DAVIES INSIGHTS

2017

GOVERNANCE

DAVIES

Davies Governance Insights

2017

Davies is a law firm focused on high-stakes matters. Committed to achieving superior outcomes for our clients, we are consistently at the heart of their largest and most complex deals and cases. With offices in Toronto, Montréal and New York, our capabilities extend seamlessly to every continent. Contact any of our lawyers to talk with us about your situation. Visit us at www.dwpv.com.

The information in this publication should not be relied upon as legal advice. We encourage you to contact us directly with any specific questions.

Contents

Introduction and Overview

Now into our seventh annual edition of *Davies Governance Insights*, it has become clear that corporate governance remains a focus for Canadian public companies, their investors, management and boards, and will continue to do so for the coming years. Over the last decade we have witnessed an expanding list of governance issues that boards of directors, senior management and other governance professionals are required to stay abreast of. Many of these are "best practices," and are frequently touted as processes that all public companies should implement.

However, with more and more demands being placed on boards and their committees, the challenge becomes how to manage these competing demands and establish priorities. Recent studies indicate that the average director is now required to spend between 250 to 300 hours per year on each directorship. The burdens on directors' time are typically greater if they chair the board or a committee, or serve on one or more committees; moreover, such demands are significantly heightened when stewarding companies through significant challenges, activist pressures or major transactions.

While governance issues abound and governance practices and policies continue to evolve, we are witnessing a seemingly countervailing trend. A small yet influential group of institutional investors are demanding that companies and their boards spend more time on advancing their organizations' (and their shareholders') long-term interests, and less time on what are perceived by some as non-value-adding governance items, according to advocates of the *Commonsense Principles of Corporate Governance* and the Focusing Capital on the Long Term initiative.[1] And although corporate strategy is perhaps one of the most important areas requiring board oversight, evidence suggests that most boards are not spending sufficient time discussing strategy, but are instead forced to focus on countless governance issues and the current news cycle to produce positive quarterly results. Against this backdrop, we are often asked by our clients – what is a board to do?

The answer will be different for each issuer depending on a multitude of factors; however, the starting point must necessarily be building a solid understanding of the current trends and practices in corporate governance, including those within the issuer's industry and peer groups. In that regard, in-house counsel and the corporate secretary can play an instrumental role, bringing their skills, experience and judgment to the table in tracking the issues and coordinating with the chairs of the board and governance committee to assess which issues require prioritizing over others that may only warrant monitoring. In some areas, members of the finance team can also assist by helping quantify the potential impacts of different risks or opportunities for the organization, such as in the area of environmental, social and governance (ESG) issues. With the advice of external counsel when appropriate, these key gatekeepers can provide significant value by conducting preliminary evaluations of new or recurring governance issues and trends potentially of relevance to the organization, having regard to the issuer's performance, strategy, operations and risks.

It is trite to say that there is no one-size-fits-all solution, but it is especially true in the corporate governance landscape. Some of the developments discussed in this year's report will be more or less applicable for each organization. Having now established ourselves as experts on governance matters, we can also help gauge the relative importance of these issues and trends for each issuer's unique circumstances.

Many of the themes covered in our 2016 report continued to trend in boardrooms across Canada in 2017, and some yielded new and interesting developments from which important lessons can be learned. In addition to providing our in-depth perspective on these core themes, we also tackle novel issues beginning to emerge in the governance space that in-house counsel, boards and senior management must be aware of, such as in the area of climate change. Importantly, many of 2017's top governance issues and trends, both old and new, involve initiatives aimed at optimizing the leadership and performance of Canada's public companies through improvements in governance structures and processes. Examining new developments through that prism, we aim to provide practical insights into their relevance to organizations, which in turn can highlight areas where changes to current practices or policies may be appropriate. Specifically, we zoom in on the following trends and issues:

- **Climate change and sustainability** risk identification, management and disclosure practices and developments in Canada and abroad;
- **Update on shareholder engagement initiatives,** including novel approaches to active engagement adopted in Canada and the United Kingdom;
- **How shareholders are getting their concerns to the table,** including through the first-ever proxy access bylaw proposals in Canada and shareholder proposals on diversity, climate change and other issues, as well as an update on recent legal developments relating to shareholder requisition rights;
- **Top trends and legal developments in shareholder activism,** including proxy contests as of the midway point in 2017, lessons drawn from the *Eco Oro, Liquor Stores* and other proxy fights, and the implications of growing opposition by shareholders and proxy advisory firms to negotiated transactions;
- **Leadership diversity trends,** including the top steps that issuers should consider taking to improve the diversity of their organizations, as well as

the reasons behind the sluggish pace of improvements in gender diversity among Canada's boards and executive teams;

- **Governance challenges and issues in dual-class share structures,** with a focus on the wave in recent years of IPOs involving dual-class share structures in Canada and the United States and the scrutiny these structures have attracted;
- **Executive compensation and say-on-pay** practices in Canada and the United States, including commentary on the results of the second-ever "say-on-pay frequency vote" held in the United States this year; and
- **Corporate law changes aimed at implementing "true majority voting,"** including the potentially significant impact of proposed CBCA and OBCA changes on federally and Ontario-incorporated public companies, and recent guidance by the TSX on the "exceptional circumstances" in which undersupported directors may remain on the board.

