Corporate Board Governance in Canada
2019 Emerging Trends and Issues

In Partnership with Patrick O’Callaghan and Associates
Better governance is more than simply compliance. The objective is making the board a strategic asset.
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A New Decade

Introduction

As we were preparing to publish our first report on Canadian corporate governance in the new decade, we looked back on the data, analysis and commentary that we have published for the last 26 years. As valuable as statistics were in the past, boards are now more interested in a qualitative discussion about the issues they are facing than in comparative tables about structural elements like board size, range of committees, etc. Good governance practices are well-established in the Canadian corporate world. At the same time, directors face a rapidly changing world and increasingly complex business and operating environments.

In 1993, when we first published our annual review on board practices and director compensation, the business world was in the early stages of defining “corporate governance” as shareholders sought information about how the directors overseeing their investments approached their responsibilities. Today, business leaders and media have a comprehensive grasp of corporate governance.

The board chairs, directors and executive management with whom we work are looking for our perspective, advice and implementation assistance based on our understanding of their unique circumstances and our deep domestic and international experience across all industries and company sizes. As a result, we decided to retire our comprehensive governance and director compensation data tables and shift the emphasis of our reporting to important governance events or emerging issues.
With this 27th annual report on corporate governance in Canada, we hope that you will find our new direction both interesting and valuable reading.

The balance between profit and purpose was one of most controversial topics discussed in the business and investing communities in 2019. In last year’s report, we commented that the emphasis that stakeholders placed on the development of a long-term strategy that embraces a larger purpose for the corporation was a true reflection of its culture and values. We were not surprised to see The Business Roundtable (BRT), a U.S. association of Chief Executive Officers, release its “Statement on the Purpose of a Corporation” in August 2019. This document declared that shareholder primacy is in the past, and that corporations have a commitment to a variety of stakeholders including employees, suppliers, communities, customers, and shareholders. On page 4, we look at the reaction to the BRT’s new purpose statement, and how it might affect Canadian corporations.

On page 10 we look at the most interesting results and trends from an analysis of the governance disclosure from the largest 300 Canadian public companies.

With this 27th annual report on corporate governance in Canada, we hope that you will find our new direction both interesting and valuable reading. We are excited about a new approach for a new decade and look forward to hearing your feedback regarding future content. Boards have come a long way in the last quarter century, and future challenges will come faster and likely be increasingly complex.
The Business Roundtable’s Statement on the Purpose of a Corporation – A Recognition of On-Going Change

Corporate purpose has evolved over the past ten years in response to new forces at play. There has been steady progress towards engagement with stakeholders. There has been proactive development through voluntary reporting on environmental and social issues, and considerable establishment of these efforts inside corporations. The shareholder primacy model came under further scrutiny, in both Canada and the US, after the burst of the tech bubble in 2002 and the 2008 financial crisis.

Internal roles, processes and reporting mechanisms that address ESG (environmental, social and governance) issues became much more widely implemented. Corporations proactively announce their own initiatives and sometimes partner with, or seek support from outside organizations. This is progress, and it came over a relatively short period of time.

Board governance guidelines emerged in the 1990s with a focus on structural, quantifiable items such as board size, the number and types of committees, and the independence, experience and skills of individual directors. More than 20 years later, active board engagement with shareholders on ESG issues is the norm. Relationships between investors and corporations are, generally, much less defensive and focus more on engagement and growth.

The BRT’s Journey to a New Corporate Purpose

Milton Friedman argued that the primary obligation of a business was to increase profit for shareholders, as long as it does so without deception or fraud. Shareholder primacy was widely accepted by the financial and business communities from the 1930s through to its height in the mid 1970s. The beginning of its decline in popularity started in the late 1990s and early 2000s.

1 The Business Roundtable is the pre-eminent business leader’s organization in the United States and its members are the CEOs of America’s leading 200 corporations. Their view on corporate governance issues and especially the purpose of a corporation is very relevant, not only to Americans, but to corporations operating throughout the world.
Prior to its 2019 Statement, the Business Roundtable periodically published and updated “Principles of Corporate Governance” (the “Principles”). The changes over the years in these documents show the evolution of corporate purpose in the United States. In the 2010 edition, the “Key Corporate Actors” were the board, management and shareholders. Stakeholders received little attention. The 2010 Principles stated,

“Business Roundtable continues to believe that corporate governance should be enhanced through conscientious and forward-looking action by a business community that focuses on generating long-term shareholder value with the highest degree of integrity.”

