LaneCaputo Compensation Inc.
Fall 2014
CLIENT ADVISORY

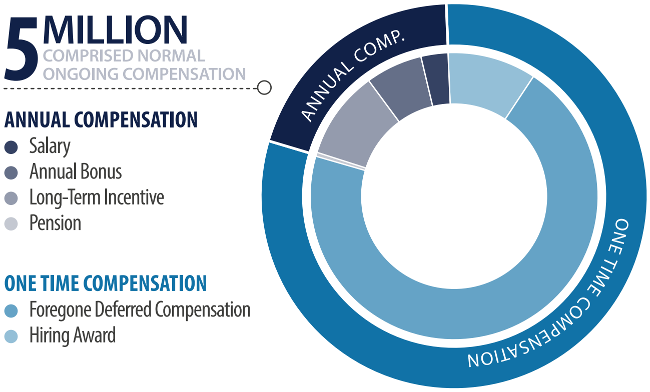
THE IMPORTANCE OF TRANSPARENT PROXY DISCLOSURE

Unlike apples, executives do not grow on trees. Those in the C-Suite in Alberta know that to operate here, you have to utilize a unique set of skills to meet the challenges of its fast-growing economy and to oversee the billions of dollars of capital required to develop the province's vast resource base. Alberta's CEOs require a strong technical knowledge base as well as those intangible qualities such as leadership, risk evaluation, and the ability to execute.

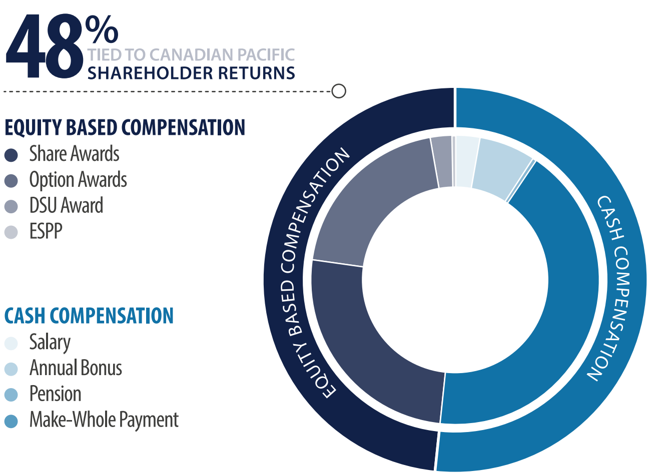
Like the price of apples, the market also sets the price for executives' compensation levels. Companies must pay competitive salaries and reward executives appropriately for superior performance, or they risk losing their top talent to competitors. Jim Pantelidis, Chairman of Venture 250 company Parkland Fuel Corp., was recently quoted supporting this reasoning. "Finding a good CEO is the hardest exercise that any board can undertake. I think we need to be very cautious that if we don't follow this process and remain competitive, the worst thing that can happen is you lose your CEO or you lose some of your top executives. And if you do, then you have real problems." (Calgary Herald, June 12, 2014 *'Activist investor takes salary fight to AGMs'*)

Despite the market-based compensation practices employed at most public companies, Boards are rightfully facing escalating scrutiny surrounding executive compensation packages. Increased scrutiny, in turn, increases the likelihood that a company's executive pay practices will be misunderstood; misunderstandings that could cost a company valuable goodwill among the shareholders and the public. The best way to reduce the risk of misinterpretation is to create a transparent proxy disclosure that outlines not only the company's compensation plan but also answers *"how"* and *"why"* executive compensation levels were earned. Many companies have been reluctant to provide extra detail over and above what is required by securities regulators for fear of misperception and challenge. This approach leaves investors, proxy advisors, and the media free to interpret executive pay programs with their own slant, versus the intent of the Board in designing these plans.

A recent high profile example of transparent disclosure was the pay package provided by Canadian Pacific Ltd. upon recent hiring of its Chief Operating Officer. Although the compensation package earned the top spot on the Calgary Herald's Top 100 Paid Executives list (Calgary Herald, June 19, 2014 *'CEO pay: Special payments boost earnings of city's highest paid executives'*), Canadian Pacific did a good job disclosing the details of the package in its Management Information Circular. The disclosure highlighted that despite the eye-catching reported compensation of $26 million, $21 million was delivered in the form of make-whole and hiring bonus payments provided to replace foregone deferred compensation that had already been earned during his tenure at Canadian National Railway Co., and just $5 million of the total comprised normal, ongoing compensation *(Figure 1)*.

