

Portfolio Management Association of Canada Principles of Corporate Governance

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FINAL



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Introduction

Corporate governance is the set of principles, procedures and rules that direct and control the affairs of a company. The objective of good corporate citizenship is to promote strong, viable and competitive corporations, with the purpose of enhancing shareholder value.

Some areas of corporate governance are established by legislative and regulatory framework, while other aspects are within the control of a company's board of directors, management and shareholders. This document deals with the aspect of corporate governance that is not legislated or regulated but rather, under the control of directors, management and shareholders.

The following are recommendations that PMAC views as best practice corporate governance guidelines for public companies.

A. Boards of Directors

Overview

The boards of directors are stewards of a corporation's assets and represent the interests of the shareholders. The board's responsibility is to add value to those assets by engaging in a mature and constructive relationship with management to build a successful corporation and enhance shareholder value.

The board's key functions are to approve direction of corporate strategy, supervise risk management, and evaluate performance of the company and management; concurrently, the board maintains accountability to shareholders. In performing these functions, directors act independently from management, rather than for any special interest group. All directors should be nominated on the basis of experience and expertise. Overall, the board is responsible for determining, implementing, and maintaining a culture of integrity and ethical behaviour.

Recommendations

1. Voting for Directors

One of the basic rights and responsibilities of shareholders is the election of directors to the board. Separately voting for each director nominee allows shareholders to best make effective decisions regarding potential directors. PMAC recommends separate votes for individual nominees.

Cumulative voting allows shareholders to stack their votes behind one or a few board candidates. This procedure may result in a minority of shareholders skewing the votes and electing directors who see their role as representing the interest of special groups. PMAC recommends that cumulative voting be disallowed.

Shareholders should have an effective ability to vote directors both on and off the board, as it gives shareholders input into board composition. Plurality voting gives shareholders no such input. Ideally board members should be elected to the board using a majority vote system where shareholders have the option of voting "for" and "against" individual directors, and directors must receive a majority of votes "for" to be elected to the board.

2. Staggered Boards

In a staggered board only a portion of directors are elected in a given year. For example, with a three-year staggered term, one-third of the board members are elected each year for three-year terms. The advantage to this process is that staggered boards may promote continuity in corporate direction and facilitate long-term planning. However, staggered boards make it difficult to replace individual directors who are not effective, or to

challenge or change board control. PMAC recommends the election of all directors annually, by individual, and does not support staggered boards.

3. Independence of Directors

PMAC recommends that a significant majority of a board of directors (two-thirds or more) be unrelated to the company, management or a majority shareholder. Ideally the only related director on a board would be the CEO of the corporation. PMAC considers an unrelated director to be a director who is independent of management and free from any interest or business relationship that could interfere with that director's ability to act in the best interests of the corporation. An unrelated director should not be a former employee of the company or a representative of a key supplier to or a key client of the company. Each director should have sufficient share ownership to align his or her interests with those of other shareholders. Remuneration of members of the board in the form of shares is strongly preferred. It is strongly favoured that directors receiving compensation in the form of shares retain those shares for the duration of their tenure. Options on shares are not acceptable as a form of compensation.

In-camera board meetings of unrelated board members only, give an opportunity for more candid discussions than at formal board meetings. These meetings will help to facilitate and enhance overall board independence. It is also recommended that after these meetings, the chair of the in-camera meetings should meet with the chief executive officer to advise him or her of the topics that were discussed.

PMAC also recommends that interlinking directorships with related companies be avoided.

4. Separation of Chair and CEO

The role of Chair of the board is different from that of Chief Executive Officer. PMAC believes that one person would have difficulty fulfilling both roles without a conflict of interest. Separating the roles assists in establishing an appropriate balance between management and directors, thereby increasing accountability and ensuring that the board serves to represent the interest of shareholders, not management.

PMAC recommends that the roles of Chair of the board and Chief Executive Officer be separate without exception. It is also strongly recommended that an unrelated director serve as chair.

5. Board Committees

Boards of directors often appoint committees to deal with specific issues and to perform particular functions. Public corporations should include at a minimum the committees

listed below and PMAC strongly prefers that the Audit Committee and the Compensation Committee be composed entirely of independent directors, and that the Corporate Governance and Nominating committees be chaired by an independent director and are made up of a majority of independent directors. It is also strongly recommended that CEO's or other listed companies do not sit on the Compensation Committees.