The 2012 Principles expanded on the “Key Corporate Actors” with recognition that:

“The relationships of the board and management with shareholders should be characterized by transparency and appropriate engagement; their relationships with employees should be characterized by fairness; their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.”

However, the framework of corporate values was still seen as something to “provide long-term value to the shareholders.”
In the 2016 edition, the BRT appeared to pull back slightly and focused on the board, management and shareholders in its “Key Corporate Actors” section, with the statement:

“Corporations are for-profit enterprises that are designed to provide sustainable long-term value to all shareholders. Accordingly, shareholders should not expect to use the public companies in which they invest as platforms for the advancement of their personal agendas or for the promotion of general political or social causes.”

The Commonsense Principles were updated to address “unhealthy short-termism,” and encourage a broader effort to foster engagement among companies, boards and investors. Martin Lipton’s “The New Paradigm” argues that:

“If a corporation, its board of directors and its CEO and management team are diligently pursuing well-conceived strategies that were developed with the participation of independent, competent and engaged directors, and its consumers, employees, suppliers and communities are satisfied with the corporation’s performance, the corporation will have a strong capital market, an engaged workforce, and a solid social reputation. It will also have the resources to be successful in the long term.”

Beyond the Business Roundtable

The BRT is not the only organization that has evolved towards a broader corporate purpose. In 1998 Robert Rubinstein advocated the “Triple Bottom Line” which would value social purpose in addition to profit and loss. Gen Xers and Millennials have supported Certified B Corporations since they appeared in 2006. These companies resisted corporate governance practices that were tightly linked to maximizing only shareholder value. In 2007, 84 companies were Certified B, and today there are more than 1,700 in 50 countries.

Institutional investors have increased demand for statements regarding the interests of customers, employees, suppliers, communities and shareholders in corporate purpose statements. This pressure is frequently linked with the call to focus on long-term value rather than short-term quarterly results. Larry Fink made this topic an important part of his 2018 letter to BlackRock Inc. shareholders.

In 2019 The Business Roundtable (“BRT”) stated:

“While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders.”

Stakeholders are listed as customers, employees, suppliers, communities and shareholders with no indication of primacy among those groups.

CSR and ESG

“Corporate Social Responsibility” (CSR) took root in the 1990s, primarily as external activism. It represents a company’s efforts to positively impact employees, consumers, the environment and wider community. When it started, companies were largely defensive and CSR was often seen as a public relations effort. ESG came into the conversation when institutional investors became more involved and companies sought a way to formalize their efforts. It focuses on measuring CSR activities to assess a company’s actions. Exactly how to measure ESG is still under debate, and will be a large part of the corporate governance conversation in the next decade.

2 Social enterprises verified by B Lab, a non-profit organization.
4 https://www.governanceprinciples.org
operations are in the hands of competent executives, investors will support the corporation and refuse to support short-term financial activists seeking to force short-term value enhancements without regard to long-term value implications.”

And finally, in early December 2019, Klaus Schwab, the Chairman of the World Economic Forum argued that publicly-listed corporations’ focus only on profit-seeking is increasingly unsustainable and disconnected from the real economy. He believes this has occurred for several reasons:

“One likely reason is the “Greta Thunberg” effect. The young Swedish climate activist has reminded us that adherence to the current economic system represents a betrayal of future generations, owing to its environmental unsustainability. Another (related) reason is that Millennials and Generation Z no longer want to work for, invest in, or buy from companies that lack values beyond maximizing shareholder value. And, finally, executives and investors have started to recognize that their own long-term success is closely linked to that of their customers, employees, and suppliers.”

What is the relevance of the BRT Statement?

The BRT’s new definition of corporate purpose does not change any legislation or regulation. However, it is a commitment from a powerful and influential American business group. It is also reflective of a larger global public conversation about “social justice” in society and its institutions. What used to be seen as conflicting forces of shareholders and social activists are now coming together inside corporations. There are still tensions as the outliers clash, but the progress that has been made over the last decade has resulted in a much more collaborative environment.

