

DAVIES INSIGHTS

GOVERNANCE

DAVIES

Governance Insights

2013



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Executive Summary

This third annual edition of **Governance Insights** presents Davies' analysis of the corporate governance practices of Canadian public companies over the course of 2013 and the trends and issues that influenced and shaped them.

We expect 2014 to be an active year for governance themes with greater calls for diversity on boards, a growing shareholder voice on "say on pay" resolutions, and further regulatory initiatives around proxy voting and the regulation of proxy advisory firms. We also anticipate continued discussion on shareholder activism and scrutiny of the tools and strategies used by issuers and shareholders.

We begin our report by profiling Canadian boards and their membership in Chapter 1, **Directors and Boards**. We expect additional calls – including from regulators – for reforms to foster diversity on boards and in management, including in the longer term the promotion of racial and ethnic diversity among Canada's corporate leaders. We observe that the most common profile for a director of a TSX 60 issuer remains a male in his early 60s and that there continues to be a significant deficit of women on Canadian boards, with only 10.5% of a subset of 3,275 board seats occupied by women in 2013. We also review the different prescriptions suggested by regulators and investors for augmenting the presence of women on boards.

In Chapter 2, we review the **Executive and Director Compensation** practices of Canadian issuers and comment on the trends that we have observed over the last two years. One important trend is the tremendous acceptance of "say on pay" practices as a tool for fostering shareholder engagement, particularly among larger Canadian issuers. In 2013, just over 80% of TSX 60 issuers put say on pay resolutions forward, as compared to just over 50% in 2011. We expect the practice of say on pay to gain momentum among the remaining issuers on the TSX Composite and SmallCap indices, partly at the urging of institutional investors, shareholder advisory firms and governance advisory groups. On the flip side, we expect that shareholders will become increasingly more comfortable with using these practices to express their dissatisfaction for compensation and related governance matters, potentially resulting in more failed votes. In our discussion, we suggest steps that boards should take to avoid being surprised by the result of a say on pay vote.

In Chapter 3, **Shareholder Voting Issues**, we provide an update on the status of regulators' initiatives on proxy voting and the regulation of proxy advisory firms – two areas where further developments can be expected in 2014. In 2013, there has been a growing awareness among Canadian securities regulators of the issues and challenges relating to the operation of the proxy voting system that Davies initially canvassed in our 2010 paper "[The Quality of the Shareholder Vote in Canada](#)". We also review the status and evolution year-over-year of issuers' practices in the area of majority voting – a practice now firmly

entrenched in Canada. It remains to be seen, however, whether the prevalence of majority voting practices will translate into more shareholders withholding support from management nominees. We also expect that by the end of this year, mandated majority voting will become the reality, and we discuss additional trends we expect to see in this area, including a greater push for under-supported directors to resign.

Directors of Canadian public companies will be increasingly exposed to shareholder activism of one type or another, making it more important than ever that they have a strong understanding of the rationales underpinning activism and the different strategies and techniques employed by issuers and activists in the context of shareholder engagement. Shareholder activism and the success rate of dissident shareholders continued to rise in 2013, with the number of proxy contests in Canada growing from just five in 2003 to 30 year-to-date in 2013. Activism is also emerging as a significant new asset class. In Chapter 4, **Shareholder Initiatives**, we canvass the various reasons for these trends and some of the tools issuers and dissidents should be aware of, such as shareholder proposal and requisition rights, short slate proposals and universal proxies. Our discussion sheds light on key trends and issues emerging in this area, such as the increased scrutiny on “vote buying”, director compensation by dissidents and “empty voting”, and the potential benefits to issuers of using advance notice by-laws to thwart ambushes by dissidents. We also canvass recent judicial developments in this field.

The heightened focus on how issuers with operations in emerging markets manage risk that we observed in 2012 has continued into 2013, accompanied by important new developments in the area of anti-corruption legislation and enforcement. These developments, some of which can serve as cautionary tales for boards faced with similar challenges, are highlighted in Chapter 5, **Risk Oversight: Operations in Emerging Markets**. Given the vigorous approach Canada is taking to combat foreign corrupt practices, boards of issuers, particularly those with substantial operations in emerging markets, should carefully consider their risk management approach to ensure a robust system and proper practices are in place to manage the risks of operating in foreign jurisdictions.

Canadian boards have long considered the shareholder rights plan a potentially effective tool for responding to significant stock accumulations or unsolicited bids. In recent years, companies have been facing uncertainty as to when and if “a rights plan must go” as a result of some rights plan decisions by securities regulators. In response, in 2013, two alternative proposals for regulating so-called “poison pills” have been put forward by the Canadian securities regulators: one that would largely shift the decision of whether a rights plan remains in place to issuers’ shareholders, and the other focused on defensive

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tactics generally and affording boards greater deference in the exercise of their duties. In our final Chapter 6, **Rights Plans: Governance Issues in Changes of Control**, we discuss these two alternative approaches and key arguments on both sides of the debate. Importantly, we conclude that both approaches would have a significant impact on the manner in which directors may respond to control offers, the strategies employed by bidders and the relative leverage that boards and bidders may possess in the future.

If you would like to discuss any of the issues raised in this report, please contact any of the Davies partners listed on the Key Contacts page.

Database and Methodology

The data in this report is drawn from the 2013 management information circulars of 372 issuers on the Toronto Stock Exchange (the "TSX") and which are included in one (or both) of the Composite Index and the SmallCap Index as at May 31, 2013. There are a total of 2,383 issuers listed on the TSX. Although the 372 Composite Index and SmallCap Index issuers included in our study universe represent only 16% of the total listed issuers, they represent 82% of the total market cap on the TSX.¹

Descriptions of the relevant indices discussed in this paper are set out below.

Composite Index: The S&P/TSX Composite Index (referred to as the "Composite Index") comprises 238 issuers. It is the "headline index" and the principal broad market measure for the Canadian equity markets. It includes common stock and income trust units.² Five of the 238 Composite Index issuers did not have a proxy circular for the relevant time period discussed; accordingly, our analysis is based on 233 Composite Index companies.

There are two components to the Composite Index referred to in this report:

- **TSX 60:** The S&P/TSX 60 Index (referred to as the "TSX 60") is a subset of the Composite Index and represents Canada's 60 largest issuers by market capitalization.
- **Completion Index:** The S&P/TSX Completion Index (referred to as the "Completion Index") is the Composite Index, excluding the TSX 60 issuers. It comprises 178 issuers. (Our analysis included only 173 of the issuers on the Completion Index because, as noted above, five issuers did not have circulars.)

SmallCap Index: The S&P/TSX SmallCap Index (referred to as the "SmallCap Index") includes 223 issuers, 78 of which also meet the market capitalization eligibility criteria and are part of the Composite Index.³ (Our analysis included only 213 of the issuers on the SmallCap Index because 10 issuers did not have circulars.)

Where we reference corporate statutes in this report, we are referring to the *Canada Business Corporations Act* (the "CBCA"), unless otherwise stated.

¹ As at May 31, 2013.

² Standard & Poor's, "S&P/TSX Canadian Indices Methodology" (September 2013), online: <http://ca.spindices.com/documents/methodologies/methodology-sp-tsx-canadian-indices.pdf>.

³ To qualify for the Composite Index, an issuer must, at the time of determining eligibility, (i) represent a minimum weight of 0.05% of the index and (ii) have a minimum volume-weighted average share price of at least \$1. To qualify for the SmallCap Index, an issuer must have a market capitalization that is at least \$100 million but not more than \$1.5 billion.

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Directors and Boards

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Directors and Boards



Director Profile

Similar to our findings in 2011, the most common profile for a director of a TSX 60 issuer remains a male in his early sixties. He is a Canadian resident and is independent of management and has served on his current board for the last eight years. While the typical director in 2011 served on two to four other public company boards, we are finding that in 2013, he sits on one to two other boards. The other public company boards on which he serves are likely not those of TSX 60 issuers; only 73 directors sit on more than one TSX 60 board.


RESIDENCY

Three-quarters (75%) of directors of issuers on the Composite Index are resident Canadians. Consistent with the trend of globalization of business and capital markets, that represents a decrease from 78% in 2011. A similar decrease is witnessed on the TSX 60, where the numbers are lower (70% in 2013, as compared with 78% in 2011). On the SmallCap Index, where the proportion of resident Canadian directors has traditionally been lower than the Composite Index, the percentage has remained constant at 81%.

To the extent that directors of the Composite Index are recruited from other jurisdictions, it is typically (66%) from the United States. Only 7% of directors of issuers on the Composite Index who are not resident Canadians are from the United Kingdom, 3% are from Australia and approximately 2% are from each of China, Hong Kong and Peru. These figures are similar both across the TSX 60 issuers⁴ and the SmallCap Index.⁵

AGE

Directors are typically experienced individuals with strong reputations and records of success who begin their board careers when they are at least in their mid- to late-50s. As in 2011, directors of TSX 60 issuers tend to be a bit older than directors of issuers on the Completion Index or the SmallCap Index. Among TSX 60 directors, approximately 36% are under the age of 60 (2011: 35%). The percentage of directors under the age of 60 is higher on the Completion Index (43% in 2013 and 44% in 2011) and on the SmallCap Index (48% in both 2013 and 2011). Thirty-five per cent of TSX 60 directors are between the ages of 50-60 (compared with 29% in 2011). This is comparable with the directors on



The most common profile for a director of a TSX 60 issuer remains a male in his early sixties.

⁴ For TSX 60 issuers, non-resident-Canadian directors are drawn from the United States (69%), United Kingdom (9%), Hong Kong and Australia (3% in each case) and Mexico (2%).

⁵ For issuers on the SmallCap Index, non-resident-Canadian directors are drawn from the United States (63%), United Kingdom (5%) and Australia and Peru (2% in each case).

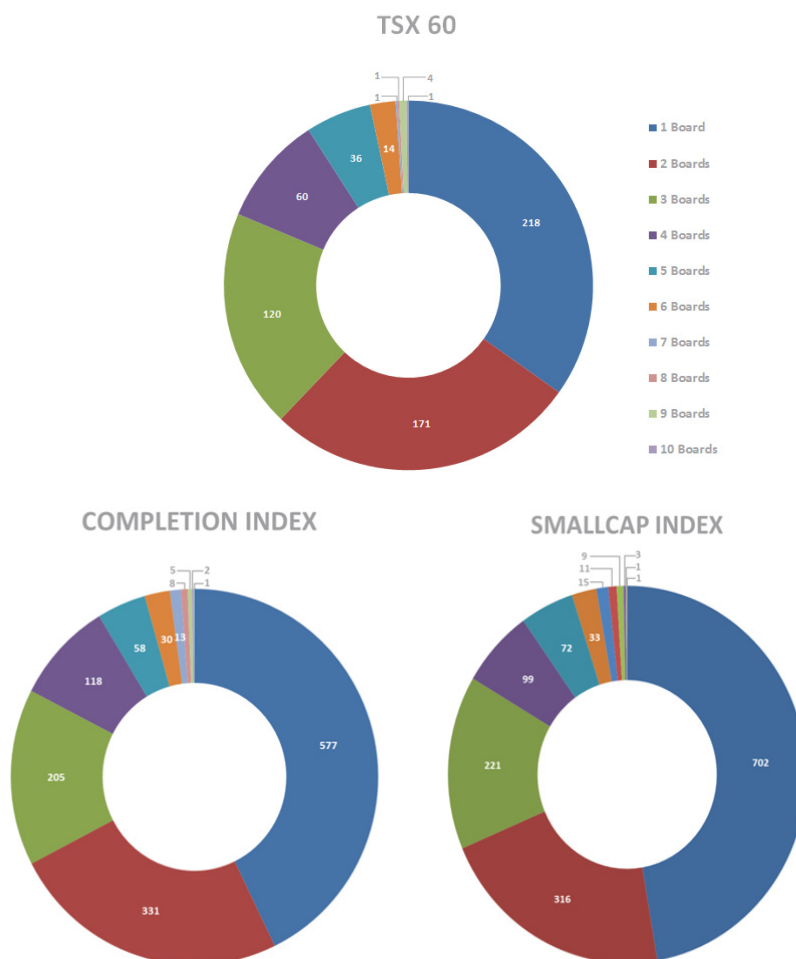
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Directors and Boards

the Completion Index and the SmallCap Index (39% and 42% in 2013, slightly higher from 33% and 35% in 2011, respectively).

→ Service on Other Boards

If a director holds a board position with any other reporting issuer, the issuer is required to identify such other issuer in its corporate governance disclosure, in part to identify situations in which directors may be overextended because they sit on too many public company boards (otherwise known as "overboarding").



Since 2011, the number of directors on the TSX 60, the Completion Index and the SmallCap Index sitting on between one and four boards has increased from 86% to 92%. Approximately 57% of directors on the TSX 60, 49% on the Completion Index and 43% on the SmallCap Index sit on two to four boards.

It is also observed that fewer directors sit on six or more boards in 2013 as compared with 2011. These numbers went down from 7% to 3% on the TSX 60, from 8% to 4% on the Completion Index and from 9% to 5% on the SmallCap Index.

Illustrated on page 12 is the number of boards on which directors serve, based on the disclosure in the proxy circulars of TSX 60, Completion Index and SmallCap Index issuers. For the most part, directors have disclosed (and the charts illustrate) only public company boards on which they serve. As the charts illustrate, most directors serve on more than one public company board. Relatively few sit on five or more public company boards.

Women on Boards

Gender diversity on Canadian boards received heightened attention in 2013. The main issues receiving scrutiny have been the number of women on boards and the rate at which they rise to leadership positions once they are appointed to the board.

As with prior years, representation of women on boards is more common in Canada's largest issuers: those that comprise the TSX 60. The number of TSX 60 issuers that put at least one woman forward for election by shareholders has increased from 88% in 2011 to 90% in 2013, with the percentage of TSX 60 issuers that put two or more female candidates forward up from 65% to 72%. Following along the same trend, the percentage of issuers on the Completion Index who did not put any women forward decreased from 57% in 2011 to 49% in 2013. However, on the SmallCap Index, the percentage of companies that did not put any women forward for election increased slightly from 65% in 2011 to 67% in 2013.

WOMEN IN LEADERSHIP POSITIONS ON BOARDS

The incidence of women holding board leadership positions has also risen. The number of women chairing boards increased from seven of 360 issuers (2%) on the Composite Index and the SmallCap Index in 2011 to 14 of 372 issuers (4%) in 2013. There continue to be only two female chairs on the TSX 60 (3%): Barbara Stymiest (BlackBerry Limited) and Maureen Sabia (Canadian Tire Corporation Limited). Kathleen Taylor will become the third female TSX 60 chair and the first

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Directors and Boards

In 2013, only 10.5% of Composite Index and SmallCap Index issuers' board seats were held by women.

woman to lead the board of a major Canadian bank when she takes the position at the Royal Bank of Canada in January 2014.

The 11 women who are chairs of Completion Index and SmallCap Index issuers are: Nancy Southern (ATCO Ltd. and Canadian Utilities Ltd.), Phyllis Yaffe (Cineplex Inc.), Patrice Merrin (CML Healthcare Inc.), Heather Shaw (Corus Entertainment Inc.), Lynn Loewen (Emera Inc.), Margery Cunningham (Extendicare Inc.), Rebecca MacDonald (Just Energy Group Inc.), Françoise Bertrand (Quebecor Inc.), Kay Priestly (SouthGobi Resources Limited) and Isabelle Marcoux (Transcontinental Inc.).

Women are also gaining greater leadership participation at the committee level. While in 2011 there were 12 instances among TSX 60 issuers where women chaired the audit committee, the compensation committee or the governance and nominating committee, in 2013 this number more than doubled to 25. An increase, although more modest, is also observed on the Completion Index where the number of female chairs of such committees was 28 in 2011 and 32 in 2013, and on the SmallCap Index where the number was 26 and 28, respectively.

Taking into account the fact that some issuers are listed on both the Composite Index and the SmallCap Index, only 53 of the more than 1,500 committees across both indices were chaired by women in 2011, compared with 85 of almost 1,200 in 2013, indicating a slow yet positive trend in women's leadership on boards.

RECENT DEVELOPMENTS ON GENDER DISPARITY

Although female representation on boards and in board leadership positions has increased somewhat during the last two years, the rate of increase has been slow and significant gender disparity persists. Out of the total 3,275 board seats of issuers on the Composite Index and the SmallCap Index, only 343 (or 10.5%) were held by women. The percentage of board positions on the TSX 60 held by women is 18.4%; it is only 6.4% on the SmallCap Index. In 2013, 40% of companies on the Composite Index and 65% of issuers on the SmallCap Index do not have a single female board member.

The lack of board diversity in Canada – and gender diversity in particular – has become an increasingly pressing issue that has attracted attention from a variety of constituents and interest groups. The *2012 Catalyst Census: Financial Post 500 Women Senior Officers and Top Earners* issued in February 2013 concludes that Canada is lagging behind other countries with only marginal improvements of women who hold senior officer positions in public companies from 14.3% in 2010 to 15% in 2012.

Earlier in 2013, a number of institutional investors predicted that board diversity would be an important governance issue this year. In January, the Ontario Teachers' Pension Plan ("Teachers'") released a letter emphasizing that board

diversity is critical for the creation of an effective board and encouraged regulators to require issuers to develop diversity policies. This past May, Ontario Finance Minister Charles Sousa and then-Minister Responsible for Women's Issues Laurel Broten requested that the Ontario Securities Commission (the "OSC") undertake a public consultation process regarding disclosure requirements for gender diversity.

On July 30, 2013, the OSC published OSC Staff Consultation Paper 58-401 Disclosure Requirements Regarding Women on Boards and in Senior Management. The paper requests feedback from investors, issuers, other market participants and advisors on effective policies and practices for increasing the number of women on boards, the most effective and appropriate disclosure requirements, types of qualitative information that should be disclosed by issuers and comments on the proposed "comply or explain" model.


