## Board Shareholder Confidence Index

Our corporate governance research focuses on Boards of Directors, social networks, and corporate performance. The reports produced by the Clarkson Centre for Board Effectiveness (CCBE) are timely, reliable, actionable, and comprehensive.

Developed in spring 2003, the Board Shareholder Confidence Index comprises factors used by active shareholders to assess Boards of Directors for corporate governance best practices. While other variables can contribute to Board effectiveness – including those elements best observed from inside the boardroom – we capture those factors that influence shareholders' confidence in a Board's ability to fulfill their duties. These also differ from the TSX Guidelines for effective corporate governance in their focus upon the shareholders' perception of risk.

We evaluate and rank Boards of Directors by their potential to act effectively and by their performance as indicated by past practices. The score is developed using four linked steps and the result is a transparent, objective, and adaptable rating system which assigns companies listed on the S&P/TSX Composite Index an **overall score** from AAA+ [highest] to C [lowest].

**NEW FOR 2011:** **Director Orientation**
**Issues Options to Directors**
**Individual Voting**
**Annual Director Elections**
**Detailed Voting Results on Director Elections**

## Glossary of Terms

## 1. Individual Potential

In order for shareholders' interests to be fully represented by the Board of Directors, individual Directors must be able to act independently from the interests of management, and independently from the other Directors as well. Stock ownership indicates that a Director's interest is aligned with that of shareholders, thereby providing motivation for Directors to improve company performance. Director meeting attendance indicates whether a Director is adequately committed to the board and dedicates sufficient time in exercising his or her responsibilities. Individual Potential comprises these three factors: Director Independence, Director Stock Ownership and Director Meeting Attendance.

## 2. Group Potential

Group Potential represents the potential for the Board as a whole to best represent the interests of shareholders without compromising the Individual Potential of the Directors. The factors determining Group Potential are Board Meeting Structure, the implementation of Board Evaluation Processes, use of a Board Skills Matrix to manage board composition, and Disclosure of Continuing Education Opportunities and Orientation Process available to directors. (Removed director meeting attendance and moved to individual)

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## 3. Past Practices

Past practices are assessed by evaluating the results of Board decisions. Scoring is based on practices that investor surveys generally regard as being opposed to or in the interests of shareholders, including:

- Excessive option grants and/or dilution
- Option re-pricing
- No link between CEO pay and company performance
- Option gains disclosed
- Options to Directors
- Evergreen option plans
- Outstanding loans to Directors or Executives
- Majority voting in Director elections
- Individual voting
- Annual director elections
- Detailed voting results of director elections
- CEO succession practice and disclosure

## SCORING CRITERIA

# 1. INDIVIDUAL POTENTIAL

## 1(a) Director Independence

### i. Independence

Director Independence measures the independence of individual Directors from one another, as well as from company management.

Relationships with management increase the potential risk that a Director will put executive interests before those of the shareholder. If a Director meets any of the following criteria, she/he is considered related to management:

- Employee of the company or a related company (currently or within three years)
- Executive of any affiliated company
- Director or Director's firm has provided legal, auditing, or consulting services to the company (within the last 3 years)
- Kinship to CEO
- Any other relationship deemed material by CCBE which does not fall under the above categories.

At least two-thirds of the Board must be independent from management or else a deduction is made. The deduction increases as the proportion of related Directors increases.

**Scoring**

| % Independence | Deduction |
|---|---|
| **Less than 30%** | **-15** |
| **30% - 49.9%** | **-10** |
| **50% - 59.9%** | **-5** |
| **60% - 66.6%** | **-3** |
| **66.7% or more** | **No deduction** |

### ii. Interlocks

It is also important that relationships between Directors be kept to a minimum. If two Directors sit on more than one Board together, this is referred to as a "Director Interlock" and there becomes a perceived risk of decisions being made in the interests of another company. A deduction is made if more than one Director Interlock is present on a Board. Scoring in this area has previously only recognized interlocks between those companies listed on the S&P/TSX Composite Index, however the scope has been broadened since 2007 to consider all other publicly traded companies upon which Directors serve. A further deduction is made if two CEO's from different companies sit on each other's boards, this is referred to as an "Executive interlock."

