Chartered Accountants of Canada

20 Questions Directors Should Ask about the Role of the **Human Resources and Compensation Committee**

WRITTEN BY
Lisa Slipp and Paul Hooper

20 QUESTIONS

How to use this publication

Each “20 Questions” briefing is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management — and themselves — tough questions.

The questions are not intended to be a precise checklist, but rather a way to provide insight and stimulate discussion on important topics. The comments that accompany the questions provide directors with a basis for critically assessing the answers they get and digging deeper as necessary.

The comments summarize current thinking on the issues and the practices of leading organizations. Although the questions apply to most medium to large organizations, the answers will vary according to the size, complexity and sophistication of each individual organization.

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20 Questions Directors Should Ask about the Role of the **Human Resources and Compensation Committee**

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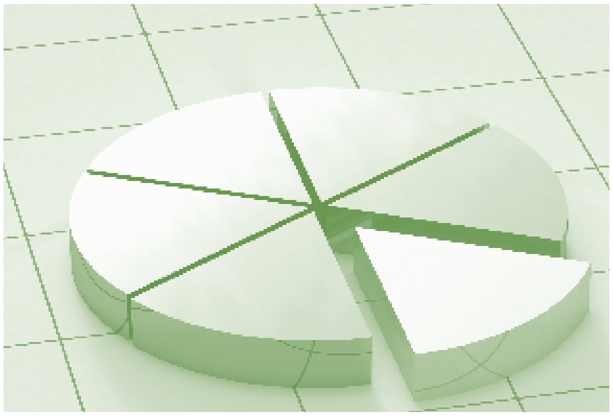
Table of Contents



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Preface

The Risk Management and Governance Board (RMGB) of the Canadian Institute of Chartered Accountants has commissioned this briefing to help directors understand the role of the Human Resources and Compensation Committee (the Committee) and how to assist it in functioning effectively. It is intended as an educational or reference tool for less experienced directors or those who are newly appointed Committee members. Experienced directors will likely be familiar with many of the concepts discussed in the publication but may still find it a useful guide to their duties and responsibilities as Committee members.

This publication discusses the evolution of HR and Compensation Committees, and provides a context for its members' changing role as the Committee expands its responsibilities to include broader HR issues. Some companies may not yet be significantly enhancing the Committee's agenda. However, the publication reflects changing business circumstances and resulting corporate governance adjustments arising in Canada, the United States, the United Kingdom, and across the globe as a result of the increasingly international business context and focus on global pay and performance. The publication also suggests ways in which the Committee can fulfill its oversight responsibilities in a proactive way in light of the changing executive pay and HR environment.

The RMGB acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, Lisa Slipp and Paul Hooper who wrote this document under their guidance, and the CICA staff who provided support to the project.

Brian Ferguson, CA
Chair, Risk Management and Governance Board

Introduction

When legislators, regulators, investors and others scrutinize boards of directors of public companies today, it is the board's Human Resources and Compensation Committee that is increasingly the focus of their attention, in much the same way that audit committees were in the spotlight a few years ago.

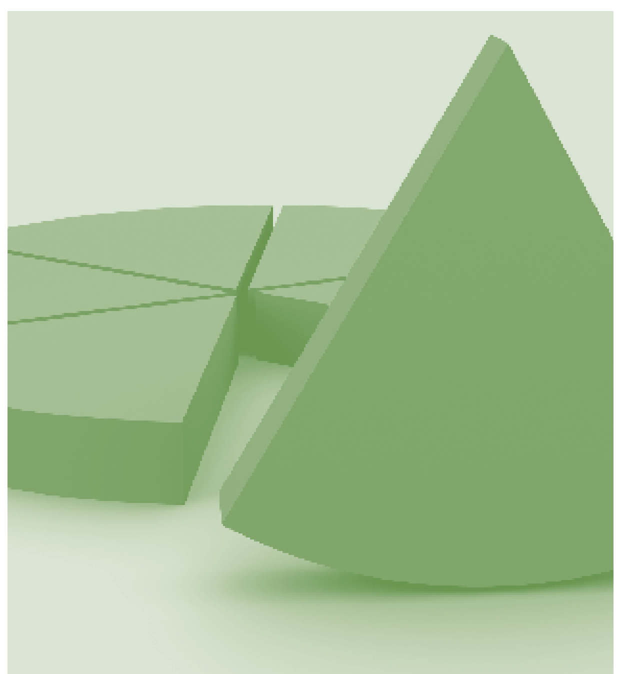
The role of the Human Resources and Compensation Committee (the Committee) is changing, and is becoming much broader than its core responsibilities of overseeing executive pay, incentive plans and succession planning in the context of the company's compensation philosophy, financial results and overarching business strategy. Issues of executive talent, performance and future leadership are top priorities for companies today, which is why Committees are focusing on the acquisition, development and retention of skilled, knowledgeable and experienced executives. And since a company's investment in its "human capital" is critical for staying ahead of the competition and driving business performance, many Committees have responsibilities that also cover other key human resource issues.

The way in which HR and Compensation Committees carry out their broader responsibilities and how well they perform under heightened scrutiny of their activities will set the stage for decisions about future legislative, regulatory and shareholder initiatives in the executive compensation area. Committees should remain focused on providing thoughtful input, rigorous oversight and measured approval. They should play an active part in shaping and approving executive compensation and other HR programs, but their role is neither to replace nor replicate the role of management, which is responsible for designing, recommending and ultimately implementing the company's human resource and compensation programs.

To help it carry out its responsibilities effectively, the Committee should:

- have a mandate or written charter of sufficient scope to ensure that current executive talent priorities and other strategic HR issues are raised in the course of its annual work plan;
- execute its mandate efficiently and effectively and fulfill all of the tasks delegated to it;
- include members who have the experience, independence, capabilities and competence to tackle the Committee's designated responsibilities; and
- interact appropriately and effectively with other relevant parties, including the full board of directors and other board committees, management, outside advisors and, possibly, shareholders, in the course of carrying out its responsibilities.

By paying close attention to its priorities as well as its fiduciary responsibility to the company, the Committee will be best able to discharge its duties on behalf of the board, increase its value to the company, and contribute to the success of the overall business. Also, by contributing their business expertise to broader human capital and talent issues, Committee members will help the company optimize a key company asset—its employees—and use them to their fullest potential.



Role and Responsibilities

1. Why and how should the Committee's role evolve?

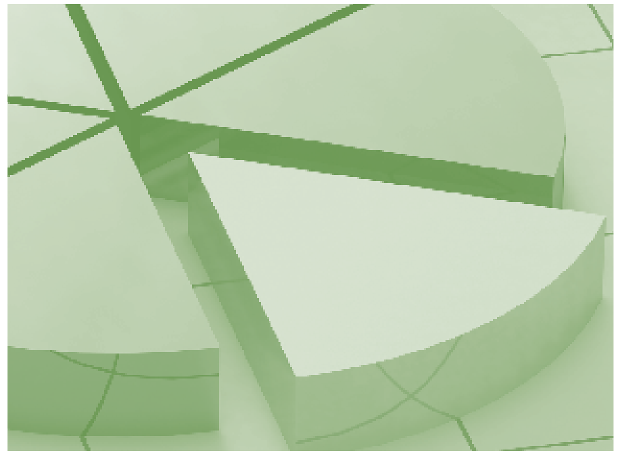
There tends to be a range of practices between larger and smaller companies; however, at most companies the HR and Compensation Committee's responsibilities typically include reviewing and recommending for approval:

- the company's overall compensation philosophy and all aspects of executive pay, including the level and mix of components;
- the selection of companies used for "benchmarking" compensation to competitors' pay;
- the chief executive officer's (CEO's) and other executives' pay and performance links;
- employment agreements, including termination and change-of-control provisions;
- equity and pension plan eligibility and design;
- equity award grant practices and shareholder dilution levels;
- share ownership and retention guidelines; and
- executive compensation disclosure.

At many companies, the mandate of the Committee has changed beyond these traditional responsibilities to:

- a more active "representative of the owner" role, rather than a reactive (that is, "review and approve") one; and
- focus more broadly on executive development and succession planning in addition to pay and performance evaluation.

For example, as issues around recruiting, retaining and managing executive talent receive greater attention from company management, the programs designed to attract executive talent, develop internal candidates, retain high performers and enhance their engagement are increasingly making their way onto the Committee's agenda. Often, the Committee is responsible for overseeing broader compensation and benefits programs since these programs are increasingly integral to recruiting and retention. Such programs may include all-encompassing severance and change-of-control programs; recruiting practices such as sign-on awards; succession planning for more than just the CEO;



executive and employee pensions; and employee and retiree benefits.

Further, as companies focus more on other high-cost or high-value human capital initiatives such as talent management, training and development, workforce and career planning, broad-based incentive program design and collective bargaining agreements, the focus of the Committee is evolving from one that has been almost exclusively centered on the top executives and their compensation to a broader examination of company-wide programs and key strategic HR issues. With changing employee demographics and the global "war for talent," some Committees are even discussing wide-ranging human capital issues, such as international recruiting, outsourcing and off-shoring. Since these expansive HR issues create significant risks and opportunities for many companies, management may benefit from discussion and input at the Committee level.

2. How might the Committee's expanding role affect its written charter?

As the Committee's role evolves, consideration should be given to whether or not changes should be made to its charter to reflect the Committee's additional responsibilities.

The Committee's charter should clearly describe the expectations of the Committee, its responsibilities, and how it functions. It should include sufficient detail so the Committee, other board members, management and shareholders understand the Committee's role and accountabilities. The charter should also provide some flexibility so the Committee's role may be altered to allow it to respond to new compensation and HR issues as they arise. At a minimum, the written charter should establish:

- the Committee's role, including the identification of specific executive positions whose individual compensation falls directly under the Committee's purview;
- the Committee's duties and responsibilities and how they relate to those of the full board, including the identification of matters for which the Committee approves versus recommends actions to the full board for approval;
- the Committee members' qualifications, appointment, rotation policy and removal;
- the Committee's structure and operations (including its authority to delegate to subcommittees);
- the Committee's use of and ability to hire, fire and approve the fees of outside advisors;
- the Committee chair's responsibilities and how the chair is selected; and
- the way in which the Committee conducts its annual performance self-evaluation.