The "comply or explain" model proposed by the OSC requires non-venture issuers to provide disclosure on an annual basis in four areas: (1) policies regarding the representation of women on the board and in senior management; (2) consideration of the representation of women in the director selection process; (3) consideration of the representation of women in the board evaluation process; and (4) measurement regarding the representation of women in the organization and specifically on the board and in senior management. If a policy has been adopted, the issuer should:

- provide a summary of the key provisions or disclose the policy in its entirety;
- set out how the policy is intended to advance the participation of women on the board and in senior management;
- explain how the policy is implemented;
- describe measurable objectives under the policy;
- disclose annual and cumulative progress by the issuer in achieving these objectives; and
- describe how the board measures the effectiveness of the policy.

If the issuer does not have such a policy, it should explain why and identify any risks or opportunity costs associated with its decision to not enact a policy.

The OSC received over 40 responses during the comment period and overall the comments strongly support the initiative by the OSC to increase board diversity, in particular the representation of women on boards and in senior management.

Proponents of the "comply or explain" model believe that, at a minimum, this model will provide transparency, encourage faster evolution and help foster stricter rules if necessary. There were a number of parties who encouraged the



**Under debate:
disclosure
model vs.
mandatory
quotas for
women on
boards.**

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OSC to take a broader approach to board diversity and to include all under-represented groups.

There were a few negative comments that strongly urged the OSC not to adopt any formal model because it will limit the board's ability to act in the best interest of the company and could force boards to appoint less qualified candidates. These opponents believe any OSC initiative will result in tokenism and eventually lead to quotas which will restrain companies from selecting the most qualified candidates.

Some commentators believe mandatory quotas are too restrictive and instead suggest that a rule that requires women to be included as half the candidates on a shortlist to fill any board vacancy will be more effective. The opposition argues that the current disclosure rules under National Instrument 58-101 *Disclosure of Corporate Governance Practices*, which require issuers to describe the process by which the board identifies new candidates, are sufficient, on the premise that companies should be able to act on their own without any sort of regulation that arbitrarily constrains boards.

In October 2013, Teachers' submitted a letter to the OSC outlining a proposal to increase the number of female directors on Canadian boards. Teachers' believes that the voluntary "comply or explain" model is inadequate as voluntary efforts by Canadian companies have thus far resulted in little or no change to board diversity. Two years ago, the United Kingdom launched a model similar to the one proposed by the OSC. While the initiative produced an initial increase in the number of women on boards, growth has stagnated and the U.K. is now considering implementing mandatory quotas. The pension fund expressed concerns that companies would simply fall back on pretexts, such as not being able to find any qualified women for board positions, to explain the absence of women representatives. Teachers' therefore proposed that companies that fail to have at least three female directors by 2020 should be delisted from the TSX. This proposal is grounded in research showing that companies make better decisions when their boards are more diverse, and the view that a minimum of three female board members is necessary to see the benefits of board diversity. Teachers' currently has four women board members, including Eileen Mercier as chair.

Although the OSC's recommendations have not yet been released, there is leadership in taking gender diversity seriously. As mentioned, on August 31, 2013, the Royal Bank of Canada announced the appointment of Kathleen Taylor as its next chair, making her the first woman to lead the board of a major chartered bank in Canada and potentially paving the way for improved gender diversity on Canadian boards. We are witnessing the start of a new era where more women are likely to serve in key leadership positions on boards, with diversity expected to lead to more efficient boards and Canadian capital markets. However, the

initiatives are not likely to stop there. In the medium- to long-term, we expect to see additional calls for reforms to encourage diversity on boards and in management more broadly, including promoting racial and ethnic diversity among the leadership of Canada's public companies.

Director Independence

An issuer's need for a board of directors that is independent of management continues to be an important topic in corporate governance. If a board is dominated by members of management, the concern is that the board will not be in a position to oversee management effectively. Independence can also be compromised if a director (like a consultant) has a significant relationship with the issuer, which management controls. Increasingly, there are questions about whether the focus on independence has gone too far and whether board composition should be balanced with more directors who have industry-specific experience, regardless of whether they are independent of management.

HOW MANY INDEPENDENT DIRECTORS SHOULD AN ISSUER HAVE?

Canadian securities regulators recommend that at least a majority of directors be independent. Many institutional investors also recommend that a majority of the board be independent but typically will not withhold votes from a director or a slate unless they believe that the lack of independence is negatively affecting the ability of the board to act in the best interest of the corporation. Institutional Shareholder Services ("ISS") recommends that its clients withhold votes in situations where less than a majority of the board of a TSX issuer is independent. The Canadian Coalition for Good Governance ("CCGG") goes further, recommending that two-thirds of the board be independent.

COMPLIANCE WITH INDEPENDENCE EXPECTATIONS

As reported in 2011, issuers on the Composite Index typically maintain a level of independence on their boards that goes far beyond the 50% recommended by regulators, investors and proxy advisory firms and even beyond the two-thirds recommended by CCGG. The percentage of directors of Composite Index issuers who, on average, are independent of management has remained relatively constant (77% in 2011 and 76% in 2013). The percentage is higher among TSX 60 companies, where the percentage of directors who are independent of management was 82% in 2011 and 83% in 2013.

There are five issuers on the Composite Index that do not have a majority of independent directors. Most do not explain why this is and there is no regulatory

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Directors and Boards

requirement to make such disclosure. The requirement is to disclose whether or not a majority of directors are independent. If a majority of directors are not independent, the issuer must describe what the board of directors does to facilitate its exercise of independent judgement in carrying out its responsibilities. Typically, such disclosure includes reference to the independent directors holding *in camera* sessions at the end of regularly scheduled meetings, or separate meetings, in each case where non-independent directors and members of management are not present; the presence of a lead independent director chairing discussions among the independent directors and ensuring the board is able to function independently of management; and/or actual or potential conflicts being referred to independent directors.

CHAIR INDEPENDENCE

The separation of CEO and chair is one governance practice advocated as a means of fostering the independence of the board from management. Considerably more Composite Index companies have adopted this practice in 2013 (approximately 85% compared with 60% in 2011) and the results are similar on the TSX 60 and the SmallCap Index. Although it is generally recommended that where the chair is the CEO or is otherwise not independent of management, the board should appoint a lead director who acts as the liaison between management and the independent directors, approximately one-third of issuers with non-independent (or executive) chairs (chairs who are the CEO or are otherwise not independent of management) continue to not have a lead director.

CONTROLLED COMPANY ISSUES

Standards of independence set out by Canadian regulators provide that officers and directors of controlling shareholders are not independent. Outside directors of affiliates are not excluded by National Instrument 52-110 *Audit Committees* but are excluded by Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* for certain related-party transaction reviews.

In 2013, the number of issuers on the Composite Index that have a controlling shareholder (i.e., shareholder holding more than 50% of the voting shares) remains significant at 26 issuers (11%) and points to the continued need to address the issues affecting controlled companies. The issue is that on questions of management and corporate performance, as opposed to related-party transactions, the interests of the controlling shareholder are aligned with those of other shareholders, whereas on questions of how the board deals with related-party transactions involving the controlling shareholder, the interests of the controlling shareholder are not aligned with those of other shareholders.

Dual-class voting structures maintained by several public companies raise governance issues that go beyond those in other controlled companies. These issues are complicated by the fact that the controlling shareholder typically does not have an equity investment in the issuer that is commensurate with its voting power. The last two years have seen a general decline in the number of issuers with dual-class voting structures. In 2013, five TSX 60 companies had dual-class share (“DCS”) structures, compared to nine in 2011; a similar decrease is observed on the SmallCap Index where the number of issuers with DCS structures dropped from 15 to 12. At the same time, however, there has been an increase in issuers with DCS structures on the Completion Index (12 in 2011 and 15 in 2013).

The DCS issue received increased attention most recently in September 2013 when CCGG issued a new set of guidelines. In its publication, CCGG discusses the advantages and disadvantages of DCS structures and provides guidelines that it believes strike a balance between the competing considerations. The guidelines are primarily intended for new companies considering implementing a DCS structure as part of their initial public offering, but CCGG also encourages existing DCS companies to consider applying the stated principles.

On director elections, the CCGG guidelines provide that holders of multiple voting shares (“MVS”) should only be entitled to nominate the number of directors equal to the least of (i) two-thirds of the board; (ii) the number obtained when the board size is multiplied by the percentage of total voting rights held by the MVS holders; and (iii) if the holders of the MVS are “related” to management of the controlled corporation, then one-third of the board. The CCGG guidelines also recommend that MVS holders have a “meaningful equity ownership stake” in the company (a four-to-one ratio of voting rights of MVS to subordinate voting shares (“SVS”) would generally meet this test).

The guidelines also provide that DCS structures should collapse and MVS should be exchanged for SVS on a one-for-one basis at an appropriate time, as determined by the DCS company board and, if practicable, as set out in the DCS company’s articles, unless the continuation of the DCS structure is approved by a majority of the SVS holders voting separately every five years. Furthermore, CCGG recommends that: (i) reporting issuers should not have non-voting common shares; (ii) all DCS companies, regardless of whether listed on the TSX or not, should have coattails; (iii) an MVS holder not be allowed to monetize its shares by entering into a derivative transaction; and (iv) no premium be paid to the owners of MVS upon collapse of the DCS structure.

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Directors and Boards

➔ Board Size

The appropriate size for a board of directors is a question of balance and depends on a number of factors, including market cap, the complexity of the issuer's business, representation by significant or controlling shareholders and the need to populate board committees.

Not surprisingly, larger issuers tend to have larger boards. Consistent with our findings in 2011, virtually all TSX 60 issuers (95%) have at least nine members on their board. Board size of issuers on the Completion Index and the SmallCap Index has largely remained the same between 2011 and 2013, with the percentage of issuers with nine or more member boards constant at 46% on the Completion Index and slightly down on the SmallCap Index from 30% to 25%.

AVERAGE SIZE OF BOARDS (NUMBER OF DIRECTORS)

	2011	2012	2013
TSX 60	12	13	12
Completion Index	9	9.3	8.9
SmallCap Index	8	7.9	7.6

The size of boards varies widely across the TSX 60. About 57% of those issuers' boards have between nine and 12 members. A very significant percentage – but one which has decreased from 44% in 2011 to 38% in 2013 – has 13 members or more.

Issuers on the Completion Index tend to be smaller. Over half of these issuers (57%) have boards of seven to nine members. While in 2011 one issuer on the Completion Index had only four members, in 2013 the smallest board was comprised of five members. There are, however, Completion Index issuers with larger boards: 27% (slightly up from 25% in 2011) have boards of 10 to 14 members. There are also five issuers on the Completion Index that have 15 members or more.

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Executive and Director Compensation

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Executive and Director Compensation



Compensation issues continue to be at the forefront of governance discussions in 2013. In this chapter, we examine the evolution of compensation practices of Canadian issuers with regards to both management and directors – two groups that are compensated quite differently.

How Are Directors Compensated?

The general premise of Canadian corporate law with regards to director compensation is that directors have the authority to determine their own compensation, absolved from conflict of interest rules that would otherwise apply to matters in which they have a personal interest. In most cases, a director receives an annual retainer, plus a fee for each meeting she attends (referred to as a *per diem*, meeting fee or attendance fee). In about one-third of the cases, issuers on the Composite Index and SmallCap Index pay their directors a flat fee, with no additional attendance-related fee. On the TSX 60, the portion of issuers with flat-fee director compensation structures is slightly higher at 38%.

It is also common for directors to receive some form of share-based compensation. In some cases, directors may choose to have some or all of their cash compensation paid out in shares (or as discussed below, some type of phantom stock unit). In other cases, the share-based compensation is in addition to their retainers and *per diems*. Directors who are also officers or employees of the issuer (such as the CEO) typically do not receive board compensation in addition to their executive compensation.

RETAINERS

The annual retainer is generally intended to compensate directors for committing themselves to service on the board and for much of the board-related activity that occurs outside of meetings (and is therefore not covered by the *per diem*). Directors may also receive an additional retainer for committee membership.

There has been an upwards trend in the amount of annual retainers. While in 2011 70% of TSX 60 directors received retainers of at least \$50,000 per year, that percentage increased to 90% in 2013. Similarly, the percentage of TSX 60 directors receiving more than \$100,000 per annum rose from 40% in 2011 to 65% in 2013. That amount constitutes twice as much as the retainers typically paid to directors of other issuers on the Composite Index.

A similar upward trend is observed among the rest of the Composite Index issuers. While in 2011 over 75% of directors on the Completion Index received annual retainers of \$50,000 or less, in 2013 that percentage decreased to 57%, indicating that now more directors receive retainers above the \$50,000 mark.

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Executive and Director Compensation

There is a trend towards closing the gap in board chair compensation between larger and smaller issuers.

On the SmallCap Index, the proportion of directors who receive annual retainers of \$50,000 or less continues to be just over three-quarters.

Additional retainers may also be paid to directors who serve on *ad hoc* special committees.

BOARD CHAIR RETAINERS

The board chair typically receives a larger annual retainer than other directors, reflecting the amount of additional time that the chair invests in planning and chairing meetings and in coordinating with management on behalf of the board. The following are some observations which point to a downward trend in board chair compensation for TSX 60 companies and an upward trend on the Completion Index and the SmallCap Index.

Chairs of TSX 60 issuers:

- The percentage of chairs who are paid more than \$550,000 a year declined from more than 10% in 2011 to just 5% in 2013.
- Similarly, the proportion of chairs who are paid retainers of more than \$350,000 decreased from 33% in 2011 to 23% in 2013.
- In 2013, most chairs continued to be paid annual retainers of at least \$250,000, but that percentage declined significantly from 75% in 2011 to 58% in 2013, pointing to a downward trend.

Chairs of Completion Index issuers:

- One chair in 2011 and six chairs in 2013 received an annual retainer of greater than \$350,000.
- At the same time, the percentage of chairs who received less than \$100,000 decreased from almost 80% in 2011 to 56% in 2013, reflecting an upward trend in the compensation of chairs on the Completion Index.

Chairs of SmallCap Index issuers:

- The percentage of chairs receiving no additional compensation remained relatively constant (34% in 2011 and 35% in 2013).
- About 40% of SmallCap Index issuers in 2011 and 46% in 2013 received over \$50,000, with five issuers in 2011 and seven issuers in 2013 paying their chairs \$250,000 to \$350,000, pointing to an upward trend in board chair retainers on the SmallCap Index.

These trends indicate a narrowing of the gap in board chair compensation between larger and smaller issuers from both ends of the scale.

COMMITTEE CHAIR RETAINERS

In the vast majority of cases, chairs of the audit committees of TSX 60 issuers (75% in 2011 and 73% in 2013) and Completion Index issuers (69% in 2011 and 75% in 2013) continue to receive annual retainers that are higher than the retainers paid to other committee chairs, as expected given the burdensome nature of audit committee work. SmallCap Index issuers are catching up to this same trend with the percentage of issuers paying higher retainers to audit committees up to 71% in 2013 from 56% in 2011.


ATTENDANCE FEES

An attendance fee (or meeting fee or *per diem*) is an amount paid to a director for each meeting that she attends. The average *per diem* amount for each of the TSX 60, Composite Index and SmallCap Index issuers is around the \$1,000 mark. Some issuers pay committee chairs an additional *per diem* if they are engaged in committee work between meetings or may pay a director a *per diem* if she takes on some type of special assignment. Some issuers also pay a travel fee to compensate directors for their time if they have to travel a significant distance to attend meetings of the board or committees.

SHARE-BASED COMPENSATION

Directors may receive some type of share-based compensation either in lieu of cash (if they so choose) or in addition to cash payments. For some years now, the investor community has generally been against directors receiving options, believing that options align the interests of directors with the interests of management more than shareholders. Many institutional investors do not support stock options for directors. The Canada Pension Plan Investment Board ("CPPIB") notes that direct share ownership is more effective and efficient in aligning the interests of directors with the interests of shareholders. CCGG has also stated that stock options for directors are inappropriate (for the same reasons) and that share-based compensation subject to performance conditions or vesting periods (other than deferred stock units) is inappropriate for directors.

It would now be unusual for a director of a large Canadian issuer to receive options. For example, only three issuers in 2011 and two issuers in 2013 on the TSX 60 disclosed that they had granted options to their directors. While options continue to be used by smaller issuers for whom it may often be difficult to pay directors entirely (or at all) in cash, the rate at which options are issued is decreasing, if only modestly. The percentage of Completion Index companies that issue stock options to directors decreased from 37% in 2011 to 34% in 2013; the decrease was from over 50% to 46% on the SmallCap Index.



It is unusual for a director of a large Canadian issuer to receive options.

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Executive and Director Compensation

It has become typical for issuers to adopt share ownership guidelines for directors, requiring directors to own shares or share-based compensation, such as DSUs, with a value equal to a multiple of their annual retainers.

Deferred Share Units (“DSUs”) continue to be the most common form of share-based compensation for directors of TSX 60 issuers (90% in 2011 and 85% in 2013). The use percentage of DSUs on the Completion Index and the SmallCap Index is smaller but has seen a modest increase over time (50% in 2011 compared with 58% in 2013 for the Completion Index and 26% in 2011 compared with 36% in 2013 for SmallCap Index issuers).

DIRECTOR SHARE OWNERSHIP REQUIREMENT

It has become typical for issuers to adopt share ownership guidelines for directors which require directors to own shares or share-based compensation, such as DSUs, with a value equal to a multiple of their annual retainers. All TSX 60 issuers reported some form of director stock ownership requirement in 2013, compared with 59 issuers in 2011. The number of issuers adopting director stock ownership policies also increased from 69% in 2011 to 78% in 2013 on the Completion Index and from 44% to 46%, respectively, for SmallCap issuers. We also observe an increase in the ownership multiple requirement (3.57x retainer in 2011 and 3.88x retainer in 2013 for TSX 60 companies, 3.16x compared with 3.37x, respectively, for the Completion Index and 3.12x compared with 3.37x, respectively, on the SmallCap Index).