**Scoring**

| # Interlocks | Deduction |
|---|---|
| **>1 Director interlock (or 1 three-Director interlock) and at least 1 Executive interlock** | **-5 + -2 points per Executive interlock** |
| **>1 Director interlock (or 1three-Director interlock) and 0 Executive interlocks** | **-5** |
| **1 Interlock or 0 Director Interlocks (or 0 three-Director interlocks) and 1 Executive interlock** | **-2 per Executive interlock** |
| **1 or 0 Interlocks (or 0 three-Director interlocks) and 0 Executive interlock** | **No Deduction** |

### iii. Excessive Board Memberships

In order to perform effectively, a Director must not have too many obligations beyond her/his duties on the Board. A Company receives a deduction for every Director who is a member of more than five S&P/TSX Composite Index boards.

**Scoring**

| # S&P/ TSX Boards | Deduction |
|---|---|
| **>= 5 Boards** | **-5 (per Director)** |
| **Otherwise** | **No Deduction** |

### Overall Independence Letter Grades

| Total Deductions | Grade |
|---|---|
| **No Deduction** | **AAA** |
| **-2 to -4** | **AA** |
| **-5 to -7** | **A** |
| **-8 to -9** | **B** |
| **More than -10** | **C** |

## 1(b) Director Attendance

Poor director attendance can be an indicator that a director is overcommitted and unable to dedicate sufficient time to board matters. If a director is incapable of committing to his/her board responsibilities, the board must review that director's membership.

A deduction is made if a director standing for re-election failed to attend at least ¾ of board or individual committee meetings. A deduction will be automatically made if there is not enough disclosure to determine director attendance.

**Scoring**

| Meeting Attendance | Deduction |
|---|---|
| **All directors attended at least 75% of all meetings** | **No Deduction** |
| **At least 1 director attended < 75% of meetings but is not being re-elected** | **No Deduction** |
| **At least 1 director attended <75% of meetings and is standing for re-election** | **-2 per director (max deduction of -10)** |
| **Not enough disclosure to determine is anyone missed excessive meetings** | **-10** |

**Overall Director Attendance Letter Grades**

| Total Deduction | Grade |
|---|---|
| **No Deduction** | **AAA** |
| **-2** | **AA** |
| **-4** | **A** |
| **-6** | **B** |
| **Less than or equal to -8** | **C** |

## 1(c) Director Stock Ownership

A Director, however independent and experienced, requires motivation to act in the best interest of shareholders. This motivation is measured as a function of a Director's stock ownership in the company.

The value of the annual retainer is calculated as the sum of the stated annual cash retainer, the grant date value of any share-based awards and the disclosed fair value of option grants. Committee member fees, chair retainers and attendance fees are excluded.

In cases where Directors receive an annual retainer, a deduction is made when the stock ownership multiple is less than 3 times the calculated annual retainer. When there is no retainer, a deduction occurs when the ownership is less than $30,000.

### Director Ownership Scoring

**When a retainer is awarded:**

| Ownership Multiple | Deduction |
|---|---|
| 1 director owns less than 3x retainer | -3 per director (max deduction of 15) |
| Otherwise | No deduction |

**When no retainer is awarded:**

| Average Share Ownership | Deduction |
|---|---|
| 1 director owns less than $30,000 | -3 per director (max deduction of 15) |
| Otherwise | No deduction |

### Overall Stock Ownership Letter Grades

| Total Deductions | Grade |
|---|---|
| No deduction | AAA |
| -3 | AA |
| -6 | A |
| -9 | B |
| Less or equal to -12 | C |

## 2. GROUP POTENTIAL

## 2(a) Structure

A company's score in this category is based on the characteristics of its Board meeting structure. The structure of a Board and its meetings can encourage or impede the Individual Potential of its Directors, as well as affect the Board's output. Structural measurements include:

i) The separation of CEO and Chair positions
ii) Independence of Audit, Compensation and Nominating Committee members
iii) The ratio of voting rights to share ownership between share classes.

### i. CEO/Chair Split

The perceived potential for the Board to operate independently from management is decreased if the CEO and Chair positions are not separated and therefore a deduction is made if this is the case. A smaller deduction is given to companies with no CEO/Chair split but that have appointed an Independent Lead Director to lead Board meetings, and to companies with split CEO and Chair positions, but a related Chair.

