Corporate Governance

CPP Investment Board

Corporate Governance: An Investor Perspective

Presentation

by

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to the

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Good afternoon, ladies and gentlemen. Thank you for inviting me to speak to this conference, particularly because the topic, corporate governance, continues to make headlines and remains one of the most important stories in business today.

That's not to say it's a new topic. One of the earliest references to governance is in the Gospel of Luke, Chapter 16: the parable of the unjust steward who is rebuked for squandering his master's wealth. The point of the story is that you cannot serve both God and money. But the parable is also explicit about the need to keep an eye on stewards. As it says, "he that is unjust in the least is unjust also in much."

We've been relearning this Biblical lesson at breakneck speed in recent times. Exposes of those who've been unjust in much have been quickly followed by a wave of reform in North America and Europe – from the excesses of Enron and WorldCom to the correctives of Sarbanes-Oxley in no time.

Legislators and regulators are much more engaged than before. Many companies are responding positively by changing their governance practices to make boards and managements more accountable to shareholder-owners. Rating agencies such as Moody's are incorporating governance analysis on their overall evaluations of companies.

Reform has been fast in coming because abuses undermined investor confidence in the capital market. The need for change has been all the more urgent because corporate scandals coincided with the bear market.

The renovation of corporate governance has come a long way in a sort time.

The heightened appetite for good governance is not a fad. It's a necessity. We are in the midst of a healthy and ongoing debate about governance practices and how they should be framed.

The debate encompasses not only the basic rules and codes of conduct for boards and managements of public corporations, but also broader issues of corporate reporting and accounting standards. It is the sum total of corporate behaviour – and the perceived inadequacy of that behaviour – that is under discussion. There are a number of complex problems that demand solutions.

It's also wise to remember that good corporate governance is not some finite objective that we can achieve and then forget. It is an evolving process.

Equally, good governance cannot be achieved by crafting a precise rule for every circumstance. There is no checklist that will guarantee high standards. This is perhaps because corporate governance is as much about culture as it is structure, and as much about the example set by boards and managements as it is the rules imposed on them.

Good governance, then, can be considered at least as subjective as it is objective. Therein lies a challenge. Legislators, regulators, directors, managers, industry groups, ratings agencies and investors are, in their different ways, trying to determine what good governance should look like, what it can be expected to do for corporations and their investors – and, perhaps just as important, what it can't. There is a host of questions, many of which have no clear answers.
We can say that almost everyone recognizes that constructive change is not only necessary but possible. Many aren't just talking about improving corporate governance; they're doing something about it. I mentioned the Sarbanes-Oxley Act. Regulators in Great Britain are similarly taking a hard look at the adequacy of their laws.

In Canada, we're seeing reform initiatives from the federal and provincial governments, the

Senate, various associations, regulators and institutional investors individually and collectively as well as boards and managements who, in my view, have been emboldened to make positive changes in their governance practices.

The CPP Investment Board's contribution

Where does the CPP Investment Board fit in this picture? As an institutional investor with a unique mandate, we want to provide thoughtful suggestions for some of the governance dilemmas that we all face. We believe we can contribute to reforms that will strengthen corporate governance. This, in turn, will enhance shareholder value. Better corporate governance over time will also inspire renewed confidence in capital markets.

Today I want to talk to you about the two basic ways in which we feel we can make a contribution. The first is the example of our own governance structure and how it strengthens our ability to fulfill our mandate. The second is in the manner in which we are exercising our voting rights in order to make a positive contribution to change.
We currently manage $17.5 billion on behalf of 16 million CPP beneficiaries and contributors. That dollar amount is expected to grow to $80 billion by 2006 and approximately $160 billion by 2013.

This money is being invested under a very specific mandate: to contribute to the long-term health of the Canada Pension Plan by investing for maximum return without undue risk of loss.

We have approximately 18 years before we are expected to pay any investment income to the Canada Pension Plan. We are long-term investors dedicated to achieving superior risk-adjusted returns.

We want to invest in companies with strong boards and managements who have compelling long-term visions, who have the company's best interests and those of the shareholders at heart.

Our objective is not to make a quick profit and move on. We are happy to hold our shares a long time and support companies as they pursue and achieve their goals.

It seems to me that our mandate, our potential growth and the interests of Canadians are entirely consistent with seeking the highest possible standards of corporate governance.

In our view, improved governance will help public companies produce consistent long-term gains in shareholder value.

We believe the CPP Investment Board can lead by example because we've been blessed with a sound corporate governance platform. One cannot credibly preach what one doesn't practice.

The CPP Investment Board's governance:

Let me now tell you briefly about the CPP Investment Board's governance system.

We think our legislated governance structure works well, thanks to the foresight of the federal and provincial politicians who created it. In 1997, as part of the reforms to the Canada Pension Plan, they constructed a governance model that balances political independence from government with rigorous public accounting and responsibility to Parliament, the provinces and the people of Canada.

We try to balance independence and accountability in a number of ways.