→ CEO Compensation Issues

CEO compensation is typically set by a fully independent compensation committee or by the full board on the recommendation of that committee. Compensation committees will often retain expert compensation consultants to provide them with comparator analysis. Decisions about CEO compensation are also influenced by the guidelines established by proxy advisory firms like ISS and Glass Lewis & Co., LLC (“Glass Lewis”).

Canadian securities regulation requires significant disclosure about executive compensation with particular emphasis on CEO compensation. Typically, a CEO will receive a salary, cash bonus and stock-based long-term compensation. Other forms of compensation, such as car allowances, insurance and other benefits and perquisites, are also provided.

CASH-BASED COMPENSATION

The average cash compensation (salary plus bonus) for CEOs reported this year decreased for TSX 60, and SmallCap Index issuers but increased on the Completion Index compared with two years earlier. The average CEO cash compensation for TSX 60 companies was \$2.76 million in 2013, as compared with \$2.88 million in 2011. The split between base salary and bonus shifted

slightly in favour of base salary, the proportion of which increased from 37% in 2011 to 40% in 2013. The compensation of CEOs of issuers on the Completion Index averaged \$1.34 million in 2013; this is a slight downward change from 2011's average of \$1.37 million, with the proportion of base salary increasing from 40% to 46%. CEO cash compensation of SmallCap Index issuers averaged \$1.22 million in 2011 and decreased to \$830,000 in 2013, with the base salary proportion up from 37% to 54%.

STOCK-BASED COMPONENTS

In addition to base salary and bonus, CEOs are typically awarded some form of stock-based compensation which may be subject to time-vesting, performance-vesting or both. CEOs receive share-based compensation in a variety of forms. Options and DSUs (most commonly in the form of restricted share units ("RSUs")) are the most common form of share-based compensation for CEOs. Over the last two years, the practice of granting options to CEOs by issuers on the Composite Index and the SmallCap Index has declined from 70% of issuers on both indices to 66%. On the TSX 60, this practice increased slightly from 80% to 82%. Similarly, the percentage of Composite Index and SmallCap Index issuers reporting grants of RSUs has declined from 55% to 32%.


The vast majority (approximately 80% in 2011 and 73% in 2013) of TSX 60 issuers offered stock-based compensation that was subject to performance-based vesting. This practice was less prevalent on the Completion Index and the SmallCap Index combined (51% in 2011 and 34% in 2013).

SHARE OWNERSHIP REQUIREMENTS

The vast majority (90%) of TSX 60 issuers require their CEOs to hold shares while they hold the office of CEO. While this number falls significantly for issuers on the Completion Index and SmallCap Index, the trend by issuers in those indices has been upwards. From 2011 to 2013, the percentage of issuers with share ownership requirements rose from 47% to 68% on the Completion Index and from 30% to 36% on the SmallCap Index. The number of shares that CEOs are required to hold is generally a multiple of their salary which has remained relatively constant since 2011. The average multiple in 2013 was 4.6x for TSX 60 companies (2011: 4.5x), as compared to 3.3x for Completion Index companies (2011: 3.2x) and only 2.9 for SmallCap Index issuers (2011: 3x).

CHANGE OF CONTROL CLAUSES

Most of the issuers on the Composite Index and the SmallCap Index contract with their CEOs to provide them with certain payments upon a change of control. Substantially all change of control arrangements are "double trigger" requiring both a change of control and the termination of the executive's employment



The vast majority (90%) of TSX 60 issuers require their CEOs to hold shares while they hold the office of CEO.

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The change of control payments generally range from 200% to 250% of the executive's cash compensation (base and bonus), depending on the size of the issuer.

following that change of control. Single-trigger change of control arrangements are now rare.

Change of control arrangements are in place for over three-quarters of the issuers reviewed (TSX 60: up from 80% in 2011 to 83% in 2013; Completion Index: up from 73% in 2011 to 75% in 2013; and SmallCap Index: up from 74% in 2011 to 81% in 2013). The change of control payments generally range from 200% to 250% of the executive's cash compensation (base and bonus), depending on the size of the issuer. On average, TSX 60 issuers provide their executives with 2.35x their cash compensation (down from 2.5x in 2011). On average, Completion Index issuers tend to pay slightly less (2.21x cash compensation, down from 2.25x in 2011) and SmallCap Index issuers less again (2.06x, down from 2.12x in 2011).

CLAWBACKS

Clawback provisions require the CEO to either repay some or all of the bonus or relinquish some or all of the equity-based award in situations where the award would have been lower if based on a subsequent restatement of the financial statements that the company was required to do, or in cases of gross negligence, intentional misconduct or fraud.

We have observed an increase in the use of clawback provisions related to the payment of bonuses and/or stock-based compensation. In 2013, 63% of TSX 60 issuers have clawbacks, compared with fewer than 50% in 2011. Over the same period, this percentage increased from 13% to 25% for CEOs on the Completion Index and from approximately 5% to 10% for SmallCap Index CEOs.

→ Say on Pay

The 2013 proxy season was the fourth year for "say on pay" in Canada. Since 2009 when only a handful of issuers put a say on pay vote to their shareholders, there has been tremendous acceptance of the concept. In 2013, 80% of TSX 60 issuers put say on pay resolutions forward, as compared to just over 50% in 2011. As predicted, the trend has continued upwards year-over-year, with issuers on the TSX 60 leading the charge. Issuers on the Completion Index have been slower to follow, although they are increasingly doing so at the urging of institutional investors, shareholder advisory firms like ISS and Glass Lewis, and governance advisory groups like CCGG.

SAY ON PAY RESOLUTIONS

Say on pay resolutions in Canada typically are in the model form recommended by CCGG in 2009 and developed in consultation with many of the issuers who

led the adoption of the say on pay votes in Canada, with slight variations. In almost all cases, say on pay votes are put forward to shareholders on an advisory basis, meaning that the outcome of the vote is not binding on the issuer, nor does it diminish the role or responsibilities of the board of directors for executive compensation decisions, for which shareholders will continue to hold boards accountable (even if they have previously expressed support for the issuer's compensation practices through a say on pay vote).

While say on pay votes are not mandatory in Canada, CCGG recommends that boards voluntarily add to each annual meeting agenda a shareholder advisory vote on the board's and company's reports on executive compensation contained in its proxy circular, with a form of resolution, to the effect that shareholders *accept* (as opposed to endorse or ratify), on an advisory basis and not to diminish the role and responsibilities of the board, the approach to executive compensation disclosed in the proxy circular.

ISS and Glass Lewis are strongly supportive of say on pay votes and, increasingly, both firms are scrutinizing issuers' compensation practices. They are now inclined to recommend "against" on say on pay resolutions and to potentially recommend withholding votes from incumbent nominees serving on an issuer's compensation committee or the full board where they believe there are significant misalignments between CEO pay and company performance.


Since say on pay votes in Canada are not mandatory, their frequency ultimately remains up to an issuer's board. In the United States, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank") requires they be held at least every three years. In practice, most issuers in Canada that hold say on pay votes are doing so annually and the same holds true in the U.S.

SAY ON PAY IN THE 2013 PROXY SEASON

Over the past three years, for those issuers that put say on pay votes to their shareholders in Canada, the resolutions have typically enjoyed very strong support from their shareholders. In 2013, more than three-quarters received at least 85% "in favour" votes (slightly higher than 2011's 72%), with almost half receiving more than 95% of votes in favour (2011: 35%). In 2013, only two issuers that held say on pay votes in Canada received a low level of support for their compensation disclosure.

BARRICK'S SAY ON PAY EXPERIENCE

Barrick Gold Corporation ("Barrick") held non-binding shareholder advisory votes on executive compensation in each of 2010, 2011 and 2012. In its proxy circular mailed to shareholders for its April 2013 annual shareholders meeting ("AGM"), the board of directors once again put forward an advisory vote relating



The 2013 proxy season saw more than three-quarters (representing about 81%) of TSX 60 issuers put say on pay resolutions to their shareholders, up from 53% in 2011.

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Executive and Director Compensation

In 2013, only two issuers that held say on pay votes in Canada received a low level of support for their compensation disclosure: Barrick Gold Corporation (14.8%) and Canadian Natural Resources Limited (55.8%).

to executive compensation to provide shareholders with the opportunity to vote “for” or “against” Barrick’s approach to executive compensation using CCGG’s recommended form. The circular disclosed that “[s]ince this vote is advisory, it will not be binding upon the Board. However, the Board and, in particular, the Compensation Committee will consider the outcome of the vote as part of its ongoing review of executive compensation. The Company plans to hold an advisory shareholder vote on approach to executive compensation on an annual basis.”⁶

Following Barrick’s AGM, the Company announced in its report on voting results that the advisory vote on executive compensation had not been approved, with only 14.8% of votes cast “for” the resolution and the remaining 85.2% cast “against”. Before Barrick, the only other company in Canada to lose a say on pay vote was QLT Inc., which reportedly received 42% support in 2012.

The results of Barrick’s failed vote came on the heels of a public protest by eight major investment management firms,⁷ which issued a press release on April 19, 2013 stating they intended to vote against Barrick’s pay practices in protest of a US\$11.9-million signing bonus paid to Mr. John Thornton in 2012 when he was named executive co-chair of Barrick’s board. Barrick’s 2013 proxy circular disclosed that his total compensation for 2012 was \$17 million, which the investment group said was “unprecedented” and unwarranted in a year when Barrick’s financial results were down. The investment firms argued that the compensation was inconsistent with the governance principle of pay-for-performance and set a troubling precedent in Canadian capital markets. Representatives of Barrick indicated that while they agreed with the principles of pay-for-performance, Barrick needed to make an exception to lure Mr. Thornton to accept the executive co-chair position.

Barrick has publicly reported that it is revamping its executive pay program in response to feedback received from its institutional shareholders following the 2013 annual meeting.

EMERGING TRENDS AND GUIDANCE FOR BOARDS

Whether one believes that say on pay votes are necessary or meaningful, or questions the utility of holding such votes on an annual basis (which many

6 Barrick Gold Corporation Management Proxy Circular dated March 18, 2013 in respect of its Annual General Meeting of Shareholders held on April 24, 2013, p.15.


7 The investment firms, with assets under management of \$916 billion, comprised Alberta Investment Management Corp. (AIMCo), British Columbia Investment Management Corporation (bcIMC), Caisse de dépôt et placement du Québec (CDPQ), Canada Pension Plan Investment Board (CPPIB), Hermes Equity Ownership Services (Hermes EOS), Ontario Municipal Employees Retirement System (OMERS), Ontario Teachers’ Pension Plan (Teachers’) and Public Sector Pension Investment Board (PSP Investments).

issuers are doing), say on pay votes have become a widely adopted tool for fostering shareholder engagement, particularly among larger Canadian issuers. The practice is endorsed by a large segment of the institutional shareholder community and their advisors. CCGG recommends that the best practice is to hold say on pay votes annually. While CCGG recognizes the vote is non-binding, it advocates boards taking the results of the vote into account when considering future compensation policies, procedures and decisions and in determining whether there is a need to increase engagement with shareholders on compensation and related matters. CCGG also recommends that boards ensure the detailed results of the say on pay vote are fully disclosed. Where a significant number of shareholders oppose a say on pay resolution, CCGG recommends that boards consult with opposing shareholders to understand their concerns and review the company's approach to compensation in that context. Boards should also follow up with shareholders on any significant year-over-year declines in support of say on pay resolutions, regardless of the level of support achieved. To that end, CCGG has proposed a model policy providing guidance on say on pay, including a form of resolution and recommended actions to be taken by the board in response to such votes.

Beyond the reasons articulated above, it is prudent for boards to strive to understand how their shareholders feel about important governance issues, including the compensation philosophy and practices approved by the board. As we have previously recommended, there are at least three steps a board should consider:

- It should receive regular reports from the issuer's investor relations professionals about the feedback they are receiving from shareholders.
- It should be aware of the recommendations of leading proxy advisory firms like ISS and Glass Lewis in this area.
- It should consider receiving advice from a proxy solicitor about how investors are feeling more broadly about issues, and about the perceived responsiveness of issuer to investor views.

These steps will help a board avoid being surprised by the result of a say on pay vote and provide guidance on how best to anticipate investor concerns and respond before investors feel as though they must resort to voting "no" on say on pay.



Shareholders may become more comfortable with using say on pay votes to express their dissatisfaction with compensation and related governance matters, resulting in more failed votes.

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Shareholder Voting Issues

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Shareholder Voting Issues



→ Proxy Voting Developments

This year has seen a continuation of increased awareness by the Canadian securities regulators of the issues and challenges relating to the operation of the proxy voting system in Canada that we observed in the last two years. These issues and challenges were canvassed in Davies' 2010 paper "[The Quality of the Shareholder Vote in Canada](#)" which contributed to raising awareness of and focusing on the issues surrounding the complex and opaque processes that make up the Canadian proxy plumbing system.

Improving the proxy voting system has remained a focus of the OSC in 2013. The OSC established as one of its key initiatives for 2013-2014 the improvement of shareholder democracy and protection by (i) facilitating the adoption of majority voting for elections of directors by issuers listed on the TSX (discussed further below) and (ii) identifying the key proxy voting infrastructure issues and publishing a consultation paper. Proxy reform, while not mentioned in the initial draft statement of priorities of the OSC, was subsequently added as a result of comments received from a number of large institutional shareholders urging that proxy voting issues be made a priority.

In August 2013, the Canadian Securities Administrators ("CSA") issued a consultation paper reviewing the proxy voting infrastructure and seeking to outline a proposed approach to address the various concerns.⁸ The CSA paper acknowledges the importance of shareholder voting traditionally but also notes that recent trends such as the rise in institutional share ownership of public companies, the presence of activist hedge fund investors and an increased willingness to challenge boards and management are anticipated to result in greater stress on the proxy voting infrastructure.

The CSA paper highlights several areas for discussion that the CSA has determined may impact the accuracy of the infrastructure. It focuses on the need to address two main issues (each of which are discussed in further detail below): (i) whether the current infrastructure adequately supports accurate and reliable vote counting; and (ii) whether a vote confirmation system should be introduced so that shareholders can be confident their votes have been transmitted, received and counted at a shareholders meeting.

ACCURATE VOTE RECONCILIATION

Vote reconciliation refers to the process of reconciling proxy votes and voting instructions against the securities entitlements in the system. Two principal challenges in this area are noted by the CSA:

⁸ See Consultation Paper 54-401 *Review of Proxy Voting Infrastructure* (the "CSA paper").

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- *Valid Votes Discarded:* Validly submitted proxy votes may be discarded if they cannot be properly matched.
- *One Share, Multiple Votes:* How to ensure the same share is not voted by a lender and a borrower, or by a seller and a purchaser of securities of the issuer transferred after the record date.

Four main factors are identified in the CSA paper as contributing to the complexity of proxy voting and the challenges of vote reconciliation:

1. The intermediated holding system, including the pooling of securities and the phenomenon of investors not owning shares but “securities entitlements”.
2. Share lending where voting rights are transferred contractually, but the lender may still be the “owner” in the intermediary’s records. As a result, the “borrower” is entitled to vote the shares and receive dividends, but contractually the “lender” retains the economic exposure to the lent shares without the corresponding voting rights. At the same time, the lender may continue to be noted as an “owner” in the intermediary’s records.
3. Use of voting agents where voting authority is often delegated to an advisor but the investor is still solicited for voting instructions.
4. The Objecting Beneficial Owner (“OBO”) / Non-Objecting Beneficial Owner (“NOBO”) concepts and the problems associated with OBOs not disclosing their identity, contact information or security holdings.

END-TO-END VOTE CONFIRMATION SYSTEM

The CSA paper examines whether shareholders should receive a communication that their proxy votes and voting instructions have been properly transmitted, received and tabulated. The absence of confirmation creates doubt as to whether the investor’s voting instructions have been properly carried out, which can create tensions, especially in cases of close votes.

Other issues noted in the CSA paper include:

- the impact of the OBO/NOBO concepts on the reliability of proxy votes;
- the inability of investment managers to vote clients’ shares held in discretionary accounts; and
- the accountability of service providers such as Broadridge Financial Solutions, Inc.

In the paper, the CSA is mostly posing questions for feedback but suggests that more accurate vote reconciliation may, in the long term, require changes to record dates, proxy cut-off dates and technology investments, and notes that

Broadridge has started to develop end-to-end vote confirmation functionality. In the coming months, we expect more dialogue and eventually reforms as the CSA reviews the feedback and attempts to formulate a regulatory response.

The OSC has announced its intention to hold a roundtable to further explore the issues identified in the CSA paper in late January 2014.

➔ Role and Regulation of Proxy Advisory Firms

In 2013, the role and influence of proxy advisory firms such as ISS and Glass Lewis have continued to be a focus for the Canadian securities regulators, as well as their U.S. and European counterparts. Concerns have been raised regarding the extent to which proxy advisory firms have, effectively, imposed uniform and somewhat arbitrary corporate governance standards on companies through investors' over-reliance on proxy advisors' voting recommendations. To date, there has been no regulation of proxy advisory firms despite the influence that their recommendations can have on institutional and retail investors when exercising voting rights.

CSA CONSULTATION PAPER ON PROXY ADVISORS: 2013 UPDATE

As previously reported, in June 2012 the CSA released a consultation paper soliciting comments on whether proxy advisors should be regulated.⁹ The comment period on this consultation paper closed on September 21, 2012. Sixty-two comment letters were received, including 26 comments from issuers, 16 comments from institutional shareholders or shareholder organizations and seven responses from Canadian law firms, including Davies. Three proxy advisory firms also responded, including ISS and Glass Lewis.