Boards of directors are still elected by the shareholders, and boards will still hire (or fire) the CEO and approve strategy, budgets and risk tolerance. However, given the CEO’s typical leadership role in setting corporate strategy, a public declaration of commitment by the Chief Executives of many of the largest companies in the United States carries considerable weight and merits attention.

The Statement forwards the argument for a long-term growth focus because it recognizes the need to develop trusting relationships throughout the complex environments in which corporations operate. Shareholders, customers, employees, suppliers and communities all need to trust that corporations are dealing with them fairly, and they will reward corporations that they believe are trustworthy. The Trust Project at Northwestern University found that “For sellers, trust can become a critical competitive advantage: Buyers are more likely to do business with companies that they believe to be “virtuous sellers”—that is, not solely interested in maximizing profit.”

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In a pure shareholder primacy approach, anything that increases profit is acceptable, as long as it is done so within the law. While technically a corporation following this pattern may not be doing anything wrong, it may damage its ability to earn the trust of employees, customers, suppliers and communities. In our information-saturated world, a corporation that communicates that it is trustworthy must demonstrate that claim with real action. Well-informed consumers, workers, suppliers and communities are looking for information about which corporations they can trust and will act on that information.

Public trust in a corporation is not just based on honesty with regard to what it is selling, but also in its reputation as a ‘good corporate citizen’. If it invests in communities and its workforce, and deals fairly with suppliers and customers, its reputation will benefit. A balanced stakeholder approach recognizes that the interests of shareholders cannot be separated from the needs of stakeholders. They are often the same people; either through direct ownership or through benefit from pension plan investment.

The 2019 BRT Statement and its Impact on Canadian Companies

The Canadian business environment is slightly different than that in the United States. Canadian companies incorporated under the Canada Business Corporations Act are required to “act honestly and in good faith with a view to the best interests of the corporation”7. Canadian companies and have the latitude to consider the interests of shareholders, employees, retirees and pensioners, creditors, consumers, and governments, and to consider the environment and the long term interests of the corporation.8

The Canadian Coalition for Good Governance (“CCGG”) believes, “The board has a responsibility to ensure that all material risk factors, including E&S, [environmental and social] are managed, and that there is ongoing organizational understanding and ownership of their business impact. It is obvious that E&S concerns can create reputational risk for companies, but that risk is increasingly extending to shareholders.”9 The CCGG recognizes that policies need to be flexible as “…there is no “correct” approach to E&S governance and it very much is a journey. Each company’s approach will be based on its unique situation and strategic course, and will take time to develop.”10

The Canada Pension Plan Investment Board states, “Over the exceptionally long investment-horizon over which we invest, ESG factors have the potential to be significant drivers - or barriers - to profitability and shareholder value.”11

As we discussed last year,12 institutional investors have already declared intent to vote against or withhold votes from corporations that do not nominate enough women to their boards. We anticipate that investors may take a similar approach to other ESG issues going forward. For example, the forestry sector transformed its practices when customers and investors insisted on sustainable harvesting. Larry Fink of BlackRock echoed the importance for companies to consider environmental issues in his 2019 letter to shareholders, stating, “Climate change has become a defining factor in companies’ long-term prospects.”

Now that the BRT has made clear a corporate commitment to stakeholders, conversations between shareholders, boards and management teams should evolve to concrete goals and commitments. There is no definitive way to assess

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7 Canada Business Corporations Act (R.S.C., 1985, c. C-44), section 122(1)(a).
8 Canada Business Corporations Act (R.S.C., 1985, c. C-44), section 122(1.1)
ESG in the same manner as financial measures. However, qualitative conversations about these goals along with corporate strategy, risk and resources can lead to a mutual understanding of goals and expectations.

To ignore this movement would be the equivalent of burying one’s head in the sand. It should be no surprise that the savviest business people in America now have a business purpose that is more inclusive and addresses some of the most pressing concerns of our times. Canadian corporations have a lot to be proud of with regard to ESG, but they cannot rest on their laurels.

There will be challenges ahead as corporations and their stakeholders struggle to manage expectations and find the right balance between purpose and profit. If there is a serious dip in the economy, it will put this new order to the test. Stephen Bainbridge, professor of law at the University of California, Los Angeles, pointed this out in the Economist, “What the world has not yet seen is a situation where the ESG issues come into material, systemic conflicts with profits. Purpose is the flavor of the month, but are companies really going to give shareholders a 10% haircut for the sake of stakeholders?” 13

It is easy to make promises when things are going well. This is why ESG commitments need to be fully integrated into strategy and risk processes. They are no longer something apart from how the corporation operates, but rather an integral part of the system.

