SHAREHOLDER ACTIVISM AND PROXY CONTESTS: ISSUES AND TRENDS

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DAVIES

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The year 2015 was significant for proxy contests in Canada, with a total of 55 contests, exceeding the previous record high of 43 contests set in 2009. Although the spike in the number of contests in 2015 may have been exceptional, coinciding with a period of economic downturn in Canada and continued deterioration in commodity markets, the number of activist contests has shown a relatively steady trend upward, from single digit occurrences in the early-to-mid 2000s to 30, 32 and 30 contests in 2012, 2013 and 2014, respectively.[1] Backed by these numbers, a consensus has formed that shareholder activism has established itself as a permanent feature in the landscape of Canadian corporate governance.

Contests in Canada continue to be focused primarily on the resource sector and on Canada's smaller-market-cap companies. Owing to the nature of the Canadian capital markets, large-cap contests have been periodic. Fewer than 5 of the 55 contests this past year involved large-cap issuers (greater than $2-billion market capitalization).

The number of proxy contests alone is not the full measure of the extent of shareholder activism. Past public successes by activists have motivated boards of public companies to engage with activists privately and to implement changes where a convincing case is made by the activist without the dispute ever entering the public arena. In addition, the influence of activists, coupled with the increased focus of regulators, investors and other market participants on corporate governance and shareholder democracy, has prompted many public companies to be proactive in addressing perceived problems in their governance or performance in an effort to ward off activist overtures even before they emerge.

This article discusses activism trends in Canada and some of the principal issues and challenges faced by both activists and target companies, as well as notable recent developments and contrasts between Canadian[2] rules and the U.S. requirements.

1 The Right to Requisition a Shareholders' Meeting

One of the most powerful rights 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. On receiving a valid requisition proposing proper shareholder business[3] – most commonly, to remove and elect directors – the directors must, within 21 days, call a meeting of shareholders to transact the business stated in the requisition.[4]

CONTENT OF REQUISITION

The requisition right is not quite as powerful as it appears to be due to a series of judicial developments that have made the effective use of the requisition right difficult. Canadian courts have held shareholders to a high standard of technical compliance in submitting requisitions and have demonstrated a propensity to invalidate requisitions on technical grounds. For example, in *Bioniche*, a 2013 decision of the Ontario Superior Court of

1 Proxy contest data from Kingsdale Shareholder Services Inc.

2 For the purposes of this article, our analysis is generally based on the *Canada Business Corporations Act* (CBCA), the federal corporate law under which the plurality of Canadian listed companies are incorporated. The corporate statutes of the other major Canadian jurisdictions are substantially similar with respect to proxy solicitation and shareholder rights, with some exceptions that are beyond the scope of this article.

3 To be valid, a shareholder's requisition must state the business to be transacted at the meeting. In July 2013 the Ontario Superior Court of Justice in *Wells v Bioniche Life Sciences Inc.* (*Bioniche*, discussed below) held that a requisition for a meeting to elect new directors must include the names and qualifications of the proposed nominees. In addition, the requisitioning shareholder may be required to provide information to be included in the management circular for the meeting. Failure to provide such information may relieve the directors of the obligation to call the meeting.

4 CBCA, s. 143.

Justice, the Court upheld a board's decision to reject a requisition on the basis that it had not been signed by a registered holder of 5%, even though the shareholder who had submitted the request was known by the board to beneficially own a sufficient number of shares to requisition a meeting.[5]

Canadian courts have also grafted their own additional requirements onto the statutory requirements for requisitions. For example, in *Bioniche* the Court found the shareholder's requisition to be invalid because the dissident proposed the removal of the directors but did not provide any names or biographical information for new directors to be proposed by the dissident. In fact, however, the corporate statutes do not contemplate that a shareholder requisitioning a meeting to remove directors will necessarily propose nominees to fill the vacancies created by the removals. The Court's finding in *Bioniche* constituted a new court-imposed requirement. The Court's requirement for such information to be provided with a requisition could also mean that a dissident must have recruited its nominees well in advance of the date by which notice must be provided under the company's advance notice bylaw (typically 30 days) prior to the meeting.

TIMING OF MEETING

Canadian courts have interpreted the directors' statutory obligation to "call" a meeting within 21 days of the requisition as being satisfied simply by the announcement of a date for the meeting. The board need not actually hold the meeting or even mail a notice of 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 regarded as a reasonable time will depend 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. Delays of up to four to seven months have been accepted by the courts. Often, boards responding to a requisition will schedule the requisitioned meeting to be held at the same time as the annual general meeting, even if the annual meeting is as much as six months away. This was the case in *Marks v Intrinsyc Software International*,[6] in which the board, citing the disruption and expenses of holding a special meeting of shareholders, scheduled the requisitioned meeting to occur at the same time as the annual general meeting, 155 days after the date of the requisition. In considering the dissident's complaint over the delay, the Ontario Court deferred to the business judgment of the board, accepting as reasonable the board's scheduling of the requisitioned meeting to avoid unnecessary costs.

MEETING CALLED BY SHAREHOLDERS

If the directors do not call a meeting within 21 days of receiving the requisition, any shareholder who signed the requisition may call the meeting. The corporation is required to reimburse the shareholders for expenses they reasonably incurred in requisitioning, calling and holding the meeting unless shareholders resolve otherwise at the requisitioned meeting. However, what exactly happens when the shareholder calls the meeting is not entirely clear: the statute provides little guidance, and there is scant precedent to look to because 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. Although this statutory right is clearly enshrined, again, the *Bioniche* case casts some uncertainty over whether this right would be supported by the courts if challenged. Following their first failed attempt to requisition a meeting, the dissident Bioniche shareholders submitted a second, fully compliant requisition. Before the requisition was submitted, the board of Bioniche announced that it had set a date for the company's AGM and established a record date for the meeting. The announcement was made six months prior to the meeting date, much earlier than the date the AGM would normally be announced. The board then relied on a provision in the corporate statute that relieves a board from having to call a shareholders' meeting in response to a requisition if a record date for a meeting has already been set. Although the Court concluded that the right of a shareholder to call a meeting applies when a board declines to do so, even if a board has already fixed a record date, the Court added that "a court would be

5 2013 ONSC 4871.