At the end of September 2013, the CSA provided an update on the consultation process relating to the potential regulation of proxy advisory firms. The update ([*CSA Notice 25-301 Update on CSA Consultation Paper 25-401 Potential Regulation of Proxy Advisory Firms*](#)) provides a summary of the comment letters received in response to the 2012 consultation paper and indicates that the CSA has determined that a "policy-based" response is warranted that would give guidance on recommended practices and disclosure for proxy advisory firms. The CSA intends to publish for comment its proposed approach in the first quarter of 2014.

⁹ See [*Consultation Paper 25-401 Potential Regulation of Proxy Advisory Firms*](#).

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The update reveals significant differences in perspective between issuers and institutional investors that emerged through the comment process. Among the key comments identified in the update are the following:

- While issuers are concerned about the influence of proxy advisory firms, institutional clients noted that proxy advisory firms provide them with useful and cost-effective services when exercising voting rights and are generally satisfied with the services provided.
- Commenters generally agreed that the business model or ownership of proxy advisory firms may lead to conflicts of interest. A majority of issuers believe that conflicts of interest are not appropriately mitigated, whereas a majority of institutional investors believe that conflicts of interest are properly identified, managed and disclosed.
- While issuers are concerned with potential inaccuracies in research reports, a majority of institutional investors believe that the dialogue processes currently in place are sufficient to avoid factual errors.
- Issuers questioned the quality of the vote recommendations made by proxy advisory firms and favoured increased transparency and disclosure of underlying methodologies and analyses, whereas institutional investors did not believe that additional information would be beneficial to the market and argued against requiring disclosure of proprietary analytical models.
- The views on the appropriate CSA response diverged from a rule-based approach, including registration of proxy advisory firms as advisors, to publishing a set of principles and best practices. Proxy advisory firms do not believe their activities should be regulated.

For further analysis from Davies on the CSA update, see our article "[Canadian Securities Administrators to Propose Policy-Based Approach to Regulating Proxy Advisory Firms](#)".¹⁰

U.S. AND EUROPEAN DEVELOPMENTS

The consultative process under way in Canada follows in the wake of similar steps by regulators in both the United States and Europe. A similar information-seeking exercise was undertaken by the Securities and Exchange Commission ("SEC") in 2010 with its concept release on the U.S. proxy system.¹¹ In response to the feedback received, the SEC is expected to provide guidance on how proxy advisory firms could be regulated under U.S. federal securities laws, although the timing on any such regulation is unclear.

¹⁰ <http://www.dwpv.com/en/Resources/Publications/2013/Canadian-Securities-Administrators-to-Propose-Policy-Based-Approach-to-Regulating-Proxy-Advisory-Firms>.

¹¹ See <http://www.sec.gov/rules/concept/2010/34-62495.pdf>.

In the meantime, the U.S. Chamber of Commerce Center for Capital Markets Competitiveness (the “CCMC”) released in early 2013 several principles seeking to create transparency, accountability and good governance systems for proxy advisory firms. The CCMC’s principles, titled “Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice”¹², seek to improve corporate governance by ensuring that proxy advisory firms:

- are free of conflicts of interest that could influence vote recommendations;
- ensure that reports are factually correct and establish a fair and reasonable process for correcting errors;
- produce vote recommendations and policy standards that are supported by data-driven procedures and methodologies that tie recommendations to shareholder value;
- allow for a robust dialogue between proxy advisory firms and stakeholders when developing policy standards and vote recommendations;
- provide vote recommendations to reflect the individual condition, status and structure for each company and not employ one-size-fits all voting advice; and
- provide for communication with public companies to prevent factual errors and better understand the facts surrounding the financial condition and governance of a company.

In a similar vein, in a speech delivered in July 2013, SEC Commissioner Daniel Gallagher called for the SEC to consider a number of reforms for the proxy advisory industry. Commissioner Gallagher noted the potential phenomenon that institutional shareholders, particularly investment advisers, may overly rely on proxy firms for advice when they cast corporate votes for clients, raising the risk that they are not in fact acting in the best interest of their fiduciary customers. He expressed the view that the SEC should “issue guidance clarifying to institutional investors that they need to take responsibility for their voting decisions rather than engaging in rote reliance on proxy advisory firm recommendations”.¹³

In Europe, a similar consultative process on the role of the proxy advisory industry was conducted over the last two years, on the basis of which in February 2013 the European Securities and Markets Authority (“ESMA”) released a final report, “Feedback statement on the consultation regarding the role of the proxy advisory industry”, summarizing its findings and position.¹⁴ Based on

12 See <http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf>.

13 See <http://www.sec.gov/News/Speech/Detail/Speech/1370539700301>.

14 See <http://www.esma.europa.eu/mt/system/files/2013-84.pdf>.

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the input received and its own analysis, ESMA concluded that it has not been provided with clear evidence of market failure in relation to how proxy advisors interact with investors and issuers. However, it has identified several areas, mostly relating to transparency and disclosure, where it believes a coordinated effort of the proxy advisory industry would foster greater understanding and assurance among other stakeholders.

As a result, ESMA has encouraged the proxy advisory industry to develop its own EU Code of Conduct. It intends to review the development around an EU Code of Conduct concept in two years and may reconsider its position if no substantial progress has been made by that time. To help develop such a Code, ESMA has drafted a set of principles, which are summarized below:

1. Proxy advisors should seek to avoid conflicts of interest with their clients. Where a conflict effectively or potentially arises the proxy advisor should adequately disclose this conflict and the steps which it has taken to mitigate the conflict.
2. Proxy advisors should provide investors with information on the process used in making their general and specific recommendations and any limitations or conditions to be taken into account on the advice provided. In addition, proxy advisors should:
 - disclose both publicly and to client investors the methodology and sources they use in making their voting recommendations, and how their voting policies and guidelines are applied to produce voting recommendations;
 - be aware of the local market, legal and regulatory conditions to which issuers are subject, and disclose whether/how these conditions are taken into due account in the proxy advisor's advice; and
 - inform investors about their dialogue with issuers, and of the nature of that dialogue.

➔ Majority and Individual Director Voting

BACKGROUND

Majority voting for directors of public companies has become firmly entrenched in Canada. The widespread adoption of majority voting policies was initially due to strong support for the practice and its underlying principles among institutional investors and shareholder advisory firms. In 2012, rule changes

adopted by the TSX further encouraged the practice. Year-over-year increases in the implementation of majority voting among Canadian issuers are not a recent phenomenon. However, we see the focus shifting to a push by investors for more stringent requirements surrounding majority voting and majority voting policies in both Canada and the U.S., including calls for making its implementation mandatory and the adoption of stricter requirements for resignations by directors who fail to obtain majority approval.


Briefly, majority voting replaces the historical practice of electing a director on a plurality basis, where in the absence of more nominees than board seats, a single vote “for” a director is sufficient to elect the director under corporate law, even if all of the other shares are “withheld” from voting. Majority voting, by contrast, requires each director to get more “for” votes than there are “withhold” votes with respect to the candidate’s election. There are three key elements to majority voting: the shareholder vote on the election of each director individually, rather than by slate; public disclosure of the results of that vote; and adoption of a board policy to deal with situations in which a majority of votes cast for any individual director are withheld from such director.

CURRENT PRACTICE AND TRENDS

Two of the three key elements of majority voting (individual director voting and public disclosure of the results) are now required of all TSX issuers effective December 31, 2012. Even before this rule change, individual director voting had become the norm in Canada, with the historical practice of electing directors by slate having been entirely eliminated among TSX 60 issuers. Among Composite Index issuers and SmallCap Index issuers, an overwhelming 99% of issuers in each of the indices have adopted individual director voting. This compares to 2011 figures in which only 87% of Composite Index issuers and 80% of SmallCap Index issuers permitted shareholders to vote for directors on an individual basis.

Specifically, the 2012 TSX amendments introduced three new rules. First, the TSX made the practice of electing directors individually mandatory. The TSX also mandated the practice of issuing a news release providing detailed disclosure of the voting results on the election of each individual director, whether cast by ballot or show of hands. For votes cast by show of hands, issuers are permitted to limit their disclosure to the results represented by proxies, given the practical difficulty of determining exact numbers when votes are cast by show of hands.¹⁵

The percentage of TSX 60 issuers that report the percentage results of their director elections rose to 97% in 2013 from 88% in 2011. While this practice



Majority voting for directors of public companies has become firmly entrenched in Canada due to a combination of strong support for the practice and its underlying principles among institutional investors and shareholder advisory firms, and changes in regulatory requirements implemented in 2012 designed to encourage the practice.

¹⁵ This is currently “accepted practice” by the TSX but is expected to be formally entrenched in the TSX rules as a result of further amendments anticipated to come into effect at the end of 2013.

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continues to be lower for Completion Index issuers (2013: 88%; 2011: 59%) and SmallCap Index issuers (2013: 79%; 2011: 48%), it is clear that for all TSX-listed issuers individual director voting and the reporting thereof have become the norm, and most issuers are complying with the TSX rules and governance best practices in this regard.

Second, the TSX amendments included a new requirement for TSX issuers to hold annual elections for all directors, making staggered or classified boards impossible for TSX-issuers, (although their incidence in Canada has always been quite low, especially relative to other jurisdictions like the United States and Australia).

Lastly, the 2012 TSX rule amendments implemented a “comply or explain” approach to majority voting: issuers must disclose in their proxy circulars whether they have adopted a majority voting policy and, if not, why not. For those who have not adopted such a policy, in addition to having to publicly report voting results for each director, they must also advise the TSX if any directors fail to secure a majority of votes in their favour at the meeting.

ISSUERS WITH MAJORITY VOTING POLICIES

2011	2013
TSX 60	
91%	97%
Completion Index	
54%	87%
SmallCap Index	
34%	85%

Many issuers had already adopted majority voting prior to the 2012 TSX amendments and the number continues to rise. In 2011, 91% of TSX 60 issuers disclosed that they had a majority voting policy; this number reached a new high of 97% of TSX 60 issuers in 2013. For the Completion Index, the number of


issuers with majority voting rose to 87% in 2013 from 54% in 2011, while even the number of SmallCap Index issuers with majority voting rose to 85% in 2013 from just 34% in 2011. Although majority voting is not mandatory in Canada, the TSX's adoption of the "comply or explain" model has clearly been effective in influencing a large proportion of listed issuers to adopt majority voting.

Despite the prevalence of majority voting in Canada, it remains extremely rare for a majority of votes to be withheld from an individual director. Of the 320 Composite Index and SmallCap Index issuers who reported their voting results for individual director elections in 2013, the average percentage of votes withheld from an individual was 4.4%, which is slightly lower than, but not meaningfully different from, the average percentage of withheld votes in prior years (2011: 5.6%). Overall, for those issuers that reported the voting results for director elections, about 86% of the directors received more than 90% of the votes cast "for" them. The breakdown by TSX Index, for those issuers that reported the voting results for director elections was as follows:

- **TSX 60:** All directors received 69.9% or more votes cast "for" them (with no directors receiving less than 51% approval) and 89.5% received 91% or more votes cast in their favour.
- **Completion Index:** All except two directors received 51% or more votes cast "for" them, and 85% received 91% or more votes cast in their favour.
- **SmallCap Index:** All except four directors (two of whom are directors of an issuer listed on the Completion Index and therefore included in the preceding bullet) received 51% or more votes cast "for" them and 79.8% received 91% or more votes cast in their favour.

Interestingly, despite institutional shareholders' support for majority voting, to date there has been no discernible trend of shareholders withholding their support from management nominees. In fact, as highlighted by the data above, for those issuers that reported voting results for director elections during 2013, only two directors of one issuer on the Composite Index and one additional director of one other issuer on the SmallCap Index received less than a majority of votes cast.

Perhaps the most interesting development that we have observed with respect to majority voting has been the response of issuers to a majority of "withhold" votes. While some directors in Canada and the U.S. have faced circumstances in which they have had more votes "withheld" than voted "for" them, this has not resulted in the automatic resignation of the director, even among issuers that have adopted majority voting policies. There have been several examples in both Canada and the U.S. in 2013 where directors who failed to get a majority vote offered to resign in accordance with the company's policy but found their resignations rejected and continued to serve on the board. This has fueled



For those issuers that reported voting results for director elections during 2013, only two directors of one issuer in the Composite Index received less than a majority of votes cast.

debate on whether majority voting should be mandated (as opposed to being merely company policy) and whether more stringent rules requiring directors to resign (and have their resignations accepted) in all cases where a majority of votes are withheld should be imposed.

EMERGING TRENDS AND NEXT STEPS

At the time the TSX adopted its “comply or explain” approach to majority voting in December 2012, it published further proposed amendments to its rules that would make majority voting mandatory for all TSX-listed issuers. It is widely expected that the TSX will adopt these amendments by the end of 2013. If implemented, the amended rules would require all TSX-listed issuers to have majority voting (but not necessarily a majority voting policy) for director elections at uncontested meetings held after December 31, 2013. As a result, any director nominee who receives a majority of “withheld” votes in an uncontested meeting, even though still properly elected as a matter of corporate law, would have to offer her resignation for the issuer to comply with the TSX rules.

Although these amendments would not require a TSX issuer to adopt a majority voting policy, as a practical matter, we expect that most issuers will want to establish a protocol for dealing with circumstances where a particular nominee receives a majority of votes “against” or they are withheld from her election. The alternative is to deal with the situation on an ad hoc basis if and when the need arises, which may be awkward and generate dissatisfaction among shareholders.

Although majority voting policies may vary from issuer to issuer, the ultimate goal of the policy is to provide a mechanism in uncontested elections by which any directors who receive a majority of “withheld” votes are effectively removed from the board. Most policies are non-binding and require the board to accept the resignation, absent exceptional circumstances, and issue a press release announcing its decision. This requirement is also in line with the TSX’s expectations. Some policies go further and require the board to accept the director’s resignation in all cases, but these are less common.

Media reports, letters and other publications by institutional investors, shareholder advisory firms and corporate governance watchdogs indicate that an active push is being made to mandate majority voting and require boards to accept directors’ resignations in cases where a majority of votes are withheld, *barring extraordinary circumstances*. In this regard, ISS and Glass Lewis both voiced the view in their 2013 proxy guidelines that majority voting enhances shareholder democracy and board accountability and, to that end, they generally support proposals calling for majority voting in uncontested elections. Glass Lewis also indicates that for Canadian companies that elect to “explain” why they do not have a majority voting policy rather than to comply, as permitted

under the current TSX rules, they will recommend that shareholders withhold votes from all members of the issuer's governance committee. In Canada, ISS will vote for resolutions requesting that a board adopt a majority vote standard and a resignation policy or the company amend its by-laws to provide for majority voting.

We expect that by the end of this year mandated majority voting will become the reality and TSX issuers will be strongly encouraged to adopt majority voting policies that provide for the resignation of under-supported directors, absent exceptional circumstances. In the longer term, we also expect that majority voting may become mandated in the United States, and we will continue to see, from the stock exchange and securities regulators, more guidance and perhaps even prescriptions as to the contents of majority voting policies and what sorts of circumstances may legitimately entitle a board to reject a director's resignation under those policies.

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→ Activism as a Developing Asset Class

Shareholder activism continues to rise. Over the past 10 years, the number of proxy contests in Canada has risen from just five in 2003 to 30 in 2012 and 30 to date in 2013, with two significant spikes in 2008 and 2009 coinciding with the global financial crisis.¹⁶ There are many factors contributing to this trend, but principal among them are the increased opportunities for activism resulting from certain current trends in law and practices to refer more matters to shareholders for approval (such as the approval of poison pills).

In addition to the rise in number of contests, the success rate for dissident shareholders has increased. One contributing factor is the increased receptiveness of the shareholder community to the efforts of shareholder activists. This is due in part to the shift away from historical “corporate raider” agendas of activists towards more sophisticated approaches that tend to be more focused on governance matters and therefore have a broader appeal to the shareholder base. In particular, activists are focusing on corporate strategy, governance and board independence and effectiveness.

It is also due to the positive shareholder returns that can be delivered in thoughtful activist campaigns. Indeed, in the last several years, activism has emerged as a significant asset class, with many major institutional shareholders investing portions of their portfolios in activist or event-driven funds. The value owned by activist investors in TSX-listed companies has been steadily on the rise over the last two years and has grown from \$10.8 billion in 2011 to \$15.2 billion in 2013.¹⁷ Similarly, the assets under management that U.S. activist funds had at the end of 2012 were US\$65.5 billion, as compared with US\$11.8 billion in 2003.¹⁸ Given the increase in the success rate of activist campaigns, this trend is likely to continue.

Boards of directors of Canadian public companies will increasingly be exposed to shareholder activism of one type or another and, accordingly, a strong understanding of the rationales for activism and the techniques used by activists is important for directors. The benefits activism is believed to advance include the following:

- **Check on Management:** Shareholder activists are seen to provide a check on management which complements existing rules and regulations in a way

Over the past 10 years, the number of proxy contests in Canada has risen from just five in 2003 to 30 in 2012 and 30 to date in 2013.

¹⁶ Kingsdale Shareholder Services Inc.

¹⁷ As at June 30, 2011 and June 30, 2013, respectively, based on data provided by Bloomberg.

¹⁸ Data sourced by HFR Inc., as cited in *Activist Fights Draw More Attention*.

