long-term incentives be linked to specific performance targets."
- The following features are desirable in full-value equity award plans:

1. The inclusion of performance metrics
2. Performance periods of at least 3 years
3. At least one relative performance metric
4. No re-testing or lowering of performance conditions
5. Performance metrics that cannot be easily manipulated by management
6. Stretching metrics that incentivize executives to strive for outstanding performance
7. Individual limits expressed as a % of salary

- Glass Lewis benchmarks a company's top 5 executives' pay and its performance relative to a group of peer companies selected by Equilar
- Relative performance is measured across 5 metrics:
    1. TSR *
    2. EPS growth *
    3. Change in Operating Cash Flow *
    4. ROA
    5. ROE

    ** Calculated based on 1, 2 and 3 year weighted averages*

15GBSDCN#

Gallagher McDowall CEO Research

	S&P/TSX 60 2015 Average (in millions)	TSX 61 – 120 2015 Average (in millions)	Diff.
Base Salaries	$1.22	$0.85	+44%
Total Cash	$3.08	$1.97	+56%
LTI	$4.81	$2.09	+130%
Total Direct	$7.89	$4.06	+94%

Source: *Does Size Matter? CEO Compensation in Canada:* 2016 Update, Gallagher McDowall Associates, 2016

Additional Cost to hire an American CEO in Canada	Cost per CEO
Annual Revenues in Nominal Dollars – under $5 billion	+ $2.7 million[1]
Annual Revenues in Nominal Dollars - $5 - $50 billion	+ $8.1 million[1]
[1] In Canadian currency assuming $0.75 Canadian dollar.	

Source*: Be Careful When Crossing the Border*, Gallagher McDowall Associates, 2015

Full reports available at www.mcdowallassociates.com

15GBSDCN#

Trends In Executive Compensation

S&P/TSX 60 – 6 Year change (2010 vs. 2015)

- Average Base Salary for CEO's has increased by about 8% over the last 6 years or about 1.5% per year (in line with inflation over the same period of time).
- Average Short–Term Incentives have increased by 7%.
- Total Direct has increased by about 24%.
- Options grants have remained consistent with about a 5% increase, while share based awards (RSUs, PSUs) have increased by 61% over the same time period.

TSX 61 to 120 – 6 Year change (2010 vs. 2015)

- Average Base Salaries are up by 43% or about 7% per year
- Average STI has increased by 22%
- Total Direct has increased by 35%
- Share-Based awards increasing by 88% and Option Values increasing by 11% and over the same period

An Example of How Executive Compensation Has Changed

Year	Event	Changes in Compensation Policy	CEO Base	Bonus	Share Based Awards	Options	Total Direct
2006		• Stock options are the only LTI vehicle • Automatic annual option awards at 3 x salary • $1.6 million grant value "retention" option award to CEO	$ 450,000	$ 562,500	$ -	$ -	$1,012,500
2009	New CSA disclosure rules are applied	• RSU plan introduced • CEO's contract re-amended: AIP target increased to 1.25 x salary, LTI target set at 1.50 x salary of (105% Options and 45% RSUs), • $1.15 million payment for cancelling the retiring allowance and for signing the contract	$ 550,000	$ 687,500	$ -	$ 199,291	$1,436,791
2010	Say on pay resolution is introduced	• Shareholding requirements increased for CEO from 4 to 5 x salary and for EVPs from 1 to 2 x salary	$ 650,000	$1,137,500	$ 292,494	$ 682,501	$2,762,495
2011	Shareholder letter from HRCC is introduced Key directors meet with CCGG	• Clawback and hedging policies are introduced • Risk management discussion is introduced	$ 680,000	$1,190,000	$ 306,010	$ 713,997	$2,890,007
2013	Former CEO retires	• New CEO promoted from within at 26% lower salary, and AIP target of 1 x salary, and LTIP target of 1.30 x salary	$ 481,490	$ 658,333	$ 217,596	$ 404,084	$1,761,503
2014	PSU plan introduced for SVPs and above.	• 2014 PSU awards to vest based on relative TSR, with 25th percentile threshold and target of 50th percentile	$ 587,500	$ 900,000	$ 467,998	$ 312,019	$2,267,517
2015	Increased PSU weighting, with 25% maximum option weighting	• Number of option eligible employees reduced from 370 to 40 • Added 2nd PSU performance measure (growth in adjusted cash flow per share) with 50% weighting • Double trigger RSU and PSU vesting introduced • Removed accelerated option vesting on retirement • Expanded AIP to make all employees eligible	$ 675,000	$ 697,000	$ 672,750	$ 224,250	$2,269,000
2016	Changing to single 3 year PSU period from average of 3 annual periods	• Removing insurance companies from TSR peer group, while increasing weighting on TSX Capped Financials Index • Changing PSU weighting to 30% relative TSR performance, 30% grow in adjusted cash EPS and 40% achievement of specified strategic objectives • Increasing option term from 5 to 7 years					