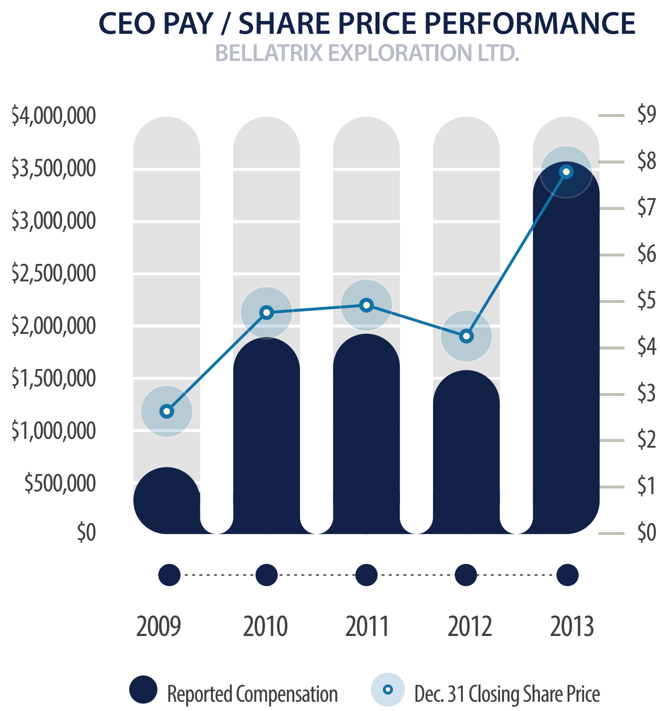


Of Mr. Creel's $26 million total compensation in 2014, it was highlighted that nearly 50% is tied to Canadian Pacific shareholder returns in the form of equity-based incentive compensation, as is over 50% of his annual cash compensation. As a company's Management Information Circular is one of the best ways for companies to get a message to shareholders, it is important to show a connection between shareholder fortunes and executive compensation.



LINKING PAY AND PERFORMANCE

Most shareholders are generally supportive of executive compensation programs that tie executive pay to shareholder returns — if executives receive significant total compensation increases year over year, there should be significant shareholder value created in that year and vice versa. As Alberta Venture's *Million Dollar Men* highlights (Alberta Venture, September 2014 *'Million Dollar Men'*), the total compensation of Raymond Smith of Bellatrix Exploration Ltd. increased by 137% in 2013. When put in context of total shareholder return over that same period (an increase of 83%), the alignment between shareholder return and this pay increase seems much more reasonable:



Of particular note when examining the pay-for-performance correlation in the figure above is that Mr. Smith's total compensation generally fluctuated with the fortunes of shareholders over the past five-year period and that the majority of the compensation received by Mr. Smith was in the form of performance-contingent pay (bonus and long-term incentives); guaranteed compensation (salary) comprised, on average, just over 20% of his total pay package over the past five years.

Well-designed compensation programs should also reward the achievement of annual, or multi-year operational or financial targets, versus solely share price performance. While these operational targets may be necessary milestones towards longer-term shareholder value creation, their achievement does not always immediately translate into a higher share price. In such cases, good disclosure can be helpful in communicating perceived disconnects between executive pay and shareholder returns; especially when these perceived disconnects are also a function of the way in which equity-based compensation values are required to be reported in information circulars.

REALIZABLE PAY AND THE PROBLEM WITH GRANT DATE FAIR VALUE

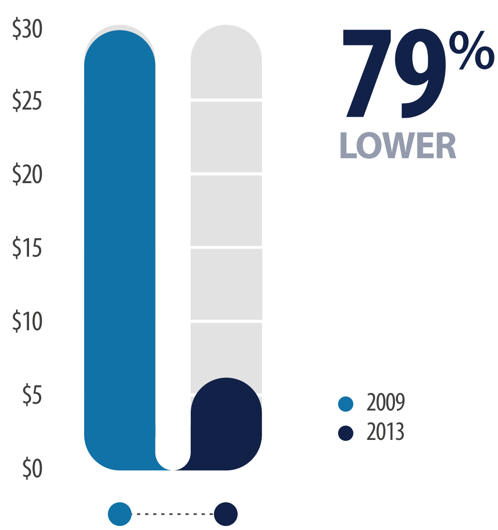
The largest and most often (incorrectly) quoted component of executive pay is the long-term incentive package (stock options, restricted share units, etc.). When discussing the value of these incentives, we are commonly referring to the 'grant-date fair value' of a compensation package, which is its *estimated* value at the time of grant. The grant date fair value attempts to estimate the financial opportunity provided to an executive by the grant of these incentives and provides some normalization to compare executives across companies. The actual 'take-home' value realized, however, is often very different from the value disclosed at time of grant and this 'realizable value' should be considered when evaluating the pay-for-performance relationship of an executive pay package. The Management Information Circular is the optimal place for this type of disclosure.

