

Revisiting Equity Compensation Strategies in Volatile Times

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Agenda

Introduction

Status Quo & Current Best Practices

Distortions

Efficiencies

Introduction

Three arguments:

- Current compensation disclosures at best mischaracterize and at worst distort the real implications of plan designs
- Is it acceptable to ignore real costs to the company?
- Failure to show real costs contributes to misalignment of executive and stakeholder interests

Introduction (cont.)

Stakeholder demands for transparent linkage of pay and performance have now been joined by regulatory initiatives requiring greater disclosure in both Canada and the US

- Canadian Securities Administrators: New rules adopted 2008
- U.S. Securities and Exchange Commission: New proxy disclosure rules adopted 2006

Will this result in more meaningful disclosure?

Introduction (cont.)

The disclosure rules themselves are lengthy and byzantine

One document released by a compensation consulting house detailing new SEC disclosure rules is 430 pages

More difficult to have meaningful “say on pay” if interpretation of disclosure requires expensive specialized advice

Status Quo

Current approaches to comparison of compensation:

- Retrospective
- Gross pay (inadequate analysis of net benefit to employee)
- Gross cost (inadequate analysis of compensation cost and tax deduction)

Disclosures are only simple insofar as they reflect gross numbers

Status Quo (cont.)

It's only recently that "total take" was even discernible from disclosures

Focus of any stress-testing and design decision-making is typically on how individual elements track

Watch analogy: we've analyzed how the gears work, but how well does it keep time?

Questions or Comments?

Current Best Practices

Canadian Coalition for Good Governance best practices (from its 2008 guidance):

- Build an independent compensation committee
- Develop an independent point of view
- Test pay-to-performance linkages
- Establish share ownership guidelines
- Disclose the compensation regime

Current Best Practices – Focus on Linkages

Example 1: CIBC

2008 Proxy Circular, page 21

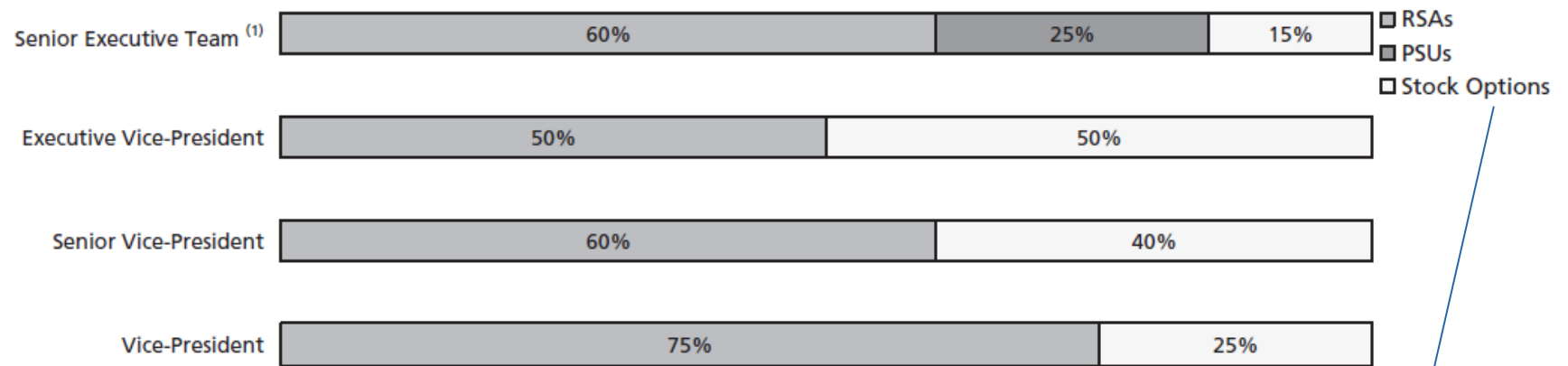
Compensation Programs:	
Chief Executive Officer Option Grant with Performance-based Vesting	<p>Mr. McCaughey received a special grant of 250,000 options upon his appointment as President and Chief Executive Officer. The vesting of this award is conditional on CIBC achieving total shareholder return that is equal to or greater than the average of the other four major Canadian banks for specified performance periods. This grant will only have realizable value if and when these future performance hurdles are met.</p> <p>The first and second tranches of this option grant (50,000 options each) met the time and performance based vesting conditions on October 31, 2006 and October 31, 2007 respectively, as CIBC's total shareholder return exceeded the average total shareholder return for the other four major Canadian banks for each of the 2006 and 2007 fiscal years.</p>
Holdback on Chief Executive Officer Compensation	<p>The Chief Executive Officer's annual cash and deferred equity awards (excluding options) for a fiscal year are determined by the Committee at the end of the following fiscal year. This allows the Committee to take into account any post year-end events that would influence assessment of performance for the current year.</p>
Test Future Pay-for-Performance Linkages	<p>The Committee tests executive compensation programs under a variety of performance scenarios to ensure that the value delivered to executives is linked to CIBC's performance over the long term. For example:</p> <ul style="list-style-type: none"> the Committee reviewed an analysis of the amounts that the Chief Executive Officer could eventually receive in equity payouts over the next 5 and 10 year periods using a variety of growth scenarios.

