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Canadian Centre for Ethics & Corporate Policy

management ethics

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An Interview with Claude Lamoureux

Ellen Mary Mills
Executive Director, Ethics Centre CA

In December, Ellen Mary Mills sat down with Claude Lamoureux, the President and CEO of the Ontario Teachers' Pension Plan and a Founding Member of the Canadian Coalition for Good Governance, to discuss issues relating to executive compensation.

Ellen Mary Mills - A great deal of ink has been spent on the subject of galloping increases in executive compensation and the ever widening gap between the highest paid executive and the lowest paid worker. I'd like to talk to you today about the current level of executive compensation in Canada, disclosure, the use of stock options and the Board approval process.

Claude Lamoureux –Let's start with disclosure. Disclosure is a wonderful thing, except it only does one thing – it increases everybody's compensation.

John McNeil, the ex-CEO of Sun Life, wrote an article on this subject, in October of 1993, if I remember correctly. More recently, the Financial Post reported that the NHL players' union gave the list of everybody's salary to the agent of every player. So why did they do that? To help them compare players' performance in order to raise salaries.

When we apply disclosure to a corporation we say that it doesn't matter – but it does. When you fire somebody, the next person you hire says: you paid my predecessor $X amount and I'm worth upwards of one and a half times that amount. It's tough for a board to resist approving the higher compensation, especially if somebody is being hired from the outside. I know disclosure might be great for shareholders, but I don't think it is really helping us that much in the long run.

EMM - Then what do we do with this issue of disclosure because a lot of people say we need more, particularly in the area of retirement or supplemental benefits.

CL - Well, the more I think about it, the more I think we should disclose compensation in the aggregate. But when it comes to pensions, what you want to disclose is not so much how much pension somebody is going to get, but the increase in the present value of the pension. The same applies to other fringe benefits?

And you know that this is not mandated. Let's look at Jack Welch of GE. I think Jack produced a lot of value, but GE knew the rules and didn't have to disclose all of his benefits when he retired. Well, he can use the executive plane. He has an executive secretary, he has this, and he has that. When you add it all up, it's significant and for the average share owner, it's a lot of money. Compare it with how much he made previously and maybe how much value is to be added. I don't think it's that significant, but

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EDITORIAL

Management Ethics

JULIE WALSH & LARRY HEBB,
Co-editors

This is the first issue of Management Ethics for 2005 and our first release as editors. We would like to thank Sally Gunz, the departing editor of Management Ethics. Sally has made a fantastic contribution to the Ethics Centre through her thoughtful and insightful editorials over the past two years. We appreciate her guidance and assistance in preparing this issue and hope that we can ably follow in her capable footsteps.

We are excited to be taking the helm of this publication at a time when issues concerning business ethics and corporate governance are receiving unprecedented scrutiny. Over the past year, we have witnessed the serious struggles and demise of numerous corporations as financial scandals were revealed and the media was often consumed with stories of mismanagement and corporate ethics gone awry. 2004 also continued an era of legislative reform as, among other notable developments, Parliament introduced changes to the Criminal Code for attributing criminal liability to corporations and other organizations and protecting whistleblowers from retaliation, securities regulators proposed new corporate governance practices and disclosure requirements, and audit committees assumed new responsibilities addressing the receipt of complaints about an organization's financial reporting practices.

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In looking over past issues of Management Ethics, it is interesting to note that editorials and articles have frequently addressed the issues of whistleblowing, the publication of codes of conduct and struggles over the meaning of "business ethics." One could find it depressing that views frequently promoted by contributors to Management Ethics are only now making their way into the myriad of practices and laws governing Canadian corporations and other organizations or are the subject of frequent discussion. One could also consider these to be great triumphs for supporters of corporate reform, with the increased focus on the importance of championing ethical business practices. Regardless of your opinion of whether these developments are too little or too much, these reforms make for very interesting times for the Ethics Centre CA with its mandate of enhancing sensitivity to the issues.

