HIGHLIGHTS FROM THE 2016 PROXY SEASON – TSX 60: A TALE OF TWO ECONOMIES

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2015 was a challenging year for Canadian issuers, as evidenced by a 10% decline in the TSX 60 index. A closer look, however, reveals fortune diverging largely along industry lines: in the face of weak commodity prices, TSX 60 companies in the mining and energy sectors saw a 30% decline in total shareholder return on average, while non-resource sectors fared comparatively better, returning 2%.

This dichotomy was reflected in CEO compensation. While overall CEO pay among the TSX 60 increased by a modest 1.2% to $7.6 million in 2015, CEO pay outside the resource sector increased 15%, while oil & gas and mining decreased 15%[1] and 22%, respectively.

With the Canadian dollar losing significant ground to the US dollar (a decrease in value of 16% in 2015 and roughly 25% since 2013), exchange rates figured prominently in the compensation discussion this past year. For example, in relation to directors pay, a number of major issuers adopted a nominal pay policy in 2015 (i.e., US domiciled-directors received the same dollar amounts in USD as Canadian-domiciled directors received in CAD).

Topics Covered

This briefing summarizes Hugessen's observations on the following topics:

- TSX 60 CEO pay levels, mix and plan design
- Notable themes in compensation policies and practices
- Governance and regulatory update
- Implications for 2017 and beyond

Support from the shareholder community for executive compensation continued to be relatively strong (as at May 25, average say-on-pay support was 90%; consistent with last year). However, there appeared to be more shareholders expressing concern with pay programs as the number of companies receiving a SoP vote below 90% increased significantly from last year (85% of companies received 90%+ in 2015, while only 68% to date in 2016).

There are numerous lessons to be learned as Compensation Committees turn their attention to their company's own compensation frameworks, and evaluate modifications for 2017 and beyond.

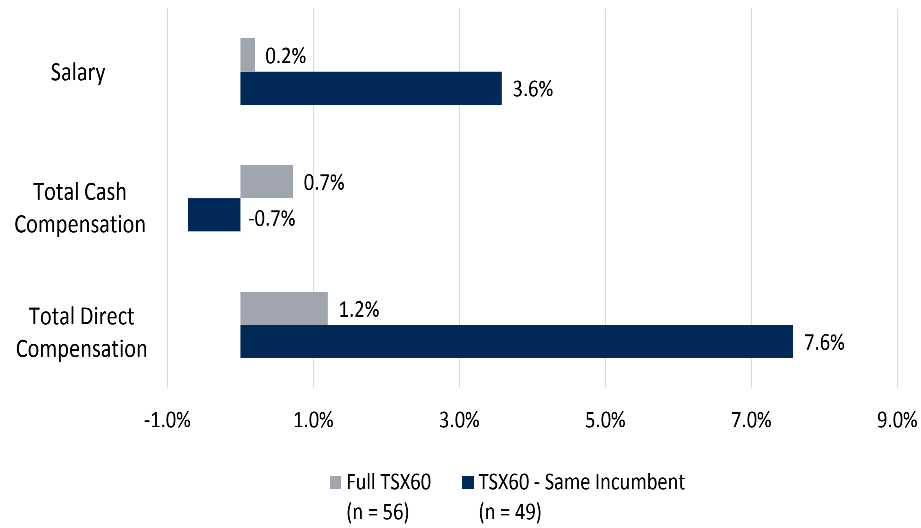
[1] We note that although overall pay levels fell within the oil & gas industry, average pay rose by 15% for infrastructure companies, compared to the sharp decline experienced by producing companies

TSX 60 CEO PAY LEVELS, MIX AND PLAN DESIGN

Pay Levels

Median actual total direct compensation ("TDC") for TSX 60 CEOs in 2015 was $7.6 million, an increase of 1.2% from the 2014 median[2]. The year-over-year increase in TDC was driven by higher long-term incentive (LTI) grants, as actual annual bonuses paid in 2015 were 106% of target, a decrease from 116% of target in 2014.