6 2013 ONSC 737.

unlikely to *uphold a meeting* called by a shareholder" in circumstances in which one of the statutory exceptions to the board's obligation to call a meeting applies. Therefore, only future consideration of this issue will provide clarity. Until then, significant uncertainty remains.

Bioniche illustrates how Canadian courts have allowed boards to use technicalities to defeat requisition rights. The Court agreed with the dissident Bioniche shareholders that the board's early announcement of the record date for the AGM was clearly calculated to allow the board to reject a valid requisition; however, the Court declined to find fault with the board's actions, applying the deferential business judgment rule standard of review to the board's actions and concluding that the effect of delaying the dissidents' ability to challenge management by six months was reasonable in order to allow the board to pursue the business plan that it believed was in the company's best interests.

The combined effect of these judicial developments presents a significant challenge for shareholders seeking to requisition a meeting to change a board. As a consequence of these limitations, the vast majority of proxy contests unfold at annual shareholder meetings. Of the 189 proxy contests in Canada in the six-year period from 2010 to 2015, only 34 were initiated by requisition.

2 Stake-Building and Beneficial Ownership Reporting

Ordinarily, shareholders acquiring a significant position in a Canadian listed company are required to file a public early warning report disclosing their ownership once they acquire beneficial ownership of 10% or more of any class of equity or voting securities of the company. Upon reaching 10%, the shareholder is required to promptly announce its acquisition by press release, file an early warning report within two trading days of the acquisition and stop acquiring any further securities of the relevant class for one full trading day after the filing of the early warning report.[7]

Amendments to the Canadian early warning requirements coming into force on May 9, 2016 (discussed below) will require more detailed disclosure than is currently required regarding the purpose of the acquisition and the shareholder's intentions with respect to the issuer.[8] The scope of the disclosure will closely resemble the requirements of Rule 13d under the U.S. *Securities Exchange Act of 1934*.

Canadian early warning reporting requirements are regarded by some as being more lenient than those under Rule 13d because the Canadian requirement is triggered at 10%, whereas the U.S. requirement is triggered at 5%. However, the U.S. rules provide a considerably longer grace period for disclosing one's position – the initial report must be filed within 10 days in contrast to Canada's requirement for an immediate press release – and the U.S. rules do not impose a trading moratorium.

ALTERNATIVE MONTHLY REPORTING

Under the Canadian regime, there is an exception from the obligation to issue a press release and immediate early warning report as well as from the trading moratorium for shareholders eligible to use the Alternative Monthly Reporting System (AMRS).[9] Under the AMRS, rather than issue an immediate report, the shareholder must file a report within 10 days of the end of the month in which the 10% threshold is crossed. To rely on the AMRS, the shareholder must be an "eligible institutional investor". This includes financial institutions, mutual

7 *Securities Act* (Ontario), s. 102.1 and National Instrument 62-103 – *Early Warning System and Related Take-Over Bid and Insider Reporting Issues* (NI 62-103), Part 3.

8 CSA Notice of Amendments to Early Warning System – Amendments to Multilateral Instrument 62-104 Take-Over Bids and Issuer Bids and National Instrument 62-103 The Early Warning System and Related Take-Over Bid and Insider Reporting Issues, and Changes to National Policy 62-203 Take-Over Bids and Issuer Bids (CSA Notice of Amendments to Early Warning System).

9 NI 62-103, Part 4.

funds and pension funds, and generally includes investment funds such as hedge funds that are managed by a registered investment adviser (including advisers registered by the U.S. Securities and Exchange Commission (SEC) under the U.S. *Investment Advisers Act of 1940*).

DISQUALIFICATIONS FROM AMRS

A shareholder will be disqualified from AMRS eligibility if the shareholder intends to make a formal takeover bid for the company or to propose a transaction that would give the shareholder effective control over the company[10] or, after the amendments come into effect on May 9, 2016, the shareholder solicits proxies (including private solicitation under an exemption) in support of dissident board nominees or in opposition to a merger.[11] Notably, merely having an intention to propose a dissident slate at a shareholders' meeting or holding securities for the purpose of influencing the control or management of the company do *not* disqualify the shareholder from relying on the AMRS. This is in contrast to Rule 13d, which requires a shareholder to switch from a Schedule 13G filing to a Schedule 13D filing if its intention changes from being a passive investor to being active (for example, as a result of deciding to propose a nominee for the board or merely having the purpose or effect of influencing the control of the company).

ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION SUBMISSIONS

The amendments to the early warning reporting system and the AMRS that will come into force on May 9, 2016 were the result of an effort begun in March 2013 by the Canadian Securities Administrators (CSA), which is the association of Canadian provincial and territorial securities regulators) to revise Canada's beneficial ownership reporting regime. The CSA had initially proposed lowering the disclosure threshold under both the early warning regime and the AMRS from 10% beneficial ownership of equity or voting securities to 5%. Owing to numerous comment letters that the CSA received from various market participants, including a comprehensive submission made by the Alternative Investment Management Association (AIMA) and the Managed Funds Association (MFA) with the assistance of Davies Ward Phillips & Vineberg LLP, the CSA resolved to leave the early warning reporting and the AMRS disclosure thresholds at the current 10%. The AIMA and MFA submission made the case that engaged shareholders and activist investors serve as a check on management, contain agency costs, improve corporate governance and have been shown in a number of empirical studies to have a positive impact both on firm value and operating performance of target companies. The full text of the MFA and AIMA comment letter is available at http://www.osc.gov.on.ca/documents/en/Securities-Category6-Comments/com_20130712_62-104_kaswellsj.pdf.

