Corporate Governance

Strengthening Corporate Governance:

An Institutional Investor Point of View

Presentation

by

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Good morning ladies and gentlemen.

I'm gratified to see so many of you here, but in one sense I am a little surprised. It made me wonder if your President hadn't billed the event with some irresistible title, like Carlucci II, but he assured me that he did not.

Therefore, you must be here because of your interest in corporate governance – an old topic that presents little if anything new in the way of philosophical breakthroughs.

What is new, of course, is the level of interest that people have in the subject. In business, government, regulatory and investment circles, it is the latest hot topic, one that is almost guaranteed to draw a crowd.

The legendary vaudeville actor and singer, Eddie Cantor, when asked how it was that he had become an overnight success replied, "It was easy. I just kept trying for 20 years."

So it's been with corporate governance. People like Claude Lamoureux, Bill Dimma, Steven Jarislowsky and many others who have laboured for years to get us to pay attention to governance issues, must be startled by their sudden celebrity status.

More seriously, this is the best of times for advocates of good corporate governance. The wind is truly at their backs. Whether through legislative or regulatory change, shareholder activism or newly emboldened directors, there is great momentum in favour of improved governance.

The reasons why are fairly obvious. But let me begin by assuring you that I am not going to work myself into a lather of indignation this morning by listing the all-too-familiar corporate frauds and governance failures.

Rather, I am going to discuss three matters that I hope will set the stage for some questions and discussion at the end of my remarks.

The three topics I am going to discuss are:

- the role the Canada Pension Plan Investment Board will play in the corporate governance world
- some specifics of our recently released proxy voting principles and guidelines
- and finally, some of the concerns I have about the risks we face if we get too much of a good governance "good thing"

Before addressing each of these points, however, let me give you some background on the CPP Investment Board – our mandate and our governance structure.

Our mandate is very specific: it is to contribute to the long-term health of the Canada Pension Plan by maximizing investment returns without undue risk of loss.

We currently manage approximately $18 billion on behalf of 16 million CPP beneficiaries and contributors. We do so in the context of total CPP assets, which also include $38 billion in fixed income securities that are presently administered in Ottawa.

However, given the rate at which we are acquiring new cash and the forthcoming transfer of the $38 billion in cash and bonds from the federal Department of Finance, we expect our assets to reach almost $80 billion by 2007 and exceed $160 billion within a decade.

Obviously, designing and implementing a governance model for a fiduciary with this volume of assets and this many stakeholders is critical to successfully discharging our mandate and earning public confidence.

Our legislated governance structure works well, thanks to the foresight of the federal and provincial politicians who created it, and our board of directors, who have given it life.

In 1997, as part of the reforms to the Canada Pension Plan, the federal and provincial finance ministers constructed a governance model that balances political independence from government with rigorous public accountability and responsibility to Parliament, the provinces and the people of Canada.

This balance is achieved in a number of ways.

Our legislation requires us to have "a sufficient number of directors with proven financial ability or relevant work experience." In other words, a knowledgeable board.

Unlike other Crown corporations, board candidates are nominated by a committee appointed by the federal and provincial finance ministers. Candidates are then selected by the federal minister in consultation with the provincial ministers.

As a result, our board consists of experienced professionals with backgrounds in accounting, economics, actuarial science and investment banking. They are independent, and independently minded.

As well, our legislation gives the board powers that reinforce the buffer zone between governments and our investment professionals. The board, for example, appoints the chief executive officer. It sets compensation, including incentive compensation, for all officers. It approves the appointment of external investment managers as well as internal and external auditors, and ensures that systems to monitor and control risks are in place.

The result is that we have a governance model that allows our investment professionals to make decisions and meet their fiduciary responsibilities to Canadian workers without fear of political influence, and with a clear understanding of their accountability to the board of directors.

Despite this independence, governments have ample ability to see what we're doing with Canadians' money. The federal finance minister, for example, is required to authorize a special examination of our books, records, systems and practices every six years. This will occur, in consultation with the provinces, within the next two years.

The federal minister also has the authority to appoint a firm of auditors to conduct a special audit at his discretion if he or she were ever to judge it to be warranted.

But we are not satisfied just to meet the basic demands of the legislation. We go further, developing our own practices relating to policies, procedures and transparency.

We are pro-active on ethical issues, including the reporting of personal securities trading and potential conflicts of interest.

Some of our recent efforts to upgrade our standards include the introduction of a self-administered loyalty test for directors and the external examination of our conflict of interest policies.

And later this year, we'll announce the appointment of an external advisor to advise on potential conflicts and ethical conduct issues.

I'm pleased to be able to tell you that when I attended a World Bank public pension fund management conference in Washington last week, the CPP Investment Board's governance structure was cited regularly by delegates from over 50 different countries, as a role model for the world.