Year-over-Year Changes in Actual Compensation

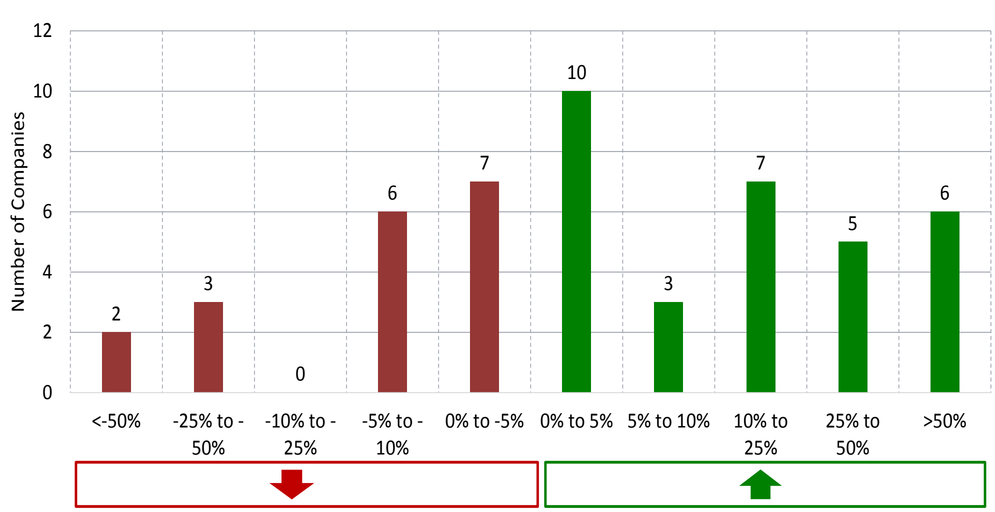


To eliminate the "noise" generated by different TSX 60 constituents and individual CEOs, we also examined pay for those companies that were part of the TSX 60, and had same incumbent CEO, in both 2014 and 2015 (n = 49)[3]:

- Median actual TDC was $8.2 million, a 7.6% increase from 2014; this represents the highest annual increase in the past four years
- Oil & gas and mining companies accounted for all the major decreases in TDC, whereas pay increases were observed across various sectors

In 2014, there were twelve new CEOs in the TSX 60, who saw, on average, a 31% decrease in actual TDC compared to their predecessors. When we looked at pay for new CEOs in 2015, we observed mixed results[3] – two increases, one decrease and one remaining flat compared to their predecessors. However, these represented relatively unusual situations (e.g., a returning CEO, an appointment of non-family member CEO).

Changes in Same Incumbant Actual TDC Y/o/Y (n=49)

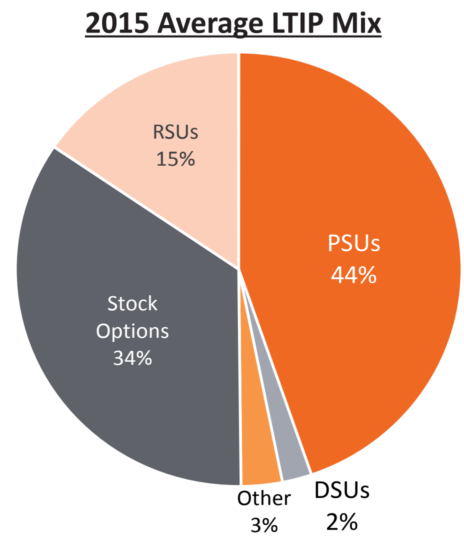


It should be noted these aggregate pay statistics represent changes in the grant date fair value of equity awards, which can be significantly different from a CEO's "realized" and "realizable" pay experience. For example, Encana disclosed that its CEO's realizable pay declined 67% over the last 3 years from the reported grant date value.

[2] As at May 20, 2016, data is not available for Saputo and Alimentation Couche-Tard. Data was excluded for Valeant and Constellation due to irregular pay practices. Total cash compensation (TCC) = base salary + annual bonus; Total direct compensation (TDC) = total cash compensation + long-term incentives

[3] TSX 60 additions: Emera, Franco Nevada, Constellation Software and Dollarama; Removals: Canadian Oil Sands, Catamaran, Talisman and Transalta; CEO transitions: SNC-Lavalin, Telus, Fortis and Bombardier

Pay Mix and Design



We observe the continuation of recent trends regarding pay mix and plan design, including:

- Long-Term Incentive Plan Mix – no major changes – performance share units (PSUs) remain the most prevalent LTI vehicle (49 TSX 60 companies currently grant PSUs to their CEOs)
  - PSUs continue to constitute the largest proportion of LTIP mixes (average of 45% in 2015)
  - Use of stock options within the LTIP mix has stabilized between 30% - 35% and RSUs remain close to 15%
  - DSUs and other forms of LTIP account for the remainder
- PSU Performance Metrics – Total Shareholder Return (TSR) remains the most prevalent metric used (36 of 49 companies). 60% of companies use two or more metrics in their PSU frameworks
  - Return metrics (e.g., ROE) are the most common metrics used besides TSR
  - We are beginning to see more companies supplement these metrics with operating measures such as total customer connection (TELUS) and same-store sales growth (Canadian Tire)
- Longer-Term LTIPs – We have not seen a meaningful increase in the adoption of longer-term LTIPs, despite the topic being advocated by various institutional shareholders (e.g., *Focusing Capital on the Long Term* initiative originated by CPPIB and McKinsey). Some adopters of longer-term LTIPs include ARC (10-year restricted stock) and Manulife (effective 2015, introduced formal restrictions on all stock options awarded – restricting exercise prior to the fifth anniversary of grant)