A sample charter provided by the Bank of Montreal is presented in Appendix A.

3. How should the Committee evaluate the company's pay philosophy and executives' total compensation?

Evaluating executive pay is one of the Committee's fundamental responsibilities. The Committee and the board should work with management to establish the company's overarching compensation philosophy.

The company's pay philosophy should be a "living" document that is periodically reviewed and altered as circumstances require. The pay philosophy should clearly articulate the fundamental principles under which management, the Committee and the board set, review and approve compensation, but also be flexible enough to allow the company to respond to market and other business changes. Companies should describe their pay philosophy in their annual proxy circulars so shareholders can assess how the pay philosophy relates to their investment objectives and determine whether the company's executive compensation programs are aligned with its pay philosophy.

Total compensation should be evaluated for consistency with the company's pay philosophy as disclosed in the company's proxy circular. To further assist it in evaluating total compensation, the Committee should consider using the following tools:

- ***External benchmarks.*** To evaluate the reasonableness and appropriateness of compensation, many Committees consider comparisons to external benchmarks (i.e., compensation provided by a group of competitors) while exercising discretion to approve pay that is higher or lower than "market" depending on executive and company performance. Establishing a comparable peer group or selecting a compensation survey is typically done by a compensation consultant or management. The Committee should review and approve the selections and be comfortable with the comparisons. A note of caution: although peer group data is an important tool for evaluating executive pay, it should not be used in a vacuum. The data should be considered in the context of the company's business and labour market, which increasingly may be a global market.
- ***Internal pay equity analyses.*** Compensation plans that are not perceived to be fair internally can create conflict within the executive suite or with other employee groups. Therefore, in addition to using external benchmarks, pay levels should also be evaluated for fairness by assessing them against internal measures. An internal pay equity analysis can help the Committee compare compensation at all levels within the organization. The Committee should review *all* aspects of total remuneration to determine whether it is out of line with that of other executives and employees. For example, the CEO's cash compensation (salary and bonus) may appear to be fair, but when equity awards and post-employment benefits (including severance) are added to the pay fairness analysis, it may reveal ratios that are out of line with others. In addition, although perquisites are typically not a significant proportion of total remuneration, they sometimes raise concerns among employees and shareholders. Although there are no standards for what are considered appropriate ratios, the Committee should be sure to evaluate internal pay equity to help reinforce good employer-employee relations.
- ***Tally sheets.*** The Committee should annually assess all aspects of compensation in the

context of the company's performance and the performance of each executive. Tally sheets list each element of total remuneration including salary, annual and long-term incentives, retirement plan benefits, and other benefits and perquisites to provide a total figure for what an executive might receive under various performance and termination scenarios. Tally sheets are typically prepared by management or a compensation consultant, however the Committee should understand how they work and their importance in overseeing total pay. Tally sheets can help the Committee evaluate the reasonableness and appropriateness of each compensation element and its cost to the company. They can also be used to assess the overall value of compensation provided to each executive and how each element fits into the overall program and affects other aspects of compensation. Tally sheets can also provide an early estimate of what investors may see disclosed in the company's next proxy circular. (A sample tally sheet provided by Mercer is presented in Appendix B.)

- ***Wealth accumulation analyses.*** Wealth accumulation analyses are another tool the Committee can use to determine whether additional equity grants, severance or pension benefits are necessary or effective and whether the company's compensation programs and mix are consistent with its overall business strategy. Wealth accumulation analyses are similar to tally sheets but rather than just taking a compensation snapshot, they can be used to project accumulated wealth assuming different stock price scenarios, compensation increases, future equity awards, and growth in retirement benefits. They can also identify unintended consequences, such as providing executives with greater rewards if they leave the company rather than stay with it. The Committee can use wealth accumulation analyses to test the reasonableness of current pay decisions, and assess the impact of plan design features and the balance between executive wealth, increased shareholder wealth and company performance.

Enhanced proxy disclosure provides shareholders, the media and other employees with a better view of a company's total compensation for the year, and year-over-year. Committees, therefore, may want to expand their use of tally sheets and wealth accumulation analyses to evaluate the pay of *all* senior executives to determine if it is reasonable, defensible, necessary and effective (see Question 9 on the Committee's role regarding compensation disclosure).

FOR MORE INFORMATION, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT EXECUTIVE COMPENSATION*

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4. How does the Committee evaluate the pay-for-performance link?

Evaluating the pay-for-performance link has become a core responsibility of the Committee and it typically requires more than just demonstrating a relationship between pay and performance. Investors expect a company to pay an appropriate amount for performance that contributes to the company's long-term success and a sustainable increase in share value. When used properly and effectively to drive company performance, incentive compensation benefits both employees and shareholders. When this relationship is out of line, however, undue risks may arise: either the company's compensation costs may be too high, thereby reducing its bottom line, or the company may risk losing key executives if its pay levels do not sufficiently reward their good performance.

One important way to effectively link pay and performance is to set appropriate performance objectives for the CEO and the other executives. In reviewing the performance measurement process, the Committee should compare the goals selected for incentive plans with the objectives set out in the company's internal business plan (such as improving net income year-over-year), and the objectives of its qualitative strategic plans. That said, however, the Committee should not ignore opportunities that may arise for longer-term shareholder value creation, such as a merger or acquisition, even if it comes at the expense of short-term results. The Committee should also consider external indicators, such as a comparison of the company's performance to a peer group or the overall performance of its industry.

Plans that allow room for discretion provide the Committee with the flexibility to make adjustments in the event of unexpected or unusual market changes, such as a rapid transformation of the company's industry that results in peer group changes, when the company's performance has been affected by an unusual event or windfall, or when the company records negative returns for its shareholders even though its relative results are outstanding. Having room to adjust for these changes will better enable the company to retain its best talent during bad times.

Through discussions with management and the board, the Committee should satisfy itself that the performance targets it approves for incentive plans are challenging yet achievable. The goals should be established through a process of rigorous sensitivity analysis and "stress-testing" of projected financial results. Each goal should be clearly stated and identifiable so performance can be easily monitored against it. If the incentive plan includes threshold, target and maximum goals, the goals at each level should be set with consideration given to their probability of achievement, which may vary from one performance measure to another and from year to year.

It is important to remember that incentive plan formulas are effectively based on the use of discretion in advance of the facts so they should not be solely relied upon to produce the right results. Pay decisions should reflect all relevant facts and events, including those that could not have been foreseen when the formulas were set. Committee members should be prepared to use informed judgement to adjust formula-driven awards as appropriate. These discretionary adjustments should not be based on arbitrary decisions; instead, they should be determined through the application of informed judgment and common sense that can be explained in the proxy disclosure.

To evaluate the effectiveness of the pay-for-performance link, the Committee should review the effectiveness and appropriateness of the incentive plans and resulting awards, including:

- whether pay is awarded when the executive or company failed to meet goals (including documentary evidence that the Committee or the full board reviewed the CEO's and other executives' performance);
- the weighting on short- versus long-term goals;
- whether the plans are aligned with and balanced between the executives' interests and the company's interests;
- whether both qualitative and quantitative goals (and not just stock price) are considered; and
- whether all final decisions are made independent of management.

If the Committee's responsibilities include assessing incentive compensation plans for a broader group of employees, it should develop guidelines to assess the compensation principles set out by management, including whether:

- management has selected the right performance measures;
- the performance targets are challenging but achievable; and
- payouts properly reflect results achieved.

5. What is the Committee's role in overseeing the equity compensation program?

Equity awards are one of the most significant components of executive compensation because they can constitute a large proportion of total remuneration and, if the stock performs well, may generate substantial wealth for the executive. The board is responsible for overseeing the company's equity grant practices and for making decisions about equity awards to the CEO, other senior executives and all eligible employees in aggregate, though it may delegate this responsibility to the Committee. Sometimes, the CEO is also permitted to make certain grants within approved parameters. Due to the heightened attention paid to equity compensation in recent years, many Committees are taking a greater role in overseeing the use and administration of equity plans through equity grant guidelines, share value dilution analyses and share ownership guidelines:

- ***Equity grant guidelines.*** Many companies have adopted equity grant guidelines to address procedures for the timing of equity grants. These policies typically state who has the authority to grant equity awards and set out the procedures for documenting the awards that are granted and notification of the recipient. Companies should establish a regular grant schedule, with possible exceptions stipulated for new hire or promotional grants.
- ***Share value dilution analyses.*** Share value dilution is defined as the shares allocated to employee equity compensation plans as a percentage of the outstanding shares of the company. This has become an important focus for Committees, since shareholders

and proxy voting advisory firms evaluate dilution levels particularly when a new equity compensation plan is being submitted for shareholder approval. Committees should, therefore, carefully assess share value dilution when reviewing and approving equity awards to executives and other employees.

- ***Share ownership guidelines.*** To maximize the effect of equity grants in aligning management's interests with those of the shareholders, many companies adopt share ownership or retention guidelines (or both) that require executives (and often board members) to acquire and hold a certain number or value of company shares. The Committee should evaluate executive share ownership levels annually and determine whether the company's share ownership guidelines effectively align these interests.

The Committee should also perform a risk analysis of its equity award policies to evaluate whether they might encourage executives to take excessive risks or manipulate the company's stock price for the executives' short-term gain.