- **Audit Committee** – Responsible for accurate accounting and reporting of the company's financial performance. Also responsible for internal controls and management information systems as well as all reporting of findings to shareholders. Members on this committee must possess relevant accounting expertise to fulfill their role on this committee.
- **Corporate Governance Committee** – While the entire board is ultimately responsible for Corporate Governance, it is this committee's responsibility to focus full attention on such issues and make the board aware of them as they arise, and develop appropriate policies.
- **Compensation Committee** – Responsible for assessment and compensation of senior management.
- **Nominating Committee** - Responsible for assessment of existing directors, identification of needs, and identification, recruitment, nomination and orientation of new directors.

6. Size of Board of Directors

The number of directors on a board is important to the effectiveness of the board. The board should be small enough to be cohesive and effective but large enough to ensure diversity of opinion and expertise. PMAC recommends that an appropriate board size is between nine and 20 directors for a large company, and between five and nine directors for a small company. A key priority of the board should be to ensure that it has enough competent and independent members, regardless of size.

7. Overboarding

Overboarding is the term that is used to refer to how many boards a director sits on and if this is too many. Being a director of a public company requires a significant commitment of time in order to do the job well. Any director who has significant other commitments in the form of other directorships and/or is a CEO of a listed company may not be able to perform their board duties to the standard required. It is recommended that a director sit on no more than six public company boards, and in case of a current CEO, no more than two boards.

8. Reporting

The boards should produce an annual report to all shareholders, which outlines each board member's background, compensation and other boards they serve. In addition, a record of board meeting attendance in the past year should be included. All board members should attend a minimum of 75% of board and committee meetings in person. PMAC recommends voting against or withhold voting for those directors who have a poor attendance record (attended less than 75% of meetings for two consecutive years) at board meetings.

9. Audit Process

The audit plays a vital role in the corporate governance process. Not only does it give credibility to the company's financial information, but it also gives shareholders comfort that the financial information has been presented in accordance with established accounting standards.

The audit process should involve the establishment of an independent audit committee and the appointment of an independent auditor by that committee. The auditor should report directly to the Audit Committee, and not to management.

Auditors and/or the audit partner should be rotated on a regular basis.

10. Audit Fees

The amount and composition of fees paid to an auditor can compromise an auditor's ability to act independently and perform an audit that is free from undue influence by management. Requiring that a substantial majority of the fees paid to the auditors is for audit and audit-related services will help to ensure auditor independence.

B. Management

Overview

Executive compensation and incentives are the costs that shareholders are prepared to pay for having people with relevant expertise and experience manage the company for them and enhance long-term shareholder value. Well-designed compensation structures can serve to align the interests of directors, management and shareholders.

Management favours compensation where there is limited downside, whereas shareholders prefer it to be tied to company performance. Companies must strike a balance between compensation practices that are required to attract and retain qualified executives that can maintain the company's competitive position.

In addressing compensation issues, companies are best served by establishing a Compensation Committee whose task is to ensure that compensation arrangements are structured in such a way as to ensure that this balance is achieved.

Recommendations

1. Management Compensation

The principal interest of shareholders is to build long-term shareholder value. Compensation packages should induce management to become owners of enough stock such that their interests are aligned with the shareholders'. There should be a positive and significant correlation over a reasonable period of time between compensation and the enhancement of shareholder value. Compensation must be high enough to attract and retain qualified management and be competitive within the company's respective industry, but should not reward failure or mediocrity. PMAC believes that executive compensation should be competitive without being excessive. Part of the executive total compensation arrangements for senior management should be linked to the company's performance.