We end our review with a catalogue of other important developments in governance standards from the past year, including those relating to advance notice bylaws, directors' and officers' personal liability for oppressive conduct, and guidance on the use and role of independent committees and fairness opinions in conflict of interest transactions.

Our corporate governance experts can help your board, committees, in-house counsel and senior management craft custom solutions to ensure your practices continue to be aligned with current corporate governance trends and requirements with a view to optimizing your decision-making structures and processes and corporate performance.

For more information on any of the issues raised in this report or to explore how we can bring value to your board and governance teams, contact one of our experts listed under "Key Contacts" at the end of this report.

01

Getting Ready for Climate Change: Risk Identification, Management and Disclosure Trends

Climate change is becoming a top governance and risk management issue for public companies in Canada and abroad. Natural disasters, such as Hurricane Harvey, the recent British Columbia wildfires and the earlier Fort McMurray wildfires, just to name a few, can have disastrous impacts on companies and their employees, supply chains, communities and other stakeholders, as well as serious financial repercussions. Here, in our first-ever report on climate change–related initiatives relevant to public companies, we discuss some of the top trends and sustainability frameworks, as well as regulatory perspectives, developing in the area of climate-related risk identification, mitigation and disclosure practices.

01 Getting Ready for Climate Change: Risk Identification, Management and Disclosure Trends

Issuers and their boards will face more demands to quantify and disclose the impacts of climate change on their businesses and will need to provide greater transparency on the steps they are taking to manage those risks.

In prior years' *Davies Governance Insights* reports, we discussed various risk management issues requiring public company boards' attention and oversight.[2] To date, risk management has been particularly focused on issues such as emerging market risks, foreign corrupt practices, disclosure risks, subsidiary governance, and e-commerce and cybersecurity risks. While these issues continue to attract attention and warrant board oversight, this past year, greater focus by Canadian and foreign regulators and the investment community has been placed on the identification, disclosure and mitigation of risks associated with social, environmental and climate-related factors applicable to the business.

The Board's Role in Risk Management

The board's responsibility for risk management derives largely from directors' corporate law fiduciary duties, provincial securities laws and regulations, stock exchange requirements and governance best practices. Risks, which vary by company and industry, include operational risks, geopolitical risks, corrupt practices risks, economic and market risks and disclosure risks. While directors are not responsible for day-to-day risk management, they are required to obtain reasonable assurance that senior management has identified the principal risks relating to the business and put in place appropriate risk-management policies and procedures that are consistent with the company's risk profile. Risk-oversight responsibilities are typically divided between the board as a whole and board committees, particularly where risk management committees or other committees with expertise have been established.

Increasingly, with continued focus on climate change, global warming and other environmental and social factors, market participants and regulators are looking to public companies and their boards to create frameworks for identifying, managing and providing disclosure on climate-related risks and initiatives of the business.

Climate Change Initiatives: ESG Under Focus

Although there is no comprehensive regulatory framework yet in force in Canada (or, for that matter, in much of the rest of the world) in respect of climate-related disclosure requirements, a number of initiatives are underway.

In September 2015, Mark Carney, the Governor of the Bank of England and the Chairman of the G20's Financial Stability Board, gave a speech on the impact of climate change on long-term financial stability and called for the establishment of an industry-led group to create a framework for effective disclosure of the impact on businesses of climate change–related information. This led to the creation of the Task Force on Climate-Related Financial Disclosures (Task Force), which released its report in June 2017. The aim of the Task Force is to create a comprehensive and non-compulsory framework for use by companies, focusing on four core elements: governance, strategy, risk management, and metrics and targets. The Task Force is but one recent initiative that treats climate change risks as material financial factors to be measured and disclosed in response to the needs of investors, lenders and other stakeholders.