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Boards will increasingly be exposed to shareholder activism of one type or another as a result of shareholder activists feeling more confident about their prospects for success and other historically passive shareholders more frequently weighing in on activist campaigns.

that a wide range of passive beneficial shareholders cannot do, due to lack of human, informational and financial resources. Engaged shareholders prompting the adoption of good corporate governance practices can improve board oversight of management as boards challenged by engaged shareholders are more inclined to hold management accountable for company performance and to tie compensation to performance.¹⁹

- *Superior Returns on Investment:* Some studies have observed that the market typically prices a 5%-10% abnormal return into a target company's share price upon disclosure of an activist's investment.²⁰ This reaction is largely due to the history of improved share price and return on investment at companies subject to shareholder engagement, which improvements studies have shown would not have occurred in the absence of the activist.²¹ Other studies have found no evidence of a reversal of stock returns during a five-year period after the U.S. Schedule 13D announcement by an activist, nor did the targets of activism exhibit abnormal negative returns during the same period.²²
- *More Efficient Allocation of Assets:* Studies have shown that the involvement of an engaged shareholder can facilitate the efficient reallocation of assets.²³ A recent "plant-level" study revealed that plants sold by companies after activist intervention exhibited lower than average productivity prior to the sale and experienced greater than average improvement in the hands of new owners.²⁴ Consider, for example, recent instances of activists urging companies to unlock hidden value by spinning off business units or assets that fall outside of the issuer's core business, such as the recent activist campaigns by Sandell Asset Management in respect of Bob Evans Farms Inc., Barrington Capital Group LP in respect of Darden Restaurants, JANA Partners LLC in respect of Outerwall Inc., Continental Grain Co. in respect of Smithfield Foods Inc., and Relational Investors LLC and the California State Teachers' Retirement System in respect of The Timken Co.

19 Lucian Bebchuk and Robert Jackson, "The Law and Economics of Blockholder Disclosure" (2012) 2 Harv Bus L Rev 39 at 48.

20 Bebchuk, *ibid* at 47-48. See also Alon Brav *et al.*, "The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Product Market Competition" (The National Bureau of Economic Research, March 2013) NBER Working Paper No 17517 at 2; J.P. Morgan, "Hedge fund activists 2.0: They are back! Creating value through pro-active strategies in response to hedge fund activism", (April 2010) at 6.

21 Brav, *ibid* at 1-5.

22 Lucian Bebchuk, "The Myth that Insulating Boards Serves Long-Term Value" (2013) 113 Colum L Rev at 32, citing Lucian Bebchuk, Alon Brav and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism" (2013) working paper.

23 Brav, *supra* note 21 at 2-4.

24 Brav, *ibid* at 3.

Of course the other side of the debate is also well developed. Concern has been expressed with the potential influence that activist shareholders can exert over issuers, pushing their own agenda – often said to focus on short-term goals – to the detriment of other shareholders or the issuer's best interests.

Finding the appropriate balance between fostering shareholder engagement and preserving deference to boards' authority will be an ongoing challenge, but in the meantime we believe that a rise in shareholder activism will continue, both with existing shareholder activists feeling more confident about their prospects for success and other, historically passive shareholders, more frequently weighing in on activist campaigns.

➔ Shareholder Proposals

One of the fundamental rights of shareholders under Canadian corporate law is the ability to use the shareholder proposal regime to put certain business on the agenda of a meeting of shareholders, including submitting nominations for the election of directors. Proposals can be advisory or binding, depending on the subject matter. The business submitted by a shareholder proposal must be included in the management proxy circular for the corporation's annual general meeting. Under the CBCA, in order to be eligible to submit a shareholder proposal, a shareholder must hold, or have the support of shareholders in aggregate holding, voting shares equal to at least 1% of the outstanding voting shares or whose fair market value is at least \$2,000. Typically, such shares must have been held for at least six months prior to the shareholder submitting the proposal. Also, a shareholder proposal to nominate a director must be signed by one or more holders of shares representing in the aggregate not less than 5% of the shares entitled to vote at the meeting.

A corporation can reject a proposal where it appears that the proposal does not relate in a significant way to the business or affairs of the corporation, and is not required to include a shareholder proposal in its management proxy circular if it is not submitted to the corporation at least 90 days before the anniversary date of the notice of meeting that was sent to shareholders in connection with the previous year's annual meeting.

During the 2013 proxy season, based on a review of issuers on the Composite Index and the SmallCap Index, only 14 issuers (all of which were in the Composite Index) had shareholder proposals on their annual meeting agenda and, consistent with past years, seven of those issuers were financial institutions.

Issuers continue to face shareholder proposals for governance-related changes, although the technical proposal right may not be the most effective tool for a shareholder seeking to nominate director(s) to a public company board.

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During the 2013 proxy season, only 14 issuers (all of which were in the Composite Index) had shareholder proposals on their annual meeting agenda.

For the most part, shareholder proposals continue to receive very weak support from shareholders (typically less than 10%). The nature of the proposals varies, with some typically receiving more support than others. The following are some of the most frequent proposals received during the 2013 proxy season:

- “Gender parity on the board” proposals were put to seven issuers in 2013 (up from two in 2012), with one issuer, Laurentian Bank of Canada, having received 21.29% of the votes cast in favour of the proposal. The remaining proposals in this area received support ranging from 2.16% to 7.9%.
- “Say on pay” proposals were put to six issuers in 2013 (up from three in 2012), with votes in favour ranging from 2.89% (in the case of The Jean Coutu Group (PJC) Inc., a SmallCap Index issuer) and as high as 34.7% (in the case of Metro Inc.).
- “Equitable treatment with respect to pension plans” proposals, which refer to requiring the board to adopt a policy to offer all employees, regardless of reporting level, the same type of pension plan with the same scale applied, were put to seven issuers in 2013 (as compared to no such proposals in 2012), with votes in favour ranging from 1.5% (in the case of The Toronto-Dominion Bank) to 19.03% (in the case of Laurentian Bank of Canada).
- “Greater disclosure of pension plan oversight” proposals, which refer to the board assuring shareholders and stakeholders annually that the pension plans offered are managed in accordance with sound management practices, were put to nine issuers (as opposed to only one in 2012), with votes in favour ranging from 0.31% (in the case of The Jean Coutu Group (PJC) Inc.) to 17.02% (in the case of Laurentian Bank of Canada).
- “Consideration of all stakeholders”, which is a proposal that refers to requests for a board to revise its mandate to stipulate that its primary responsibility is to preserve and improve the viability of the issuer and ensure that the issuer is managed in its fundamental interest, with respect for the shareholders and the other stakeholders. This proposal was put to three issuers in 2013 (as compared to none in 2012), with votes in favour ranging from 0.56% (in the case of Bombardier Inc.) to 1.22% (in the case of Metro Inc.).

Shareholder proposals are also available to shareholders as a tool for nominating directors to a board, and there is no limit on the number of nominees that may be proposed. The ability of a shareholder to cause an issuer to include a director nominee in the management proxy circular could save a dissident shareholder the considerable expense of preparing and mailing a dissident proxy circular, although the inclusion of a dissident's nominee(s) in management's proxy circular does not relieve the dissident from its obligation to mail its own circular to shareholders if it wishes to engage in a general solicitation of proxies.

Solicitation is broadly defined under Canadian law. For a shareholder seeking to communicate with and secure the support of other shareholders in advancing its campaign, the obligation to mail a dissident circular may be triggered even if the shareholder has been successful in having its proposal included in the management proxy circular. This, and a number of other factors listed below, has resulted in shareholder proposal provisions rarely being used in Canada for the purpose of nominating directors.

- First, the deadline for submitting a proposal typically occurs four to six months before a meeting date and has often passed before a dissident shareholder has firmed up its plans to take action.
- Second, the statutory 500-word limitation gives shareholders little scope for making their case, particularly in areas as controversial as the election of directors.
- Third, shareholders with 5% of the shares already have the right to requisition a meeting. The deadline for requisitioning a meeting will typically occur much later than the deadline for submitting a proposal. As a result, any shareholder considering submitting a nomination via a proposal could instead submit a requisition at a later date and then agree with management that the requisitioned business (e.g., to elect the dissident's nominees) could be dealt with at the annual meeting instead.

→ Requisitioning Shareholder Meetings

Another powerful right that shareholders of Canadian corporations enjoy is the right of holders of not less than 5% of the issued voting shares to requisition the directors to call a shareholders meeting. Similar to shareholder proposals, the nature of the business requested to be transacted at a requisitioned meeting is not limited, and there are limited statutory exceptions to a company's obligation to call the meeting upon receiving a valid requisition. In recent years, this requisition right has most frequently been used by dissident shareholders to propose one or more director nominee(s), in place of some or all of the directors nominated by management of the issuer, and can prove to be a useful tool for initiating a proxy contest.

To be valid, a shareholder's requisition must state the business to be transacted at the meeting. Canadian courts have considered the scope of this requirement in the context of proceedings held to determine whether a requisition by a shareholder was valid. Most recently, in July 2013, the Ontario Superior Court of Justice in *Wells v Bioniche Life Sciences Inc.* ("*Wells v Bioniche*") held that a requisition for a meeting to elect new directors must include the names and

A powerful right that shareholders of Canadian corporations enjoy is the right of holders of not less than 5% of the issued voting shares to requisition the directors to call a shareholders meeting.

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The requirements to requisition are technical and courts expect strict compliance.

qualifications of the proposed nominees; the level of detail should be sufficient to enable the board to issue notice of the requisitioned meeting and to permit shareholders to form a reasoned judgment. In addition, the requisitioning shareholder may be required to provide information to be included in management's circular for the meeting and a mere undertaking to provide that information in time for inclusion in the management proxy circular may not be sufficient. Failure to provide such information may relieve the directors of the obligation to call the meeting.

As to who is eligible to requisition, many corporate statutes such as the CBCA indicate that a "holder" of not less than 5% of the shares is eligible to requisition a meeting. Historically, the fact that the CBCA and some other corporate statutes do not specify "registered holders" in the cases of the requisition right, but do in other provisions distinguish between registered and beneficial owners, has meant that beneficial or registered holders of the threshold number of shares can properly requisition a meeting. However, in the recent *Wells v Bioniche* case, the dissidents' initial requisition was rejected by the board of Bioniche, on the basis that the requisitioning shareholders were not registered holders. The Court, in considering several issues before them, determined that while Bioniche could have treated the requisitioning shareholders as entitled to submit the requisition, it was entitled to decline to do so and, accordingly, the first requisition submitted was properly rejected.

While ultimately this defect was cured by the requisitioning shareholders, it does create some uncertainty as to whether beneficial holders may requisition a meeting, particularly in light of the recent *TELUS* decision (discussed further below), where a requisition was ruled invalid by the trial judge on the basis that the requisition was submitted by Clearing and Depository Services Inc. ("CDS"), as the registered shareholder, without identifying the beneficial owner of the shares. Although this decision was overturned on appeal, the two outcomes create some uncertainty about whether beneficial owners may have the validity of their requisitions questioned. The prudent course of action may therefore be for beneficial owners seeking to requisition meetings to either have the shares transferred to them in registered form or, alternatively, submit a requisition in which both the registered owner, like CDS, signs onto the requisition along with the beneficial owner(s).

A requisition for a meeting to elect new directors must include the names and qualifications of the proposed nominees.

On receiving a valid requisition proposing proper shareholder business, the directors must within 21 days *call* a meeting of shareholders to transact the business stated in the requisition. The obligation to "call" a meeting has been interpreted by the courts to be satisfied by the announcement of a date on which the meeting will be held; it is not necessary to actually hold the meeting or even to mail notice of the meeting within the 21 days. Rather, the meeting must be held within a reasonable time determined in the good faith business judgment


of the directors. What is a reasonable time depends on the circumstances: for example, whether the requisitioned meeting pertains to a specific transaction or pending event and whether the requisitioning shareholders would be prejudiced by delay.

In its 2013 decision in *Marks v Intrinsyc Software International*, the Ontario Superior Court considered 150 days to be reasonable for a requisitioned meeting called to consider the removal of the board and election of new directors. The court concluded that the decision of the board to delay the requisitioned meeting so that it coincided with the annual general meeting in order to avoid the cost of two meetings was within a range of reasonableness, and the requisitioning shareholder could not point to any specific prejudice he would suffer from the delay. The Court noted that in these cases, the role of the court is to determine whether the board applied the appropriate degree of prudence and diligence in coming to its decision on the timing of the meeting, rather than second-guessing the board's judgment based on a proper consideration of various factors.

If the directors do not call a meeting within 21 days of receiving the requisition, any shareholder who signed the requisition may do so. Unless the shareholders resolve otherwise at the requisitioned meeting, the corporation is required to reimburse the shareholders for expenses reasonably incurred by them in requisitioning, calling and holding the meeting. What exactly happens when the shareholder calls the meeting is not entirely clear; the corporate statutes provide little guidance and there is scant precedent to look to as in virtually all cases the corporation calls the requisitioned meeting.

Alternatively, a shareholder can apply to the court for an order compelling the corporation to hold a meeting. While this statutory right is clearly enshrined, the *Wells v Bioniche* case casts some uncertainty over whether this right would be supported by the courts, if challenged. In that case, the requisitioning shareholders sought to exercise their right under the CBCA to call a meeting at an earlier date than that scheduled by the board. While the Court concluded that the right for a shareholder to call a meeting when a board declines to do so applies even where a board has already fixed a record date, the Court added that "a court would be unlikely to *uphold a meeting* called by a shareholder" in circumstances where one of the exceptions to the board's obligation to call a meeting applies. What was meant by this statement is unclear. Does it mean a shareholder still has the right to call and hold a meeting but that the decision of the shareholders at that meeting may be challenged? Or would a shareholder's statutory right to reimbursement that otherwise applies fail? Only future consideration of the issue will provide clarity.

Our research has shown that, in fact, the requisition right is exercised quite infrequently. Our review of publicly disclosed shareholders meetings



Courts are reluctant to second-guess a board's judgment over what constitutes a reasonable amount of time between calling and holding a requisitioned meeting.

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requisitioned between 2008 and 2012 found that only 62 meeting requisitions were issued over that five-year period. Of those, only a nominal percentage actually led to a proxy contest, suggesting that some commentators' concerns about the potential strength of this tool for influencing issuers may be overstated. Nevertheless, the requisition right is available to shareholders and can be an important way for the requisitioning shareholder to engage with the board and to seek a cooperative solution for addressing a shareholder's dissatisfaction without the need for resorting to costly and highly publicized proxy battles.

➔ Short Slate Proposals: The New Reality

Canadian corporate statutes generally provide that the shareholders may, by ordinary resolution at a special meeting, remove one or more directors from office and elect their replacements. This right, coupled with the right of shareholders to requisition meetings, prevents Canadian corporations from implementing "classified" or "staggered" boards in which directors are elected for multiple-year terms with only a subset of the board subject to turnover at any given annual meeting. As a result, at each annual meeting a dissident has the ability to have its nominees elected to fill all or a majority of board seats.

While classified or staggered boards that prevent a similar result still exist in the United States, they are increasingly facing scrutiny, with several issuers moving away from staggered boards in order to allow shareholders to vote for the election of all directors annually. This has been in part driven by recommendations of proxy advisory firms like ISS and Glass Lewis. For example, in Glass Lewis' 2013 U.S. and Canadian Proxy Guidelines, it indicates that it favours the repeal of staggered boards in favour of the election of directors annually, on the basis that staggered boards may be less accountable to shareholders. Similarly, ISS indicates in its Canadian and U.S. 2013 Proxy Guidelines that it will recommend voting "for" proposals to repeal classified boards and to hold director elections annually; it will also recommend voting "against" any proposal to classify a board.

In Canada, proxy contests have historically sought to replace an entire board. Proxy contests are increasingly focused on governance matters and dissidents are using "short slate" proposals to change less than the entirety of the board. Examples of this in recent proxy contests fought in 2013 include: Mineral Deposits Ltd.'s proposal to elect three nominees to the board of Teranga Gold Corporation; Dundee Corp.'s contest to replace two board members of Formation Metals Inc.; JEC Capital Partners' proposal to elect two directors to the board

Proxy contests increasingly involve governance-related matters and "short slate" proposals to change less than all of an issuer's board.

of Ithaca Energy Inc.; Andre Tanguay's proposal to replace three directors at Solid Gold Corp.; and the contest by JANA Partners LLC ("JANA") to elect five directors to the board of Agrium Inc. ("Agrium").

We expect this shift in approach is likely to continue, with more short-slate proposals emerging in contests involving proposals by dissidents to effect board change. While ISS and Glass Lewis vote on a case-by-case basis in contested director elections – taking into account various factors, including board performance, management's track record and the qualifications of nominees on both management's and dissidents' slates – typically, investors seeking board changes will find it easier to garner the support of ISS and Glass Lewis in cases where they are proposing a short slate and not seeking majority control of a board. For example, ISS states in its 2013 Canadian Proxy Guidelines that when a dissident seeks a majority of board seats, the burden of proving the change is warranted is heightened, requiring dissidents to provide a well-reasoned and detailed plan, including the dissident's strategic initiatives, a transition plan, and the identification of a qualified and credible new management team. When a dissident seeks a minority of board seats, the burden of proof imposed is lower. ISS will not require a detailed plan of action, nor is the dissident required to prove that its plan is preferable to the incumbent plan. Rather, the dissident need only show that board change is preferable to the status quo and that the dissident's slate will add value to board deliberations.

Interestingly, the recent proxy contests by JANA in respect of Agrium and Pershing Square Capital Management, LP ("Pershing Square") in respect of Canadian Pacific Railway Limited involved short-slate proposals and obtained the support of ISS to varying degrees. In light of this, we expect to see more frequent short-slate proposals.

➔ **Universal Proxy: An Important Tool for Issuers and Activists Alike**

Canadian proxy solicitation rules are more flexible than their U.S. counterparts in that a dissident may use a "universal ballot" or "universal proxy" type of proxy card that includes both management and dissident nominees on the dissident proxy card. This is distinct from the U.S. proxy rules which require the dissident to obtain the consent of each individual named on the dissident card, which effectively prevents dissidents from using a universal proxy.

The ability to use a universal proxy in Canada is an important tool available to activists, as it offers shareholders the choice to pick and choose among

Canadian proxy solicitation rules permit the use of "universal" proxy cards or ballots naming both management and dissident nominees on the same card.

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Universal proxies can provide an important informational improvement to the issuers or dissidents that use them.

all candidates for election or a combination of management and dissident nominees. For many shareholders, this makes the dissident card a more attractive option as they can tailor their vote, voting for the combination of management and dissident nominees that they think makes most sense. For example, where a shareholder is supportive of a dissident but believes that the dissident slate put forward is too large, a universal ballot allows the shareholder to vote for a subset of the dissident nominees while still voting for one or more management nominees.