Our goal over the next year is to provide a forum for debate about organizational ethics and we look forward to informing you of developments concerning ethical practices, legal reforms and other noteworthy events of interest. We value your opinion and welcome submissions about events, articles or alternative viewpoints you may wish to express.

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everybody was surprised by it. Clearly we should disclose every element of compensation, including pensions. But I would still favour going back to the way we had it before, i.e. disclosing the aggregate compensation of the top five people although I think the genie is out of the bottle.

EMM - Let's talk about stock options. This vehicle has been criticized every which way, but are stock options still a viable mechanism? Do they need fine tuning or should they just be replaced entirely?

CL - Well, options are really a crude way to reward people. And we all remember the 1990s. It was a period where the main reason for the increase in the value of listed shares was the decrease in the level of interest rates. When the stock market went up, we expected everything to go up. But in the last few years, things have not gone up. A CEO can do tremendous work in a down market, but if that person has options, she gets nothing. She probably works three times as hard as she did when times were easy, like sometime in the 1990s. That's why on occasion we've advocated, if you want to give options, give indexed options – indexed to the sub-index of the TSX or to the TSX so at least if some stocks go down, people will be rewarded. While we prefer shares, if people have to give options, one better way is indexed options. If the idea of options is to make sure that management's incentive is in line with the shareholders, well, let's make sure that it does this.

EMM - Now, when we were talking about options, what about the notion of performance-linked options? And how difficult is it, particularly when you're talking about a CEO?

CL - I don't think it's that hard to link options to a target at the CEO level. Generally, what most shareholders look at, and how we evaluate companies, is how much free cash flow will a company generate? That's fairly easy to measure, although you can still play games with what is called free cash flow, but that's one way to measure it. On the other hand, a company could have a different objective. They may want to go into Asia. Well, you won't make money going into Asia for three or four years. So, maybe this objective accounts for twenty-five percent of the bonus. A lot of companies have found ways to reward people based on a specific objective. But in general, CEOs are there to increase the value of the shares, so that could be a large component, but it should not be the only element rewarded.

EMM - I know part of your mandate within the Canadian Coalition for Good Governance ("CCGG") is to try and develop best practices and then sell these to CEOs. In the area of executive compensation, have you developed best practices?

CL - No, that's a work in progress. It is a difficult one, but the basic principles are easy. An example I like to use in speeches is American Express. When Harvey Golub retired in 2000, he got the best bonuses he ever had in his life because Amex was making lots of money. That impacted his pension, impacted everything. Within six months of his departure, Amex wrote off one billion dollars.

Do you know what they were doing? They were investing in bonds that paid very, very high yield except it was also high risk. I'm sure that when Mr. Golub was there he never looked too much for the risk. But a year later, or within six months, you get a new CEO who says, "Hey, this is unsustainable". He goes to the board and convinces it to take a write-down of one billion dollars. Nobody went back to Mr. Golub to say, "We need to re-calculate your bonuses, you owe us money".

EMM - Now what does a large investor like the Ontario Teachers' Pension Plan do when something like that happens? What tools are at your disposal to object and to get changes?

CL - A lot of times these bonuses should not be paid in cash right away. They should be paid in a "bank account" and the "bank account" itself should be paid over three to five years, even years after retirement. The bank would allow for debits and credits. You can add to it, but you should also be able to subtract from it. A number of companies have adopted this approach.

I don't know if you are familiar with "E.V.A." or economic value added. Essentially, you pay the CEO for the economic value he or she creates, which is your profit minus the cost of capital. And the cost of capital includes not only the cost of equity but the cost of your debt. For many corporations, it's easy to have a huge profit but if you have a capital that is fifty billion, you can make a billion and it's only two percent return on the equity. The EVA approach has been used by a number of corporations and it has a lot of merit.

EMM – In light of recent cases where both compensation committees and boards were seriously criticized for not doing due diligence in approving compensation arrangements, do you think that this has had a sobering effect on boards and compensation committees?

CL - In the U.S. it certainly has had an effect, but in Canada, I'm not sure. In the U.S. there will be a lawsuit after the Disney case is finished, whereas in Canada, there is not much you can do. Our laws and the enforcement of our laws are generally lax. After all the scandals that we've had, how many people are in jail or have paid even a decent fine?