TREATMENT OF DERIVATIVES

The MFA and AIMA comment letter was also successful in advocating that equity equivalent derivatives not be included in determining whether an early warning report obligation is triggered. Initially, the CSA had proposed that all derivatives giving the holder the economic equivalent of ownership should be included in determining the holder's beneficial ownership, regardless of whether the derivatives were cash-settled or gave the holder the right to require delivery of the underlying shares. In response to comments on the proposed rules, including from AIMA, the CSA determined not to require inclusion of equity equivalent derivatives in determining whether an early warning reporting obligation is triggered.

However, to address concerns of some commenters that derivatives are used to hide ownership of shares, the CSA has provided guidance regarding circumstances in which an investor will be deemed to beneficially own shares underlying an equity derivative. For example, an investor could be deemed to beneficially own shares underlying a derivative (whether or not cash-settled) when it has the ability formally or informally to obtain the securities or to direct the voting of securities held by a counterparty to the derivative.

10 NI 62-103, s. 4.2.

11 CSA Notice of Amendments to Early Warning System.

3 Competition/Antitrust Legislation

Canada's antitrust regime does not impose notification or government-clearance obligations at the early stake-building stage by the activist and does not, unlike the *Hart-Scott-Rodino Antitrust Improvements Act of 1976* (HSR Act) in the United States, distinguish between shareholders with passive intent and those with an intention to effect change in the policies of the target company. In Canada, notification under the *Competition Act* is not required until the acquirer acquires more than 20% of the target's voting shares, and notification under Canada's *Investment Canada Act* is not required for an acquisition of less than a 1/3 voting interest in a Canadian business. In contrast, in the United States, the HSR Act can work, in effect, as an early warning system requiring notification of the target and government clearance at the early stake-building stage and a lengthy moratorium on purchases after the filing with the regulatory authority.

4 Group Formation: Insider Trading and Joint Actor Characterization

One of the challenges faced by activists in Canada is to gauge and organize support from major Canadian institutional investors. Canadian institutions are wary about aligning themselves publicly with a dissident shareholder, at least at the beginning of a long contest, primarily out of concern to preserve their freedom to trade in the securities of the target issuer. Their concern stems from two considerations: insider trading and joint actor characterization.

INSIDER TRADING

Under Canadian insider trading rules, a person in a special relationship with a public company is prohibited from trading with knowledge of material information that has not been generally disclosed. This prohibition extends to anyone who learns of material information from a special relationship person. The Canadian rules do not turn on notions of "duty" and "misappropriation". The category of "special relationship" persons is large and includes a person that beneficially owns more than 10% of the voting securities of the target company. Thus, an activist holding more than 10% of a company's shares is a person in a special relationship with the company. Non-public information that the activist may learn in its discussions with the target company about, for example, the target's business plans or the target's response to the activist's proposals may amount to material undisclosed information that, if communicated by the activist to the institutional shareholder, will restrict that shareholder's ability to trade. It is even possible in these circumstances that information about the activist's own plans vis-à-vis the target company could amount to material undisclosed information that, if disclosed to the institutional shareholder, would similarly restrict the shareholder's ability to trade.

JOINT ACTORS

The second concern relates to the issue of "joint actor" characterization, which under Canadian securities law is relevant both for purposes of the early warning disclosure requirements and for compliance with Canada's takeover bid regime.

Under Canadian securities legislation, if the activist has an agreement, commitment or understanding with another shareholder that they intend to exercise voting rights in concert, they will be *presumed* to be joint actors. If the agreement, commitment or understanding is with respect to the *acquisition* of shares of the target company, they will be *deemed* to be joint actors. As a consequence, their holdings will be aggregated for purposes of determining whether the 10% early warning disclosure obligation has been triggered, and the joint actor will have to be named in the activist shareholder's early warning report. The mere formation of a group holding more than 10% will not trigger a filing obligation unless it is a change in a material fact stated in a previously filed report.

Perhaps more significantly, their holdings will also be aggregated for purposes of determining whether the mandatory takeover bid rules have been triggered. Canadian securities legislation requires that the acquisition of more than 20% of the outstanding voting or equity securities of an issuer be made through a formal takeover bid to all shareholders, subject to limited exceptions. The mere formation of a group holding more than 20% will not trigger the rule, but the first purchase of even a single share by a member of the group will require compliance with the bid regime unless the purchase can be made under one of the limited statutory exemptions. Accordingly, the activist and the institutional shareholder will need to ensure that their purchases and sales are coordinated in a manner to ensure compliance with the takeover bid rules and with Canada's early warning disclosure rules. As a result, the activist and the shareholder will be unable to trade without each other's knowledge and, presumably, agreement.

Recent case law in Canada confirms that the issue is not merely a theoretical one. In the August 2013 Alberta Queen's Bench decision in *Genesis Land Development Corp. v Smoothwater Capital Corporation*, the Court found that the activist shareholder Smoothwater Capital was acting jointly and in concert with other shareholders of the targeted company from the date on which the parties participated in a conference call together with a proxy solicitation firm (because it could be inferred from that conduct that the parties had reached an understanding that they would support the proposed new slate of directors by voting in favor of the slate).