NOTABLE THEMES IN COMPENSATION POLICIES AND PRACTICES

Canadian / U.S. Foreign Exchange Environment

Impact on Benchmarking and Related Pay Decisions for Executives: The continued appreciation of the U.S. dollar in 2015 generated widespread discussion in Boardrooms across Canada. The influence of exchange rates on executive compensation was actively considered by many TSX 60 issuers; however, limited disclosure emerged detailing how it was dealt with. While twelve companies in the TSX 60 disclosed a practice of benchmarking executive compensation using U.S. peer groups, exchange rate treatment was not specifically mentioned in most cases. We highlight two interesting examples:

- Agrium – sets NEO compensation in USD using a U.S. peer group and makes adjustments in the form of increases or decreases to equity awards based on FX rate fluctuations
- BMO – kept the CEO's USD denominated salary flat in 2015; however, this resulted in a material year-over-year increase on CAD basis. In light of this, the Board exercised discretion and adjusted his cash bonus lower

Several companies offer commentary on how currency affected year-over-year trends in compensation. For example, CN explains compensation changes for its CEO and other NEOs by presenting pay data on both a constant currency basis and a currency converted basis.

Impact on Director Pay: American directors serving on Canadian boards that compensate members in CAD have experienced an approximate 25% decline in their compensation since 2013 (when expressed in USD)[4]. In order to address this, several issuers have adopted a policy of paying American directors in USD, including:

- CIBC – adopted a policy last year of paying their directors the same nominal dollars – directors who are U.S. citizens or reside primarily in the U.S. receive the same amount in USD as their Canadian colleagues receive in CAD

We note that the issue of differentiated pay among directors for the same role on a board remains a hot button issue in the director community.

Significant One-Time Awards

The institutional shareholder community has recently shone a light on the practice of granting large one-time awards to executives, led by OTPP and CPPIB who released a research paper on this topic in early 2016[5]. Despite the increased focus, 2015 saw a continued incidence of one-time awards, including:

- Telus – in re-appointing Darren Entwistle as CEO (from Executive Chair), Telus renegotiated his employment contract, and granted him a special one-time award of CAD $2.7 million in RSUs in exchange for concessions related to shareholder-friendly severance, non-competition, Change of Control and clawbacks terms
- Canadian Pacific – incoming CFO received a "one-time make whole" payment of approximately CAD $4.5 million in relation to his appointment, consisting of cash, stock options and PSUs
- Loblaw – NEOs received a special one-time grant of PSUs to promote key operating targets over a three-year period

ISS and Glass Lewis commented on the one-time awards for both Telus and Canadian Pacific, calling into question the rationale behind the awards.

Application of Discretion by the Board / Compensation Committee

In 2015, we observed increased use of Board discretion in both annual bonus payout and long-term equity grant determinations, particularly in the resource sector. For example:

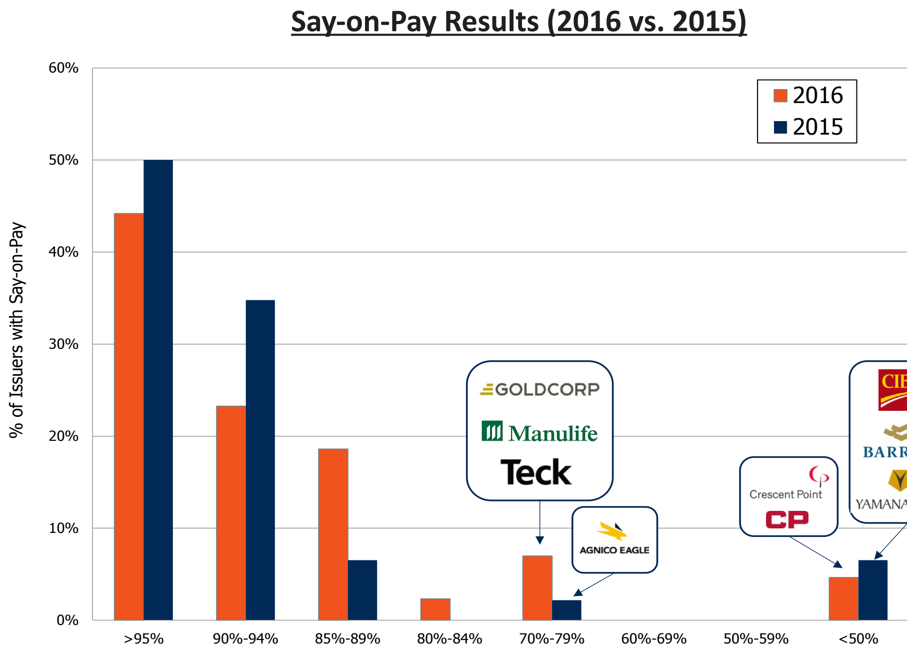
- Husky Energy disregarded the scorecard-calculated payout and awarded no annual bonuses, while other Boards used their discretion to lower bonuses below the formulaic result (e.g., Cenovus:-50%, Encana:-15% and Goldcorp:-22%)
- Cenovus granted the same number of LTI units as in previous years, which resulted in a significant decrease in TDC from 2014 levels
- Other organizations reduced the grant date value provided (e.g. Inter Pipeline)