**Scoring**

| Split? | Deduction |
|---|---|
| **No split/no Lead Director** | **-15** |
| **Split / Chair is Related** | **-10** |
| **No Split / Lead Director Appointed** | **-5** |
| **Split / Related Chair / Lead Director Appointed** | **-5** |
| **Otherwise** | **No Deduction** |

### ii. Committee Independence

Full-independence of a company's committees is necessary to ensure that executive compensation, company accounting and board nominations are handled with no conflicts of interest between management and shareholders.

Deductions are made if a dependent Director (as determined in the Director Independence section) is a member of the Audit or Compensation committees. A deduction will also be made if more than one dependent Director is a member of the Nominating committee. (Note that executives of Parent Companies are considered unrelated on the Compensation and Nominating Committees.)

If an interlock exists between two executives on the Compensation Committees of each others' companies, the involved Directors are considered related with respect to these Compensation Committees. This is to discourage situations where executives from different companies are determining each other's salaries.

Additional restrictions are placed on committee membership: deductions are also made if any Related-Independent Directors sit on the Audit or Compensation Committees. The criteria for Related-Independence includes:

- Non-Management major shareholder (>30% votes)
- Kinship to non-management major shareholder of company of interest

Each committee is scored separately.

**Scoring**

| Committee Independence | Deduction |
|---|---|
| **Related Director(s) on Audit Committee or 1 director with an Executive interlock** | **-10** |
| **Related Director(s) on Compensation Committee or 1 director with an Executive interlock** | **-10** |
| **2 or more Related Directors on the Nominating Committee** | **-10** |
| **Full Committee Independence** | **No Deduction** |

### iii. Share Structure

Many companies have several classes of shares, and often the different classes do not have equal voting rights. An imbalance of voting rights decreases shareholder influence on Board decisions.

EXAMPLE:

| **Class** | **Votes per Share** | **Shares Outstanding** |
|---|---|---|
| Class A Voting | 1 | 10,000 |
| Class B Non-Voting | 0 | 5,000,000 |

In this case, all the company's voting rights are associated with a small minority of the outstanding shares.

Deductions in this area are graduated— as the disproportion between shares and voting rights increases, so does the deduction. No deduction is made for companies whose multiple share classes are allowed the same number of votes per share.

**Scoring**

| Share Structure | Deduction |
|---|---|
| • **<20% of Equity Controls >80% of Votes** | **-20** |
| • **40% or Less Equity Controls 60% or More Votes** | **-15** |
| • **<50% of Equity controls >50% of Votes** | **-10** |
| • **>50% of Equity controls >50% of Votes** | **No Deduction** |
| • **No Dual Class or Subordinated Share Structure** | **No Deduction** |

### Overall Structure Letter Grades

| Total Deduction | Letter Grade |
|---|---|
| No Deduction | AAA |
| -5 | AA |
| -10 to -19 | A |
| -20 | B |
| -25 or greater | C |

## 2(b) Systems

### i. Evaluation Processes

In order to receive a perfect score in this category, a company must implement regular and formal evaluation processes for the Board as a whole and for each of its individual Directors. Scoring is based on disclosure of the evaluation processes; if the fact of these evaluations is mentioned but with no details as to processes, a deduction is still made. Full-Board and Individual Director evaluations are scored separately.

**Scoring**

| Evaluation Processes | Deduction |
|---|---|
| No Full-Board Evaluation | -10 |
| No Individual Director Evaluation | -10 |
| Otherwise | No Deduction |

### ii. Skills Matrix

The annual management information circular is the primary resource for educating the shareholders regarding the directors standing for election. Including a skills matrix in the circular illustrates for shareholders how each director fits the needs of the board and highlights the skills that each director provides. Use of a skills matrix also provides a framework for boards to identify gaps and redundancies in board composition.

A deduction is made if the individual skills of each director are not listed and if the skill set or requirements of the board as a whole are not disclosed.