5 Poison Pills

Many Canadian and U.S. public companies have adopted poison pills that provide that if an "acquiring person" exceeds a specified level of ownership (typically 20%), all shareholders other than the acquiring person can purchase stock at a substantial discount to the market price of the shares, resulting in significant dilution to the acquiring person. Canadian poison pills, like U.S. pills, treat an acquiring person as the beneficial owner of shares owned by its joint actors. However, Canadian pills have evolved differently from U.S. pills because the Toronto Stock Exchange requires that pills be approved by shareholder vote. This requirement has given shareholders and ultimately Institutional Shareholder Services Inc. (ISS) considerable influence over the terms of poison pills. One of the ways in which Canadian pills differ from U.S. pills is that typically the definition of "joint actor" will *not* include persons with whom the acquiring person has an agreement to jointly vote shares, but rather only persons with whom the acquiring person has an agreement with respect to the acquisition of shares. U.S.-style voting pills that expand definitions of "beneficial ownership" or "acting jointly or in concert" to capture agreements among investors to vote together or campaign to change or influence the control of an issuer have not gained ground here. Recent commentary by Canadian securities regulators that echoes the voting guidelines of proxy advisory firms in Canada has made clear that rights plans should be effective only against takeover bids and should not apply to transactions or circumstances involving a shareholder vote such as contested director elections.

6 Selective Disclosure

In Canada, the extent to which an activist can communicate information to other shareholders is not entirely resolved. Disclosure of material non-public information by a special relationship person (for example, a 10%-plus shareholder) to another person constitutes "tipping" under Canadian securities law. Moreover, unlike in the U.S., tipping is prohibited regardless of how the recipient acquired the information and regardless of whether the recipient enters into a confidentiality agreement to maintain the confidentiality of the information.

There is a specific carve-out for a person considering, evaluating or proposing to make a takeover bid to become a party to a business combination or to acquire a substantial portion of a reporting issuer's property that allows the person to disclose material information in the necessary course of its business to effect such a transaction. However, no similar statutory exception exists for disclosures made by a person proposing a board change or proxy contest.

For the activist shareholder holding more than 10% of a company's shares, the question is whether the activist's disclosure to others of its intention to pursue a board change or proxy contest constitutes prohibited tipping. The activist's plans may not amount to a "material fact" – that is, a fact "that would reasonably be expected to have a significant effect on the market price or value of the securities"; but if the plans do amount to a material fact, the only basis upon which disclosure of those plans to another would not constitute tipping would be if the disclosure were made in the necessary course of business. "Necessary course of business" does not mean in the "ordinary course of business". What is unresolved is whether these words mean "in the necessary course of the *issuer's* business" – to allow communications between an issuer and its counsel or an issuer and its lender, for example – or whether they can be read to mean "in the necessary course of the *tipper's* business". The specific statutory carve-out for a person considering, evaluating or proposing to make a takeover bid or to become a party to a business combination that was noted above does not apply here. Given this uncertainty and given the activist's susceptibility to legal challenge, activists must exercise caution and may be practically constrained from communicating information to other shareholders whose support they are seeking.

7 Voting Shares Acquired After the Record Date

The question of who is entitled to vote at a shareholders' meeting is determined by the particular corporate statute under which a company is incorporated. The CBCA stipulates that only a shareholder whose name appears on the shareholders list on the stated record date for the meeting is entitled to vote at the meeting. However, corporate legislation in several provinces and territories of Canada allows a purchaser of shares after the record date to vote at the meeting so long as the purchaser produces properly endorsed share certificates or otherwise establishes the purchaser's ownership of the shares and asks the corporation (typically not later than 10 days before the meeting) to have his or her name included in the list of shareholders entitled to vote.

8 Empty Voting

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

In February 2012, TELUS decided to collapse into a single class its non-voting and voting shares (which aside from 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 TELUS shares. As a result of the announcement, the historical 4%–5% spread between the trading prices of the two classes of shares narrowed because TELUS was proposing to convert non-voting shares into voting shares on a one-for-one basis. After the announcement, Mason acquired almost 19% of the voting shares, but hedged that position by selling short both voting and non-voting shares, so 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 Mason's small economic interest in the company led to Mason being labeled 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. Ultimately TELUS was successful in accomplishing the share collapse.

During the contest between Mason and TELUS, the British Columbia courts had several occasions to comment on the concept of empty voting. The first occasion arose in the context of a TELUS application to the B.C. Supreme Court to invalidate on technical grounds a requisition for a shareholders' meeting made by Mason. Although the Court did not rule on the empty voting issue, it issued a strong statement against empty voting, 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 reinstated Mason's requisition and disagreed with the lower court's statement that the courts have the authority to intervene in cases of empty voting, even on broad equitable grounds. The appeal Court stated that any remedy must lie in legislative or regulatory change. The third occasion arose in the final court proceeding (to approve the plan of arrangement under which the collapse was effected). In that proceeding, the B.C. 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 never in doubt.

The contest between TELUS and Mason highlighted the complexity of the empty voting issue. Since then, Canadian corporate and securities regulators have continued to grapple with the question of what, if any, legal changes might be appropriate in light of commenters' expressed concerns over the empty voting issue. For example, the CSA's recent changes to the beneficial ownership reporting regimes, discussed above, require enhanced disclosure aimed at identifying situations in which empty voting might exist.

9 Classified Boards

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 to remove directors, 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 take control of the board.

10 Short Slate Proposals

Historically, short slate proposals had been relatively infrequent in Canada, with most contests involving proposals to replace the entire board. Where they did occur, they were typically unsuccessful. However, since Pershing Square's successful campaign to elect a minority slate of directors of Canadian Pacific Railway in 2012, short slates have become more frequent. This is particularly true in contests involving larger Canadian companies where the recommendations of proxy advisory firms ISS and Glass Lewis & Co. LLC are more influential.