6. What is the Committee's role in talent management and retention?

Talent management is crucial to a company's success. In the global "war for talent," companies must be able to identify, develop and retain their best people, while also better managing those individuals who are underachieving. Although this has not traditionally been an issue of concern for the Committee, because of the importance of talent management to the company as a whole, many Committees now include it on their agendas. The Committee's role is to ensure that management has effective processes in place to:

- retain key employees;
- identify, train and reward high-performing and high-potential talent;
- align individual capabilities with business goals and strategies;
- manage underperformers; and
- build a strong talent pipeline for succession to key roles, most importantly the CEO.

Although the above activities are clearly the responsibilities of management, the Committee should oversee the process, understand the issues being addressed and lend assistance where appropriate. For example, although management should be most knowledgeable about the type of talent required by the company, since the talent market for top executives is no longer restricted by geography, locating that talent may not be a straightforward task. The Committee and other board members may be able to assist management in identifying qualified candidates in broader geographies who could be recruited to fill key positions.

Committee members may also be able to contribute ideas about new compensation methods or practices in other industries that management may wish to consider using to attract key talent or retain high performers. The Committee can also provide valuable input to assist management in determining whether certain compensation methods are appropriate and are likely to be successful in rewarding and retaining talent. For example, companies in the oil and gas industry often use broad-based equity to attract and retain employees at all levels. Similarly, financial services firms tend to use large bonus pools that are distributed quite broadly, well beyond top executives. The Committee can help management evaluate the size and distribution of these awards and determine whether they are necessary, appropriate and likely to be effective in rewarding and retaining talent.

Retaining key executives during a significant ownership transaction can be a particularly important agenda item for the Committee. It is important to address this issue early in the transaction process in order to maintain the stability of the executive team and preserve the expected value of the deal. The Committee can assist by determining:

- which executives are critical to retain;
- whether the current programs would be effective in retaining them (or might encourage them to leave);
- the size of potential retention awards; and
- the overall cost of the retention program.

Other issues that the Committee and management should address in conjunction with legal counsel and outside consultants include the future of employment agreements and long-term incentive programs after the transaction is completed, and the cost of severance payments triggered by the transaction. If the company is merging with another organization that has differing pay policies, the Committee should assess these policies and ensure that management implements consistent, fair and competitive policies after the merger. In cases of an international merger, the Committee must also consider the assimilation of compensation norms and differing pay levels and provide input to management in determining whether pay should be set according to a global or local scale and whether the company should use similar compensation vehicles throughout the new global organization.

Another way in which the Committee, together with the full board, may be able to assist the company in fighting the global talent war is by providing input to decisions about off-shoring or outsourcing work for which talent is not readily available in the company's primary labour market. These types of arrangements are becoming more prevalent and are increasingly critical to the success of companies in the global marketplace. For example, the Committee might review management's recommendations on relocating facilities to a different geography to take advantage of available talent.

7. How can the Committee contribute to leadership development, diversity and succession planning?

Companies need effective leadership to achieve the goals of the business. An important role of the Committee, therefore, is to oversee the company's leadership development and succession planning programs to ensure that they are effective in building and retaining future talent and that they support diversity within the leadership ranks.

Developing leaders who can operate effectively in multiple geographies and have an understanding of a variety of cultures is an imperative in the current global business environment. The Committee may be able to assist management in developing both global leaders and local leaders with a global perspective who are needed to run companies in a rapidly changing global environment. The Committee should help the company focus on developing leaders who understand the risks and opportunities of expanding into and operating in worldwide markets and who appreciate a diversity of experience and capabilities within the workforce. While it is already important today, in the future it will be even more critical for management to consider ethnic, cultural, geographic and gender diversity in its ranks to strengthen the company's collective capabilities. A diversity of perspectives enhances decision-making because it brings a wider understanding of the various needs and market drivers that affect employees and customers around the globe.

Many Committees, together with their full boards, are taking on broader oversight of the smooth transition of executives. With their knowledge of the company's business strategy and plans, Committee and board members can actively participate, alongside management, in evaluating and helping to develop succession plans to manage executive talent at *all* levels. The Committee can also play an important role in developing plans to retain critical talent that may be wooed away by a competitor.

An executive succession plan should:

- require the Committee to work with the CEO each year to develop a set of criteria for the skills and competencies needed to execute the company's long-term strategy;
- establish an objective framework for finding the talent that meets the company's evolving needs (with particular focus on internal talent);
- include a strategy for developing and monitoring top talent internally, including identifying needs for training, on-the-job experience and leadership development as well as establishing career development programs;
- set out a non-emergency succession plan and require that the company's emergency succession plan be reviewed annually; and
- require the Committee to annually review and make recommendations to the full board regarding the status of the succession plan.

It is important to note that a succession planning policy that supports *internal* succession may avoid some of the problems associated with outside recruiting, such as the possible need to pay an outside candidate more than the company would normally pay; internal inequities caused by different pay levels; and difficulty retaining current executives who feel they were not given a fair opportunity to be considered as a potential successor.

FOR MORE INFORMATION, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT CEO SUCCESSION*

8. What is the Committee's role in approving employment agreements, including severance and change-of-control benefits?

The Committee's role is to act on the board's behalf to shape and recommend the CEO's employment contract and oversee management's negotiation of employment contracts with other key executives, particularly with respect to severance provisions.

Recent high-profile cases have brought to light significant payments made to departing executives even where their tenure was short and fraught with controversy and poor performance. Committees and management at many companies are now carefully evaluating the potential severance payments for all senior executives to determine whether they are appropriate.

When hiring a new CEO or other executive, the Committee should consider whether a contract is appropriate and, if so, how long it should remain in effect. Committee members should understand the contract's provisions, particularly any guaranteed bonus payments, "evergreen" provisions that continue to extend the contract, and potential payments in the event of termination or a change of control of the company.

Tally sheets (see Question 3) will help the Committee determine the extent of potential payments that executives may receive upon termination under a variety of scenarios. From this analysis, the Committee can ascertain the size of these amounts and their possible effect on the company's bottom line. Since investors will use proxy disclosures to form their own conclusions about the significance of these potential payments, the Committee should be confident of the rationale for providing them.

9. What role should the Committee play with respect to compensation disclosure?

The disclosure of compensation awarded to senior executives has been, and continues to be, a key focus of both regulators and investors. The stated objectives of the disclosure are "to communicate the compensation the board of directors intended the company to pay" and to "provide insight into executive compensation as a key aspect of the overall stewardship and governance of the company" and "help investors understand how decisions about executive compensation are made"[1].

> The Compensation Discussion and Analysis is a narrative that discusses compensation policies and decisions and analyzes the significant elements of executive pay.

The annual proxy circular should disclose all facets of the compensation program, including a total remuneration figure and a discussion and analysis of the "how" and "why" of the company's pay decisions. The disclosure should outline the company's executive compensation policies and pay levels and provide a discussion of and the rationale for each element of total remuneration (such as base salary, annual incentives, long-term incentives, retirement benefits, severance benefits and perquisites). Specifically, the disclosure must discuss:

- the objectives of the compensation program;
- what the program is designed to reward;
- the specific elements of compensation and why each element was chosen;
- how the amount of compensation was determined; and
- how each element, and the company's decisions about each element, fit into the company's overall compensation objectives and how those decisions affect decisions about other elements.

The Committee is not responsible for drafting the compensation disclosure. It does have a critical role in reviewing the disclosure to be satisfied that it accurately reflects the decisions that were made by the Committee and the board and the rationale for those decisions. The Committee should work closely with the audit committee to coordinate the compensation disclosure with the company's financial and other disclosures.

To demonstrate responsible decision making, the disclosure provided in the Compensation Discussion and Analysis should clearly explain the Committee's rationale for its decisions. The discussion of the Committee's deliberations should, therefore, be sufficiently documented in the Committee's meeting minutes (see Question 16) to ensure that this rationale is properly captured for purposes of the proxy disclosure.

[1] Form 51-102F6 *Statement of Executive Compensation*

The disclosure of executive compensation is also an opportunity to tell the company's own compensation story and demonstrate strong pay governance practices. As a result, the Committee may wish to supplement the disclosure that the company is required to provide with additional information and explanation to give investors a better understanding of the approach taken by the company and the role of the Committee and the board. Often, companies will use the pay disclosure in their annual proxy circular as a means of demonstrating strong pay governance practices to shareholders and employees.

10. What is the Committee's role in pension plan design and administration?

The design and administration of pension plans are typically the responsibility of a combination of board committees, including the pension committee (if there is one at the board level) and the audit and compensation committees, with ultimate responsibility resting with the full board. The board's role is to determine the type of pension plans to offer and the size of the benefit, while day-to-day operation of the plans is typically delegated to a plan administrator. The type of plan should be appropriate for the nature of the company, be competitive in its industry, and be properly communicated to eligible participants.

Pension plans sometimes present major challenges, particularly for smaller pension funds that outsource significant functions. If the outside plan administrator does not communicate sufficiently with the company in its role as pension plan sponsor, this may leave a void that either the board or Committee should try to fill in order to oversee the plan's proper functioning.

Other issues the Committee should address include:

- ***Conflicts of interest.*** The board should confirm that the plan's legal, contractual and fiduciary obligations are being met and that concerns about conflicts of interest are addressed; this is particularly important in larger organizations where the company is typically both the plan sponsor and plan administrator and the two roles may have different interests. The pension plan's governance policies should provide management and the board with guidance in properly resolving potential conflicts. The Committee should work closely with the pension and audit committees to divide responsibilities for the plan and monitor compliance with it.
- ***Plan design and funding issues.*** The audit or pension committee may have responsibility for monitoring the company's exposure to the funding and investment risk for defined benefit plans sponsored by the company. The Committee should clearly understand how decisions related to the plan design affect these risks. Although employees bear the investment risk with defined contribution plans, the Committee should understand the company's responsibility for selecting the investment managers and investment alternatives and for educating employees.
- ***Supplemental plans.*** Supplemental retirement plans can provide a valuable benefit to executives and can be helpful in attracting and retaining executive talent. The Committee should understand the design, funding issues and specific risks associated with these plans so it can determine whether the benefits provided by these plans are properly aligned with the other components of executive compensation and with the company's overall compensation objectives.