A universal proxy was first used successfully in Canada in Pershing Square's proxy contest for Canadian Pacific Railway. In that contest, both sides ended up using universal proxy cards: management presumably doing so pre-emptively so that its card would not be viewed as less flexible than Pershing Square's. In JANA's battle with Agrium earlier this year – in which the U.S. hedge fund sought to, among other things, have five dissident nominees elected to Agrium's 12-person board – JANA used a quasi-universal proxy, in which it offered shareholders the choice of voting among seven incumbents that JANA could live with, plus five of JANA's nominees on its proxy card, in contrast to Agrium which only listed the 12 incumbents on its card. While JANA was not successful in its campaign to have its nominees elected, the use of a quasi-universal proxy nonetheless afforded shareholders greater flexibility to choose among both incumbent and dissident nominees than was offered by the issuer.

The use of a universal proxy can also provide an important informational advantage to issuers and dissidents and, when used by issuers, their management. In the absence of some form of protocol agreement between a dissident and the issuer, typically, neither side will have access to proxies submitted on the other side's card. As a result, it can be difficult in proxy contests to know until well into the process the relative level of support had by each of management and the dissidents. By using a universal proxy, and persuading shareholders to use that proxy to cast their votes, issuers and dissidents can obtain a clearer picture, and more comfort as to their relative prospects for success, in advance based on their access to all proxies received by them.

→ **Vote Buying and Director Nominee Compensation**

The high profile proxy contest in which U.S. hedge Fund JANA sought to have five nominees elected to the board of Agrium focused attention on two important issues: (i) the practice of companies compensating brokers for soliciting favourable votes from retail shareholders, and (ii) the use of

compensation for director nominees by a dissident. The use of these tactics may have significantly impacted the relative level of support received by Agrium and JANA in the proxy contest. With the continued rise of activism, we expect these issues will capture the attention of Canadian regulators.

VOTE BUYING

The use of soliciting dealer fees has historically only been seen in take-over bids and similar transactions. In these transactions, bidders seeking to achieve success in their bids or plans of arrangement would retain a dealer to form a soliciting dealer group that would compensate brokers (at the bidders' cost) for getting their retail clients to tender to the bid or vote in favour of the arrangement. The fees serve as a form of commission to brokers for tenders by their clients and are designed to incent brokers to reach out to shareholders that otherwise might not have the benefit of receiving important information about the bid absent such incentives. While the practice has raised some objection from shareholder advocates on the basis that the fees may compromise the ability of brokers to provide unbiased advice to shareholders on whether to tender to a bid or vote for the transaction, the practice has become fairly common.

Until 2012, the use of soliciting dealer fees had been limited to corporate transactions and had never been used in proxy fights relating to the election of a board of directors. This changed in the 2012 proxy fight involving EnerCare Inc. ("EnerCare"). In that contest, EnerCare's management formed a soliciting dealer group to compensate brokers for securing votes in favour of the incumbent board's re-election. Although the dissident in that case objected and the practice drew some criticism, the issue did not garner much notice at the time because of the low profile of the contest and the fact that the votes of retail shareholders were not material to its outcome.

In contrast, the discovery by JANA of the soliciting dealer fees offered by Agrium in its 2013 proxy contest generated intense media coverage and reaction from shareholders and focused attention on the propriety of the practice, not only in proxy contests for board elections but also in the broader M&A context. In Agrium's case, the company entered into an arrangement in which brokers were paid \$0.25 per share for each shareholder voting in favour of management's slate, with payment conditional on the successful election of all of management's nominees. These arrangements were not disclosed publicly and were only discovered by JANA in the final week of the contest.

Shareholder and public reaction to Agrium's use of such fees in the context of the election of directors was negative. Numerous shareholder organizations and commentators condemned the practice, particularly in the context of a board election. Notably, CCGG published an op-ed piece in *The Globe and Mail*



The use of soliciting dealer fees to secure shareholder support in proxy fights in Canada is a recent and controversial development.

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Solicitation fees, or “vote buying”, in contested board elections are under scrutiny and may garner negative judicial attention.

newspaper asserting that Agrium’s “vote buying” was inconsistent with the basic tenets of shareholder democracy and the fiduciary duties of directors. The newspaper also published an editorial criticizing the Agrium board for the practice.

While perhaps strictly legal in Canada according to some commentators, the payment of soliciting dealer fees by a board to assist it in getting re-elected raises a number of legal and policy issues. Is it a proper use of corporate power vested in the board to authorize the use of company funds to create incentives for brokers to obtain votes from their clients in support of the incumbents’ re-election? Canadian courts have held that the best interests of the corporation in the context of a contested shareholders meeting centre on the maintenance of the integrity and propriety of the voting procedure. Agrium’s stated rationale for paying the fees in its case was to increase the chances of getting information to and securing the participation of retail shareholders in the meeting, given the importance of the election; in the absence of such incentive payments to brokers, Agrium argued that such shareholders might not otherwise be reached. However, the terms of the payment did not reward brokers merely for getting their clients to vote. Rather, they provided for payment only *if* the votes were in favour of the incumbent board *and* all of the incumbents were successfully elected, raising questions as to whether the use of company funds to achieve such a result might constitute a breach of directors’ fiduciary duties.

The controversy arising from Agrium’s use of soliciting dealer fees has also raised questions about the legality of the brokers’ participation in the practice under Canadian law. It has been noted that dealers in the United States will not engage in the practice on grounds that by taking compensation for soliciting votes they would run afoul of proxy solicitation rules in Rule 14a-2 under the U.S. *Securities Exchange Act of 1934* (the “Exchange Act”). Some have asserted that, in contrast, nothing prohibits the practice in Canada. However, interestingly, Canadian proxy solicitation rules are substantially similar to the rules in the United States that are cited as prohibiting the practice. Another potential explanation for the difference in approach in the United States is the different duty owed by a broker to his or her client, and the view that brokers should not put themselves in a position of conflict with their clients.

We believe that Canadian securities regulators are examining the existing rule framework and considering whether to implement new rules to prohibit the practice. In the meantime, because of the negative reaction of shareholders and the press to the practice, we would not expect the practice to be seen again in a contested board election.

COMPENSATION ARRANGEMENTS FOR DIRECTOR NOMINEES

To address the challenge of attracting good board candidates into the battleground of a proxy contest, some activists have offered compensation arrangements for director nominees. In two high profile proxy contests in 2013, one in Canada and one in the United States, this practice came under attack.

In Canada, JANA entered into arrangements with the five nominees it was trying to elect to Agrium's board to pay them a fixed cash payment of \$50,000 each plus a profit participation interest in any profit JANA generated from its ownership of Agrium shares over a three-year period.

These compensation arrangements with JANA's nominees became a focus of Agrium's attack on JANA in the contest. Agrium labelled the profit participations as "golden leashes" that compromised the independence of JANA's nominees. Agrium alleged that these arrangements were short-term compensation that incentivized the nominees to pursue actions to the detriment of the long-term value of Agrium and would compromise the ability of the board to function. JANA defended the arrangements noting that they did not impose any obligation on the nominees other than to stand for election and that the profit participations were designed with a view to aligning the interests of the nominees with the interests of Agrium shareholders.

The compensation arrangements drew a strong negative comment from proxy advisory firm Glass Lewis; several shareholders who ultimately supported Agrium also noted their opposition. For example, Alberta Investment Management Corporation issued a press release declaring its support for Agrium's incumbent board in which it noted concerns that JANA's compensation of its nominees could have negative effects on the board, including lack of independence, fragmented voting and reduced efficacy. CPPIB also noted its concern with JANA's compensation arrangements in its announcement of support for Agrium's board. In a close contest, JANA's nominee compensation arrangements likely impacted its ability to gather the necessary shareholder support.

At the same time that JANA was waging its contest with Agrium, Elliott Management Corp. ("Elliott Management") was engaged in its own proxy fight with Hess Corp. ("Hess") in the United States. Like JANA, Elliott Management had entered into compensation arrangements that would provide performance incentives to its nominees which were the subject of strong criticism from Hess. Citing the ongoing distraction caused by the compensation issue, shortly prior to the Hess shareholders meeting Elliott Management's nominees agreed to waive their compensation arrangement should they be elected to the board. On the same day that this concession was announced, Hess and Elliott Management announced a settlement that saw two of the dissident's nominees elected.



Post-election compensation for nominees poses various problems and has attracted strong negative views from governance commentators.

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The timing of the waiver and the settlement suggests that the compensation arrangements might have presented an obstacle in the settlement discussions.

While compensation paid by activists during the pendency of a proxy contest will likely continue to be acceptable, activist-funded post-election compensation arrangements for nominees will be scrutinized by shareholders and issuers, and activists can anticipate continued strong resistance to the practice.

➔ Judicial Balancing of Shareholder Rights and Board Authority

OPPRESSION REMEDY AND THE MOSQUITO DECISION

In addition to the focus of regulators on shareholder engagement, Canadian courts are also scrutinizing the conduct of issuers and shareholders in activist situations.

One important backdrop to any proxy battle in Canada is the so-called “oppression remedy” available to shareholders under Canadian corporate law whose “reasonable expectations” have been “unfairly prejudiced”, “unfairly disregarded” or “oppressed” by the actions of the directors. In the context of a proxy fight, a shareholder’s reasonable expectations may be said to include the right to exercise its voting franchise without undue interference or coercion from the board of directors.

The oppression remedy provides the courts with broad-ranging authority and discretion to remedy a wrong to individual complainants. In oppression cases, the courts apply an “effects-based test”, and can grant remedies even where bad faith or improper motives are not established. It is not unusual for dissident shareholders to claim oppression in response to actions taken by the target board of directors in the context of a proxy fight. A successful claim can result in the invalidation of a meeting result and a requirement to hold a new meeting.

In the August 2012 case of *International Energy and Mineral Resources Investment (Hong Kong) Company Limited v Mosquito Consolidated Gold Mines Limited*, the oppression remedy was invoked by a dissident shareholder who complained that management’s proxy solicitation firm was using a telephone voting system called “Televote” through which proxy solicitation agents would take voting instructions orally over the phone from retail shareholders. In addition to finding that the use of Televote was oppressive because of the lack of safeguards to ensure that voting instructions could be authenticated, the British Columbia Supreme Court also noted that the use of Televote by the management side after the dissidents had emerged and the contest began

The oppression remedy provides courts with broad powers, and can be an important tool in proxy contests for shareholders whose reasonable expectations are unfairly prejudiced, disregarded or oppressed.


created an imbalance in the way votes were taken between management and the dissident group and that this gave management an “unfair advantage”.

DISSIDENT PROXY DISCLOSURE AND THE SMOOTHWATER AND ST. ELIAS DECISIONS

The August 2013 decision of the Alberta Queen's Bench in *Genesis Land Development Corp. v Smoothwater Capital Corporation et al.* is also instructive and highlights the importance of complete and accurate public disclosure, on a timely basis, by activist shareholders in proxy contests. Following the release by Genesis Land Development Corp. (“Genesis”) of its proxy materials for its scheduled AGM, in which it proposed a slate of eight nominees to the Genesis board, Smoothwater Capital Corporation (“Smoothwater”) initiated several discussions with management urging changes to the Genesis board without success. In July 2013, Smoothwater launched a proxy battle and released a dissident proxy circular proposing its own slate of seven nominees. In response to the dissident circular, Genesis brought proceedings in the Court seeking, among other things, an order disentitling Smoothwater (which held about 22% of the Genesis stock) and other shareholders, Liberty Street Capital Corp. (“Liberty”), Garfield Mitchell (owner of Smoothwater), his brother Mark Mitchell (a member of the Genesis board and significant shareholder with almost 10% ownership) and Edwin Nordholm (a principal of Liberty), from voting their shares at the AGM. In the proceedings, Genesis alleged that these respondents were “acting jointly and in concert” and had failed to disclose their common intentions to gain control of the company’s board as required by applicable securities laws.

Smoothwater and its founder, Garfield Mitchell, had issued several early warning reports leading up to the formal launch of its proxy battle. However, most reports were filed late and, most significantly, in no case did they indicate that they were acting jointly or in concert with any other person. While ultimately Smoothwater, Liberty and their principals, Messrs. Mitchell and Nordholm, executed a voting agreement in late July 2013, the Court held the parties had been acting jointly or in concert as of July 8, which was the date on which all of those parties and Mr. Mark Mitchell held a conference call among themselves in which proxy solicitation firm Kingsdale Shareholder Services Inc. participated. Despite the respondents’ various communications and dealings prior to July 8, the Court found that the evidence fell short of establishing that the respondents were acting jointly or in concert prior to that date, which Genesis was required to prove on a balance of probabilities.

Ultimately, the Court held in favour of Genesis, finding that the respondents were acting jointly and in concert and had failed to provide the appropriate disclosures. On this basis, the Court postponed the AGM for a further one-month period, in order for the respondents to correct the disclosure and



“Joint actor” relationships and early warning reporting disclosure are important considerations in proxy contests, as well as corporate transactions.

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In proxy contests, courts will give significant weight to the correctness, adequacy and timeliness of disclosure.

give the market sufficient time to digest the information. In the end, Genesis and Smoothwater reached a settlement in which certain of Smoothwater's nominees were appointed to the Genesis board, including Mr. Stephen Griggs, the CEO of Smoothwater who also became chair of the Genesis board. However, the settlement also required Smoothwater to support several of the Genesis management nominees, and required Smoothwater to refrain from proxy contests or a public take-over bid in respect of Genesis for two years.

The case is interesting as it confirms that early warning reporting is relevant for purposes beyond just signalling take-over bids. In fact, in its decision, the Court accepted the broad objectives recently ascribed to the early warning reporting regime in the CSA's proposed amendments to the system released earlier this year, including the objective of anticipating proxy-related matters. The Court also concluded that, based on its analysis, the term "acting jointly and in concert" was clearly not limited to the take-over bid context, as argued by the respondents, but also applies to proxy contests.

Another recent case, the June 2013 decision of the B.C. Supreme Court in *Hastman v St. Elias Mines Ltd.*, also illustrates the importance of proper disclosure in proxy contests. In that case, a dissident group of shareholders, which included Messrs. Darcy and Gilby Hastman, undertook a proxy solicitation campaign and prepared a dissident circular proposing the election of five director nominees to the board of St. Elias Mines Ltd. ("St. Elias"). The day after the circular was released, St. Elias advised the dissidents of its concerns regarding deficient and misleading information in the circular and recommended that the dissidents mail a corrected dissident circular to shareholders and publicly note the corrections in a press release. However, the dissidents chose to do nothing to cure the issues. While the dissidents obtained over 90% of the votes in favour of their candidates at the St. Elias AGM, the chair of the St. Elias board refused to accept the proxies. The dissidents brought an application seeking relief under the "oppression remedy" and sought to have the results of the AGM set aside, arguing that their circular did not contain any material misrepresentations and that non-acceptance of the dissident proxies was oppressive.

The B.C. Supreme Court disagreed. The Court found that the information provided by the dissidents was deficient and misleading because it failed to disclose that two of the nominees could not in fact serve on the St. Elias board as they had failed to submit consents to act as directors in advance of the AGM, as required by St. Elias' articles. Moreover, one nominee had been disqualified under the TSX Venture rules from serving as a director because of sanctions imposed in 2010. Without that nominee, who was the only dissident nominee with prior public board experience, the dissidents' slate of nominees would not

have complied with the applicable TSX Venture rules which require that at least one nominee have public company experience.

A critical factor in St. Elias' success in this case is very likely the fact that the chair of the St. Elias board had provided the dissidents with advance notice of the deficiencies, and gave them a reasonable opportunity to correct the record. The Court stated that "the dissident shareholders had a responsibility to ensure that the circular was complete and correct before it was released. They did not meet that responsibility. Instead, they fashioned a document that left out significant information and misstated information." The Court added that because of the dissidents' choices and actions, or lack thereof, St. Elias had no choice but to reject the proxies, so as to protect shareholders from electing a slate that was invalid and that would not benefit the issuer.

EMPTY VOTING AND THE TELUS DECISION

The issue of "empty voting", or exercising voting power without a corresponding equity interest, garnered significant attention in the last two years as a result of Mason Capital Management LLC's ("Mason") opposition to a capital reorganization proposed by TELUS Corp. ("TELUS") to collapse its dual-class share structure.

In February 2012, TELUS announced its proposal to collapse into a single class its non-voting and voting shares (which aside for voting rights were essentially identical) in order to align the distribution of voting rights with the capital investment made by investors and to enhance the liquidity and marketability of the TELUS shares. Under the proposal, non-voting shares would be converted into voting shares on a one-to-one exchange. As a result of the announcement, the historical 4%-5% spread between the trading prices of the two classes of shares narrowed. After the announcement, Mason acquired almost 19% of the voting shares but hedged that position by selling short both voting and non-voting shares, such that Mason's economic exposure to TELUS was only 0.21% of TELUS's outstanding shares. The disconnect between Mason's right to vote almost 19% of the TELUS common shares and its small economic interest in the company led to Mason being labelled an "empty voter". Mason's strategy was to defeat the share collapse proposal and profit when the spread between the trading prices of the voting and non-voting shares was restored.

Mason's strategy was initially successful. With Mason having the right to vote 19% of the outstanding voting shares on a resolution that required two-thirds approval of those shares represented at the meeting, TELUS determined that the share collapse proposal would not pass and withdrew the proposal from the agenda the day before its May 2012 annual meeting. However, in its announcement, TELUS stated its commitment to effecting a share collapse on a one-for-one basis.

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“Empty voters”, or those exercising voting power without a corresponding economic interest, may increasingly face challenges concerning the legitimacy of their exercise of shareholder voting rights.