Summary - Current State

- Reporting of the Chief Executive Officer pay ratio is ramping up, for better or worst.
- Stock Options are continuing to be under attack but what will replace them?
- Proxy Advisory Groups are not only influencing director thinking on executive compensation but are also encouraging generic executive compensation through TSR measures.
- Say on Pay has compelled companies to look carefully at plan designs.
- CEO total compensation is now relatively flat in the top 60 companies, with the growth seen mostly in share based awards
- CEO compensation growing aggressively in second group of 60 companies across all elements (except Stock Options)
- NEO aggregate compensation compared to the CEO remains relatively consistent at just under 50% (as compared to 33% in US)

INCENTIVE PLAN DESIGN OUTLIERS

WARNING: Don’t Try These Stunts at Home

- Instead of focusing on what the majority is doing, we have collected outlier data.
- We have gathered certain atypical plans disclosed in information circulars.
- Some companies are trying to redress a company-specific issue.
- Most are trying to respond to shareholder concerns.
- We do not necessarily endorse these arrangements.
- Our purpose is to explore the underlying issues being addressed by these approaches.

15GBSDCN#

Three Categories of Outliers

1. **The Outright Bizarre** – These plans are of questionable design and/or may test tax rules.
2. **Response to a Particular Event** – Plans that have been developed to deal with an M & A or the appointment of a new CEO.
3. **Response to Board Imperatives** – These initiatives attempt to deal with criticism bourn by Executive Compensation plans from various parties or they attempt to provide more effective ways of paying for performance.

We will be looking at the 3rd group today…

	Real Ownership	"Look Back" Performance Grants	Stock Option Dilution	Performance Vesting (Stock Options)	Mandatory hold of shares for ownership guidelines
ARC	X*				
Barrick	X*	X	X		
Blackberry	X		X		
Brookfield	X^		X		
Cdn Natural Res		X			
CGI	X			X	
Crescent Point		X		X	
Constellation Software			X		
Eldorado Gold	X+				
Enbridge		X		X	
Fairfax	X*			X	
First Quantum	X				
Imperial Oil	X+				
Loblaws	X			X	
Magna				X	
Maple Leaf Foods	X*	X			X
Methanex	X*				X
Rogers				X	

* Open-market shares purchased by company ^ Complicated escrow system used + Treasury or Cash at Board Discretion

ARC Resources - Restricted Share Plan

- ARC Resources has introduced a new long-term restricted share plan for 2015
  - Treasury shares are issued to a third party trustee on the grant date
  - The awards have a 10 year term, with one-third vesting on each of the 8th, 9th and 10th anniversaries
  - Grants will be taxed at time of share issue, not upon vesting
    - Cash component provided to offset income taxes
  - Dividends will be reinvested within the trust
- ARC will continue to use PSUs and Options in addition to the new plan

Dilutive

Long Term Vesting

Not a SDA

Painless tax treatment

Why introduce this type of Plan as well as Stock Options?

- Real equity is put in the hands of plan participants
- If the share price depreciates, losses are real
- Real alignment with shareholders

Barrick Gold - Performance Granted Units

- 100% of NEO long-term incentives going forward to be in "Performance Granted Share Units" (PGSUs)
- PGSU grant sizes to be based on "Long-Term Company Scorecard" that measures achievement of 5 quantitative and 3 qualitative measures for the previous year, within a 0 to 100% range
- Awards vest at the end of the third calendar year from the date of grant
- After-tax value of awards used to purchase open market shares through a third party administrative agent
- Shares cannot be sold until a participant retires or leaves the company (or over two years if the participant joins a competitor)
  - Participants receive dividends during the non-sale period
  - Compensation Committee has authority to waive the prohibitions on the sale, transfer or other disposition of the shares on a case-by-case basis, without shareholder approval

No more options

Look Back

Participant owns them

Long-term hold

15GBSDCN#

PotashCorp – Performance Option Pools

- Until recently, every year Potash asked shareholders to approve a pool of performance stock options for the current year's awards
- The options vest based on the amount by which the company's CFROI exceeds its weighted average cost of capital (WACC) over a three year performance period:

No automatic Awards

CFROI – WACC Results	Vesting Percentage
Less than 0%	0%
0.2%	30%
1.2%	70%
2.20%	90%
2.5%	100%

Performance Vesting

Cash flow return on invested capital [i.e.: real cash available] minus ***weighted average cost of capital (WACC)*** [i.e.: the average rate of return a company expects to compensate all its different investors.]