Although both ISS and Glass Lewis vote on a case-by-case basis in contested director elections, the burden for an activist to justify a change to a majority of the target's board is significantly heavier, with ISS requiring the activist to set out a more detailed business plan for the company. For large, more complex companies, institutional shareholders are also wary of the greater disruption and loss of institutional memory that can result from majority changes to the board. Consequently, activists are more likely to be successful in such situations by advancing short slates.

11 Limited Private Proxy Solicitation and Advance Notice Bylaws

Canadian securities laws and most corporate statutes provide an exception to the proxy solicitation rules, allowing shareholders (but not the company) to avoid having to send 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).[12] This method of solicitation is inexpensive and may be effective when 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 very few constraints on the manner in which a shareholder relying upon this exemption may solicit proxies. In some past instances, 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 any prior warning.

An advance notice bylaw, requiring a shareholder to provide advance notice to an issuer if it wishes to propose nominees to the board, can of course eliminate the risk of an ambush. Advance notice bylaws have gained significant traction in Canada over the past several years. In 2012, Canadian courts condoned the use of these bylaws on the basis that they foster an orderly nomination process and informed decision-making by providing shareholders with reasonable notice of, and information concerning, a contested election of directors. As a result of support for these bylaws, many Canadian issuers have now adopted them. By May 2015, 51% of Canadian issuers listed on the S&P/TSX Composite and SmallCap indices had adopted such bylaws.

In late 2014/early 2015, ISS and Glass Lewis issued more restrictive guidance for evaluating advance notice requirements in Canada, taking a negative view of onerous disclosure requirements and provisions that allow a board of directors to postpone a meeting without a corresponding extension to the nomination deadlines. The reformulated policies were largely in response to the Ontario Superior Court's 2014 decision in *Orange Capital, LLC v Partners REIT*,[13] in which the Court found that advance notice requirements are to be used only as a "shield" to protect shareholders and management, not as a "sword" to prevent nominations by shareholders or to buy time for management to defeat an activist.

ISS and Glass Lewis have also reformulated their policies to identify acceptable features of advance notice requirements versus those that may be offensive and may trigger negative recommendations by the proxy advisory firms. In light of these policy reforms by the proxy advisory firms and the *Orange Capital* decision, issuers will need to adopt bylaws with reasonable terms and apply them in a manner that is commercially reasonable and not tactical or intended to thwart an activist shareholder seeking to exercise its fundamental shareholder franchise to elect nominees.

12 Public Proxy Solicitation and the Broadcast Exemption

Canadian rules provide a "public broadcast" exemption that can be used alone or in combination with the 15-shareholder exemption discussed above to enable a dissident (but not an issuer's management) to solicit proxies and support for its campaign without "sending" a proxy circular to shareholders.[14] To rely on the exemption, the solicitation must be made by public broadcast or publication (for example, by press release, statement on radio or television, publicly available website or public speech), and prescribed materials and

12 CBCA, s. 150(1.1) and National Instrument 51-102 – *Continuous Disclosure Obligations* (NI 51-102), s. 9.2(2).

13 2014 ONSC 3793.

14 CBCA, s. 150(1.2) and NI 51-102, s. 9.2(4).

disclosure must be filed on SEDAR, together with the communication intended to be published. For activists seeking to rely on this exemption in connection with the election of directors, a document containing prescribed information concerning the proposed nominees must also be filed on SEDAR.[15]

Pershing Square's successful campaign to elect its nominees to the board of Canadian Pacific Railway serves as a good example of the utility of the broadcast exemption to activists and the flexibility it affords to engage in a robust solicitation campaign, particularly in the early stages, without incurring the additional costs and burdens of mailing a dissident information circular. In the case of Pershing Square, reliance on the exemption, combined with the filing of an initial "pre-emptive" proxy circular, enabled Pershing Square to mount a multi-faceted solicitation campaign involving public town hall meetings, press releases, speeches, media interviews, shareholder one-on-one meetings and a customized website, over the course of months and long before Canadian Pacific Railway's management had filed its proxy circular. Since then, other activists proposing governance and board changes have relied on the public broadcast exemption to build shareholder support for their proposals before filing, or in the absence of, a dissident proxy circular.

Although issuers are prohibited from soliciting proxies prior to filing their management proxy circulars, they are not completely handcuffed from responding to an activist in the lead-up to filing. Smoothwater Capital Partners LP's (Smoothwater's) proxy contest to replace the board of Equity Financial Holdings Inc. (Equity) in late 2013/early 2014 illustrates the latitude a court may grant to an issuer that responds to an activist prior to filing its proxy materials. Smoothwater commenced its proxy contest in reliance on the public broadcast exemption, issuing a press release and then subsequently requisitioning a meeting. In response to a Smoothwater press release criticizing the Equity board and Equity's decision to delay the requisitioned meeting, Equity issued a press release defending the actions of its directors and outlining its concerns with Smoothwater's nominees and confirming that a proxy circular was forthcoming. The press release was issued before Equity had sent out its management proxy circular but the release confirmed that it was forthcoming. Smoothwater challenged the Equity release as an improper solicitation of proxies under the CBCA, claiming that the release constituted a solicitation (that is, a "communication to a shareholder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy"[16]) prior to the filing of the management proxy circular. The Ontario Superior Court of Justice held that whether a communication is a solicitation is a question of fact that depends on the nature of the communication and the circumstances of the transmission. Looking to the principal purpose of the document, the Court held that the press release was simply a defense of Equity's leadership and of the date that it chose to hold the meeting, and that the release did not encourage shareholders to provide proxies to Equity.[17] The Court by no means endorsed issuers launching full scale public campaigns prior to filing their proxy circulars. But the Smoothwater contest illustrates that an activist relying on the broadcast exemption cannot in every instance expect to go unchallenged by the issuer in the lead-up to filing the management proxy circular.