Implications for Boards

Every board, regardless of industry, needs to examine its own policies and practices with regard to how it communicates with and responds to stakeholders. Directors need to ensure that these practices are embedded in the corporation’s operations and culture. Below is a list of questions the board might consider:

- Does the board have a regular process to review the corporation’s commitments, action plans and with regard to stakeholder concerns? Is the corporation at any risk for not being able to deliver on commitments?

- Have the board and management team integrated a way to consider and address stakeholder concerns into the strategic planning, operational planning and risk management processes?

- Is the board prepared to discuss ESG issues with major shareholders and other stakeholders, including development of mutually agreed measurements and goals?

- Is the corporation’s ESG disclosure as thorough as it could be? Is it appropriate for your industry?

- Are there any activist stakeholders asking for something the corporation cannot provide? If yes, is there a way you can engage in building a better relationship with them?
Part Two

2019 Proxy Circulars - Emerging Trends and Issues

As we mentioned earlier, this is the first time since 1993 that our annual board Report does not include an exhaustive set of governance and director compensation data tables. We have, however highlighted those disclosure items where we have seen a notable change, or felt merited attention.

Board Diversity – It is Not Just About Gender

The board recruitment and succession planning process continues to be challenging for directors, while also being a crucial element to board effectiveness. There are external pressures to increase diversity from shareholders, regulators, employees, and communities. These exist along with pressure to put together a highly skilled and experienced board without bloating it to a size where it becomes inefficient. Increased workloads and restrictions on over-boarding have limited the number of boards a director can take on.

Part of the solution lies in looking to non-traditional sources of directors, and to some extent, there is evidence that boards have been following this practice. Current or past CEOs have historically been a desirable background for board membership. This makes sense. One of a board’s most important responsibilities (some say it is the most important) is to hire, fire and oversee the CEO, so having a few people on the board who have held this role is beneficial. However, there is a slow change away from CEO focused board recruiting; in 2018, 40% of newly elected directors were current or past CEOs, compared to 42% in 2017 and 46% in 2013.

There has also been a reduction in other C-suite backgrounds in new directors. In 2013, 42% of newly elected directors were in active C-suite roles, compared to 30% in 2018.

Gender

While diversity is not only focused on gender, it is important to note that Canadian boards have made steady progress in increasing the representation of women on corporate boards:

- In 2018, 93% of the 300 largest company boards had at least one female director. This is the highest representation of women on corporate boards in Canada. Just one year earlier it was at 87%, and was only 52% in 2010.
- There is also growth in boards with multiple female directors. In 2018, 30% of boards had two female directors, compared to 26% in 2017 and 15% in 2010. Eighteen percent had three female directors; a slight increase from 15% in 2017, but a big increase from 6% in 2010.
- In 2018, 35% of newly elected directors were women, compared to 34% in 2017 and 18% in 2013. We believe that the work of organizations like Catalyst and the 30% Club have played, and continue to play, an important role in these results.
The age of directors around the boardroom table also needs some focus going forward. We expected to see an increase in the proportion of directors in their 40s and 50s over the past decade, however the opposite has occurred. In 2018, 29% of directors were aged 51 to 60. This statistic has ranged between 31% and 33% between 2010 and 2017.

At the same time, the group of older directors has been growing. In 2018, 47% of directors were aged 61 to 70, after ranging between 42% and 44% since 2010. Reasons for the increase likely include executives leading active lives longer, including deferring retirement from corporate life, as well as having the energy and drive to serve on boards to a later age.

There was no expectation for a rapid increase in younger directors, but a downward trend is a problem. Gen X (in their 40s and early to mid 50s) is a smaller generation sandwiched between large groups of boomers and millennials. As the older directors retire in the next decade, will there be enough experienced people to take their places?