In parallel, there are a number of other initiatives, including by Legal & General Investment Management (LGIM), one of Europe's largest asset managers and a major global investor, which is focusing on a variety of environmental, social and governance (ESG) topics, including climate change. In its view, investors are increasingly concerned about the potentially negative impact on their investments caused by changes in regulation, technology and consumer demand, as well as increasingly adverse weather patterns. LGIM has therefore committed to the "Climate Impact Pledge" and intends to continue to engage directly with the largest companies to improve standards and practices to help companies become more resilient to policy changes, more successful in providing low carbon solutions and, ultimately, more prosperous.

At the corporate and investor level, efforts are underway in Canada to integrate sustainability considerations into governance and investment strategy. For example, Ontario Teachers' Pension Plan (Teachers') includes climate change risks as part of its risk management framework, considering both the physical impacts of climate change and the impacts of new regulatory policies on the potential for long-term value creation.[3] Teachers' also engages with companies and governments to emphasize the importance of managing climate change risks and developing solutions. RBC Global Asset Management integrates ESG factors into its investment process, offering its clients a number of socially responsible investment funds (SRI Funds) that exclude certain investments on the basis of those factors.[4] PSP Investments has also adopted a strategy of engaging directly with public companies to discuss concerns regarding ESG risks in order to encourage sustainable corporate conduct and enhance long-term shareholder value.[5] The approach of these major institutional investors reflects an increasingly pragmatic view of climate change factors, focusing less on value-based judgments and more on the significance of climate-related risks on overall risk and financial performance.

Ontario Teachers' Pension Plan, RBC Global Asset Management and PSP Investments have all incorporated climate change factors into one or more aspects of their investment strategies or risk management frameworks and, in some cases, they engage with public companies to discuss their concerns regarding ESG risks.

At the non-profit level, organizations such as the Sustainability Accounting Standards Board (SASB) and the Climate Disclosure Standards Board (CDSB) have established sustainability standards to help public corporations identify and disclose material information to investors. SASB and CDSB have developed a series of reporting standards for companies from all sectors, including a Climate Change Reporting Framework, which companies can use to incorporate climate change—related information into mainstream financial reports.[6] These voluntary

A recent high-profile shareholder lawsuit in Australia over a public company's failure to include a discussion of climate change risk is likely to increase public and regulatory interest in climate-related disclosure requirements.

standards offer one way for issuers to respond to investors' growing interest in sustainability-related risks and opportunities.

At the international level, the United Nations (UN) has developed 17 Sustainable Development Goals (SDGs) aimed at addressing sustainable development over the 2016 to 2030 period; several UN member states, including Canada, have signed on to the SDGs.[7] Many of the goals focus on environmental factors, such as ensuring sustainable consumption and production patterns, taking action to combat climate change and promoting sustainable growth. Major companies, including Microsoft Corp., ING Group and Pfizer Inc., are reporting on aspects of the SDGs and incorporating sustainable development goals into their business strategies. Since climate-related disclosures remain voluntary in Canada and companies may select from a variety of reporting frameworks, issues of consistency are significant. The SDGs offer a set of common goals and targets that companies may use, as well as a framework for reporting on progress that is consistent and flexible across sectors – at a minimum, the SDGs offer a starting point for boards and management to focus their thinking on how ESG risks may affect their business.

FIGURE 1-1: UNITED NATIONS' SUSTAINABLE DEVELOPMENT GOALS

1. NO POVERTY
2. ZERO HUNGER
3. GOOD HEALTH AND WELL-BEING
4. QUALITY EDUCATION
5. GENDER EQUALITY
6. CLEAN WATER AND SANITATION
7. AFFORDABLE AND CLEAN ENERGY
8. DECENT WORK AND ECONOMIC GROWTH
9. INDUSTRY, INNOVATION AND INFRASTRUCTURE
10. REDUCED INEQUALITIES
11. SUSTAINABLE CITIES AND COMMUNITIES
12. RESPONSIBLE CONSUMPTION AND PRODUCTION
13. CLIMATE ACTION
14. LIFE BELOW WATER
15. LIFE ON LAND
16. PEACE, JUSTICE AND STRONG INSTITUTIONS
17. PARTNERSHIPS FOR THE GOALS

Current and Proposed Regulations on Climate and Environmental Disclosures

Against this backdrop and in response to the growing global interest in climate change–risk disclosure by public companies, in March 2017 the Canadian Securities Administrators (CSA) began a review of the initiatives and regulations around the world.

Currently, reporting issuers in Canada need to disclose material risks generally, with further guidance provided in CSA Staff Notice 51-333 – *Environmental Reporting Guidance*, which dates back to 2010. The Staff Notice builds upon the current rules for mandatory disclosure of material information and how they relate to various environmental issues. Under the Staff Notice, five key disclosure requirements are identified: (1) environmental risks, (2) trends and uncertainties, (3) environmental liabilities, (4) asset retirement obligations, and (5) financial and operational effects of environmental protection requirements. With regard to governance, the Staff Notice recommends disclosure of the board's responsibilities for environmental risk oversight and any delegation of these responsibilities. The Staff Notice also suggests there is a trend of interpreting rules relating to material disclosure with a new emphasis on climate and environmental factors.