It starts with a strong board. 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.

Until very recently, the idea of mandating competency was a radical idea. In doing so, our legislation was visionary.

The manner of our directors’ appointment is unlike that of other Crown corporations. In our case, a committee appointed by federal and provincial finance ministers nominates candidates, who are then selected by the federal minister in consultation with the provinces. As a result, our board consists of experienced professionals with backgrounds in accounting, economics, actuarial science and investment banking – from both the public and private sectors. They are able, 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 and approves major policies. It is also charged with appointing internal and external auditors.

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.

Despite these powers, governments have ample ability to see what we’re doing with Canadians’ money. For example, every six years the federal finance minister must authorize a special examination of the controls that we have in place on our books, records, systems and other practices. This audit 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.

We have instituted a wide array of policies. We are pro-active on ethical issues, requiring, for example, that directors and employees pre-clear personal securities trading through an internal compliance officer. Our external auditor receives copies of broker statements for each employee and reports on compliance to the board’s audit committee.

We follow similar standards with regard to reporting potential conflicts of interest on the part of directors and senior management. Directors, for example, must disclose any personal relationships that may appear to compromise their independence or ability to provide an impartial and objective decision. And they must disclose any business activity that could directly or indirectly affect the activities of the CPP Investment Board.

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 counsel us on potential conflicts and ethical conduct issues.

It’s gratifying to be able to tell you that a recent study by the World Bank credits Canada and the CPP Investment Board as having “best practice” governance policies and practices among nation state pension funds. We’re fortunate to have such a strong foundation on which to help build the retirement future of Canadians.

But I stress, it is only a foundation. It’s something to build on, to constantly upgrade.

<u>What we are doing externally</u>

That's a brief summary of our internal story. The second topic I want to discuss today is our external activity, how we can use our proxies to encourage governance measures that will improve long-term shareholder value.

Our Proxy Voting Guidelines, which indicate how we will vote on a wide range of corporate governance issues that are fundamental to long-term shareholder value, are designed to encourage governance that has shareholder interests at heart.

The guidelines are based on some important principles: the alignment of the interests of management with those of shareholders through share ownership; the need for a long-term perspective on shareholder value; the need to behave ethically; and the need for full and timely disclosure.

In general, the guidelines support resolutions that empower boards of directors on behalf of shareholders and reaffirm management accountability. We are also using our voting influence to stimulate disclosure of information relevant to assessing the possible impact of corporate behavior on long-term investment prospects.

We don't intend to walk away from companies by selling our shares every time we feel they are not currently acting in the best interest of all shareholders. Through our proxy voting principles and guidelines, which are published on our website, we provide guidance on what we regard as good governance, improved accounting standards and sound financial structures.

Let me give you a few examples of specific guidelines and the thinking behind them.

Independent directors

We support boards that contain at least a majority of independent directors.

Why? The cornerstone of effective corporate governance is that boards represent the best interests of all shareholders. We think this can best be achieved by ensuring that a majority of directors is independent of management.

By the way, we define an independent director as an individual who is not a member of management, and is unrelated by blood or marriage to a member of senior management. This individual does not have a material business or personal financial interest as a provider of goods or services to the company, and has not been an employee of or material provider of goods or services to the company for at least three years. Other than director's fees and shareholdings, this person will have no other direct or indirect material relationship to the company.

In other words, the individual's judgment should not be compromised by other loyalties in serving the best interests of all shareholders.

Requiring a majority of independent directors can be a challenge in a company where the founders, either as business partners or a family, are senior managers and shareholders. But in our view, any company that is publicly traded, irrespective of origin or size, should subscribe to the highest level of governance. That includes having a majority of independent directors.

Of course, we've taken this position knowing there is ultimately no guarantee that having independent directors will necessarily contribute one iota to the creation of long-term shareholder value. On the other hand, there's abundant circumstantial evidence in recent years that poor governance can do much to destroy shareholder value.

Not surprisingly, we support the idea that a majority of the members of audit, compensation and nominating/governance committees be independent directors.

The audit function

And because we believe that investor confidence depends on the integrity of a company's financial reporting, we also have a number of guidelines dedicated to the audit function.

One is that audit committees should consist solely of individuals with financial expertise or financial literacy. We believe the financial expertise and financial literacy of audit committee members should be disclosed.

We support the strengthening of audit committee authority over the appointment and accountability of the company's auditors. Only the audit committee (acting on behalf of the board and, therefore, on behalf of the shareholders) should have the authority to hire and fire audit firms. Audit firms, for their part, should be fully accountable to the audit committee.

We support the disclosure in the company's annual report of all audit, audit-related and non-audit fees paid to each audit firm.

We also support greater disclosure of the company's audit policies and procedures.

The audit committee should disclose its process for meeting with audit firms without management present. It should also disclose the company's policies and procedures for reviewing and approving risk management policies and procedures, compliance with legal and regulatory requirements, and financial disclosure through financial news releases and the annual report.