[4] Spot FX rate as of May 24, 2016

[5] https://www.otpp.com/news/article/-/article/756413

2016 Say-on-Pay ("SoP") Update

In 2016 to date, there have been two SoP failures among the TSX 60 – Canadian Pacific and Crescent Point. The principal reasons behind these results appear to be pay and performance disconnects and internal pay inequality.



- Average SoP support to date (May 20) for the TSX 60 is 90%, in line with 2015 proxy season results, even though fewer companies received support greater than 90% this year
- The three issuers that failed SoP in 2015 recovered strongly this year by making significant changes to their compensation programs and / or adjusting the quantum of executive pay (Barrick: 92% vs. 27%, CIBC: 96% vs. 43% and Yamana: 87% vs. 37%)
- There has been a significant decrease in SoP scores in the oil and gas industry from 2015 to 2016 (average score fell from 95% to 87%)

Proxy Advisor Update

International Shareholder Services (ISS) and Glass Lewis continue to exert influence on voting results. In 2016, Glass Lewis has been more aggressive compared to ISS, recommending against more issuers. To date, Glass Lewis has issued nine recommendations against SoP within the TSX 60 (Canadian Pacific, CNRL, Crescent Point, Encana, Franco Nevada, Goldcorp, Magna, Manulife and Teck), compared to four in 2015. ISS has recommended against three so far in 2016 (CP Rail, Crescent Point and Teck), compared to two in 2015.

- The negative vote recommendations were not specific to a particular industry unlike last year, where miners garnered most of the negative recommendations
- Beyond concerns with pay and performance, Glass Lewis has consistently raised issues with large sign-on payments and equity instruments that allow for vesting below a median level of performance (the latter being a topic the Canadian Coalition for Good Governance has also recently begun to focus on)

REGULATORY AND DISCLOSURE UPDATE

Companies have evolved the way they communicate pay decisions, particularly with respect to performance disclosure. There is widespread use of a 'realized' pay analysis to illustrate the alignment of CEO pay with the shareholder experience. 33 TSX 60 companies include some variation of realized / realizable pay analysis in their proxies.

Policies around Board structure and committee mandates continue to be of importance to shareholders – this was a topic that was discussed at length during our New York roundtable discussion between directors and shareholders. Disclosure on skills matrices, onboarding of directors, and diversity initiatives has also increased. Adoption of formal diversity policies has become more prevalent amongst the TSX 60; however, we still see a wide range of practices from formal quotas (e.g. Scotiabank) to looser philosophies (e.g. Shaw Communications).

IMPLICATIONS FOR F17 AND BEYOND – CLOSING COMMENTS

In the face of continued economic uncertainty in Canada and the U.S., Boards and Compensation Committees exerted unprecedented levels of discretion, and incentive designs continued to evolve in the direction of stronger alignment between pay and performance. We anticipate a greater focus on long-term performance assessment that attempts to capture growth in shareholder value (beyond relative TSR) and further disclosure of realized / realizable pay.

Although the influence of proxy advisors remains high, shareholders are evaluating company performance and compensation practices with increasing nuance. Direct shareholder engagement by directors continues to gain prominence as a core practice among large companies to generate constructive dialogue with shareholders about their key issues and concerns.

Boards and Compensation Committees will continue to face challenges in finding the correct balance between promoting strong alignment of pay and performance, and keeping pay programs simple and justifiable to shareholders.

For those with questions or who are interested in more in-depth and customized analysis, please visit our website at www.hugessen.com for more information.

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