Consumer landscape, workplace culture and career paths have changed drastically over the past 15 to 20 years. Outside experts and management can provide insight to boards, but recruiting a few younger directors provides a twofold benefit. In the short term, boards will benefit from having their perspective at the table and part of every discussion. In the longer term, more young directors will be gaining the experience to take on leadership of committees and boards as boomers retire from board service.
Director Age Distribution

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<tr>
<th>Director Age Distribution</th>
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<td>40 and younger</td>
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Indigenous Backgrounds

Given the importance of access to land and talent and broader issues of obtaining social license, it would seem the resources sector would be especially motivated to recruit Indigenous leadership onto their boards. For example, Cameco Corporation’s diversity policy requires at least one director to have an Indigenous background and be from Saskatchewan. Several companies are specifying a consideration of aboriginal status for board diversity, including Turquoise Hill Resources Ltd., Exchange Income Corporation, Suncor Energy Inc. and NuVista Energy Ltd. Happily, the Indigenous talent pool is increasingly deep and prospective board candidates bring both a sophisticated commercial and governance mindset. Director matrices published in proxy circulars are also beginning to include indication of indigenous heritage, such as The North West Company Inc.

More generally, Canada’s diverse population (and by definition customer) is motivating companies in other sectors to take a close look at their diversity practices. Companies that do not yet have formal diversity policies are still reporting ethnic and indigenous diversity on the board, including Aurora Cannabis Inc., Corus Entertainment Inc. and CES Energy Solutions Corp.
Future Board Diversity Discussions

As the pressure to have diverse boards increases, boards must have high quality discussions about how they address diversity composition planning and recruitment. The benefit of diversity does not only mean representation of different groups in our population, but most importantly it adds diverse perspectives and life experiences. A board that ticks the “diversity” boxes that satisfies external observers does not automatically gain the value of diverse thinking. This is a difficult balance to achieve, but definitely worth the effort.

Selected Breakdown of Newly Elected Directors*

<table>
<thead>
<tr>
<th></th>
<th>Female</th>
<th>Resident outside Canada</th>
<th>Financial Background</th>
<th>Active CEO</th>
<th>Active C-Suite**</th>
<th>CEO Background**</th>
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<tbody>
<tr>
<td>2018</td>
<td>35%</td>
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<td>50%</td>
<td>19%</td>
<td>30%</td>
<td>40%</td>
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<td>2013</td>
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<td>25%</td>
<td>43%</td>
<td>23%</td>
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* In 2018, 20% of directors on the boards we studied were elected to those boards for the first time; it fluctuated between 19% and 20% between 2013 and 2017. ** includes active CEOs

Cyber Security Risk Oversight

Boards are increasingly mentioning cyber security risk as a topic the directors are concerned about. It is common on both board and committee agendas. In a review of 2019 proxy circular disclosure, 41% of boards addressed cyber security relative to board responsibilities. Of these:

- 51% held cyber security director education sessions
- 38% indicated that cyber security received focused attention in a board committee
- 26% specified that cyber security falls under the board’s risk oversight role
- 12% included cyber security knowledge in their director skill matrix
- 4% recently recruited a director with cyber security expertise
  (some boards fell into more than one category)

A focus on the board’s cyber security role will continue increase. This is a serious risk for corporations, and it changes at lightning speed. Boards that fail to properly assess and define their role will put themselves and their companies at a disadvantage.

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Initial steps in 2019 have set the stage for a continued focus. Boards that have already moved forward will have a head start. Those that have not yet addressed cyber security risk should do so without delay.
Mode of Director Compensation

The practice of compensating directors with a retainer only (no meeting fees) has grown substantially. In 2018, 62% of boards paid directors in this manner, compared to 34% in 2013.

There are no boards in Canada’s largest 300 companies that pay with meeting fees only, and the percentage that use a combined retainer and meeting fee method declined in proportion with the rise of the retainer only approach.

In 2003, only 8% of boards used the retainer-only compensation method. The most common approach was a combined retainer and meeting fee, used by 89% of companies.

The shift towards retainers recognizes the value that directors bring to the company and that director compensation goes far beyond their participation in meetings. Staying informed and educated outside of meetings is essential to good governance, and no director can afford to neglect this side of board responsibility.