Compensation program are tested under a variety of performance scenarios. An example is provided.

Distortions Introduced by Gross Analysis

From CIBC 2008 Proxy Circular:

Figure 2: Deferred Equity Mix



Option award is based on a dollar value that is determined using a Black-Scholes valuation

Distortions Introduced by Gross Analysis

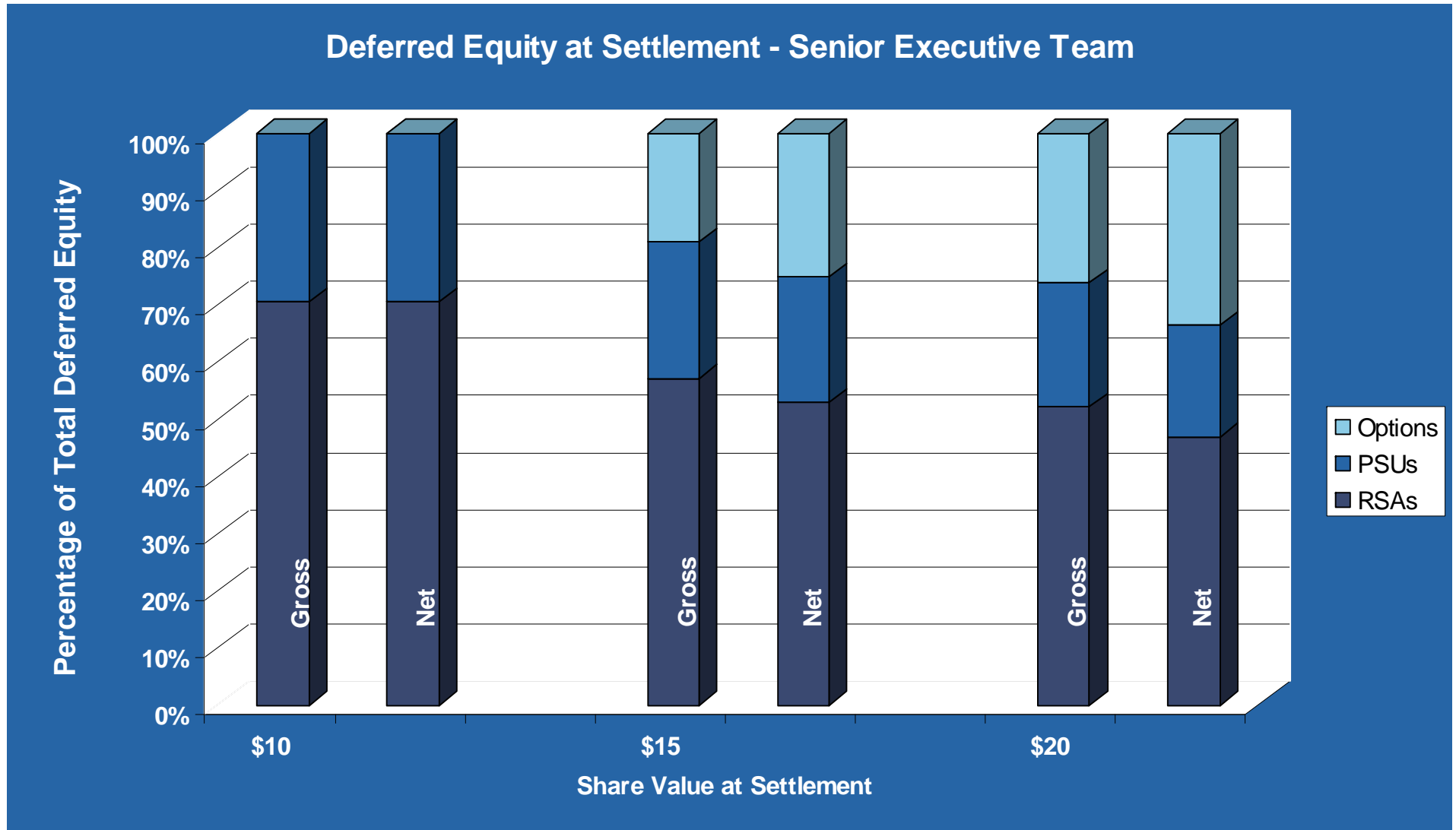
Actual Payout is markedly different from the ratios suggested by disclosures