Subsequently, Mason submitted a requisition, through CDS as the registered holder, for a meeting of shareholders to consider a proposal to amend TELUS's corporate charter to enshrine a requirement for the payment of a premium to the holders of the voting shares in connection with any collapse of TELUS's dual-class share structure. TELUS rejected Mason's requisition on a number of grounds and announced a revised proposal to collapse the dual-class share structure by way of plan of arrangement, again on a one-for-one basis, in a transaction structured in a manner that would only require approval of a majority of the voting shares, to be considered by shareholders at a newly scheduled shareholders meeting. Under this revised structure, Mason was much less likely to be able to block the approval of the collapse. Shortly thereafter, Mason, through CDS, sent a notice to the TELUS shareholders calling its own shareholders meeting immediately prior to the scheduled TELUS meeting.

TELUS applied to the British Columbia Supreme Court to have Mason's requisition quashed and to prevent the holding of the shareholders meeting called by Mason. At first instance, the Court declared Mason's requisition as invalid on a number of technical grounds, including that it did not comply with the relevant corporate legislation and because the acquisition did not identify the beneficial owner(s) on behalf of which CDS issued the requisition. Although the Court did not rule on the “empty voting” issue, it issued a strong statement against the practice, stating in obiter that a court might use its power to deny an empty voter the right to requisition a meeting.

On appeal, the B.C. Court of Appeal in its October 2012 decision, overturned the lower court and reinstated Mason's requisition. The Court of Appeal disagreed with the lower court's conclusion that the relevant corporate statute gave the judiciary authority to prevent Mason from requisitioning a meeting, and found that Mason had not violated any laws. The Court of Appeal also disagreed with the lower court's statement that the courts have the authority to intervene in cases of empty voting on broad equitable grounds; rather, the Court emphasized that it did not have the powers to disenfranchise a shareholder on the basis of a suspicion that it was engaging in empty voting and added that to the extent cases of empty voting are subverting the goals of shareholder democracy, “the remedy must lie in legislative or regulatory change”.

Ultimately, the TELUS share collapse proposal was approved by the shareholders. In the final court proceeding to approve the plan of arrangement pursuant to which the collapse was effected, the British Columbia Supreme Court was again critical of Mason's tactics and considered Mason's lack of economic interest despite its voting interest to be relevant to the court's consideration of Mason's objections to the fairness of the collapse. However, Mason's right to vote its shares, despite its lack of a commensurate economic interest, was not questioned by the court in the arrangement hearing.

Although TELUS was ultimately successful in accomplishing its share collapse, its contest with Mason highlights the complexity of the empty voting issue and the uncertainty as to how courts will deal with it. The CSA's proposed changes to early warning reporting include enhancements to disclosure obligations aimed at identifying situations where empty voting might exist. However, the CSA proposals will not effect any change in the substantive rights of an empty voter; this will likely require amendments to the statutes governing Canadian corporations.

Advance Notice Policies / By-Laws

Canadian securities laws and most corporate statutes provide an exception to the proxy solicitation rules, allowing shareholders to avoid sending a dissident proxy circular to shareholders if the total number of shareholders whose proxies are solicited is not more than 15 (joint holders being counted as one shareholder). This method of solicitation is inexpensive and may be effective where the ownership of voting shares is concentrated in the hands of a few shareholders.

Aside from the limit on the number of shareholders that a person may solicit, there are few constraints on the manner in which a shareholder relying upon this exemption may solicit proxies. In several instances in the past, dissidents have quietly conducted limited solicitations of proxies from a small number of large shareholders and “ambushed” management at an annual meeting by nominating their own alternative slate of directors from the floor without prior warning.

The ability to “ambush” a shareholders meeting has been facilitated by the absence from the Canadian corporate governance landscape of advance notice by-laws or policies that would require a dissident shareholder to give advance notice of its director nominations in order for the nominations to be valid at the meeting.

While there is a broad range of advance notice policies and by-laws in use, a functional advance notice by-law or policy typically addresses at least the period of advance notice required, and mandates disclosure in that notice by the nominating shareholder of its identity and that of its nominee(s), ownership interests of the shareholder(s) (including synthetic economic and voting interests) and its arrangements or understandings with its nominee(s) (including compensation and voting arrangements), as well as requiring undertakings from the nominee(s) with respect to their duties and compliance with the issuer's policies and procedures.

For issuers with such policies or by-laws in place, unless the proper notice and prescribed disclosure has been given to the issuer, any such proposed



Advance notice requirements can help boards protect against ambushes at shareholders meetings.

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The adoption of properly constructed advance notice requirements that are reasonable in scope is advisable.

nominee(s) would be ineligible for election at the shareholders meeting. As a result of a June 2012 decision from the British Columbia Supreme Court in *Northern Minerals Investment Corp. v Mundoro Capital Inc.* ("*Mundoro*"), the adoption of advance notice by-laws and the principles underpinning their use have now been judicially condoned. The Court in *Mundoro* held that the directors have the power to impose such a requirement pursuant to their residual powers to manage the business and affairs of the corporation. Rather than infringing shareholder rights, the Court held that such a policy in fact ensures an orderly nomination process and that shareholders are informed in advance of a meeting of what is in issue and prevents a "group of shareholders from taking advantage of a poorly attended shareholders meeting to impose their slate of directors on what could be a majority of shareholders unaware of such a possibility arising".

Following *Mundoro*, the Ontario Superior Court of Justice considered advance notice provisions enacted by Maudore Minerals Ltd., a Canadian mining company, in *Maudore Minerals Ltd. v The Harbour Foundation* ("*Maudore*"). Maudore alleged that The Harbour Foundation, its single largest shareholder, did not comply with its advance notice policy, which required shareholders to submit information on any alternative slate of directors in advance. In its July 2012 decision, the Court endorsed the adoption of Maudore's advance notice by-laws and found that they were important in ensuring all shareholders have sufficient notice of a contested election of directors.

Prior to the *Mundoro* and *Maudore* decisions, only a handful of Canadian companies had adopted advance notice by-laws, although the incidence of their use in the United States has been quite prevalent for years. However, those decisions combined with the trend in the U.S. appear to have encouraged other Canadian companies to do so. Our review of the 2013 proxy circulars of issuers on the Composite Index and the SmallCap Index found that approximately 80 issuers adopted advance notice policies or by-laws in 2013.

This trend is likely to continue, especially since ISS and Glass Lewis have spoken on the subject and indicate in their respective 2013 Canadian proxy guidelines that while advance notice by-laws or policies will be considered on a case-by-case basis, they will generally support them if they provide a reasonable framework for shareholders to nominate directors by allowing shareholders to submit director nominations as close to the meeting date as reasonably possible and within a reasonable window. To be reasonable, ISS and Glass Lewis indicate that the company's deadline for notice of shareholders' nominations of directors must not be more than 65 days and no less than 30 days prior to the annual meeting date. ISS also indicates that it is generally supportive of additional efforts by companies to ensure full disclosure of a dissident's economic and voting position in the company so long as the informational requirements are

reasonable and aimed at providing shareholders with the necessary information to review any proposed director nominees.

➔ Proposed Changes to Beneficial Ownership Reporting

In March 2013, the CSA proposed a substantial revision to Canada's "Early Warning Reporting" regime ("EWR regime") and related "Alternative Monthly Reporting System" (the "AMRS"). Briefly, the EWR regime currently requires shareholders of Canadian public companies to file a public early warning report and issue a press release promptly upon acquiring 10% or more of any class of equity or voting securities, and each time thereafter an additional 2% is acquired. Under the AMRS, which provides an important exception from the immediate reporting under the EWR regime, rather than issue an immediate report, "eligible institutional investors" may file a report within 10 days of the end of the month in which the 10% threshold is crossed. The principal changes proposed include:

- Lowering the current disclosure threshold under both the EWR and the AMRS regimes from 10% beneficial ownership of equity or voting securities to 5%.
- Reporting 2% decreases in ownership (not just 2% increases, as is currently the case), and reporting when the ownership stake falls below 5% (currently reporting is only required when an investor goes over the threshold).
- Disqualification of investors from the use of the AMRS if they intend to solicit proxies.
- Requiring increased disclosure under both the EWR and AMRS regimes with respect to the investor's intentions with respect to the issuer, as well as other enhanced disclosures.
- Requiring an investor to include "equity equivalent derivatives" (including cash-settled derivatives) in calculating its share ownership for the purpose of determining whether the 5% ownership threshold has been crossed.

Each of the proposed changes have generated significant debate and raised legal and policy issues. Two of these proposed changes in particular merit further discussion here.

Significant changes to investors' "Early Warning Reporting" and related disclosure obligations have been proposed. We expect important regulatory developments in this area.

DISQUALIFICATION OF INVESTORS FROM THE USE OF THE AMRS IF THEY INTEND TO SOLICIT PROXIES

Currently, the AMRS is available to “eligible institutional investors”, such as financial institutions, mutual and pension funds, and investment funds managed by registered advisors, unless the investor makes or intends to make a take-over bid for securities of the issuer or proposes, or intends to propose, a reorganization, amalgamation, merger, arrangement or similar business combination pursuant to which the investor would obtain a controlling interest in the issuer. The proposed amendments would significantly expand the circumstances in which a non-passive shareholder would lose the ability to rely on the less onerous AMRS regime. Under the CSA proposal, an investor that solicits, or intends to solicit, proxies from shareholders of an issuer on matters relating to the election of directors would be disentitled from using the AMRS.

We expect that this proposed change will receive a great deal of discussion. Many investors are concerned that the scope of the proposed change is unduly broad, particularly since many activist investors do not have the ability to influence or control an issuer acting on their own. In addition, many investors highlight the fact that most activists today do not seek to replace entire boards, or even a majority, instead preferring short slates. Others have also expressed concern that the extremely broad nature of the definition of “solicitation” under Canadian laws could result in investors being disentitled from reliance on the AMRS as a result of mere discussions with other investors.

The proposed change stops short of the active/passive distinction under Rule 13d of the Exchange Act. For example, simply having the intent to meet with management and urge management to take certain action would not result in disqualification from the AMRS. In addition, it is expected that if this element of the proposed change is adopted, the rule will be clarified such that the disqualification from the AMRS for an intention to solicit would only catch intentions to conduct broad public solicitations, as opposed to limited solicitations of a small number of shareholders. Some commentators have recommended that any changes to the AMRS be more limited, so that investors only be disqualified from the system if the shareholder files a dissident circular that either proposes or opposes a control transaction or seeks to replace a *majority* of the issuer’s board of directors.

REQUIRING INVESTORS TO INCLUDE “EQUITY EQUIVALENT DERIVATIVES” IN CALCULATING ITS SHARE OWNERSHIP

The CSA’s proposed amendments significantly broaden the scope of interests captured within the early warning calculation to include equity derivative positions that are substantially equivalent in economic terms to conventional equity holdings. Equity equivalent derivatives would capture derivatives (even

derivatives like contracts for difference (CFDs) and total return swaps (TRSs)) that substantially replicate the economic consequences of ownership regardless of a lack of control over the referenced securities, and regardless of whether they are cash-settled. Currently, most equity derivatives are not captured, either for the purpose of determining an investor's aggregate ownership interest in calculating whether the reporting threshold has been met, or for purposes of disclosure under the EWR and the AMRS regimes. With the proposed changes, equity equivalent derivatives would be captured for both purposes.

A number of other jurisdictions have already implemented similar rules in their blockholder reporting regimes. Most notably, the U.K. Disclosure and Transparency Rules ("DTRs") have for some time captured certain qualifying financial instruments like transferable securities, options, futures, swaps, forward rate agreements and other derivatives for purposes of calculating whether the reporting threshold has been met and for disclosure purposes. The DTRs are, for many European countries, viewed as a model in this regard, with several of them adopting similar rules.

However, others are concerned about the breadth of the CSA's proposed amendments in respect of derivatives being a catch-all for all derivatives, for all purposes. First, while several blockholder disclosure regimes do capture derivative instruments for purposes of calculating whether the reporting threshold has been achieved and for disclosure, most regimes have taken a more nuanced approach, incorporating exceptions or exemptions from the rule, having regard for the need to balance the relative costs and benefits to issuers and investors. Others have objected to the CSA's proposed amendments, as crafted, as they appear premised on the notion that derivative holders have control or can exert influence over the voting rights of the shares held by the counterparty, which is often not the case.

The CSA received approximately 70 comment letters on these proposals, and we expect to continue to see more from the CSA as to possible changes in this area, although exact timing is unclear at this stage.

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Risk Oversight: Operations in Emerging Markets

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Risk Oversight: Operations in Emerging Markets




Over the past few years there has been an increase in the number of listings in Canada of foreign and domestic issuers with significant foreign operations, which has led to greater focus on foreign corrupt practices, particularly in emerging markets. Mining and resource companies are of particular relevance since often the highest quality mineral assets tend to be located in some of the world's most politically, legally and culturally challenging environments.

The many strengths of the Canadian market, including a sound banking system, expertise in financing resource companies, and competitive tax and royalty regimes, to date have attracted more than 57% of the world's public mining companies to Canada. At the end of 2012, over 50% of the world's public mining companies were listed on the TSX and the TSX Venture Exchange ("TSXV") and 70% of mining company equity capital raised globally (approximately \$10.3 billion) was raised on the TSX and TSXV. The increased prevalence of mining companies based out of Canada and their contributions to the Canadian market contextualize the importance of managing risks associated with operations in foreign jurisdictions.

In 2011, Canadian regulators shifted their focus to risks associated with issuers operating in emerging markets. The OSC commenced a regulatory review of emerging market issuers ("EM issuers") to assess the quality and accuracy of EM issuers' disclosure and corporate governance practices. The OSC reported that certain boards and audit committees of EM issuers had been deficient in their oversight of management and that proper internal controls to reflect political, legal and cultural environments of foreign jurisdictions were not in place. In 2012, the OSC released [Staff Notice 51-720 Guide for Issuers Operating in Emerging Markets](#). The notice provided a comprehensive review of eight areas that issuers must consider when operating in emerging markets: business and operating environment, language and cultural differences, corporate structure, related parties, risk management and disclosure, internal controls, use of reliance on experts, and oversight of the external auditor.

The notice emphasizes that directors should have in-depth knowledge and awareness of the political, legal and cultural environments in which the EM issuer operates and any gaps in knowledge should be addressed. By extension, foreign directors who are not aware of Canadian regulatory requirements should also be educated on such requirements. The OSC also urged EM issuers to address the risks surrounding the use of complex corporate structures since they can lead to false impressions of financial performance and obscure misappropriation of assets. Boards should be cognizant of the structures in place so as to effectively manage risk and to make well-informed decisions for the benefit of the company.

The notice also urged EM issuers to identify and monitor related-party transactions because of increased risk in foreign markets due to differences in culture and legal requirements. EM issuers should be guided by Canadian



The OSC's 2012 guidelines for issuers operating in emerging markets emphasize that directors should have in-depth knowledge and awareness of the political, legal and cultural environments in which they operate and gaps in knowledge should be addressed.

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accounting standards and securities regulations in their disclosures and should disclose: the relationship and identity of the party, the business purpose for the relationship, the amount of the transaction, and any ongoing contractual or other commitments.

With respect to risk management methods, boards should identify principal risks of the business operations in the particular emerging market jurisdiction. Such risks may include:

- political factors such as political instability and arbitrary or sudden changes to local laws;
- legal and regulatory frameworks in foreign jurisdictions where enforcement of laws and judgements may be less likely;
- corruption, bribery, civil unrest and economic uncertainty;
- access to assets; and
- potential expropriation or nationalization of assets.

EM issuers should disclose the specific risks of operating in an emerging market and provide sufficient details so that investors can make informed decisions. The disclosure should also contain the method used by the board or applicable committee to oversee the risk management processes, including a description of the strategy and systems in place. EM issuers should keep investors informed of newly identified risks as they emerge and how the company plans to address them.

→ The SNC-Lavalin Experience

The experiences of SNC-Lavalin Group Inc. (“SNC-Lavalin”) and the publicity received from its practices in Bangladesh and several African countries have contributed to the increased focus on foreign corrupt practices. In 2011, the Royal Canadian Mounted Police (“RCMP”) began to investigate SNC-Lavalin’s participation in a number of bribery and corruption scandals. To date, the RCMP has charged a number of executives and employees of SNC-Lavalin with bribery, fraud and money laundering for lucrative infrastructure contracts, under the *Corruption of Foreign Public Officials Act* (the “CFPOA”). Most recently, on September 18, 2013, the RCMP charged a former senior executive of SNC-Lavalin International Inc. and two Bangladeshi businessmen with bribery under the CFPOA.

The World Bank also launched an investigation into the alleged bribery practices of SNC-Lavalin in 2012. On April 17, 2013, the Bank announced that it had reached a settlement agreement with SNC-Lavalin with regard to its involvement

in certain bribery schemes. The settlement included debarment of SNC-Lavalin and over 100 of its affiliates for a 10-year period due to violation of the Bank's fraud and corruption policy. The debarment rendered SNC-Lavalin and the named affiliates ineligible to be awarded a Bank-financed contract until 2023. SNC-Lavalin's actions caused it to not only lose its eligibility to bid for certain contracts, but to also suffer a significant drop in value on the market, a loss of talent at all levels, and significant reputational damage.

Canada's New Enforcement Era

Probably as a repercussion of the SNC-Lavalin experience, Canada is now at the top of the World Bank's blacklist, which bans debarred companies from contributing to Bank-financed projects. This is leading to increased anti-corruption enforcement in Canada with 35 ongoing investigations in 2013, a significant increase from previous years.

One example is the investigation of Griffiths Energy International (now Caracal Energy Inc.) ("Griffiths"). In 2009, Griffiths entered into a \$2 million consulting agreement with a U.S. company wholly owned by the spouse of Chad's ambassador to Canada and the United States. The agreement was contingent on Griffiths successfully securing two petroleum exploration blocks. The suspicious consulting agreement was discovered by Griffiths' new management team in November 2011, at which time the company voluntarily reported itself to Canadian and U.S. authorities and agreed to an information sharing plan. Griffiths also conducted an internal investigation which concluded in May 2012. In January 2013, Griffiths reached a settlement agreement with Canadian authorities and agreed to pay a fine of \$10.35 million – the largest fine ever imposed under the CFPOA.