But I think that boards are now taking this more seriously. Take the example of TD Canada Trust. Last year TD visited shareholders to find out what they thought. TD said "here are some ideas we have", so not only was the board doing its own homework but it also consulted with shareholders. And if nothing else, at least the board can say, "Well, look that's not acceptable, shareholders don't like this, or shareholders are against it and so we won't do it". I mean at least it gives them one more reason to say 'no'.

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Revised Corporate Governance Proposals Released

BY JULIE WALSH

Julie is an associate in the Business Law Department of Osler, Hoskin & Harcourt LLP

In November, all Canadian securities regulators released an harmonized approach to regulating corporate governance

The regulation of corporate governance practices and disclosure was the focus of considerable debate throughout 2004. In January 2004, regulators other than British Columbia and Quebec released a draft policy and disclosure instrument. Regulators in British Columbia, Alberta and Quebec then proposed an alternative approach to disclosure in April 2004. In November, all Canadian securities regulators released an harmonized approach to regulating corporate governance, and sought comment on a proposed form of disclosure of corporate governance practices, National Instrument 58-101 (the "Disclosure Instrument"), and a proposed policy on corporate governance best practices, National Policy 58-201 (the "Practices Policy").

While the Disclosure Instrument and Practices Policy do not specify an effective date, it is unlikely that they will be in force for the upcoming proxy season and therefore, the corporate governance disclosure obligations of the TSX and the TSX Venture Exchange will continue to apply. However, issuers should consider voluntarily complying with the additional requirements in the Disclosure Instrument, as the Disclosure Instrument will satisfy the TSX corporate governance disclosure requirements.

The Practices Policy establishes 18 best practices. While many of the practices build on the existing TSX corporate governance guidelines, additional new practices have been added reflecting the Sarbanes-Oxley Act of 2002 and the listing standards of the NYSE and NASDAQ. The recommended best practices are not mandatory, but the categories for disclosure in the Disclosure Instrument generally correspond to the guidelines set out in the Practices Policy. In addition to the references to the Practices Policy, the Disclosure Instrument requires an issuer to explain how it addresses the functional objective that the recommended best practices are intended to address and focus on describing the company's corporate governance practices. This modifies the approach proposed in January 2004, requiring an issuer to comply with the practices or explain why it does not follow a particular practice.

Similar to the proposals released in January 2004, and as noted above, the Practices Policy is not mandatory. However, issuers are encouraged to consider the guidelines in developing their own corporate governance framework, thus continuing the approach of the TSX. The Practices Policy includes the following matters:

- Board composition
- Meetings of independent directors
- Board mandate
- Position descriptions for directors, the chair of the board and each committee chair
- Orientation and continuing education for all directors
- The adoption of a code of business conduct and ethics
- Nomination of directors
- Compensation
- Regular board assessments

There are numerous implications of the Disclosure Instrument and the Practices Policy and the following summarises some of the key proposals that issuers should be aware of:

- the Disclosure Instrument expressly provides for its application to non-corporate reporting issuers, including income trusts;
- compliance with the requirements under the Disclosure Instrument will be subject to continuous disclosure reviews and enforcement by securities regulators;
- issuers must disclose if they have adopted codes of business and conduct and ethics, and file on SEDAR a copy of any adopted code;
- any amendments to a code of business conduct and ethics should be approved by the board of directors;
- issuers will not be required to issue press releases disclosing every explicit or implicit waiver from the code of business conduct granted in favour of an officer or director. Instead, issuers must consider whether conduct by a director or officer constitutes a material departure from the issuer's code, and if so, this will likely give rise to a material change and therefore an obligation to issue a press release and file a material change report;
- the definition of "independent director" will be modified for purposes of service on the audit committee as well as for board composition and other committee requirements; and
- controlled companies will be affected by the definition of "independent director" and an employee of a parent who is a director on a subsidiary's board will not be considered "independent" for audit committee or other corporate governance purposes.