2. Stock Option and Incentive Compensation Plans

PMAC supports compensation and option packages that encourage management to own stock so as to align their financial interests with those of the shareholders. It is important that option plans and the cost of those plans should be clearly disclosed to all shareholders. That said, PMAC views unrestricted stock options, options priced below current market value, and lowering the exercise price on previously granted options as unacceptable practices. In PMAC's opinion, options should expire within 5 years of being granted. Furthermore, the total of all stock option plans should be capped at a maximum of 5 percent for large mature companies, and 10 percent of outstanding shares for all other companies, to prevent excessive dilution. PMAC is generally opposed to

large option grants to one individual or a small group. If a company chooses to grant restricted stock, or stock that has holding period restrictions, it should not be 100 percent vested when granted; rather it should vest over a specified period of time. Similarly, options should have a minimum holding period of at least three years before they can be exercised or sold. Stock options are an expense to a company and should be duly expensed on the income statement of the company's financial documents and disclosed to shareholders.

3. Golden Parachutes

Golden parachutes are severance packages for senior executives who are terminated or demoted following a takeover or merger. Golden parachutes are used as a means to lure or retain qualified executives by providing financial security in the case of an unexpected change in control of a company. These arrangements help to ensure that management makes decisions in the best interest of a company and its shareholders regardless of management's own welfare. However, golden parachutes can be excessive and can entrench management. PMAC recommends that golden parachutes should be reasonable. All details should be fully disclosed to shareholders at the earliest opportunity, and any severance contract should not be binding on the company until shareholders have had the opportunity to approve the agreement.

4. Corporate Loans

Corporate loans to employees, except to employees of financial institutions, in order to purchase company stock should be avoided. If however such loans are contemplated in non-financial institutions, they should be for a maximum of one-times an employee's annual salary at the prevailing bank rate. Corporations should never provide corporate guarantees for an employee's bank loan.

5. Disclosure of Compensation Practices

PMAC believes that executive compensation should be performance based, and align the interests of executives with the long-term interests of shareholders. We would like to see performance criteria clearly disclosed and defined, and if and how those criteria are met. This information should be included in the Compensation Report in the proxy circular. The performance criteria and if they have been met should be determined by the Compensation Committee.

PMAC recommends that shareholders should be allowed an advisory vote on the annual proxy to approve the Compensation Report.

Where compensation disclosure is inadequate, or the link between pay and performance is not adequately demonstrated, it is recommended that shareholders vote against the

approval of the compensation report, or if this option is not available to withhold votes from the compensation committee.

6. Aggregate Dilution from Equity-Based Compensation

There are many types of stock based compensation plans, and some of these types of plans can dilute the holding of current shareholders. For example, performance stock will result in dilution, where phantom stock will not. It is easy to focus on the dilution from stock option plans, but ignore the dilution from other types of stock based plans. As such it is important to assess the dilution of these plans individually and in aggregate. It is recommended that the aggregate dilution from all stock based compensation plans not exceed 10% of outstanding shares.

C. Shareholder Rights

Overview

Shareholders can influence the affairs of a corporation in which they invest. This can be done by directly communicating with the management and directors of the company and/or by exercising proxy voting rights. Share ownership rights are assets that should be protected and therefore shareholders should keep themselves informed about market and corporate governance issues that may affect the company in which they invest. Effective shareholders must manage their proxy votes to protect their ownership in such corporations.

PMAC Members believe it is in the best interest of their clients, that shareholder rights are exercised with the aim of enhancing long-term investment returns. The following sections address some specific issues that impact shareholders' rights.

Recommendations

1. Confidential Voting by Shareholders

Voting at annual and special meetings should be subject to the same safeguards as voting in any other election and should be free of any potential coercion and/or impropriety. With this in mind, PMAC supports confidential voting processes.

2. Takeover Protection – Shareholder Rights Plans

“Poison pills”, “crown jewel defence”, “payment of greenmail”, “going private transactions”, “leveraged buyouts” and “lock-up arrangements” are some of the shareholder rights plans that companies can adopt as anti-takeover measures. These rights plans provide the shareholders of a target company with the right to purchase or sell shares at very attractive prices in the event of an unwanted offer for that company. The effect is to significantly dilute the holdings of any acquiring person or entity that is viewed as an unwanted shareholder by the board and making the hostile takeover uneconomical to the acquirer.

Shareholder rights plans are considered among the most potent anti-takeover measures a company can adopt. Rights plans ensure that all shareholders are treated equally in the event of a change of control of the company. As well, they can provide directors of a targeted company with sufficient time to ensure that the appropriate course of action is chosen to ensure shareholder interests have been protected.