For many, the outcome in this case is disconcerting as it suggests that issuers that self-report on potential acts of bribery or corruption will still face severe sanctions. In addition to the substantial fine Griffiths paid, it also incurred the costs of conducting its internal investigation and forfeiting its planned IPO. If self-reporting is to be encouraged, Canada might consider taking an approach similar to that of the SEC against the Ralph Lauren Corporation ("RLC"). Between 2005 and 2009, Ralph Lauren Argentina paid bribes to certain government officials to facilitate entry of RLC's products into the country without the requisite paperwork and to circumvent inspection of prohibited products. Upon discovering the misconduct, RLC reported the violation to the SEC on its own initiative and fully cooperated with the SEC's investigation. In April 2013, the SEC announced that a non-prosecution agreement was reached with RLC under which the company would disgorge approximately \$700,000 of illicit profits and pay a penalty of \$882,000. RLC was not charged under the U.S.

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Foreign Corrupt Practices Act (the “FCPA”). This was the first non-prosecution agreement entered into by the SEC and the U.S. Department of Justice.

The SEC approach may be more effective to incentivize issuers to conduct internal reviews and report misconduct on their own initiative. On the flipside, there are concerns that granting excessive leniency for issuer’s that self-report misconduct may have perverse incentives, including increasing the risk that issuers may not implement appropriate risk oversight and management processes up-front to prevent such misconduct from occurring. This highlights the importance of striking a delicate balance in regulation and enforcement as foreign corruption laws continue to evolve and expand.

The 2013 decision in *R v Karigar* also illustrates Canada’s determination to enforce the provisions of the CFPOA in relation to overseas business practices. In August 2013, Nazir Karigar was the first individual to be found guilty under the CFPOA. Mr. Karigar was charged with the conspiracy to bribe Air India, a government-controlled airline, to obtain business for a Canadian security company that was controlled by executives based out of the U.S. Mr. Karigar argued that the CFPOA did not apply to his activities because the alleged misconduct took place in India and furthermore the Canadian security company was controlled by non-Canadian executives. The Ontario Superior Court of Justice rejected this argument and found that because Mr. Karigar was Canadian and the U.S. executives planned to use the bribes to benefit a Canadian company there was a “real and substantial link” to Canada and thus the CFPOA was applicable. With continued globalization and the rise of listings on Canadian exchanges of domestic and foreign issuers with significant foreign operations, this case, as well as recent changes to the CFPOA discussed below, highlights the extra-territorial reach of foreign corruption regulations, suggesting few issuers engaged in questionable conduct will be immune from potential prosecution.

➔ New Legislative Developments

In June 2013, Bill S-14 *An Act to amend the Corruption of Foreign Public Officials Act* received royal assent and amended the CFPOA to bring it closer in line with the FCPA. The following changes were introduced:

- Introduction of a “nationality jurisdiction”, which effectively does away with the requirement that the initiation or commission of the offence must have taken place within Canada for the CFPOA to apply. The amendment now deems acts committed outside of Canada, by Canadian citizens, permanent residents, corporations, societies, firms or partnerships organized in Canada, as acts committed within Canada for purposes of the CFPOA.

- Increased penalties for violations of the CFPOA, including an increased maximum imprisonment term of 14 years (up from five years).
- Addition of new offences, including a books and records offence pertaining to concealing bribery in accounting records by use of false documents, destroying accounting books and records earlier than permitted by law, and keeping secret accounts.
- Broader application as a result of the removal of the “for” profit element so that the CFPOA now applies to both for-profit and not-for-profit organizations.
- Elimination of the facilitation payment exception which allows companies to make payments to “expedite or secure the performance of a foreign public official of any act of a routine nature that is part of the foreign public official’s duties or functions”. Such functions include processing official documents, mail pick-up and delivery.

The phasing out of the facilitation payment exception is the most contentious change and has caused much concern among market participants. The Canadian Bar Association noted that “Canada should tread cautiously given the unfortunate reality that facilitation payments continue to be demanded in some countries, coupled with a lack of international consensus to eliminate the facilitation payments exception”. Our neighbours to the south continue to allow facilitation payments, as do Australia and New Zealand.

Another area that is being explored in Canada is the requirement that extractive industries disclose all payments made to foreign governments. Dodd-Frank in the U.S. includes a “transparency rule” which mandates such disclosure. In Canada, there has been some exploration of a “publish what you pay” policy through self-regulatory frameworks, however, this disclosure is not yet mandatory but may gain popularity in the future.

➔ Risk Management Practices and Emerging Markets

Given the vigorous steps Canada is taking to combat foreign corrupt practices, issuers are turning their attention to ensuring proper practices are in place to manage the risks of operating in foreign jurisdictions. To date in 2013, approximately 90 issuers on the Composite Index and SmallCap Index have discussed corruption and bribery on some level in their proxy circulars. Some have taken a more extensive look into the risks their operations face and have developed systems with checks and balances. The risk management approaches to dealing with foreign corrupt practices include:

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Delaware Court Chancellor Strine has cautioned boards and committees of companies with significant foreign operations to ensure they have a robust system of controls in place, language skills to navigate the environment and appropriately qualified accountants and legal advisors to ensure the system is functioning properly.

- policies targeting corruption, bribery and other forms of misconduct;
- training programs to educate employees about foreign corrupt practices and what their duties are under anti-corruption legislation; and
- implementing committees and/or chief risk officers to oversee risks associated with operating in foreign jurisdictions.

Of the issuers that discuss risks associated with foreign corrupt practices in their circulars, 66 employ one or a combination of the methods listed above. The remaining 22 issuers simply state that they must comply with anti-corruption legislation.

Issuers need to do more than just acknowledge foreign corrupt practices; they need to actively fight foreign corruption. In his February 2013 decision, Chancellor Leo Strine of the Delaware Court of Chancery berated the board of directors of Puda Coal Inc. ("Puda") for allowing assets of the company to be sold out from under them.²⁵ Its assets were based in China and were illegally sold by the corporation's Chairman and CEO to a third party. It took 18 months for Puda's board of independent directors to discover the scandal. Puda's shareholders brought an action against the directors for breaching their fiduciary duties. In response, the directors brought an application for summary dismissal before the Delaware Court of Chancery. Their application was denied. In coming to his decision, Chancellor Strine warned that "independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors" and added that "you're not going to be able to sit in your home in the U.S. and do a conference call four times a year and discharge your duty".

Chancellor Strine's reprimand serves as a caution to boards and committees – especially of companies with significant operations in foreign jurisdictions – that to satisfy their duties and obligations they must have a robust system of controls in place, language skills to navigate the environment and appropriately qualified accountants and legal advisors to ensure the system is functioning properly.

Boards of issuers, particularly those with substantial operations in emerging markets, should carefully consider risk management steps to ensure the issuer has a robust system in place, including:

- conducting risk assessments to clearly identify the risks associated with the organization's industry, commercial activities, suppliers and clients in the countries in which they have significant operations;
- designing compliance programs based on the unique risks identified during the assessment and ensuring the programs are clearly articulated and

²⁵ *In re Puda Coal, Inc. Stockholders Litigation*, CA No 6476-CS (Del. Ch. 2013) (Bench ruling).

accessible to all employees and third parties conducting business on the organizations' behalf;

- providing clear reporting channels and internal controls to ensure proper implementation of compliance programs;
- committing to disciplinary processes for violations to set the tone at the top and to encourage enforcement of compliance programs;
- establishing "whistleblower" policies to encourage reporting of possible violations of compliance programs; and
- evaluating the effectiveness of compliance programs on a regular basis so that boards and committees can tackle misconduct.

As we move further towards globalization of the marketplace, it becomes more important to consider the legal, political and cultural environment in which an issuer operates. It may be difficult to develop a "one-size-fits-all" approach to managing risks and so boards and senior management should regularly evaluate their unique situation and maintain appropriate systems and practices to ensure they are properly managing risk and protecting their companies and investors.

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Rights Plans: Governance Issues in Changes of Control

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→ The Current Debate over Rights Plans

Canadian boards have for 25 years considered shareholder rights plans as a potentially effective tool for responding to market accumulations or unsolicited offers. But rights plans in Canada have evolved within a regulatory regime developed by Canadian securities regulatory authorities that was based on the view that shareholders should be free to decide whether or not to accept an offer. The decisions of the regulatory authorities in rights plans hearings in this period have consistently affirmed that boards should not be able to keep a rights plan in place to effectively prevent an offer going to shareholders beyond a period of time regulatory authorities felt was sufficient for the board to (quickly) canvas alternatives to the offer that might enhance shareholder value.

A rights plan can be shareholder-approved, typically adopted in the absence of an imminent bid and approved by the shareholders within six months of adoption and maintained in place at all times, or can be a tactical plan, implemented in the face of a threatened or actual take-over bid and often allowed to lapse after six months.²⁶ While in the United States boards can typically maintain a rights plan in place indefinitely, in contrast, Canadian securities regulators have been willing to cease trade rights plans of Canadian issuers within about 45 to 70 days following commencement of a bid. However, the landscape governing shareholder rights plans in Canada has recently been changing.

In March of this year, the CSA published for comment a proposed new stand-alone rule, National Instrument 62-105 *Security Holder Rights Plans* and related amendments (the “CSA Proposal”), proposing a new regime for regulating so-called “poison pills” in Canada. At the same time, Québec’s Autorité des marchés financiers (the “AMF”) released a consultation paper with proposals for broader changes to Canada’s take-over bid and defensive tactics regimes (the “AMF Consultation Paper”), to provide a forum for discussion on its alternative approach to regulation that it believes should be considered at the same time as the CSA Proposal.

These alternative approaches have emerged, in part, in response to some of the uncertainty that has developed over the past few years as a result of decisions by securities regulators involving rights plans. Different approaches have begun to develop among provincial securities commissions in rights plan hearings when deciding when and if a rights plan must be repealed or cease-traded, resulting in some decisions that declined to cease-trade a plan that received timely, informed and strong shareholder approval.

²⁶ The TSX rules require rights plans to be approved by shareholders within six months of adoption.

The differing approaches of the CSA and AMF to regulating poison pills and defensive tactics more generally, and their potential impact on the take-over bid and defensive tactic regimes in Canada, are discussed below, followed by a consideration of some of the potential implications for boards of Canadian companies.

➔ CSA Proposal: The Shareholder Primacy Approach

The CSA Proposal reflects regulators' desire to get out of the business of deciding when rights plans must go and would shift decision-making regarding rights plans to shareholders by allowing a rights plan adopted by a target board to remain in place, provided shareholder approval is obtained within prescribed timelines. The CSA Proposal is intended to address concerns that Canada is too bidder-friendly in light of the limited number of take-over defences available to Canadian companies, particularly since the implementation of the predecessor to National Policy 62-202 *Take-Over Bids - Defensive Tactics* ("NP 62-202") in 1986, while ensuring that the majority of shareholders are supportive of a rights plan proposed by management.

The CSA Proposal includes the following basic elements:

- To remain effective following adoption by a board, a poison pill must be approved by a majority vote of the target's disinterested shareholders (i.e., excluding votes held by the bidder and its joint actors) within 90 days of the board's decision or commencement of a bid, whichever is earlier. Otherwise, the plan would automatically lapse after 90 days.
- Material changes to an existing rights plan must also be approved within 90 days of the adoption of such changes in order for the amendment to remain effective.
- If a target fails to obtain shareholder approval of the plan within the prescribed time limits, the issuer cannot adopt a new rights plan for 12 months, unless a take-over bid is commenced for the target within that 12-month period.
- Once approved by shareholders, a target's board must seek shareholder approval annually at the target's annual shareholders meeting in order for the plan to remain effective.
- Shareholders can terminate a rights plan at any time by majority vote.
- A rights plan is only effective against take-over bids or an acquisition by a person of securities of the issuer. As a result, it cannot affect the ability of

shareholders to vote their shares, make proposals, or enter into irrevocable lock-up arrangements with bidders.

- A rights plan cannot be used to discriminate between take-over bids, such that if it is waived or modified with respect to one bid, it must be waived or modified with respect to all bids.

The main implication of the CSA Proposal is that a target company will be able to forestall an unsolicited bid for at least 90 days through the adoption of tactical rights plans, thereby giving target boards more time to seek out alternatives and providing greater leverage in potential negotiations with unsolicited bidders. In addition, if the target has a shareholder-approved rights plan in place, or adopts a tactical plan in the face of a bid and immediately seeks and obtains shareholder approval, a plan could potentially remain intact indefinitely. Where a bidder cannot reach agreement with the target board, a shareholder vote to terminate a rights plan (or the failure of a target to obtain shareholder approval) will be critical to the success of the unsolicited bid. Accordingly, the CSA Proposal provides directors with an effective means for slowing or deterring a hostile bidder but ultimately leaves the final decision regarding the maintenance of a rights plan to a target's shareholders.

➔ **AMF Consultation Paper: The Board Deference Approach**

In contrast to the CSA Proposal, the AMF's approach is to replace existing NP 62-202, which governs all defensive tactics, with a new policy that would give target boards far more discretion and deference in the exercise of their fiduciary duties to respond to an unsolicited offer. The AMF's view is that regulators should regard defensive tactics as not being prejudicial to the public interest per se and therefore regulatory intervention should be limited to public interest grounds, such as if there is an abuse of shareholder rights, a negative impact on the efficiency of capital markets or mismanagement of a target board or management's conflicts of interest in the change of control context. The AMF proposes a new policy in place of NP 62-202 that would focus more on the process followed by a target board. In assessing the reasonableness of a target board's defensive tactics, the AMF would consider the following factors, among others:

- the establishment of a special committee of independent directors to consider and review the bid and make a recommendation to the board;
- the appointment of independent financial and legal advisors to assist the special committee in carrying out its mandate;

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- the conclusion of the special committee and the board that, based on their review of the bid and advice of legal and financial advisors, it is in the best interests of the target to implement a defensive measure; and
- the completeness of the disclosure provided to shareholders in the directors' circular, and other communications used by the target, on the process followed in order to make their recommendation and their reasons in support of the defensive measure.

If, based on the above, appropriate safeguard measures are implemented and monitored by the boards and their advisors, the AMF believes there can be reasonable assurance that directors' decisions are not tainted by conflicts of interest, and therefore regulators would typically give deference to the decision of the board. Regulators' involvement would therefore be limited to examining the context in which the bid takes place and the processes followed by the target board on public interest grounds, and presumably result in far less regulatory intervention.

→ Commentary on Regulatory Proposals

Comments on the CSA Proposal and the AMF Consultation Paper were due in mid-July of this year, with 74 comment letters being received by the CSA and 71 comment letters being received by the AMF. For many, there are several pros and cons associated with each alternative.

Most commentators are supportive of these respective initiatives to resolve the differing approaches that have been taken by the provincial securities commissions regarding rights plans, creating an unequal and uncertain hostile-bid regime across Canada. Some commentators have noted the CSA Proposal relies heavily on shareholders and shareholder approval to determine when a rights plan can remain in place, and what the proper scope of a rights plan should be, bringing renewed focus on the challenges that exist with the quality of shareholder voting in Canada.

As we highlighted in "[The Quality of the Shareholder Vote in Canada](#)", our 2010 paper assessing the Canadian shareholder voting process, there are a number of problems with the proxy voting system that are acknowledged to compromise (or have the potential to compromise) the quality of shareholder voting in Canada, leading to the risk that voting results may not accurately reflect the views of shareholders. For example, the voting system cannot always be relied upon to generate an accurate count on shareholder voting, as some votes might not be counted while others might be counted more than once. Also, the system

suffers from empty voting, whereby investors without any meaningful economic interest may be able to vote and influence the outcome. This can occur through the use of derivatives and hedging transactions and can also result when shareholders sell their shares after the record date for a shareholders meeting but before the meeting is held. Accordingly, for many, the CSA Proposal's focus on a shareholder primacy approach underscores the need for regulators to prioritize and move forward with improvements to the proxy voting system and regulatory framework, in order to make the CSA Proposal workable.

Some commentators favour the AMF approach, in light of the deference it gives to boards, provided they are engaged in the proper process, to carry out their fiduciary duties, particularly in light of a board's overall responsibility for managing the business and affairs of the company, having regard to the company's best interests. It would also move Canada's regulatory approach to defensive tactics closer to the U.S. approach, particularly in Delaware. However, a possible result of the AMF's proposal is that there may be a significant increase in proxy contests following take-over bids, making bids more costly and time-consuming.

In this regard, some have noted that the deference to the exercise of director fiduciary duties underpinning the AMF Consultation Paper is premised on the assumption that Canadian courts will apply the same degree of scrutiny to the discharge of fiduciary duties as is applied in other jurisdictions, like Delaware. However, Québec and Canadian corporate laws are different from Delaware (and most other U.S. states), with Canadian courts typically showing far more deference to the exercise by directors of their duties, already resulting in much narrower scope for intervention by Canadian courts.

Both the CSA and AMF proposals are based upon the need for a more flexible regime, which takes into account the wide range of circumstances faced by companies responding to control offers and the evolution of corporate governance and take-over bid techniques since the implementation of NP 62-202. Both proposals also focus on developing a unified, harmonious approach across Canada. Finally, both proposals will have a significant impact on the manner in which directors of target companies respond to control offers and the strategies employed by bidders in making their bids.

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Researching and writing this paper was a project undertaken by Davies Ward Phillips & Vineberg LLP and not on behalf of any client or other person.²⁷ If you would like to discuss any of the issues raised in this report, please contact any of the partners listed below:

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²⁷ We acknowledge the invaluable contribution of Ivana Gotzeva, Director of Knowledge Management at Davies, in researching, drafting and providing feedback throughout the preparation of this paper.

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