The Committee's decisions about pension plan design and any concerns it has about conflicts of interest, funding or plan administration should be reported to the full board.

FOR MORE INFORMATION, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT THEIR ROLE IN PENSION GOVERNANCE*

Composition and Qualifications

11. What are the independence requirements for Committee members?

Unlike audit committee members, there is no requirement under Canadian law for HR and Compensation Committee members to be independent. Nevertheless, it has become the *de facto* standard for Committee members to be independent. To determine whether individual Committee members are independent, the Committee should consider the following factors:

- ***CSA recommendations.*** Notwithstanding the lack of regulatory requirements, the Canadian Securities Administrators (CSA) recommend that compensation committees be composed entirely of independent directors. Both the CSA's recommendations and current best practices have led most companies to have fully independent Committee members.
- ***Proxy disclosure.*** A company must disclose in its proxy circular whether or not its Committee members are independent. If there are non-independent members, the company must disclose the measures it has taken to ensure an objective process for making compensation decisions.
- ***Personal relationships.*** Close relationships between management and the Committee raise concerns about the integrity of the process for setting senior executive pay. In assessing independence, the board should consider whether a director has family, personal, or business relationships with the company (or management) and the nature of these relationships. Sometimes personal relationships between Committee members and management are unavoidable because companies often choose directors with industry experience. In these situations, it may still be appropriate for such directors to serve on the Committee because the company may benefit from the director's relationships with other industry leaders.
- ***Safeguards.*** Because it may be difficult to establish complete independence from management, the Committee should adopt certain safeguards to maintain the integrity of its decision-making process. For example, the Committee should interact with management about certain issues to receive its input, such as the company's strategic objectives when assessing how executive pay is linked to business goals. However, when the Committee or the full board makes decisions related to the CEO's compensation, this should occur at *in camera* meetings when the CEO and other members of management are not present.
- ***Independent thinking.*** In addition to meeting the objective criteria for independence, Committee members should also be of independent mind. They must be willing to challenge the opinions of other Committee and board members, as well as the decisions of management. They should also be willing to state their opinions, argue for what they believe is best for the company and defend the Committee's decisions to management and shareholders, as appropriate.

According to good governance practices, Committee members should not be unduly influenced by management since the Committee sets management's compensation.

12. What capabilities and competencies should Committee members possess?

The qualifications for Committee members are not prescribed by a regulatory body. However, it would be prudent for all members to comprehend the issues and ramifications of compensation and human resource policy decisions and plan designs. At a minimum, members should:

- have an understanding of compensation and other human resource issues, in addition to specific company or industry knowledge;
- have at least one Committee member with compensation expertise, for example through prior experience as a CEO or human resource executive;
- be willing to learn and be committed to devoting the necessary time and attention to make thoughtful, educated decisions about compensation matters;
- have up-to-date knowledge of the strategic and technical aspects of performance measurement and compensation, including the pros and cons of various equity vehicles;
- have a general understanding of the proxy disclosure rules and other legal requirements affecting executive compensation; and

- be aware of emerging compensation trends and issues applicable to the company and its industry.

With the role of the Committee expanding into broader HR issues, Committee members should also have some familiarity with best practices in talent management, succession planning and leadership development. To help in addressing these matters, some Committees are adding directors with HR experience to their ranks, although they are still a small percentage of total directors. In addition, with the globalization of the business and economic marketplace, directors who have cross-border or international experience — or at least a global perspective — are valuable additions to most boards and Committees.

FOR MORE INFORMATION, SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT BUILDING A BOARD*

13. How can education and training enhance the Committee's effectiveness?

Orientation programs and continuing education can help Committee members effectively address the complex compensation and HR issues that arise at many companies today. Compensation plans and programs are more difficult to understand today than ever before and the close attention that shareholders and the media pay to compensation issues has raised the question as to whether Committee members are up to the challenge. Although many boards have general education sessions for directors and orientation programs for new members, Committee members may require specialized instruction in order to give them a complete understanding of the company's pay policy and plans.

Specialized training programs for Committee members should educate them about the way in which the company's compensation program is aligned with its pay philosophy and business strategy. They should also be designed to help Committee members understand the fundamental issues that have brought compensation matters into the spotlight and encourage the brainstorming of possible solutions to these broader issues, as well as those that specifically affect their company. The programs should also address the key attributes that apply to any well-functioning Committee, including the importance of an effective charter, proper procedures and well-defined roles and responsibilities.

Specifically, education and training for Committee members might cover:

- the company's organizational culture and compensation philosophy;
- the way in which the CEO's and other executives' performance is managed and evaluated;
- succession planning and the executive appointment strategy;
- the way that compensation levels and performance targets are set;
- the way compensation plans are designed;
- compensation disclosure and reporting requirements;
- advice on how to work with compensation consultants; and
- issues related to talent and HR risk management.

Committee members may also want to participate in director education programs sponsored by local universities and director associations. An in-house curriculum sponsored by the company's HR management, legal advisors or compensation consultants could provide supplementary instruction on specific compensation topics as well as the details of the company's own plans and programs and the rationale behind them. In addition, company management could be periodically called upon to update the Committee on new compensation strategies and legislative changes that might affect its decisions.

Process and Procedures

14. How should the Committee's annual work plan and agenda be structured?

With a well-defined charter and qualified members, the Committee is well positioned to discharge its responsibilities. In addition, however, it will also require explicit and clearly understood processes, including an annual work plan, meeting schedule and agenda, if it is to execute its responsibilities effectively.

- ***Annual work plan.*** The Committee charter should be translated into an annual work plan with a meeting schedule published a year in advance so Committee members can understand the timeline and their work expectations. It is also important to clearly lay out in advance the appropriate expectations with respect to member duties, length of meetings, preparation requirements and time allotted to major topics. Specifying these expectations ahead of time helps enhance the Committee's efficiency since it provides all members with the opportunity to prepare and be equipped and ready before each meeting. The work plan should cover performance reviews, salary changes, and bonus and long-term incentive awards; succession planning review; an overall review of HR strategy and broad-based compensation; market competitiveness evaluation; and Committee self-assessment. (A sample Committee work plan is presented in Appendix C.)
- ***Meetings.*** The Committee should meet regularly, typically three or four times a year. Each meeting should have a set agenda. At its first meeting of the company's fiscal year, the Committee would usually determine annual bonuses for results realized during the previous year (although it may assess results to-date throughout the year), and choose performance metrics and set goals for the current year. At least one meeting should be devoted to reviewing the company's overall rewards strategy and programs, the way they fit within the current compensation and business environment, and how that might change in the future. *In camera* sessions (without management present) should also be a part of each Committee meeting.
- ***Agenda.*** Committees are taking a more active role in preparing their agendas than they have in the past. Many Committee chairs develop forward-looking and comprehensive agendas to be followed as closely as possible. The agenda should include a review of items such as: attraction and retention issues; succession planning; CEO performance as it relates to compensation; compensation trends; and agreements (such as those addressing retirement benefits, retention bonuses, and severance and change-of-control benefits).

When major decisions need to be made, multiple meetings should be arranged to provide Committee members with sufficient time to understand the issues, request additional research and analysis if needed, and carefully consider the alternatives. This is sometimes called the "two or three meeting rule" and it gives Committee members a chance to conduct a systematic evaluation of important compensation matters and establish a thorough and thoughtful decision-making process. Allotting adequate time to significant topics gives the Committee an opportunity to properly consider and debate issues with management and each other. For example, the Committee may need extra time to debate the appropriateness of compensation plans that have been used in the past but may no longer be necessary or effective, such as perquisites or overly generous severance plans. These may need to be *in camera* meetings, without management present.

15. What is the role of the Committee chair?

An effective Committee chair is essential to the overall effectiveness of the Committee and its ability to handle various HR and compensation matters. Specifically, the chair should:

- be a strong and active leader as well as independent and objective;
- be a good listener who is able to draw out opinions from other Committee members;
- be experienced in or have an understanding of executive compensation and strategic HR issues;
- be able to conduct orderly and efficient meetings according to the agenda;
- brief the full board and management on Committee decisions; and
- be available to management, other board members and possibly shareholders to

answer questions about compensation and other HR topics.

One of the chair's most important tasks is to set the tone for Committee meetings to encourage fair and active debate on the matters at hand and to monitor conflicts of interest. With the increased scrutiny given to executive compensation decisions and pay-for-performance links, Committees and their chairs are now clearly in the spotlight. Shareholders and the media will look closely at who is in charge and the way in which the Committee makes its decisions.

As a result of this attention, Committee chairs are taking an active role in requesting and reviewing materials that are presented and discussed at each meeting. To provide for independent decision-making, the chair should take care that the CEO does not have undue influence over the issues the Committee chooses to address or its deliberations or decisions, particularly when they affect the CEO's pay and benefits. This presents the chair with a very fine line to walk, since the chair has to work collaboratively with the CEO and management to act in the best interests of the company.

The chair's role as a liaison between management and the Committee is of increasing importance given the expanding role of the Committee. Many Committee chairs, therefore, have "pre-meetings" with management, compensation consultants and other advisors in order to prepare for the full Committee meeting.

16. How should the Committee document its decision-making process?

The Committee's decision-making process should be accurately documented through written minutes and board materials that indicate what was presented, considered and decided. The minutes and board materials *may* include:

- key points made in support of, and opposing, each action or decision in order to demonstrate due consideration given to important issues;
- advice from outside experts, including full reports such as peer group benchmarking and survey data reports;
- documentation of important communications and decisions with respect to the hiring, compensation and firing of senior executives;
- copies of draft and final employment and other compensation agreements presented to the Committee;
- a record of the time devoted to deliberating decisions on significant issues, such as bonus amounts and equity award levels;
- documentation of the performance of senior executives; and
- documentation to back up the Committee's performance evaluations and pay decisions.