The Ethics Centre CA had submitted comments in respect of the January 2004 proposals, and among its submissions, the Ethics Centre CA recommended that issuers should be required to have a code of conduct and that board mandates should require the creation of an independent reporting system and regular discussion of ethics issues raised by the internal reporting system at board meetings.

The securities regulators have not mandated the adoption of a code, based on the regulators' goal of maintaining flexibility in corporate governance practices. Other submissions addressing the ethical framework of issuers were similarly not reflected in the Disclosure Instrument and the Practices Policy. However, it is promising to see that the Practices Policy recommends that the board should play an oversight role with respect to the ethical framework of the organization, including satisfying itself as to the integrity of the CEO and other senior officers, and that the CEO and other senior officers create a culture of integrity throughout the organization. The Practices Policy also specifically advises that a code of conduct should constitute written standards that are reasonably designed to promote integrity and to deter wrongdoing. The requirement to file a code of conduct, any amendments thereto and the requirement to disclose any conduct which constitutes a material departure from the code by a director or officer also reflect positive steps in fostering transparency in ethical matters and the maintenance of an ethical framework for an organization.

The comment period for the Practices Policy and Disclosure Instrument ended on December 13, 2004. The Ethics Centre CA will continue to keep you up to date on these developments and any initiatives it undertakes with respect to these matters.

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While I think the boards are doing a better job, clearly they have to do an even better job. They have to hire consultants that are truly independent and consultants that just don't give everybody the same recipe, because right now a lot of time that's what happens – they give everybody the same recipe.

EMM - I know that the mandate and the focus of CCGG are on good governance. Where does executive compensation fit in the Coalition's priorities?

CL - Well, it's called the Coalition for Good Governance, but maybe we should call it the "Coalition for Good Performance". At the end of the day, what are we after? We're after performing corporations. Good governance means good performance, good business. Take Warren Buffett as an example... His governance practices may not be perfect, but does he provide performance? Yes. Is he honest? Yes. Does he abuse his power? No. So, I think we have to remember what we're after. We're after performance and that's why the rules that we have are just guidelines.

EMM - Did we make any progress in the area in executive compensation in 2004 and what do you see for 2005?

CL - There was a bit of progress in compensation, but it's not obvious. The banks and a number of larger corporations are getting better. However, we've seen measurable improvements in overall governance. David Beatty, who is the National Director for CCGG, can demonstrate improved corporate governance scores based on work done by the University of Toronto.

Regarding compensation, I think consultants today clearly know that they have to be hired by the appropriate committee. Compensation will still be on the agenda in 2005. The arrival of Sarbanes-Oxley will help, and in Canada, 175 companies have to abide by SOX. If you are listed in the U.S. and part of your compensation is due to weak accounting, you're going to have to re-pay that compensation. You going to be sued in the U.S. and some people may go to jail, in fact, if we could see a few people in jail, that would help.

SPEAKERS' CORNER

The Speakers' series for this Fall was once more outstanding. For those who were not able to attend some of these talks, we provide a brief summary of the remarks made by each speaker.

FIRE & ICE: THE US AND CANADA & THE MYTH OF CONVERGING VALUES

Michael Adams
President, Environics Group of Research & Consulting Companies
Wednesday September 22nd, 2004

Michael Adams' expertise lies in the impact of social trends on public policy and corporate strategy. His talk built on his very popular recent book *Fire and Ice* and addressed the relationships between values in Canada and the United States. Mr. Adams' basic thesis is that, despite popular beliefs that suggest values in the two countries are continually converging, they are, in fact, diverging. Mr. Adams posits that this trend has existed for some time and holds consistently across all segments of society in Canada and even amongst those groups that might be considered most susceptible to US media influences, namely the young. Further, he argued that there is in fact more commonality of values across Canada than across the United States, again contradicting popular assumptions. Mr. Adams used data from his consulting company, the Environics Group, to support his case.