A discussion of realizable pay is relevant not only to create transparency into the actual value realized by executives, but to give context to the reliability of grant date fair value disclosure for various equity incentive vehicles. Stock options, for example, require substantial share price appreciation before passing the threshold where realizable pay actually exceeds their reported grant date fair value (often calculated using the Black-Scholes model or binomial option pricing models), while full value instruments such as restricted share units require no share price appreciation to deliver the reported grant value (ignoring performance-vesting restrictions). When the grant date fair value of equity incentives is combined with salary and bonus in the *total compensation* column of the Summary Compensation Table, little consideration is given to the fact that the majority of the "take-home" compensation reported in this column has actually yet to be earned.

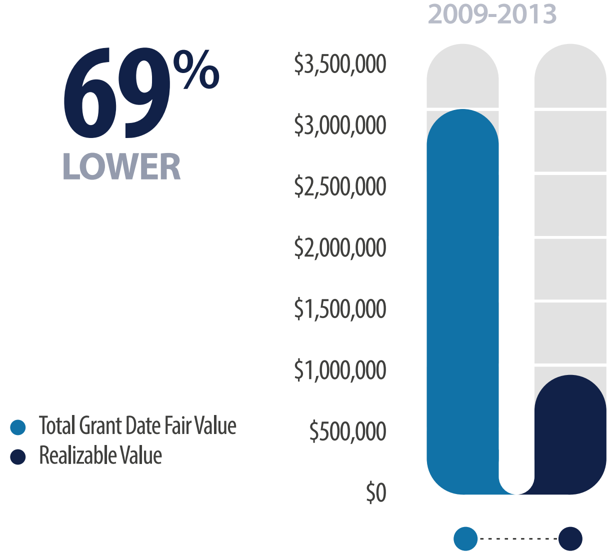
When viewed relative to that company's share price performance over the past five years, the total compensation reported for John Wright of Lightstream Resources Ltd. would appear to be wildly out of line with shareholder experience, as shareholders experienced a 29% decrease in share price in 2013 while Mr. Wright saw a 99% increase in reported earnings. What is missing from this viewpoint, however, is that nearly 65% of Mr. Wright's compensation is in the form of equity-linked compensation (stock options, RSUs, etc.) and that, over the past five years, the actual value that this executive can currently realize from the equity-based portion of his pay package is 69% lower than the value reported in the Summary Compensation Table; much closer to the shareholders' experience of a 79% share price decrease over the same time period.

Compensation starts with a fair, competitive, and defensible plan that aligns executive rewards with the fortunes of shareholders over the long term. We believe that many companies today already have this relationship right; the onus is now on them to communicate the pay-for-performance correlation effectively.

SHARE PRICE PERFORMANCE
LIGHTSTREAM RESOURCES LTD.
2009-2013



GRANT DATE FAIR VALUE COMPARED TO REALIZABLE VALUE
LIGHTSTREAM RESOURCECS LTD. CEO
2009-2013



SAY-ON-PAY

Implementation of a Say-on-Pay policy can keep a company at the forefront of corporate governance and provide a non-binding impression of the market's perception of its compensation plan by providing an avenue for shareholders to express their level of satisfaction with pay. According to research from Osler, Hoskin & Harcourt LLP, 129 Canadian issuers have taken advantage of the flexible Canadian Say-on-Pay rules and conducted a Say-on-Pay vote in the 2013 proxy season, an increase of 33% from 2012. Although not yet required in Canada, advisory Say-on-Pay votes are required in many countries.

33% INCREASE
IN 1 PROXY SEASON

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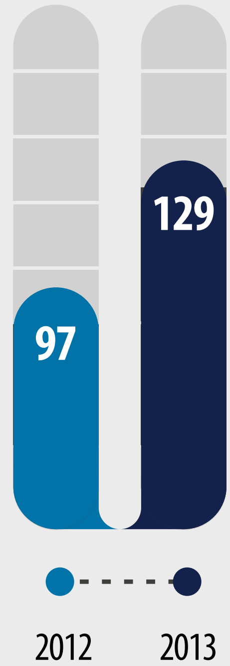

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