Having the proper documentation of the key issues considered, the decisions made and the rationale for those decisions will make the task of preparing the compensation disclosure easier and provides evidence that the Committee members have properly discharged their fiduciary duties.

17. Why should Committee self-evaluations be conducted?

An important aspect of the Committee's annual work plan is its annual evaluation of its own performance and effectiveness. In reviewing its performance, the Committee should identify its strengths and weaknesses and develop methods for improving its performance. The committee's evaluation should also include an evaluation of each member's effectiveness and whether each member has the time and skills to help fulfill the Committee's mandate. Such an evaluation may highlight any necessary membership changes or members who need additional training. The Committee should also consider matters relevant to its performance as a whole, such as the:

- manner in which matters are discussed or debated;
- adequacy of the number and length of Committee meetings;
- independence requirements and qualifications of members;
- adequacy of the Committee charter;
- appropriateness of Committee members and their skills;
- effectiveness of the Committee chair;
- value of the Committee's outside consultants and advisors; and
- adequacy and quality of the information and recommendations presented by the Committee to the board.

The Committee should report and explain the results of its self-evaluation to the board.

Interactions with Others

18. How can the Committee optimize its interactions within the company?

To execute its duties effectively, the Committee must have a good working relationship with a representative of each relevant functional area (such as HR, finance and legal) within the company and with the members of other board committees. These relationships are necessary so the Committee can take advantage of these individuals' expertise and knowledge, particularly on CEO compensation issues.

The Committee should meet regularly with senior management and it may dictate the way this interaction should occur. For example, the Committee may request that management formally present information on compensation and HR issues at Committee meetings or it may prefer to have management interact with Committee members on a less formal basis.

- ***Senior functional representatives.*** The Committee's relationships with senior functional representatives are important but must be carefully managed since these individuals report directly or indirectly to the CEO. As a general rule, the Committee should confer with management regarding information related to the company's unique business and cultural context, and consider this perspective when overseeing key HR and pay policies and practices. Since this knowledge will shed light on the potential implications for HR and compensation program design, it is an important input to the Committee's decisions.
- ***HR department.*** The HR department can be a valuable resource for the Committee on a variety of issues, including succession planning, leadership development, equity plan administration and performance evaluation. Accordingly, the Committee should have regular opportunities to meet with members of the HR department who understand human capital and executive compensation issues. The HR department can also help keep the Committee apprised of new rules and regulations that might affect the Committee's decisions. Senior HR officers should have an enhanced role in the process of determining CEO compensation. Ideally, the Committee should have a say in filling the top HR position and in his or her performance evaluations, since the Committee is expected to work closely with this individual. If the Committee's role has expanded to include a review of compensation and benefits deeper into the organization, its relationship with the HR department becomes more critical.
- ***Corporate secretary.*** The Committee chair should work closely with the corporate secretary to ensure the adequate and timely flow of information to Committee members, particularly with respect to Committee meetings, and to the full board.
- ***Other board committees.*** The Committee should communicate with other board committees, particularly the audit committee. The Committee must work with the audit committee in setting financial objectives for incentive-based compensation plans to ensure that the plan objectives are aligned with the company's strategic financial objectives. It is important for Committee members to understand the company's financial object-ives, how they are reported and how they relate to compensation vehicles and amounts. One way to increase coordination between the two committees is to have some overlapping members who can share knowledge across committees. Communication through shared reports and minutes as well as conversations between committee chairs can also facilitate this essential interaction. Compensation may be an area of financial risk which the audit committee would have to consider, including issues around incentive compensation plans that may encourage executives to take excessive risks, option grant practices, proxy disclosure and high compensation costs. For example, situations that might encourage an executive to take excessive risks might include an incentive program that rewards executives for significant growth accomplished through an acquisition, or a plan with a significant payout if a short-term performance threshold is achieved.
- ***Full board.*** The Committee should present the information it acquires and the decisions it makes to the board of directors. At meetings of the full board, all the individual committees should have an opportunity to report on their decisions and answer questions. This process will also help the Committee determine whether it should reach out to other committees to gather information when addressing issues that may concern them.

19. How should the Committee use external advisors?

The Committee's charter should provide the Committee with the authority to hire and fire outside advisors at its own discretion. This ability to draw on outside expertise (such as consultants and lawyers) is important to the Committee's success since these advisors can assist the Committee in performing its various functions, especially in areas where the Committee lacks the necessary expertise.

For example, a compensation consultant can assist the Committee by:

- evaluating the competitive positioning of executive compensation relative to peers and the broader industry;
- advising on performance measures and target award levels for annual and long-term incentive plans;
- assessing the alignment of compensation relative to the results that are achieved;
- advising on pay trends among peers and within the industry;
- evaluating the impact of equity programs on annual share use and dilution;
- reviewing the tally sheets of total compensation that have been developed by the company;
- evaluating the company's share ownership guidelines; and
- assisting with the compensation disclosure for the annual proxy circular.

Ensuring the objectivity of consulting advice on executive compensation is a corporate governance issue that is critical to the company and the Committee. The Committee and the company should establish clearly defined relationships with consultants and other advisors in order to manage potential conflicts of interest and maintain the integrity of their advice. For example, compensation consultants who advise the Committee should have a direct reporting relationship to the Committee. The Committee should have absolute authority to hire, fire, and approve the fees of its advisors. At the beginning of each engagement, the consultant or advisor should establish with the Committee and the company a clear mutual understanding of the advisor's role and reporting relationship. In evaluating a consultant's objectivity, some companies consider other work performed by the consultant and the fees received for that work. Some have pre-approval policies that require the board to approve in advance other work that the consultant is asked to perform for the company.

An engagement letter should document the key elements of the consultant's or other advisor's assignment and relationship, including roles, responsibilities, scope of services, fees, timeframe and reporting relationships, including how and to whom information and recommendations are to be communicated. The Committee should review each relationship annually to evaluate whether it continues to best serve the Committee's interests and facilitates the objectivity of the advice. The Committee should discontinue relationships with advisors where an apparent or actual conflict exists that could impact the quality or objectivity of the advice and that conflict cannot be resolved.

20. How should the Committee interact with shareholders?

Interactions with shareholders are increasingly important, especially since some investors are beginning to approach boards directly for information about or an explanation of executive pay decisions. "Say on pay" refers to a nonbinding shareholder vote on the company's executive compensation program as disclosed in its proxy circular. The say on pay movement is growing in Canada, and a number of boards have agreed to hold annual advisory votes on executive pay. The Committee should be prepared to address shareholder questions and concerns, particularly about the link between pay and performance.

- ***Committee's role.*** Shareholder communications are generally the responsibility of management, with the CEO and CFO having the primary interactions with shareholders. With issues relating to board governance, oversight, and the performance and compensation of the CEO and, possibly, even the CFO, the board and its chair (and perhaps even the Committee and its chair) have a key communications role. The Committee may, therefore, want to consider modifying its charter to incorporate a plan for communications with investors. Committee members should attend the annual shareholder meeting and thoroughly brief the board chair in advance about executive pay issues, so he or she will be prepared to answer any questions that may arise. The Committee may also wish to host a separate forum or set up a website where investors can comment, ask questions or express concerns about compensation-related matters.

- ***Investor input.*** Because of shareholders' dissatisfaction over executive pay, many investor groups, including institutional shareholders and proxy voting advisory firms, are looking to provide greater input into companies' executive compensation programs. If shareholders do not consider the executive pay program to be reasonable, defensible and properly linked to company performance, they may demand that the company rein in what they view as excessive pay or question the way that pay is linked to performance. The Committee should establish a process under which its chair would receive investor input and respond to investor concerns. The company or the Committee may even want to seek out investor input on the company's compensation programs and decisions through annual meetings with the company's largest institutional investors, to the extent permitted by law.
- ***Disclosure.*** If shareholders do not completely understand the context in which compensation decisions are made, they may question the Committee's decisions. To avoid this, the company's compensation disclosure in the annual proxy circular should adequately explain the rationale behind the Committee's decisions and provide sufficient detail about the programs to enable shareholders to make informed judgments about the company's pay plans and individual compensation packages.

Conclusion

HR and Compensation Committees are now in the spotlight because of recent concerns about excessive executive pay and sometimes questionable corporate governance practices. By taking a hard look at their policies and procedures for setting executive pay, and by focusing on an enhanced role with respect to the oversight of other critical HR and governance issues, Committees should be able to make better and more defensible decisions to support the company's overall strategic objectives.

Appendix A: Sample Committee charter from Bank of Montreal

BANK OF MONTREAL HUMAN RESOURCES AND MANAGEMENT COMPENSATION COMMITTEE CHARTER

PURPOSE

The Committee is responsible for performing the duties set out in this Charter to enable the Board to fulfill its oversight responsibilities in relation to the Bank's:

- recruitment, development and retention of its workforce;
- appointment, performance evaluation and compensation of the Chief Executive Officer and other Senior Executives;
- succession planning relating to Senior Executive and other key Executive positions including appointments, reassignments and terminations;
- compensation structure for Executives including annual, mid-term and long-term incentive plans and incentive plans involving share issuances or share awards;
- benefit plans for Executives and pension plans; and
- share ownership guidelines for Executives.