BOARDS OF DIRECTORS - MONITORING FOR ETHICAL STANDARDS

Purdy Crawford
Counsel to Osler, Hoskin & Harcourt LLP
Thursday October 21st, 2004

Purdy Crawford addressed the October luncheon on the topic of fiduciary governance. Mr. Crawford used the Globe & Mail published rankings of Boards of Directors of companies that comprised Canada's benchmark S&P/TSX composite index as the springboard for his analysis on certain problems in governance rating systems. He identified the inherent weaknesses of this "tick the box" type approach to measuring corporate governance and expressed his personal belief that good long-term financial performance, or an outstanding C.E.O., should rank higher than any ranking of the Board of Directors. Mr. Crawford went on to talk of the distinction between what he named fiduciary governance (governance designed to police the integrity of the firm) and value creating governance, and was of the view that Canadian corporations have performed far better than those in the US in terms of the former. Despite the current trend to regulating fiduciary governance, Mr. Crawford expressed a firm belief in the importance of sound leadership and discussed the ethics and integrity program at Allstream Corporation as an example of a solid and effective approach. Mr. Crawford concluded his remarks by emphasising that a culture of ethics and integrity is critical to market credibility and maintaining confidence in the leadership of the organization.

Beware the Revisionist Interpretation of History

SALLY GUNZ
Board Member & Past Editor

This is the edition in which I officially ride off into the sunset and prepare for the true delight of the academic life – the sabbatical. The Centre is indeed fortunate that Larry Hebb and Julie Walsh now take over, with the aim of maintaining the high standards established by David Selley and others. They have generously allowed me one last dance on my soap box.

The irritant this time was an article in the Globe and Mail that reflects a trend to what I call a "revisionist" interpretation of our recent ethics and accounting history. In that article (Accountants call for reform in liability laws September 20, 2004), Beppi Crosariol reports on the position of the Institute of Chartered Accountants of Ontario calling for the removal of joint-and-several liability. I am not here debating this point. Nor do I question the concern for the number of major accounting firms falling below the present four. I understand that would not be good.

What I do take exception to is the link made between the fall of Arthur Andersen LLP and risk arising from excessive civil liability – as if we might blame joint and several liability or civil claims in general for the failure of that firm. Have we forgotten so soon the enormity of the accounting failures of the recent past? Do we not remember the extraordinary cultural change at Arthur Andersen that took a once proud firm down the path of commercialism to its own demise?

Arthur Andersen failed not because of civil liability claims but because of its own criminal behaviour. While many fine and undoubtedly innocent people went down with it, this does not change the reasons for the firm's failure. The firm's actions in the destruction of documents were outrageous. Its conduct of several major audits in the 90s bore all the characteristics of a firm that had forgotten it was first a profession and only then a business. To forget what happened and why, and to go further and re-write history by implying the failure was caused by civil claims, is both wrong and dangerous. Arthur Andersen was one of the many professional facilitators to the corporate malfeasance that all but brought about the collapse of our financial markets. If we forget this history, we are at grave risk of allowing for its recurrence.

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2005 NEW CORPORATE MEMBERS

ETHICSCENTRE CA WELCOMES THE FOLLOWING NEW CORPORATE MEMBERS:
Sustaining Member – McCarthy Tetrault LLP
Sustaining Member – TORYS LLP
Supporting Member – Imperial Tobacco Canada Limited
Supporting Member – Sears Canada Inc.

UPCOMING EVENTS

ETHICSCENTRE CA WINTER LUNCHEON SPEAKER SERIES

FIRST EVENT OF THE NEW YEAR!

FEBRUARY 2ND, 2005
12 Noon
The Ontario Club
5th Floor
30 Wellington St. West

Neil Tait, Special Advisor to the President of BMO Financial Group
Ethics & Culture: How to do Business in China

MARCH 10TH, 2005
12 Noon
The Ontario Club
5th Floor
30 Wellington St. West

Roger Martin, Dean
Rotman School of Management, U of T
Corporate Citizenship: What's a CEO to do?

APRIL 13TH, 2005
12 Noon
The Ontario Club
5th Floor
30 Wellington St. West

Hon. Barbara McDougall,
Chairman, Canadian Retailers Advancing Responsible Trade
Retailing and Trade Issues

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