Note: This approach was not used in 2015

Enbridge – Performance Stock Options

- Performance Stock Option mega-grants awarded every five years or so in addition to annual time-vested stock option grants
  - Last award was made in 2012, except for a new hire in 2014
  - 2007 awards expired in 2015
  - 2012 grant value was calculated by discounting the B-S value by 11.4%
  - Full grant date value was reported in the SCT for 2012, but is annualized for competitive compensation comparison purposes (e.g. currently 115% of salary per annum for the CEO)
- Three share price hurdles had to be met for the 2012 grants to vest
  - E.g. for 2012-2016 awards, the stock price had to increase from $39.34 to $48, $53 and $58 (+22%, +36% and +47% respectively) from the August 2012 grant date for a period of 20 or more consecutive trading days
- The three share price hurdles are in turn are weighted 40%/40%/20% respectively
- Awards are also subject to time vesting at 20% per year, provided the share price hurdles are achieved
  - 60% time-vested as of the end of 2015, as all three stock price hurdles have been achieved
- 8 year option term

Mega Option Grants

Performance Vesting

TSX 61-120 Outliers

- Algonquin Power
- Atco
- CAE Inc.
- CAP REIT
- CCL Industries
- CI Financial
- CREIT
- Cominar REIT
- DH
- Element Financial
- Empire Company
- Fairfax Financial
- H&R REIT
- Hudson's Bay Company
- IGM Financial
- Intact Insurance
- Linamar
- MacDonald Dettwiler
- Maple Leaf Foods
- Methanex
- Northland Power
- Onex
- Open Text
- Peyto Exploration
- Stella-Jones
- TMX Group
- Tourmaline Oil
- Vermillion
- West Fraser Timber

29 out of 60

Items of Note

- 13 organizations in the S&P/TSX 60 use Treasury or Open market shares in their RSU/PSU equity plans
- 21 organizations in the TSX 61 to 120 companies use Treasury or Open market shares in their RSU/PSU equity plans
- 7 S&P/TSX 60 organizations use a share price hurdle, or other performance metric trigger for Stock Option vesting
- None of the TSX 61 to 120 use performance based stock options
- 4 S&P/TSX 60 organization are using a formal "look-back" approach to setting CEO and executive compensation
- 1 of the TSX 61 to 120 uses a "look-back" approach to setting future grants.

RUMINATIONS FROM THE BUSINESS STRATEGISTS

Key Performance Research Findings

“ No company can continually outperform the stock market over the long term. ”

“*Creative Destruction*”, Foster and Kaplan, 2001

“ Companies that generate strong economic profit results can sustain their competitive position over the long term, but it is not easy, as many lose their initial advantages. On average, 60% of a company’s economic profit can be attributed to the market segments the company selects, its unique proprietary advantages and its special capabilities, while 40% can be explained by the industry in which the company competes. ”

“*The Strategic Yardstick You Can’t Ignore”*, McKinsey Quarterly, 2013

“ All CEOs have aspirational long-term goals, but when it comes to priorities and plans of action, few have headlights that can shine further than two or three years. “

“*Perspectives on the Long Term*”, McKinsey Quarterly, 2015

“ Managing companies for success across a range of time frames – a requisite for achieving better performance and health – is one of the toughest challenges in business. A company’s strategy should be reflected in a portfolio of initiatives that consciously embrace different time horizons. “

“Building the Healthy Corporation”, McKinsey Quarterly, 2005

“ Organizations exist to create value for their customers, not just for their owners, and they grow customer value through employees who are engaged, are innovative and who provide superior customer service. “

“Bill George on Rethinking Capitalism”, McKinsey Interview, 2013

Obsession with TSR

- ISS and Glass Lewis have helped thrust this measure to the Say on Pay forefront.
- A recent study by Connell University's Business School and Pearl Meyer found that 52% of S&P 500 using TSR as a measure were influenced by proxy advisory services to do so. *
- The study found that:
  - There is no evidence that using TSR in an incentive plan improves future performance;
  - There is a weak negative relationship between TSR's use and revenue growth;
  - Firms with TSR-based incentive plans are typically larger, yet less profitable based on 10 year compound growth rate.