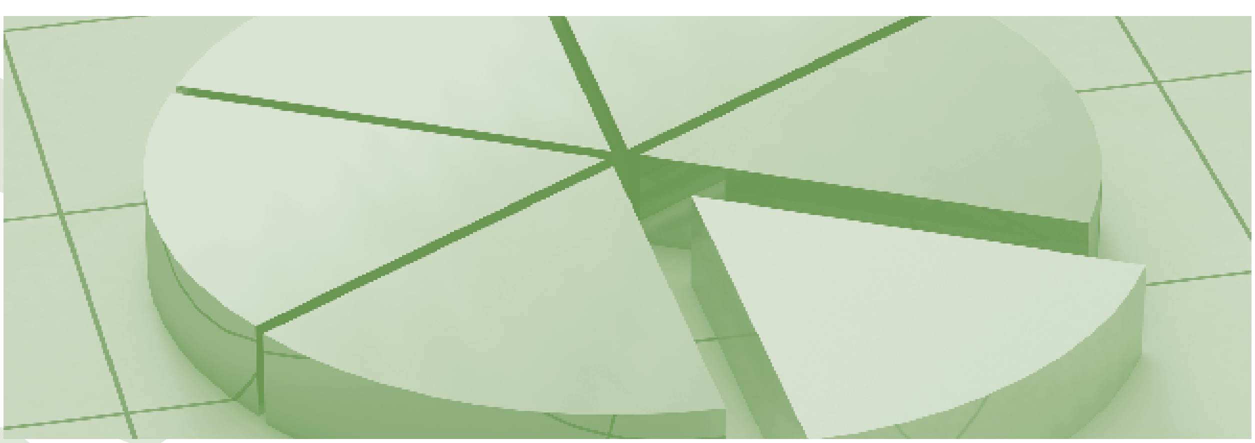
MEMBERS

The Committee shall consist of three or more Directors as determined by the Board. At least a majority of the members of the Committee shall be resident Canadians and not "affiliated" with the Bank for the purposes of the Bank Act (Canada). Each member of the Committee shall be:

- a Director who is not an officer or employee of the Bank or an affiliate of the Bank; and
- "independent" for the purposes of applicable Canadian and United States securities laws and the New York Stock Exchange Rules.

The Board shall, having considered the recommendation of the Governance and Nominating Committee, appoint the members of the Committee and the Chair of the Committee annually following the meeting of the shareholders at which Directors are elected each year. The Board may appoint a member to fill a vacancy which occurs in the Committee between annual elections of Directors and increase the number of Committee members as it determines appropriate. If a member of the Committee becomes "affiliated" with the Bank for the purposes of the *Bank Act* (Canada), the member may continue as a member of the Committee with the approval of the Governance and Nominating Committee, in consultation with the Bank's Executive Vice-President and General Counsel. Any member of the Committee may be removed or replaced at any time by the Board.

In addition to any orientation provided by the Governance and Nominating Committee, the Chair of the Committee shall provide orientation to new members of the Committee with respect to their duties and responsibilities as members of



the Committee. All members of the Committee shall have, or acquire within a reasonable period of time following their appointment, a thorough understanding of issues related to human resources and compensation with particular emphasis on executive compensation.

MEETINGS

The Committee shall meet as frequently as it determines necessary but not less than once each quarter. Meetings may be called by the Chair of the Committee or any two members of the Committee. The Chair of the Committee must call a meeting when requested to do so by any member of the Committee.

Notice of the time and place of each meeting of the Committee, other than an ad hoc meeting, shall be given to each member not less than 48 hours before the time when the meeting is to be held. A quorum of the Committee shall be a majority of its members. The powers of the Committee may be exercised at a meeting at which a quorum of the Committee is present and at which a majority of the members present are resident Canadians in person or by telephone or other electronic means or by a resolution signed by all members entitled to vote on that resolution at a meeting of the Committee. Each member is entitled to one vote in Committee proceedings.

Notice of the time and place of ad hoc meetings shall be given to each member thereof not less than two hours before the time when the meeting is to be held. Where a quorum of members of the Committee is not available for such a meeting, the Secretary of the Committee shall call upon such other members of the Board as are required to achieve the Committee's quorum requirements.

The Chair shall preside at all meetings of the Committee at which he or she is present and shall develop the agenda for each Committee meeting. The agenda for each meeting of the Committee, other than an ad hoc meeting, shall be delivered to each member of the Committee at least 48 hours prior to any meeting of the Committee, together with such other materials as the Chair determines necessary. The Chair shall designate from time to time a person who may, but need not be, a member of the Committee, to be Secretary of the Committee. Minutes shall be kept of all meetings of the Committee and shall be maintained by the Secretary of the Committee.

The procedure at meetings is to be determined by the Committee unless otherwise determined by the By-Laws of the Bank, by a resolution of the Board or by this Charter.

The Committee shall meet before and after each meeting with only members of the Committee present. The Committee may invite any Director, officer or employee of the Bank or the Bank's counsel or any other person to attend meetings of the Committee to assist in the discussion and examination of the matters under consideration by the Committee.

REPORTS

The Committee shall report the proceedings of each meeting and all recommendations made by the Committee at such meeting to the Board at the Board's next meeting. The Committee shall make such recommendations to the Board as it may deem appropriate and shall have such decision-making authority as the Board may determine from time to time. The Committee shall monitor major regulatory developments, significant shareholder initiatives and requirements related to executive compensation, assess the impact of changes in regulatory requirements on disclosure, and review and approve the report of the Committee and all other executive compensation disclosure to be included in the Bank's information circular and such other reports relating to the activities of the Committee as may be required by the Bank or the Board from time to time.

RESPONSIBILITIES AND DUTIES

The Committee shall perform the duties set out in this Charter and shall perform such other duties as may be necessary or appropriate under applicable law or stock exchange rules, or as may be delegated to the Committee by the Board from time to time, including such duties as are specified in the Bank's Board Approval/Oversight Guidelines. The Committee may from time to time appoint a subcommittee of the Board or an individual Committee member, to consider any matter which falls within the mandate of the Committee and to make recommendations to the Committee.

Recruitment, Development and Retention of the Workforce

The Committee shall:

- review bi-annually the Bank's Human Resource Corporate Policies;
- consider and as appropriate work to align compensation principles and policies with recruitment and retention strategies.

Appointment, Performance Evaluation and Compensation of the Chief Executive Officer

With respect to the Chief Executive Officer of the Bank, the Committee shall:

- review annually and approve changes, as appropriate, to a position description for the Chief Executive Officer, setting out the Chief Executive Officer's authority and responsibilities;
- review annually and as appropriate approve performance targets and corporate goals and objectives that are relevant to the Chief Executive Officer's compensation;
- conduct an annual assessment of the Chief Executive Officer's performance in meeting his or her performance targets and corporate goals and objectives
- assess annually the "tone at the top" set by the Chief Executive Officer through his or her business ethics, conduct and integrity;
- make recommendations for approval by the independent members of the Board on the Chief Executive Officer's compensation, based on the evaluation referred to above, including any changes to base salary, and any individual award allocations under annual mid-term and long-term incentive plans and under incentive plans involving share issuances or share awards;
- review and as appropriate approve the granting of perquisites to the Chief Executive Officer;
- review share holdings of the Chief Executive Officer relative to the share ownership guidelines established by the Committee, including current holdings of share-equivalent units;
- make recommendations for approval by the independent members of the Board on the appointment of a new Chief Executive Officer or the dismissal of the existing Chief Executive Officer;
- consider and as appropriate approve any agreements, including those addressing retirement, termination of employment or other special circumstances, between the Bank and the Chief Executive Officer, for execution by the Committee's Chair; and
- recommend to the Board remedial action where necessary.

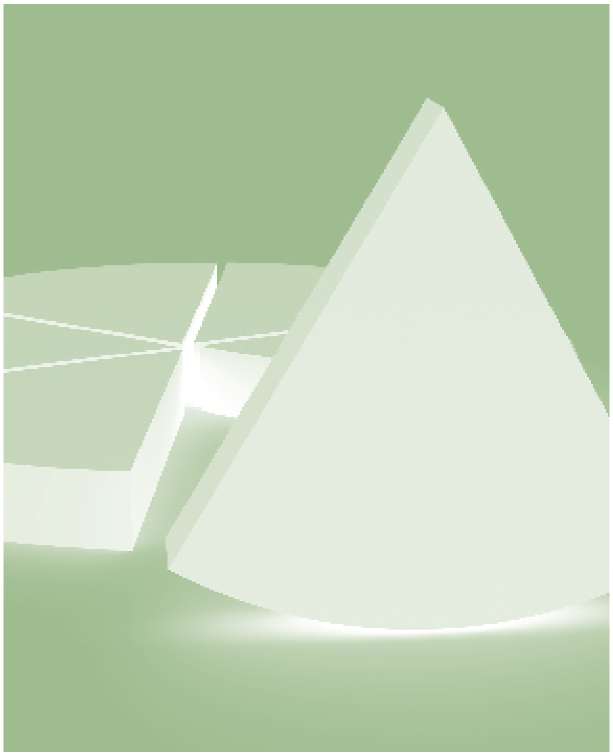
Appointment, Performance Evaluation and Compensation of other Senior Executives

With respect to the Senior Executives of the Bank, other than the Chief Executive Officer, the Committee shall:

- review and approve as appropriate the annual performance assessments submitted by the Chief Executive Officer to the Committee for such Senior Executives;
- review annually and approve as appropriate any changes to the base salaries of the Senior Executives recommended by the Chief Executive Officer, individual award allocations under annual, mid-term and long-term incentive plans and under incentive plans involving share issuances or share awards to such Senior Executives;
- review share holdings of Senior Executives relative to the share ownership guidelines established by the Committee, including current holdings of share-equivalent units;
- make recommendations for approval by the Board on the appointment of new or reassignment of current Senior Executives; and
- consider and as appropriate approve any agreements, including those addressing retirement, termination of employment or other special circumstances, including terms and conditions of appointments, between the Bank and such Senior Executives, for execution by the Chief Executive Officer.

Succession Planning

The Committee shall be responsible for the timely and effective continuity of leadership. The Committee shall review annually the Bank's succession plans and emergency preparedness planning process and make recommendations to the Board regarding any changes to the succession plan for Senior Executive positions. In addition, the Committee shall monitor the progress and development of Executives in accordance



with succession plans and review annually the adequacy of the succession pools established to foster timely and effective executive continuity.