Analysis of net settlement value of awards reveals different picture

Assume the following:

- Share price at grant: \$10
- Share price at settlement: \$15 and \$20
- Black-Scholes value: \$2.50

Distortions Introduced by Gross Analysis



Questions or Comments?

Distortions Introduced by Tax Rules

Banks are extending their performance cycles in response to governance concerns

Q. Performance cycles are too short - why? A. (in part) SDA (Salary Deferral Arrangement) Rules

- Basic Rule: Income from Employment (s. 5 or s. 6) taxed at 100% of marginal rate - No deferral
- When amounts deferred, SDA rules may apply (amounts included in income in year deferred)

Distortions Introduced by Tax Rules (cont.)

What alternatives exist to extend performance period beyond 3 years?

- May avoid SDA rules if performance features constitute “significant risk of forfeiture”
- Bonus exemption - Maximum 3 Year Deferral
- DSUs (Deferred Share Units) – deferral under 6801(d) to termination, death or retirement
- Stock plans that are subject to section 7 of the Income Tax Act are not affected by the SDA rules, and have no limit on deferral
 - Tandem plans offer employee choice and employer deduction

Efficiencies Introduced by Designing for Tax

Even the best practices in disclosure do not provide the full picture on costs and benefits associated with compensation programs

Tax rules have an impact on the length of deferrals that are permissible and therefore have a direct (but probably unintended) impact on governance