**Scoring**

| Skills Matrix | Deduction |
|---|---|
| Disclosure of board skills but no director skills | -1 |
| Disclosure of director skills but no board skills | -2 |
| No disclosure of board or director skills | -3 |
| Full Disclosure of director and board skills | No Deduction |

### iii. Continuing Education and Orientation for Directors

By providing formal continuing education opportunities to directors, boards can ensure that all of their directors have training in all areas relevant to the board's oversight of the company. Such opportunities may include training manuals, site visits, courses and retreats – however, many companies have creative and unique approaches. Director orientation is also an important educational component for new directors, which can include an orientation manual, meetings with management, etc.

In order to get full marks, companies must disclose the formal education process, the specific activities conducted in the most recent year, as well as the formal orientation process.

**Scoring**

| Director Education and Orientation | Deduction |
|---|---|
| Does not disclose this year's continuing education | -2 |
| Does not disclose formal process for Director Orientation | -1 |
| Does not disclose Continuing Education Process | -1 |
| Full disclosure of continuing education including this year's activities and director orientation process | No Deduction |

**Overall Systems Letter Grades**

| Total Deduction | Grade |
|---|---|
| No Deduction | AAA |
| -1 to -2 | AA |
| -3 to -9 | A |
| -10 to -19 | B |
| Less than or equal to -20 | C |

# 3. BOARD DECISION OUTPUT (PAST PRACTICES)

## 3(a) Compensation

### i. Dilution

Dilution occurs when options granted to executives and Directors represent a significant proportion of the outstanding shares, thus diluting returns that would otherwise go to shareholders. A deduction is made if options issued and outstanding represent more than 10% of a company's outstanding shares.

**Scoring**

| Dilution | Deduction |
|---|---|
| Company Options >10% | -10 |
| Company Options >5% | -5 |
| Company Options <5% | No Deduction |

### ii. Option Re-pricing

When a company's share performance has suffered, the cost of exercising stock options can be greater than the cost of purchasing stock at market value. In such a case, a company may decide to lower the exercise price in order to align it with the market value of the stock. Option re-pricing is perceived as relieving Directors of their responsibility for the company's performance. A deduction is made if a company has re-priced their options within the last three years.

**Scoring**

| Dilution | Deduction |
|---|---|
| Options Re-priced Within 3 Years | -20 |
| Otherwise | No deduction |

### iii. CEO Pay is Related to Performance

It is the responsibility of the Board of Directors to determine CEO compensation, and in order to best represent the interests of a company's shareholders, such compensation should be associated with the company's performance. A deduction is made here if there is no explicit link between the company's financial performance and the determination of the CEO's bonus.

**Scoring**

| Bonus Disclosure | Deduction |
|---|---|
| No financial performance connected to CEO bonus | -15 |
| Otherwise | No deduction |

### iv. Option Gains Disclosed

While boards are now required to disclose a grant date fair-value for options awarded to executives during the most recent fiscal year, the requirement to disclose the value of option gains for the year has been removed. Disclosure of options gains will give a clearer impression to shareholders as to how compensation has been affected over time.

**Scoring**

| Option Gains Disclosed | Deduction |
|---|---|
| No disclosure of option gains | -5 |
| Option gains disclosed | No deduction |

### v. Options to Directors

The granting of options to directors is becoming less common. However, many companies continue the practice. A deduction will be made if directors are eligible to receive options and/or have received them within the past 3 years.

**Scoring**

| Options to Directors | Deduction |
|---|---|
| **Directors receive options** | **-5** |
| **Directors are not eligible for options or have not received them in the past 3 years** | **No deduction** |

### vi. Evergreen Option Plan

Generally, shareholders must approve the replenishment of a company's option plan once a specific number of options have been issued. Many companies are now introducing Evergreen Option Plans, however, through which the maximum number of options approved for issue stands as a percentage of outstanding shares rather than a specific number. These plans allow companies to continue granting options in any amount up to a certain percentage dilution. Evergreen plans remove authority from shareholders, while increasing the possibility of higher dilution.