13 Compensation Arrangements for Director Nominees

One of the principal challenges that an activist faces is recruiting credible and compelling board candidates for a dissident slate. The growing prevalence and success of shareholder activism has been fueled in part by the greater independence and quality of dissident nominees, and this in turn has raised the bar for activists: the credibility of the activist will judged on its ability to attract good dissident candidates.

15 NI 51-102, s. 9.2(6). Compliance with the broadcast exemption entails other obligations, a discussion of which is beyond the scope of this article.

16 CBCA, s. 147. See the discussion of "solicitation" in section 14 below.

17 *Smoothwater Capital Partners LP I v Equity Financial Holdings Inc.*, 2014 ONSC 324.

To attract the best candidates, some activists have provided incentive compensation arrangements to those willing to serve as director nominees. In two high-profile proxy contests in 2013, this practice came under attack: one in Canada in which U.S. hedge fund JANA Partners sought to compensate its nominees proposed for election to the board of Agrium Inc., and one in the United States, in which Elliott Management Corp. entered into compensation arrangements with its nominees in its proxy fight with Hess Corp. More recently, in 2015, former Obama administration Auto Industry Task Force member Harry Wilson had been proposed as a nominee for the board of General Motors by four GM shareholders, each of which had agreed to compensation arrangements with Mr. Wilson.

In each of these examples, the director nominees were provided with compensation that included an incentive component tied to the performance of the target companies' shares over a certain period of time. In addition, compensation agreements often include a more modest fixed stipend as well as indemnity arrangements; however, these components have not attracted notable criticism. Activists have argued that incentive payments are consistent with good corporate governance because they help link director pay to performance, which can benefit all shareholders. They also argue that these arrangements are necessary to attract better candidates who would otherwise have no compensation for their significant efforts unless ultimately elected to a board. On the other side, critics have labeled director compensation arrangements as "golden leashes" leading to "poisonous conflicts" that create a subclass of directors, compromise the nominees' independence and create dysfunctional boardrooms. In particular, criticism has highlighted that the time frames of the incentive arrangements are too short to align the dissident nominees with the long-term interests of shareholders. With respect to the GM situation, Warren Buffett remarked, "I totally disagree with the idea of putting somebody on the board who has an option on some other people's stock which is only good for two years."

The U.S. Council of Institutional Investors (CII) has criticized such third-party incentive arrangements on the basis that they "blatantly contradict" CII policies on director compensation. However, rather than promoting their outright prohibition, CII has encouraged the SEC to consider rule changes that would require dissident disclosure to investors about such arrangements because existing rules fall short of such requirements.

Despite criticism from the investor community, efforts to prohibit these incentive arrangements through bylaw amendments have foundered. Such bylaw limitations had been first proposed by law firm Wachtell, Lipton, Rosen & Katz LLP in 2013, and had been adopted by several U.S. companies. In response to these bylaws, ISS stated that the adoption of restrictive director qualification bylaws without shareholder approval "may be considered a material failure of governance because the ability to elect directors is a fundamental shareholder right". ISS has gone on to say that it may recommend votes against or withheld from director nominees consistent with ISS's "Governance Failures" policy whereby such bylaws are implemented by boards.

The debate over the use of such restrictive bylaws received particularly heightened attention in the U.S. proxy contest involving U.S. bank Provident Financial Holdings Inc. in late 2013. In that case, ISS opposed the re-election of three board members of the bank who, as members of the governance committee, approved a bylaw that would prevent investor-paid director nominee compensation. Although ultimately the Provident directors were re-elected despite ISS's recommendations, the relatively low level of investor support obtained for those directors highlights the scrutiny that boards may face if they opt to implement such a bylaw.

In light of the continued debate over the issues, activists seeking to implement compensation arrangements with their nominees will need to be careful about how they are crafted to allay concerns about nominee independence and ensure they are aligned with the long-term interests of shareholders. Although compensation during the pendency of a proxy contest will likely continue to be acceptable, post-election compensation arrangements funded by the activist are more likely to be scrutinized by shareholders. Activists will therefore need to consider whether offering compensation, while helpful in attracting candidates, might alienate shareholders and jeopardize chances of success.

14 Proxy Access: Nominations for Directors Through Shareholder Proposals

SHAREHOLDER PROPOSALS

Shareholders of Canadian corporations have long had the ability to use the shareholder proposal regime to submit nominations for the election of directors. Any nominees submitted by a proposal must be included in the management proxy circular for the corporation's annual general meeting.

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. Such shares must have been held for at least six months prior to the shareholder submitting the proposal.[18] In addition to these requirements, 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.[19] There is no limit on the number of nominees that may be submitted by proposal.

The corporation can reject a proposal on a number of grounds, including that the proposal does not appear relate in a significant way to the business or affairs of the corporation. In addition, a corporation 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.[20]

Although a dissident shareholder can save considerable expense by having the company include the shareholder's nominees in the management proxy circular, such inclusion does not relieve the dissident of an obligation to mail its own circular to shareholders if it wishes to engage in a general solicitation of proxies. Given the breadth of conduct that can fall within the definition of "solicitation"[21] under Canadian corporate and securities laws, for an activist seeking to communicate with and secure the support of other shareholders in advancing its campaign, the obligation to mail a dissident circular may therefore be triggered even if the activist has been successful in having its proposal included in the management proxy circular.