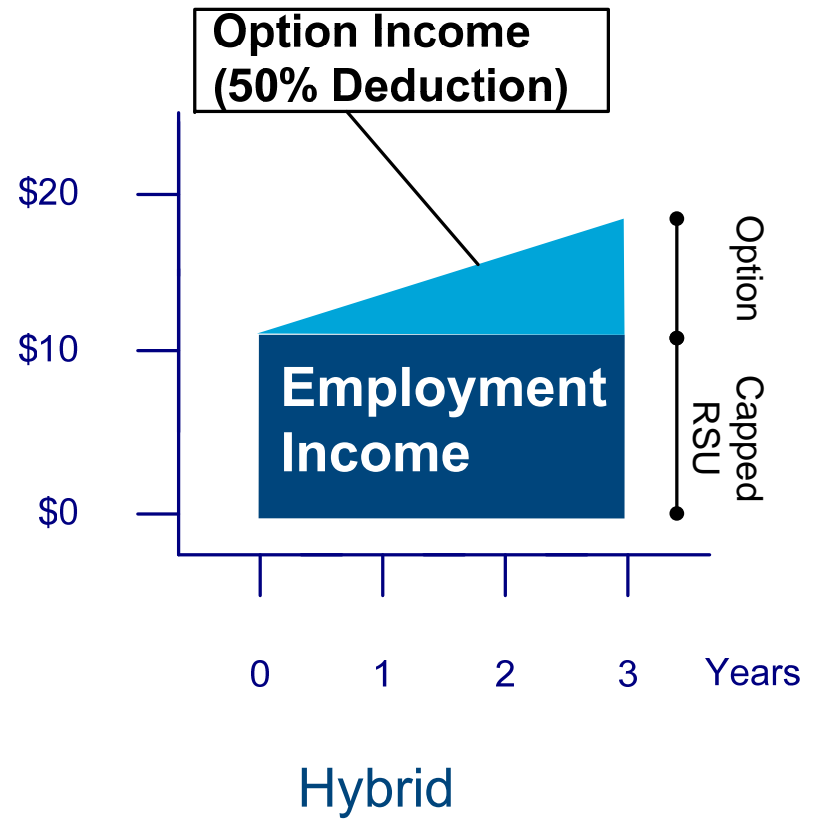
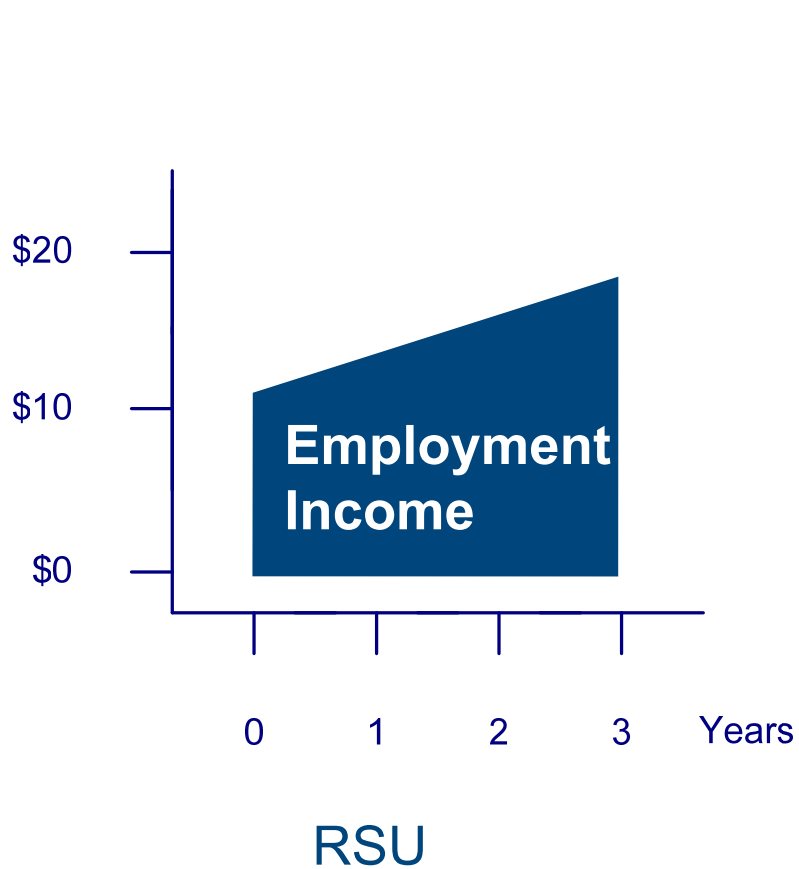
What if we considered our alternatives BEFORE or in parallel with the design of compensation programs?