Executive Appointments, Reassignments and Terminations

With respect to appointments and reassignments of Executives, the Committee shall:

- review and approve major changes to the overall organization structure of management;
- make recommendations for approval by the Board on the appointment of new Executives at the level of Senior Vice President and above;
- make recommendations for approval by the Board on the reassignment of current Executives at the level of Executive Vice President and above;
- review and approve as appropriate the early retirement or termination of Senior Executives and review the early retirement or termination of other Executives;
- review the reassignment of current Senior Vice Presidents;
- review the appointment of any new or reassigned Vice Presidents; and
- review and, where appropriate, approve the list of responsible persons and the assessment procedures required pursuant to OSFI Guideline E-17.

Compensation Structure

The Committee shall review annually and approve changes, as appropriate, to Executive compensation including compensation principles and objectives for total compensation, desired competitive positioning and comparator groups. The Committee shall also review, where appropriate, the Bank's overall compensation structure.

Annual, Mid-Term and Long-Term Incentive Plans for Executives

With respect to base salary programs and annual, mid-term and long-term incentive plans, other than plans involving share issuances or awards of shares for Executives, the Committee shall:

- review and approve as appropriate any new plans or design changes to existing plans;
- review and approve as appropriate business performance targets for incentive plan funding, monitor interim progress of performance against these targets and, after the end of the applicable performance period, assess performance and resulting incentive plan funding with the objective of aligning business results and incentive plan funding;
- review and approve as appropriate aggregate annual base salary increases and incentive awards to Executives other than Senior Executives under such plans; and
- review and approve as appropriate aggregate annual pools for ad hoc awards for Executives other than Senior Executives under such plans.

INCENTIVE PLANS INVOLVING SHARE ISSUANCES OR AWARDS OF SHARES

With respect to incentive plans involving share issuances or awards of shares, including stock option grants, the Committee shall:

- review new plans or design changes to existing plans;

- submit such plans to the full Board for its approval;
- review and approve as appropriate aggregate annual awards for Executives other than Senior Executives under such plans; and
- review and approve as appropriate aggregate annual pools for ad hoc awards for Executives other than Senior Executives under such plans.

BENEFIT PLANS FOR EXECUTIVES AND PENSION PLANS

The Committee shall:

- review and approve as appropriate any new benefit or perquisite plans or changes to existing plans for Executives;
- review and approve as appropriate the Retirement Compensation Arrangement (i.e., funded supplementary retirement arrangement) and review annually its financial status, governance structure and investment strategy; and
- together with the Pension Fund Society where appropriate, make recommendations for approval by the Board on any new pension plans or changes to existing pension plans.

SHARE OWNERSHIP GUIDELINES

The Committee shall:

- review and approve as appropriate any changes to share ownership guidelines applicable to Executives; and
- review share holdings of Executives relative to the share ownership guidelines established by the Committee, including current holdings of share-equivalent units.

Delegation of Authority

The Committee may delegate to the Chief Executive Officer the authority to exercise any right, power or responsibility that the Committee may have under any of the plans referred to above, other than in respect of Senior Executives, on such terms and conditions and within such limits as the Committee deems appropriate provided that the Chief Executive Officer subsequently advises the Committee of any right, power or responsibility so exercised by the Chief Executive Officer.

ACCESS TO MANAGEMENT AND OUTSIDE ADVISORS

The Committee shall have full, free and unrestricted access to management and employees. The Committee has the authority to engage independent legal counsel, consultants or other advisors, with respect to any issue or to assist it in fulfilling its responsibilities without consulting or obtaining the approval of any officer of the Bank and the Bank shall provide appropriate funding, as determined by the Committee, for any advisors employed by the Committee and ordinary administrative expenses of the Committee that are necessary or appropriate in carrying out its duties. For greater certainty, the Committee shall have the sole authority to retain and terminate any consulting firm used to assist in evaluating the performance and determining the compensation of the Chief Executive Officer or other Executives. The Committee shall review and approve all engagements between the Committee's advisors, legal counsel or consultants and the Bank or its subsidiaries and material entities over which the Bank has significant influence.

ANNUAL REVIEW AND ASSESSMENT

The Committee shall conduct an annual review and assessment of its performance and effectiveness, including a review of its compliance with this Charter, in accordance with the process developed by the Board's Governance and Nominating Committee and approved by the Board. The Committee shall conduct such review and assessment and report the results to the Board's Governance and Nominating Committee.

The Committee shall also review and assess the adequacy of this Charter on an annual basis taking into account all legislative and regulatory requirements applicable to the Committee as well as any best practice guidelines recommended by regulators or stock exchanges with whom the Bank has a reporting relationship, and, if appropriate, shall recommend changes to the Board's Governance and Nominating Committee.

DEFINITIONS

Capitalized terms used in this Charter have the meanings attributed to them below:

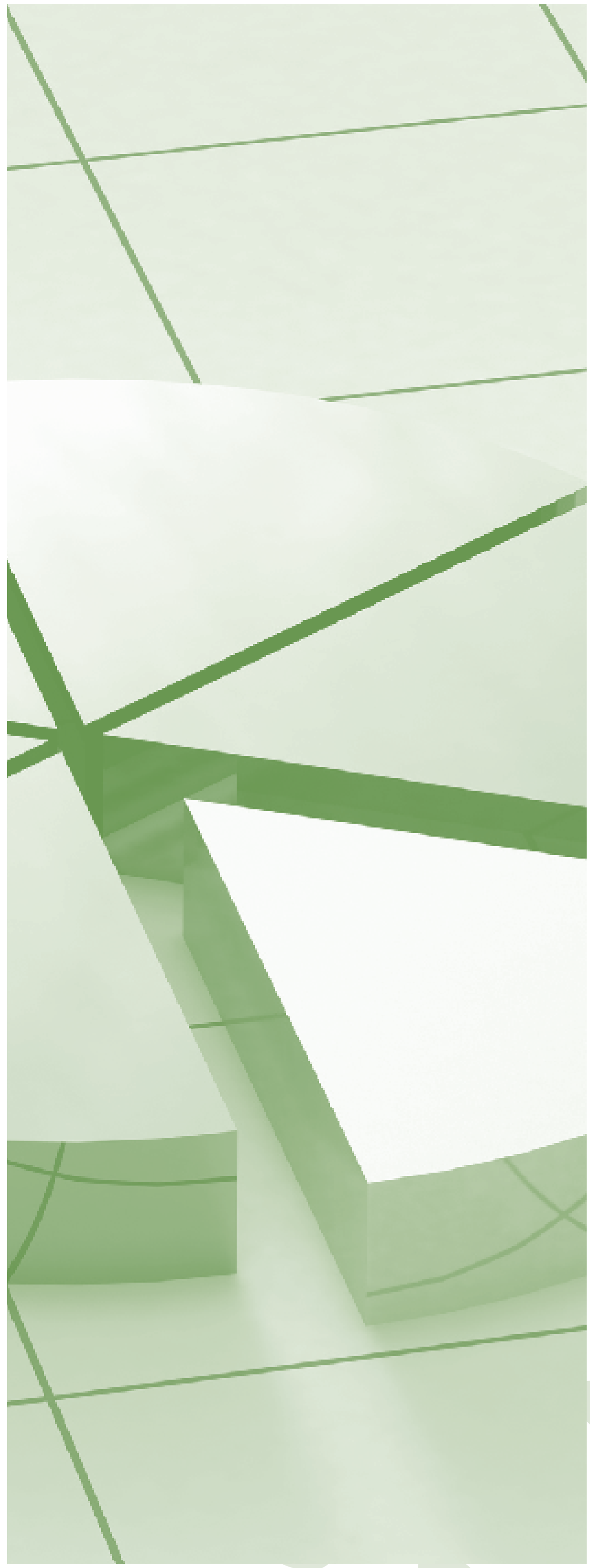
"Bank" means Bank of Montreal;

"Board" means the Board of Directors of Bank of Montreal;

"Committee" means the Human Resources and Management Compensation Committee;

"Senior Executives" means a senior officer who is a head of a principal business group or function of the Bank or who performs a policy making function for the Bank, and who reports to the Chief Executive Officer; and

"Executives" means the Senior Executives and the Vice Presidents, Senior Vice Presidents, Executive Vice Presidents and Senior Executive Vice Presidents of the Bank or those at an equivalent level in a subsidiary or affiliate of the Bank.