**Scoring**

| Evergreen Option Plan | Deduction |
|---|---|
| **Company has Evergreen Option Plan** | **-5** |
| **Otherwise** | **No deduction** |

### vii. Outstanding Loans to Directors or Executives

Although most companies have discontinued granting loans to their Directors and executives, many still have outstanding loans on their books, and some still have yet to discontinue granting loans. We regard loans to employees as an inappropriate use of shareholder money. Companies that are financial institutions and grant loans to executives and Directors at consumer rates receive no deduction for this, however, as these companies are in the business of granting loans and it is not in the company's best interest for these individuals to obtain loans from competitors.

**Scoring**

| Loans to Executives or Directors | Deduction |
|---|---|
| **Company has outstanding interest-free loans** | **-15** |
| **Company has outstanding interest-bearing loans** | **-10** |
| **Company has loans outstanding, but has discontinued granting loans.** | **-5** |
| **No outstanding loans** | **No deduction** |

### Overall Compensation Letter Grades

| Total Deduction | Grade |
|---|---|
| No Deduction | AAA |
| -5 | AA |
| -10 to -19 | A |
| -20 to -29 | B |
| Less than or equal to -30 | C |

## 3(b) Director Elections

### i. Majority Voting

Until recently, director elections in Canada were solely based on a plurality vote whereby shareholders are given only the option to vote 'for' or 'withhold' from voting. In these cases, a single vote 'for' a director results in his/her election. Majority voting systems are now being adopted by many Canadian firms, whereby a director is only elected if a majority of votes are cast 'for' his/her election. If a majority of votes are cast 'against' the director, he/she will immediately submit their resignation to be considered by the board. A deduction is made if there is no majority voting policy in place.

**Scoring**

| Majority Voting | Deduction |
|---|---|
| Majority Voting policy in place | No deduction |
| No Majority Voting | -10 |

### ii. Individual Voting

Most large public boards have replaced slate voting with individual director voting, allowing shareholders to vote for each director individually. This increases shareholder say on board composition and on director elections. A deduction is made if boards have slate voting.

**Scoring**

| Individual Voting | Deduction |
|---|---|
| Shareholders vote for individual directors | No deduction |
| Slate voting | -10 |

### iii. Annual Elections

Most boards hold annual elections requiring every director to stand for re-election every year, but a few exceptions remain. A deduction will be made if at least one director is not elected annually.

**Scoring**

| Annual Elections | Deduction |
|---|---|
| All directors are elected annually | No deduction |
| At least 1 director is not elected annually | -10 |

### iv. Detailed Voting Results

Many boards provide shareholders with a detailed report of voting results for all resolutions listed in the form of proxy. This ensures better transparency and communication between shareholders and directors. A deduction will be made if there is not sufficient disclosure on all voting resolutions indicating the percentage/number of votes for/against/withheld.

**Scoring**

| Detailed Voting Results | Deduction |
|---|---|
| **Detailed voting results for director elections and all other voting matters on form of proxy** | **No deduction** |
| **Not enough disclosure for all voting results** | **-5** |

**Overall Director Elections Letter Grades**

| Total Deduction | Grade |
|---|---|
| **No Deduction** | **AAA** |
| **-5** | **AA** |
| **-10 to -19** | **A** |
| **-20** | **B** |
| **Less than or equal to -25** | **C** |

## 3(c) CEO Succession

### i. Succession Plan Disclosure

One of the Board's most important responsibilities is ensuring that a proper succession plan is in place in the event that the CEO ceases to hold his position. Without a formal and reliable succession plan for the CEO, the company is exposed to significant risk, often accompanied by the significant cost of hiring externally. Disclosure of a formal succession plan for the CEO in the Information Circular reassures shareholders that these risks are being considered. A deduction is made if there is no disclosure of a formal succession planning process.

**Scoring**

| Succession Plan Disclosure | Deduction |
|---|---|
| **No formal succession plan process** | **-1** |
| **Formal Succession Plan process disclosed** | **No deduction** |

### Overall CEO Succession Letter Grades

| Total Deduction | Grade |
|---|---|
| No Deduction | AAA |
| -1 | B |

## Total Scores

Each company begins with 100 points from which Individual Potential, Group Potential, and Past Practices deductions are made. Total letter grades are determined as follows:

| Overall Score | Grade |
|---|---|
| 100 | AAA+ |
| 95-99 | AAA |
| 88-94 | AA |
| 75-89 | A |
| 50-74 | B |
| < 50 | C |