Efficiencies Introduced by Designing for Tax

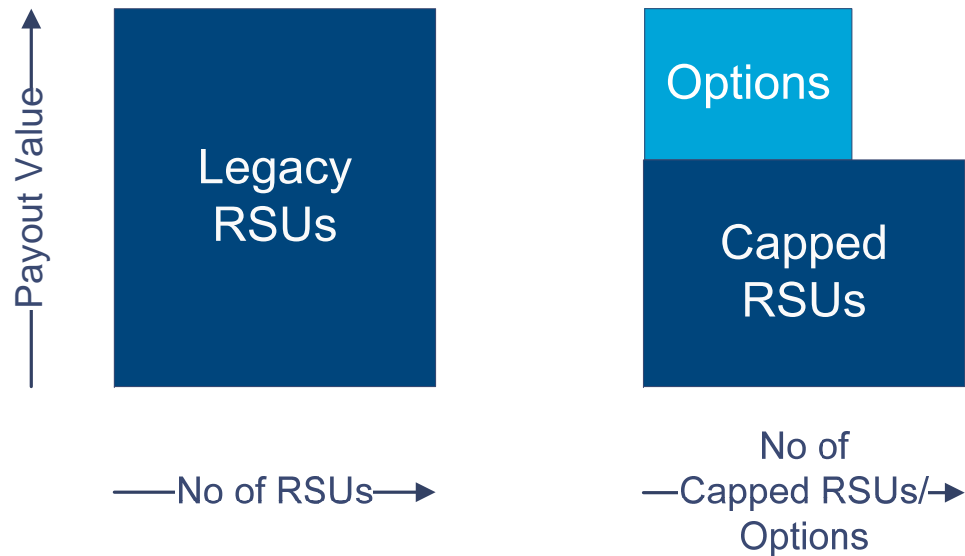
Hybrid Share Unit



Replace RSUs with Hybrid Unit



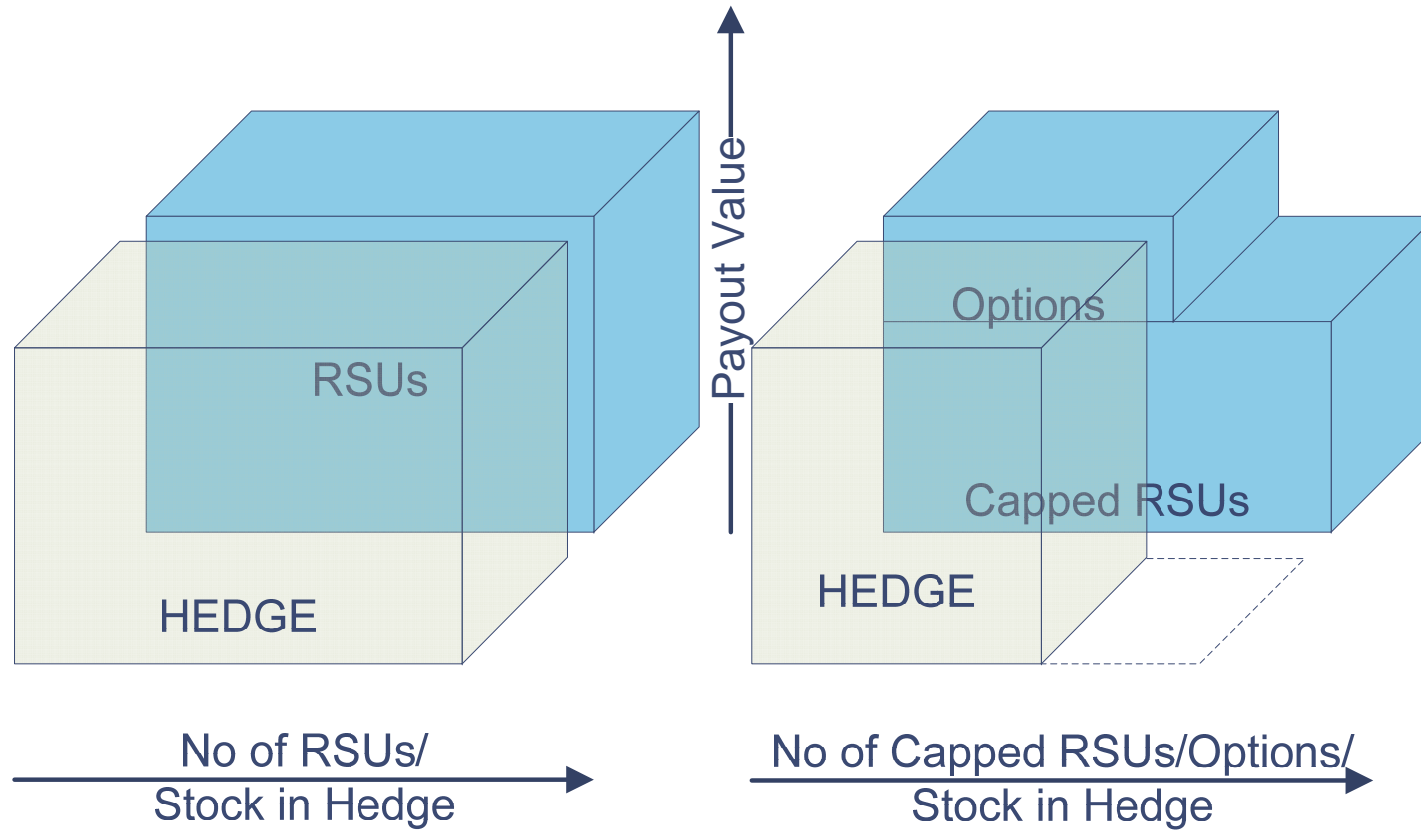
Replace RSUs with Hybrid Unit (cont.)



- Greater tax efficiency of Hybrid Unit means that number of Options can be less than number of Capped RSUs and still deliver same net benefit to employee

For every dollar of appreciation		
	RSU	Hybrid
Gross	1.00	1.00
Net of Tax	.54	.77
Difference in net benefit		.23

Hybrid – Hedge Redundancy



Designing for Tax Efficiencies

Hybrid makes use of tax efficiencies as part of its design

Hybrid is flexible in terms of implementation (stock or cash or both) and can accommodate calls for lengthier performance periods

Conclusion

Will increased scrutiny of executive compensation lead to more sophisticated analysis?

Will more sophisticated designs take advantage of tax efficiencies?

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