Stock options

When our Proxy Voting Guidelines were first published, however, the greatest attention was given to our opposition to stock options for directors, management and employees.
Stock options are problematic in many areas, including their effectiveness in aligning the interests of boards and managements with those of the shareholders. Options have the potential to dilute existing shareholdings, and they tend to focus management on short-term performance. We are also concerned about their use as a cash incentive rather than an ownership incentive, and the intractable accounting issues that surround them.

While many aspects of granting stock options could be improved, and are being improved, we still believe this form of compensation is inferior to direct share ownership. That's why our guidelines support executive stock grants at market value as part of total compensation. The guidelines also favour minimum share ownership as a multiple of annual base salary and a mandatory holding period at a minimum level expressed as a multiple of annual base salary during an executive's period of employment.

We believe these stock grants should be linked to the achievement of long-term objectives. We also think that, by linking minimum share ownership to a multiple of annual base salary, executives will have the flexibility to liquidate excess holdings for personal use while maintaining a strong tie to long-term shareholder interests.

Regardless of the specifics of a program, we support the full disclosure of executive compensation and share ownership. The same goes for director compensation and share ownership.

Principles and guidelines summary

I’ve covered just a few of our roughly 50 guidelines, but I think they give a sense of what we’re trying to accomplish. And I should point out that, other than the position we’ve taken on options, there’s little original in anything we’re doing. What we have done is taken some themes that were already out there and pushed them to a higher level.

We’ve crafted a document that we hope you will find clear and comprehensive.

As I said earlier, we are part of a broad movement to improve corporate governance that includes legislators, regulators, business leaders, academics and investors. No single group is going to come up with all the answers. We need to do it together.

That’s not to say there aren’t valid differences of opinion as to how we should go about it. Thoughtful people come to different conclusions on some governance issues. Let me share just three examples: shareholder rights plans; stock options; and mandatory retirement for directors.

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

Others automatically reject shareholder rights plans, no matter what there terms or circumstances.

The stock option debate

Some have also said that our opposition to stock options is unrealistic. They claim stock options are now entrenched in the U.S. and if Canadian companies fail to use them, they will be at significant disadvantage in attracting top executive talent.

Again, we disagree. We think our critics are confusing two separate issues: one is the alignment of management interests with those of shareholders, and the second is the question of executive compensation.

Stock options, in our opinion, are not as effective as share ownership in aligning the interests of management and shareholders. On the contrary, options have led to excesses. If this position makes Canadian companies less competitive, then our view is that some other means should be found to compensate talented managers.

Mandatory retirement

There are also contrasting views about enforced retirement of directors. Our proxy voting guidelines don’t support a mandatory retirement age because we think such a rule allows boards to avoid doing peer assessment in a formalized and rigorous way. Our belief is that directors should be assessed annually on their commitment and contributions – and not on their chronology.

Nevertheless, there are very thoughtful people who believe that, if you’re 70 years of age you should be off a board. They think there’s a risk that, once you have attained that age, you become chronologically challenged. So why take that risk?

These people aren't saying they don't believe on good governance. They simply believe that automatic retirement for directors is one element of achieving it.

Rules will always have exceptions. I was at a dinner recently with Peter Drucker. He's 94, but he's still active as a writer, teacher and consultant. Drucker is someone, who, as management writer Ken Blanchard says, "has forgotten more than most people ever knew about leadership and management." Can you imagine if, when he turned the conventional retirement age back there in the mid-1970s, someone had just said to him, "Thanks for the memories?"

Conclusion

I cite these three items, not to prove that we are right and others are wrong, but to demonstrate that there is no holy grail of good governance principles. We are all engaged in a search for best practices and we know that reasonable differences of opinion can exist. Best practice is a moveable goal, not a certain destination.

Nor are there necessarily any indelible benefits to having best practices. In a speech in Toronto a short while ago, veteran executive and director Purdy Crawford talked about the impact of fiduciary governance, those tenets of corporate governance that try to ensure directors will discharge their "legal duty of care." He said, and I quote, "they have absolutely nothing to do with creating shareholder value, other than the prevention of the destruction of shareholder value."

Purdy Crawford knows something about governance, having spent the past five years chairing a committee that has reviewed Ontario's securities legislation. He thinks the best route is to combine high standards of fiduciary governance with what he calls "value driven governance," which at heart requires knowledgeable, independent directors who have the shareholders in mind.

None of us has yet discovered a magic governance formula. What we do know, however, is that the time is ripe to seek it; the environment is receptive.

We also know that inexorable pressure for change is coming from many quarters – from politicians, regulators, business groups, rating agencies and investors large and small. All these groups should rightly contribute, and are contributing.

At the CPP Investment Board, we look forward to contributing to the betterment of corporate governance, to being a thoughtful and responsible contributor in dealing with the complex issues we now face. We also intend to use our proxies to encourage change, to help companies achieve the highest standards of corporate governance. We believe this will do much to increase shareholder value and, in so doing, benefit all Canadians.

And now I look forward to your questions.