Interestingly, despite the great interest in proxy access among shareholders, including the continuing push by the U.S. shareholder community for improved proxy access over the past several years, the Canadian provisions (which are similar to U.S. rules for shareholder proposals) have rarely been used. This is likely due to four factors:

- The deadline for submitting a proposal typically occurs four to six months prior to a meeting date and has often passed before a dissident has firmed up its plans to take action.
- The statutory word limitation is not conducive to advocacy. The proposal and the statement to support it together cannot exceed 500 words.
- As discussed above, 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. Thus any shareholder considering submitting a nomination via a proposal could instead submit a

18 CBCA, s. 137 (1.1) and CBCA Regulations, s. 46.

19 CBCA, s. 137(4).

20 CBCA, s. 137(5)(a) and CBCA Regulations, s. 49. Other corporate statutes (such as the *Business Corporations Act* (Ontario)) calculate the deadline differently.

21 "Solicitation" includes a "communication to a shareholder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy" (see CBCA, s. 147, "solicit" or "solicitation"). See also NI 51-102, s. 1.1, "solicit".

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.

- Mere inclusion of a dissident's nominees in management's circular and on management's proxy card is generally not viewed as being sufficient to give a dissident any significant likelihood of success unless the initiative is accompanied by a robust solicitation effort by the dissident. Moreover, management has considerable control over how the dissident's nominees are presented in the circular and the management proxy card. Thus a dissident will typically prefer to mail its own circular to present its nominees and use its own proxy card.

PROXY ACCESS

In addition to the shareholder proposal right discussed above, other initiatives are currently underway in Canada to enhance proxy access for shareholders.

In May 2015, the Canadian Coalition for Good Governance (CCGG), the leading Canadian governance advisory group, released its policy statement on proxy access, which has brought proxy access to the forefront of the current debates about corporate governance in Canada. CCGG believes that shareholder participation in the nomination process should not be regarded as "simply a fall-back mechanism when other attempts to improve board performance have failed", but rather should be a matter of course as a principle of good corporate governance.[22] The CCGG policy statement proposes a suite of enhancements to the current proxy access regime. They include the following:

- for issuers with market capitalizations of less than $1 billion, setting the ownership threshold for shareholder eligibility to nominate directors at 3% of the issuer's outstanding shares, and for issuers with market capitalizations of $1 billion or more, at 5% (for purposes of determining the 3% and 5% ownership thresholds, only voting interest that is tied to economic interest should count, but shareholders are permitted to coordinate and aggregate their holdings to reach the required threshold);
- limiting the number of nominees that a shareholder can put forward to three directors or 20% of the board, whichever is less;
- excluding any requirement that a nominating shareholder hold shares for any period of time prior to the nomination (but a nominating shareholder must nonetheless hold the requisite number of shares at the time of nomination up to the time of the meeting);
- requiring the disclosure about shareholder nominees in the management proxy circular to not be restricted relative to management nominees, including requiring management to present shareholder nominees in the same location and with the same prominence as management nominees and enabling nominating shareholders to provide the same level of disclosure regarding its nominees as that afforded to management;
- requiring the issuer to use a fair form of universal proxy (discussed in section 15 below);
- allowing nominating shareholders to use the issuer's proxy circular to solicit support;
- allowing for reasonable solicitation costs of nominating shareholders to be paid by the issuer; and
- requiring nominating shareholders to represent that they are not seeking control of the issuer and that their economic ownership interest is at least 3% or 5%, as applicable.

Until legislative amendments to enhance current proxy access rules are made, CCGG recommends that Canadian companies voluntarily adopt proxy access policies.

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22 CCGG Policy, "Shareholder Involvement in the Director Nomination Process: Enhanced Engagement and Proxy Access", May 2015, p. 2.

15 Universal Proxy

Canadian proxy solicitation rules are also 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 management nominees on the dissident proxy card as well as the dissident nominees. 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.

A universal proxy in Canada enables the dissident to offer shareholders the option of picking and choosing among *all* candidates for election. For many shareholders, this makes the dissident card a more attractive option because they can tailor their votes by voting for the combination of management and dissident nominees that they think makes most sense. For example, if a shareholder supports a dissident, but believes that the dissident slate put forward is too large, a universal ballot would allow the shareholder to vote for a subset of the dissident nominees and also vote for one or more management nominees. In September 2015, CCGG issued a policy statement encouraging the adoption of legislative amendments to mandate the use of a single form of proxy in contested director elections. Regardless of any legislative response, and until such time, CCGG is advocating that Canadian issuers voluntary adopt the practice of universal proxies.

A universal proxy was first used successfully in Pershing Square's proxy contest for Canadian Pacific Railway.[23] In that contest, both sides ended up using universal proxy cards – management doing so pre-emptively, presumably so that its card would not be viewed as less flexible than Pershing Square's. Similarly, in JANA Partners' battle with Agrium in 2013, JANA used a quasi-universal proxy, in which it offered shareholders the choice of voting among seven incumbents that JANA would accept, plus five of JANA's nominees on its proxy card, in contrast to Agrium which listed only the 12 management incumbents on its card. The use of universal proxies required customization to Broadridge's online voting system, which resulted in considerable additional expense to the early adopters. However, those system enhancements should be available to accommodate universal proxies in future contests without undue costs. In addition, the use of a universal proxy can provide an important informational advantage since, in the absence of some form of agreement between a dissident and the issuer, typically neither side will have advance access to proxies submitted on the other side's card. By using a universal proxy, and persuading shareholders to use that proxy to cast their votes, activists may be able to secure a clearer picture of their prospects for success in advance of the meeting.