Forms of Compensation

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<th>Form of Compensation</th>
<th>2018</th>
<th>2017</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retainer Only</td>
<td>62%</td>
<td>55%</td>
<td>34%</td>
</tr>
<tr>
<td>Retainer and Meeting Fee</td>
<td>38%</td>
<td>44%</td>
<td>64%</td>
</tr>
</tbody>
</table>

Implications for Boards

The trends highlighted above reflect the areas where we identified significant trends in the data we collected from the 300 largest public companies in Canada. Some questions your board might consider on these topics:

- Does the board have a well-designed board composition process? Is it reviewed thoroughly at least on an annual basis?
- Does the process evaluate the way corporation’s strategic plans and significant opportunities and risks affect board composition needs? Does the board’s composition strategy reflect, and where appropriate, take into consideration stakeholder concerns?
- Is there a clear understanding and agreement of how the board will approach diversity in evaluating its composition?
- When recruiting new directors, does the board look to non-traditional sources and career experience in addition to searching for more traditional backgrounds?
- Does the board have an appropriate and current depth of knowledge with regard to cyber security and other new and relevant technologies? Is education offered for directors who do not understand the issues well enough to participate in informed decision-making?
Korn Ferry

For more than fifty years, clients have trusted Korn Ferry to help them recruit world-class leadership talent. Building on this heritage, today we are a single source for a wide range of leadership and talent consulting services.

From our nearly 116 offices globally we assist organizations in attracting, developing, rewarding, retaining and sustaining their people. Services range from executive assessment and recruitment to leadership development programs, enterprise learning, succession planning, total rewards, and recruitment process outsourcing.

Korn Ferry Canada’s Board Services Practice

Korn Ferry’s Board Services team is our senior-most Partners and board recruitment specialists who focus their practice on assessing and selecting directors for corporations together with advisory support to enhance board effectiveness.

Korn Ferry’s mission is to ensure its clients recruit Board members who bring a strong track record of achievement, who will make a substantial contribution and who will enhance the competitive position of Canadian organizations.

Canada - Board Services Practice Leaders

Contact Us
Vancouver 604-608-6517, Gordon Orlikow, Canadian Board Practice Leader, gordon.orlikow@kornferry.com and 604-608-6511, Michael O’Callaghan, Office Managing Partner, michael.ocallaghan@kornferry.com
Calgary 403-269-3277, Bob Sutton, Office Managing Partner, bob.sutton@kornferry.com
Toronto 416-365-4018, Cleo Kirkland, Office Managing Partner, cleo.kirkland@kornferry.com
Montreal 514-397-9655, Nicolas Bilodeau, Senior Client Partner, nicolas.bilodeau@kornferry.com

For more Information on Korn Ferry, visit www.kornferry.com
About Us

Patrick O’Callaghan and Associates

Established in 1992, Patrick O’Callaghan and Associates have been pioneers and innovators in helping boards become a competitive advantage for their organizations.

Patrick O’Callaghan, our Founding Partner and Monique Steensma, the Senior Client Partner, have extensive experience with many of Canada’s leading public companies, private and crown corporations and a diverse range of not-for-profit organizations. We are skilled interviewers, observers, and problem solvers and recognize the critical value of understanding our client’s unique circumstances and challenges.

Practical and Actionable Advice that Ensures the Board is a Strategic Asset

Typical engagements include, but are not limited to:

• Assessing the effectiveness of boards, board chairs, committees and individual directors.

• Long and short-term board composition planning, and managing difficult challenges like board renewal and entrenched directors.

• Balancing regulatory requirements, best practices and current board culture and operating environment to develop a set of defined roles, responsibilities and processes.

• Designing a committee structure and workflow that gains the most from directors’ limited time and the many responsibilities of the board.

• Assisting boards to resolve challenging situations such as mergers, complex relationships with stakeholders, or strategic governance disclosure issues.

Contact Us

Patrick O’Callaghan and Associates
Suite 1901 - 1199 Marinaside Crescent Vancouver, BC V6Z 2Y2
Telephone: (604) 685-5880
www.poca.net
“Not everything that counts can be counted, and not everything that can be counted, counts.” - Albert Einstein
KORN FERRY

Korn Ferry is a global organizational consulting firm. We help clients synchronize strategy and talent to drive superior performance. We work with organizations to design their structures, roles and responsibilities. We help them hire the right people to bring their strategy to life. And we advise them on how to reward, develop, and motivate their people.

Our 7,500 colleagues serve clients in more than 50 countries. We offer five core solutions.

• Organizational Strategy
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*Corporate governance not an end in itself; an effective board is a competitive advantage.*

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