The World Bank's lead economist on pension matters said, and I quote, "The CPP Investment Board structure is the most advanced in the world in terms of governance principles."

I report this not to be boastful, but to point out that we do have a sound governance structure. And I can say that after several years of experience working with it, that I have confidence that one can build a better house on a strong foundation.

Given this foundation, what role do we intend to play in matters of corporate governance?

First and foremost, we must fulfill our fiduciary responsibilities to 16 million Canadians.

As I mentioned, our mandate is to maximize value without taking undue risks. In this context, we recognize that proxies on the shares we own have an economic value. We have a duty, indeed, it's our strategy, to use our proxies as one of the tools we can employ thoughtfully in seeking to enhance investment returns.

Our equity portfolio includes some 1,700 companies, based in Canada, the United States and other developed countries around the world.

As you are all too well aware, we have all been living with difficult equity markets for three years. But it will be approximately 18 years before we are expected to pay any investment income to the Canada Pension Plan to help pay pensions, so we can be patient, we have time to seek long-term value.

Consequently, we will encourage good corporate governance for the contribution it can make to our long-term results. I say this recognizing that there is no convincing evidence that good governance contributes to shareholder value. Still, common sense tells us that good governance must contribute to value creation and, importantly, to risk mitigation.

Given our responsibilities as a shareholder and a desire to make our voice heard, what are we doing to encourage good governance?

Last year, we embarked on a major project to develop proxy voting principles and guidelines that would guide our voting on a wide range of issues that are fundamental to creating long-term shareholder value. As part of our research, we looked at 10 major investment funds in Canada and the U.S. and evaluated them using a menu of some 80 items.

We developed our own document and then engaged experienced outside consultants to work with our internal team to refine our guidelines. Our board and management reviewed the guidelines as they evolved. The final version was approved in February and then released to the public.

To give you a sense of our broad thinking, allow me to read a few sentences from the introduction to that document:

"Good governance is more about corporate culture than guidelines. Ethical values and an understanding of fiduciary duty are its foundation.

Proxy voting is a component of the corporate governance process. It is one way in which shareholders, as the owners of a company, express their views on a variety of issues.

Our proxy voting guidelines give the directors and officers of companies in which we own shares guidance on how the CPP Investment Board is likely to vote on issues put to the shareholders. Many governance issues are never presented to shareholders for resolution. Nevertheless, our proxy voting principles and guidelines communicate our views on issues that boards will deal with in the normal course of business.

We stress that these are guidelines. There will be circumstances where the directors and management of a company will disagree with our guidelines for reasons we have not considered. In these situations, we will always listen.

In exercising voting rights, we do not seek to manage the companies in which the CPP Investment Board owns shares. We accept the division of authority and responsibilities among owners, governors and managers, based on the following premises:

- the shareholders own the company
- management works for the shareholders
- the interests of shareholders are best expressed through the board of directors, which provides management oversight and performance review;
- and management reports to the board of directors (and ultimately the shareholders) through the chief executive officer.

Generally, we support resolutions that empower boards of directors on behalf of the shareholders and reaffirm management accountability.

Good boards and management teams understand that they can best serve the corporation by taking a long-term view of its best interests and those of the shareholders.

The CPP Investment Board is a long-term investor, consistent with the long-term needs of the Canada Pension Plan. We are likely to own shares in many Canadian and foreign companies for decades. With billions of dollars committed to equity ownership, we cannot (nor do we chose to) walk away from companies by selling our shares every time we feel they are not currently acting in our best interests. As an owner, we accept responsibility for encouraging companies to adopt policies and practices that enhance long-term shareholder value.

As a patient investor, we will support boards and management teams through difficult periods as long as their long-term visions and strategies are clear and compelling and focused on the enhancement of long-term shareholder value. We oppose resolutions that are likely to diminish long-term shareholder value even though they may produce short-term gains. It is profit growth that ultimately drives returns on equities. Management's priority should be to enhance sustainable long-term profitability."

These guidelines address matters that are important to us. And I stress that they do not represent radical new thinking since, for the most part, developing such guidelines is a journey over well-trodden ground.

But being new to the game, we've tried to step back a bit and be as constructive as possible. After all, we want to be the kind of shareholder that companies want to have; we want boards and managements to regard us as reliable and thoughtful.

Let me share a few specific examples to give you a sense of how we've attempted to address governance issues constructively and how we're perhaps different from other investors.

Shareholder rights plans

In many proxy voting documents, shareholder rights plans, or “poison pills” as they’re sometimes disparagingly called, are seen as a method by which directors and managements seek to entrench themselves. Our view is different. It is that shareholder rights plans are more likely to be used to buy time, usually to get a better bid for the shareholders or to spurn a bid that isn’t meritorious.