* Source: “TSR, Executive Compensation, and Firm Performance A Brief prepared for the Institute for Compensation Studies”, ILR School, Cornell University, Sept 2015

Measuring Performance for the Purpose of Mid-Long Term Incentive Compensation Plans

	Operational Processes	Sales / Revenue	Operating Results	EBIT	P&L	Shareholder Return
Measure 1 Measure 2 Measure 3						

- Organizations rank various measures that run along the performance spectrum beginning with operational metrics and ending with “bottom-line” shareholder return metrics.
- Most mid-term / long-term executive compensation plan measures are currently biased towards the shareholder-return zone of the spectrum.
- Most privately held companies and not-for-profits tend to use measures closer to the left side of the spectrum

Vermillion – Equity Compensation

- "Employee Bonus Plan"
  - After-tax value of annual bonuses automatically paid 50% in cash and 50% in shares issued from treasury with immediate vesting
- "Vermillion Incentive Plan (VIP)"
  - 100% performance-based awards for all executives; other employees can choose either 100% performance-based or 75% performance-based / 25% time-vested awards
  - Performance = 3 year average of annual corporate scorecards (annual relative TSR, production growth, cost of growing reserves, health/safety/environmental, strategic plan achievements)
  - After-tax value on vesting usually settled in shares issued from treasury, as determined by the board
- No option plan for executives

Multiple measures

Barrick Gold - Performance Granted Share Units

- 100% of NEO long-term incentives going forward to be in "Performance Granted Share Units" (PGSUs)
- PGSU grant sizes to be based on "Long-Term Company Scorecard" that measures achievement of 5 quantitative and 3 qualitative measures for the previous year, within a 0 to 100% range
- Awards vest at the end of the third calendar year from the date of grant
- After-tax value of awards used to purchase open market shares through a third party administrative agent
- Shares cannot be sold until a participant retires or leaves the company (or over two years if the participant joins a competitor)
  - Participants receive dividends during the non-sale period
  - Compensation Committee has authority to waive the prohibitions on the sale, transfer or other disposition of the shares on a case-by-case basis, without shareholder approval

8 Measures!

Summary: Where We Think the Future of Equity Based compensation is Headed

Action Taken	Impacts
Development of Plans that use real ownership	• True shareholder alignment
Locked in equity based plans	• Cash awards converted to longer term instruments create longer equity vesting periods
Equity based Incentive pools based on performance	• Decouples plans from fixed market-based grants • Equity awards reward performance
“Look-back” vesting grants	• Participants rewarded for their historical performance with forward looking instruments.
Use of open-market purchased shares	• Deals with equity dilution and shareholder approvals for stock option pools
Movement towards operational measures	• Recognizes the complexity of measuring corporate and executive performance
Movement towards multiple measures	

Strategic opportunities to assess your firms readiness/need to change executive compensation practices.

- When was the last time you reviewed your compensation philosophy as a firm?
  - Does your current compensation mix and program fit your stated compensation philosophy?
  - If you had to disclose the CEO compensation ratio, what would that number look like?
  - Can you live with the press coverage if your CEO were to leave with your current severance package?

- Does your firm use TSR as a performance metric? Are you using anything else?

- You should consider review of your performance metrics if your executive compensation performance measures:
  - Are inconsistent with your organization's business plan and long-term strategy
  - Have poor "line of sight" in the eyes of your executives
  - Act more as lottery tickets, rather than as true incentives to perform well
  - Are too myopic and too numerous
  - Leave no room for board discretion (or conversely give the board too much discretion)

Strategic opportunities to assess your firms readiness/need to change executive compensation practices.

- You should consider reviewing your compensation strategy and compensation approach when:
  - You have a new CEO, who has either promoted from within or hired from outside
  - You have a new Board Chair and/or a new major shareholder/owner

- You may consider changing your approach to equity awards if:
  - It struggles with maintaining or dwindling share reserves
  - You wish to deemphasise stock options in your variable compensation mix
  - Your Board or Stakeholders are looking for more restrictions on Options
  - your firm uses any of the large financials in the US or EU as a comparator or as a financial firm
  - your organization is affected by new regulatory requirements that give you an opportunity to revise your incentive programs