16 Vote Buying: Soliciting Dealer Fees in Proxy Contests

The high-profile proxy contest in which JANA Partners sought to have five nominees elected to the board of Agrium Inc. brought under scrutiny the practice of companies compensating brokers through the payment of so-called soliciting dealer fees for soliciting shareholders' votes in favor of management.

The use of soliciting dealer fees was originally seen only in connection with takeover bids. In these transactions, bidders seeking to achieve success in their bids by meeting their minimum tender conditions would retain a dealer to form a soliciting dealers' group that would compensate brokers (at the bidders' cost) for getting their retail clients to tender to the bid. The fees served as a form of commission to brokers for shares tendered by their clients. Although the practice has raised some objection from shareholder advocates who maintained that the fees compromised the ability of brokers to provide unbiased advice to shareholders on whether to tender to a bid, the practice became fairly common.

23 The dissidents in Biovail Corporation's 2008 proxy contest also used a form of universal proxy, but were unsuccessful in that campaign. The dissidents also encountered technical difficulties with Broadridge Investor Communications Solutions (Broadridge) accepting online voting instructions on the dissident card.

Over the past decade, the use of soliciting dealer fees has migrated to Canadian M&A transactions conducted by way of a shareholder vote. In these situations, brokers are compensated for soliciting their clients' votes in favor of the transaction. In some cases, fees have been offered by rival bidders to encourage brokers to get their clients to vote against a competing transaction. Despite the variety of situations in which soliciting dealer fees have been seen, until 2012, the use of these fees had been limited to corporate transactions and had never been used in proxy fights relating to the election of a board of directors.

In 2012 and 2013, Canada witnessed the introduction of soliciting dealer fee arrangements by the incumbent board in various proxy contest contexts, including the 2012 proxy contest involving EnerCare Inc.; the 2012 battle between TELUS and Mason; and the 2013 proxy contest between JANA Partners and Agrium.

In the JANA/Agrium proxy contest in which JANA Partners sought to replace members of the board of Agrium, Agrium offered to pay soliciting dealer fees of $0.25 per share for each share voted in favor of the election of all of Agrium's incumbent directors. Unlike the earlier EnerCare contest, Agrium did not make any public disclosure of the payment of soliciting dealer fees, offering the fees in a confidential communication to broker-dealers. Agrium's use of soliciting dealer fees generated intense media coverage and negative reaction from shareholders, academics, the marketplace and international press, and focused attention on the propriety of the practice, not only in proxy contests for board elections but also in the context of M&A.

Numerous shareholder organizations and commenters condemned the practice, particularly in the context of a board election. Notably, the CCGG published an op-ed piece in Canada's *Globe and Mail* newspaper asserting that Agrium's "vote buying" was inconsistent with the basic tenets of shareholder democracy and the fiduciary duties of directors. *The Globe and Mail* also published an editorial criticizing the Agrium board for the practice.

The controversy arising from Agrium's use of the 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 the grounds that by taking compensation for soliciting votes, they would run afoul of proxy solicitation rules in Rule 14a-2 under the *Securities Exchange Act of 1934*.

Despite the negative reaction and attention brought to soliciting dealer fees in these earlier proxy contests, currently, nothing expressly prohibits a board of directors from paying soliciting dealer feels in future contests, and no regulator, court or legislature in Canada has yet outlawed the practice. However, interestingly, Canadian proxy solicitation rules are substantially similar to the rules in the United States that are cited as prohibiting the practice.

Nevertheless, it seems certain that any board using the tactic would be subject to intense criticism and would risk alienating the very shareholders whose support it was hoping to secure.

17 Regulation of Proxy Advisory Firms

Concerns among market participants about the functioning of the proxy voting system in both Canada and the United States have been gaining prominence. In 2010, our firm published a white paper on the Canadian proxy voting system, titled *The Quality of the Shareholder Vote in Canada* (available at *https://www.dwpv.com/Sites/shareholdervoting/index.htm*). The paper details the complexity of the proxy voting system and notes several areas of deficiency. Since the release of the paper in 2010, continuing discussions have taken place in the shareholder voting industry about the need for reform.

One of the issues raised in our paper related to the role and influence of proxy advisory firms such as ISS and Glass Lewis. Following a consultation process with market participants and the release for comment of a proposed policy in 2014, the CSA adopted a national policy relating to the practices of proxy advisory firms in April 2015.[24] The policy applies to firms that provide a variety of services to shareholders, which services typically include analyzing matters put forward for consideration at shareholders' meetings, making voting

24 National Policy 25-201 – *Guidance for Proxy Advisory Firms*.

recommendations, establishing voting guidelines for issuers and providing consulting services to issuers. Rather than setting out strict rules of adherence, the policy lists best practices that the CSA encourages proxy advisory firms to follow. The best practices relate to four broad areas of concern:

- **Potential conflicts of interest arising from advisory firms' consulting activities.** The policy encourages proxy advisory firms to create written policies, internal safeguards and codes of conduct to identify, manage and mitigate both actual and potential conflicts of interest, and recommends that issuers regularly evaluate the effectiveness of such measures.
- **Voting recommendations.** The policy encourages proxy advisory firms to consider publishing the methods and procedures used in formulating voting recommendations to the extent that such disclosure would not compromise the proprietary or commercially sensitive nature of the information.
- **Proxy voting guidelines.** The policy encourages proxy advisory firms to establish written policies and procedures regarding their process for developing voting guidelines.
- **External communications.** The policy outlines the information that the CSA believes proxy advisory firms should share with their clients, including proxy advisory reports, information used from analytical models and assumptions used in performing an analysis.

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