Appendix B: Sample tally sheet

Executive Name : John Doe
Position : President & CEO Age: 52
Position Tenure : 3.5 years Tenure with Company: 15 years

Annual Compensation Opportunity / History

	Target / Guideline	PY Actual
Base Salary	$500.0	$475.0
Annual Incentive	$500.0	$510.0
LTI (Expected Value of Grants)		
Options	$250.0	$118.8
Restricted Share Units	$250.0	$118.8
Benefits & Perquisites		
Car	$15.0	$15.0
Financial Planning	$2.5	$2.5
Security	$2.0	$2.0
Athletic / social club memberships	$2.0	$2.0
All Other Compensation		
DB Pension Plan — Registered	$15.0	$15.0
DB Supplementary Pension Plan	$115.0	$113.0
TOTAL	**$1,651.5**	**$1,372.0**

Amounts Payable in event of Termination

	w/o Cause	Change of Control
Salary	$1,000.0	$1,500.0
Bonus	$0.0	$1,500.0
LTI		
- vested	$930.0	$930
- unvested	$100.0	$400
Perqs & Bens	$43.0	$64.5
Other	$260.0	$390.0
TOTAL	**$2,333.0**	**$4,784.5**

Equity Values as of 12/31/XX

	Vested	Unvested	Total	10% Increase in Share Price	10% Decrease in Share Price
Options	$655	$125	**$780**	$1,140	$550
RSUs	$275	$275	**$550**	$605	$495
TOTAL	**$930**	**$400**	**$1,330**	**$1,745**	**$1,045**

Realized Gains / Payouts — Equity	RSUs	Options	TOTAL
2007	$100.0	$265.0	**$365.0**
2006	$100.0	$0.0	**$100.0**
2005	$0.0	$475.0	**$475.0**

Ownership Guideline Compliance

Ownership Guidelines	$1,500.0
Current Eligible Equity Holdings	$2,250.0
Current Holdings as Multiple of Salary	4.5
Guidelines as Multiple	3
Ownership Guideline Met	**YES**

Annual Pension Plan Benefits	Age 62 (normal)	Age 55
Registered Plan	$45.0	$30.0
SERP	$300.0	$150.0
TOTAL	**$345.0**	**$180.0**

Appendix C: Sample Committee annual work plan

Meeting	Agenda Item
Meeting #1	• Review the performance of each executive under the Committee's authority, including proposed salary changes, annual bonus awards for previous fiscal year and current year threshold, target and maximum performance objectives for the current year's annual bonus plan • Review and approve individual long-term incentive grants for executives under the Committee's direct authority • Review and approve proxy circular disclosure, including proposed responses to motions from shareholders
Meeting #2	• Review succession planning for key executive roles (approximately 20) • Evaluate management's reports on performance management, high-potential employees and diversity • With input from management and third party advisor, review the overall HR strategy and broad-based executive compensation policies for continued appropriateness – Review compensation trends and issues in the marketplace – Highlight areas for further review or redesign • Review the supplemental retirement plans for key executives
Meeting #3	• Review the market competitiveness of compensation arrangements for executives under the Committee's direct authority • Review the first draft of any proposed changes to existing compensation programs • Review and approve long-term incentive guidelines and aggregate award levels for the current year grant (for employees *not* under the Committee's direct authority) • Review and approve the salary increase guidelines for the upcoming year
Meeting #4	• Approve any changes to compensation program plans • Approve broad-based stock option awards (option awards for those eligible employees *not* under direct Committee authority) • Review and approve the meeting agenda for upcoming year • Prepare Committee self-assessment and assessment of the external advisors

Where to find more information

THE DIRECTOR SERIES*

THE 20 QUESTIONS SERIES

20 Questions Directors and Audit Committees Should Ask about IFRS Conversions
20 Questions Directors Should Ask about Building a Board
20 Questions Directors Should Ask about CEO Succession
20 Questions Directors Should Ask about Codes of Conduct
20 Questions Directors Should Ask about Crisis Management
20 Questions Directors Should Ask about Crown Corporation Governance
20 Questions Directors Should Ask about Director Compensation
20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance
20 Questions Directors Should Ask about Executive Compensation
20 Questions Directors Should Ask about Governance Assessments
20 Questions Directors Should Ask about Internal Audit (2nd ed)
20 Questions Directors Should Ask about IT
20 Questions Directors Should Ask about Management's Discussion and Analysis (2nd ed)
20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing
20 Questions Directors Should Ask about Risk (2nd ed)
20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee
20 Questions Directors Should Ask about their Role in Pension Governance
20 Questions Directors Should Ask about Special Committees
20 Questions Directors Should Ask about Strategy (2nd ed)

DIRECTOR ALERTS

The ABCP Liquidity Crunch—questions directors should ask
The Global Financial Meltdown—questions for directors to ask
Executive Compensation Disclosure—questions directors should ask

DIRECTOR BRIEFINGS

Climate Change Briefing: Questions for Directors to Ask

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Financial Aspects of Governance: What Boards Should Expect from CFOs

How CFOs are Adapting to Today's Realities

IFRS Conversions: What CFOs Need to Know and Do

Risk Management: What Boards Should Expect from CFOs

Strategic Planning: What Boards Should Expect from CFOs

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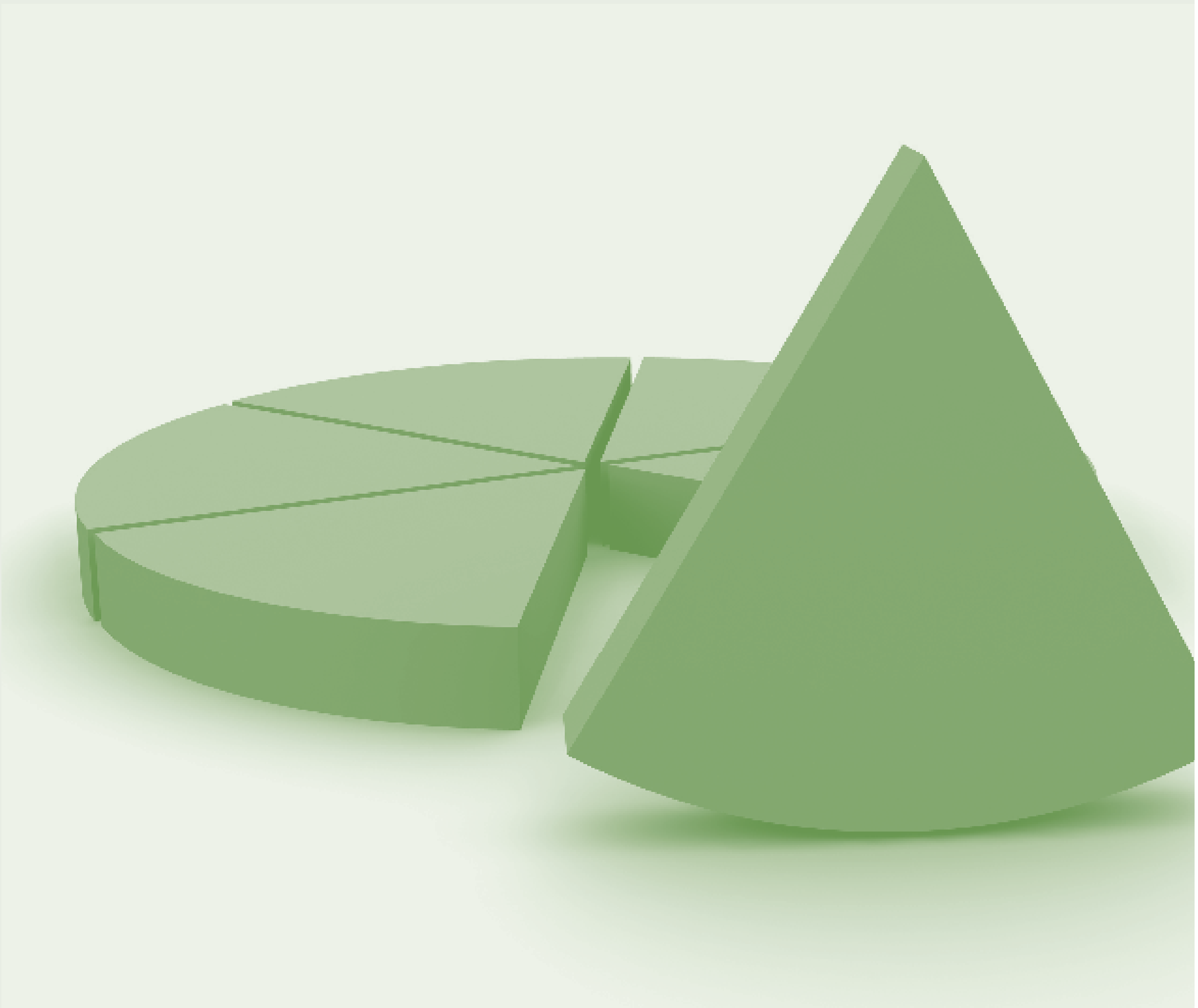
Understanding Disclosure Controls and Procedures: Helping CEOs and CFOs Respond to the Need for Better Disclosure

**Available for purchase in hard copy or free download at www.rmgb.ca.*

Notes



About the Authors

Lisa Slipp

Lisa Slipp is a Worldwide Partner and leads the executive remuneration segment of Mercer's Human Capital business in Canada. In her consulting practice, she advises clients on a variety of executive and director compensation matters, including pay levels and practices, pay and performance alignment, incentive plan design, and related governance and regulatory issues.

Lisa has over 20 years' experience working with Board Compensation Committees and senior management in a variety of industry sectors, including telecommunications, high-tech, financial services, energy and mining. She serves as the appointed Compensation Committee advisor to several large publicly-listed corporations and other organizations. She also works effectively with management while maintaining an objective perspective.

Lisa has developed innovative long-term incentive programs, involving equity or a substitute for equity, for both public and private companies. She has also supported companies with executive and employee compensation matters during periods of significant change, such as M&A transactions.

Lisa represents Canada on Mercer's global executive remuneration leadership team. She also chairs the North American Emerging Issues Team, and sits on Mercer's global executive remuneration Editorial Board. These activities provide her with ongoing and up-to-date knowledge of key trends and developments in compensation, performance measurement, governance and compliance matters.

Lisa is a frequent speaker and author on executive and director compensation and related topics. She has a BA from the University of Western Ontario and an MBA from York University.

Paul Hooper

Paul Hooper is a Principal in Mercer's Executive Compensation practice located in Toronto, Ontario. Paul has been consulting to management and board clients on the topics of compensation planning, broad-based rewards, short and long-term incentive plan design and board compensation, for 12 years.

Paul has worked with a variety of Canadian-based mining companies on assignments ranging from total compensation program reviews and total compensation strategy development to annual/long-term incentive plan design. He has conducted numerous executive compensation program reviews involving the assessment of competitive pay levels/practices and performance/pay relationships. In addition, Paul has reviewed and developed Board of Director total compensation programs, executive employment agreements, share ownership guidelines, and change-in-control and severance programs.

Prior to joining Mercer, Paul worked in various financial and business development roles in Canada and the U.S. for General Electric.

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20 Questions
Directors Should Ask about
the Role of the
**Human Resources
and Compensation Committee**

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