However, shareholder rights plans may also undermine shareholders' rights to determine the future course of the company. There is also a risk that the existence of anti-takeover

measures may adversely influence current share prices, as well as affect long-term shareholder value.

PMAC supports the following conditions regarding the creation of shareholder rights plans:

- Shareholder rights plans should have a renewable life of no longer than three years.
- Substantive amendments to a rights plan should require prior shareholder approval.
- Shareholder rights plans are generally triggered when a person acquires a specified percentage of voting shares. A threshold level of at least 20 percent is recommended before a rights plan is triggered.
- The shares held by a person who enters into a lock-up agreement with an offeror should not be counted with shares already owned by the offeror and thus the locked-up shares would not count towards the specified percentage of votes required to trigger the rights plan.
- The plan should not authorize the board to waive the plan's application or allow for redemption of rights without shareholder ratification.

3. Dual Class Shares

Common stocks normally have one vote per share. However, it is not unusual for certain types of securities to have more than one vote per share. This dual class share structure results in unequal or subordinate voting shares and provides different rights and privileges for different shareholders. It can also mean that control or power rests only in the hands of select shareholders.

It is the view of PMAC that all shares should have equal voting rights. Anyone who wants control should buy control rather than exerting it through disproportionate voting rights. PMAC opposes the creation of shares with unequal or multiple-voting rights, and recommends the elimination of such share structures.

4. Super-majority Approval of Business Transactions

A super-majority vote requirement of normally two-thirds (67 percent) or more, is set to ensure that there is agreement by the majority of shareholders on fundamental issues affecting the future of a company. It is important that the required threshold is not set too

high so that the wishes of a dissenting minority of shareholders could defeat the majority wish.

PMAC believes that a super-majority vote may be important for a number of issues but that it is equally important that an appropriate balance between ensuring broad agreement and majority rights be struck. It is the view of PMAC that the level of two-thirds (67 percent) approval level is viewed as sufficient to achieve this balance and anything above this level is excessive.

5. Linked Proposals

Linked proposals combine two separate issues into one for the purposes of a proxy vote. Often, linked proposals are designed to make an issue more acceptable to shareholders than it would be separately, thereby causing confusion or having the result of coercing shareholders into voting for it.

PMAC opposes linked proposals.

6. Unlimited Share Issues

A company may ask shareholders to authorize the issuance of additional common shares to implement a stock split, to support an acquisition or restructuring plan, to use in a stock option plan or to implement an anti-takeover plan.

Although the issuance of additional shares may in some cases be in the best interest of shareholders, in other cases it may dilute the value of existing shareholders holdings and not be in their best interests.

PMAC opposes unlimited share issues. PMAC supports the issuance of shares if the amount of stock is limited and the purpose of the issue is in the shareholders' interest.

7. Shareholder Proposals

Shareholder proposals give shareholders an opportunity to raise their concerns or issues and be heard by management and the board. These proposals give corporations the insights and knowledge of shareholders on particular issues.

PMAC supports proposals that respect the fiduciary responsibilities of management and the board. PMAC does not support proposals submitted for the purposes of enforcing personal grievances or obtaining publicity or do not pertain to the business of the corporation.

Generally PMAC supports proposals that call for enhanced disclosure where the proposal relates to an area that represents a real risk to the corporation and those risks are not adequately disclosed.

8. Disclosure

It is the view of PMAC that reporting of proxy voting results at annual and special meetings should be timely and include at a minimum the votes for, against and withheld.

Additionally, all voting should be conducted by ballot rather than a show of hands, as this will ensure that all shareholders, whether present at the meeting or not, will be treated equally. In order to maintain the integrity of the proxy voting process, it is recommended that vote results be subject to independent verification.

9. Income Trust Governance

Unitholders of income trusts should enjoy equivalent rights and protection as shareholders of a corporation do. The trust and associated entities should take steps to ensure that appropriate corporate governance practices are adopted to achieve this end.

D. Conclusion

Corporate governance are constantly changing, and as such best practices will continue to evolve over time. PMAC commits to reviewing the Principles of Corporate Governance annually, and as part of this review process any comments or feedback on the guidelines from Members would be appreciated.

Any comments on these guidelines can be directed to the chair of PMAC Investment & Corporate Governance Committee.