In this sense then, we support shareholder rights proposals that give boards extra time and flexibility to consider takeover offers and to open up the bidding process.

Obviously, we would oppose plans that we thought were not in our long-term best interests, but we regard such proposals as the rare exception rather than the rule.

Social and ethical behaviour

A second example flows from our expectation that companies should behave as responsible corporate citizens. We are not, however, interested in voting on a wide variety of specific resolutions about corporate behaviour in various social investment areas. Rather, our guidelines support resolutions in favour of reasonable disclosure.

The thinking behind our approach is that with sufficient information, the community at large will be able to judge a company’s behaviour and their verdict will be reflected in the share price. In other words, the market will make corrections rather than having shareholders become active managers of the company.

Stock options

We differ from other major investors in our outright opposition to stock options. So far, our position on options has proved the most newsworthy feature of our guidelines.

Others haven’t gone as far, but we felt it was important to do so because we think the presumed benefit of options – aligning the interest of employees with those of shareholders – can be better achieved by other means.

Stock options are problematic in a number of ways. They can potentially dilute existing shareholdings, they can focus management on short, rather than long-term goals, they reward or punish the option holders for matters over which they have no control, such as interest rate changes, and they create intractable accounting issues, to name a few.

But when you step back a bit, you realize that, in essence, stock options are primarily a way to pay cash compensation. And so far as we can tell, they pay cash in an inefficient way from the shareholders’ perspective.

We are all in favour of aligning the interests of executives with those of shareholders. We just think that direct share ownership is the way to do it. Specifically, we suggest that companies make executive stock grants at market value as part of total compensation. These grants would be linked to the achievement of long-term objectives, and have long-term holding provisions attached to them.

Mandatory retirement age

To give a fourth example, we do not support fixed terms and mandatory retirement ages for directors. The simple reason is that, in practice, we feel such restrictions allow boards to avoid doing effective peer evaluations of their directors on an annual basis. It's easier to wait until "good

old Fred" reaches the mandatory retirement age than it is to be candid about his contribution to the board.

Mandatory retirement really doesn't make sense unless you assume that directors magically become ineffectual on their 65th or 70th birthdays. We don't believe in one size fits all "best before" dates where people are concerned.

Directors who are ineffectual at age 50 ought to be culled. Productive septuagenarians ought to stay.

This is by no means an exhaustive list of our guidelines. It is merely intended to give you some examples of where we have taken a somewhat different position on important governance issues.

I now want to address my third and final point, which is: can this good governance bandwagon go too far? Is there such a thing as too much corporate governance? And can excessive governance actually undermine corporate performance?

In some ways, there's a risk that this might be the case.

If we go too far in specifying the duties and obligations of directors – not to mention the penalties for non-compliance – we risk inducing paralysis. If directors believe they have rigid checklists of duties that must be performed under a Damoclean sword of personal and corporate liability, they may become too cautious, driven more by process than substance. This could seriously reduce corporate dynamism.

A related risk is that, because of personal exposure and demands on their time, many able people may decide to avoid directorships. Many of the best and brightest avoid political life because of the harsh personal exposure it brings. The same could become true of boardroom life.

We must, I believe, be mindful that unrealistic demands and expectations could create barriers that would dissuade good people from becoming directors.

Of course, we must consider the possibility that pressure for better corporate governance will be regarded as a passing fad. Certainly, over the years, there's been evidence that corporate managements often look on shareholders as nuisances.

One CEO jokingly told me a while back that his company automatically responded to shareholder resolutions negatively. If a shareholder proposes something, he said, it must be a bad idea. The corporate secretary knows to start drafting a refutation without bothering to assess the merits of the proposal.

It shouldn't be this way. And it doesn't have to be.

A premise of responsible long-term investors is that communicating with their investees through shareholder resolutions and proxy circulars should be a last resort, not the normal course.

Constructive dialogue among officers and directors with their shareholders in order to find out what's on their minds is a better way.

I stress here that I'm not talking about selective information sharing with some of the shareholders. But on key issues that occasionally come up, it may be worthwhile to have constructive dialogue between the directors and officers of a company and its owners.

We hope that this kind of constructive dialogue is implicit in our proxy voting principles and guidelines. I say this because good corporate governance is going to be a persistent theme. And

because of our mandate to maximize value without undue risk on behalf of our 16 million stakeholders, we intend to be an active shareholder when it comes to exercising our proxy voting rights.

We have strong and clear view on certain issues, but we believe they are consistent with our ability to be a good and thoughtful shareholder, the kind any company would welcome over the long term.

Thank you. I welcome any questions you may have.