In the United States, in 2010 the Securities and Exchange Commission (SEC) issued its *Guidance Regarding Disclosure Related to Climate Change*.[8] It discusses how climate and environmental factors such as regulations, the nature of the business, litigation and various risk factors could trigger a regulatory obligation to disclose material information to the public. The guidance has resulted in an increased number of U.S. public companies disclosing climate-related information in their annual SEC filings.[9] In April 2016, the SEC issued a Concept Release soliciting public input on modernizing the sustainability disclosure requirements. The release has garnered significant interest from publicly traded companies and private sector stakeholders.

In the United Kingdom, quoted companies or U.K.-organized companies whose shares are listed on the London Stock Exchange's Main Market, any main exchange in the European Economic Area or the New York Stock Exchange or Nasdaq have, since 2013, been required to disclose annual greenhouse gas emissions data in their directors' reports. Quoted companies are also required to report on their environmental policies and their effectiveness in their annual reports.

In Australia, firms that meet various thresholds of emissions must report to the government about their emissions, energy production and energy

Natural Disasters Impact Businesses and Their Stakeholders

Each year, we witness several disasters in North America and abroad that appear to have clear links to climate change. Although weather-related events are not solely driven by human activities, it seems clear that human factors contribute to climate breakdown in the form of global warming, higher sea levels and greater storm intensity, among other things. Take, for example, the recent events surrounding the category 4 Hurricane Harvey: disasters such as this in Texas occur in some cities several times a year. Hurricane Harvey has had a disastrous impact on oil fields, rigs and refineries, forcing many businesses to shut down and resulting in significant losses.

On September 6, 2017, TSX-listed issuer Alimentation Couche-Tard Inc. released its fiscal 2018 first quarter results, disclosing that subsequent to the first-quarter-end, its store network was affected by the hurricane, causing 123 stores to close for a period of time, with 24 stores remaining closed as of September 5.[10]

Events in Canada, such as the recent wildfires in British Columbia and past wildfires in Fort McMurray, Alberta, also remind us of the serious impact natural disasters can have on businesses, their employees, the communities in which they operate and their supply chains.

Building Sustainability in Mining

In the Canadian mining industry, voluntary climate-related disclosure is becoming common practice. Major multinational and mid-tier mining companies are reporting on natural disturbances to mine infrastructure and operations, the changing access to supply chains and distribution routes resulting from warming temperatures, and challenges to environmental management and mitigation, among other factors.

Barrick Gold Corporation (Barrick) has undertaken significant work toward addressing climate change through a variety of initiatives, including through its Energy Management Policy (establishing requirements for the effective administration and control of all energy sources), an Environmental Management System and associated standards, implementation of a Five-Year Energy Plan (with a goal of reducing energy costs by at least 10%) and endorsing the International Council on Mining and Metals Position Statement on Climate Change.[13] Barrick has disclosed that by the end of 2017, it plans to conduct a climate change–risk assessment and establish targets around climate change. Barrick also recently formed a Climate Change Committee composed of multidisciplinary executives working together to broaden Barrick's Energy Strategy and further integrate the potential impact on climate change. As part of this work, Barrick has stated it will introduce a revised Climate Change Strategy Framework and Climate Change Policy; the strategy will address both greenhouse gas reductions from energy management initiatives and adaptation to climate change risks. Barrick is also working to set targets around climate change in 2017.

Companies such as Vale SA and Gold Fields Limited have developed formal climate change policies, and others, including Newmont Mining Corporation, have developed comprehensive sustainability programs.[14]

consumption. Recent high-profile environmental litigation in Australia is likely to increase public and regulatory interest in climate-related disclosure requirements. In August 2017, shareholders of the Commonwealth Bank of Australia filed suit in the Australian Federal Court alleging that by failing to include a discussion about climate risk in the bank's *2016 Annual Report to Shareholders*, the bank had not given an accurate and fair view of the financial position of its businesses.[11] The case is the first time that Australian courts will consider the materiality of climate risk and whether a public company has an obligation to disclose those risks.[12]

These trends suggest that legal requirements regarding climate reporting will continue to emerge and strengthen over time. The CSA is reviewing the existing rules and proposals elsewhere in the world, including in the United States, Australia and the United Kingdom. It is generally thought that the existing rules are either insufficient and/or poorly enforced, and the CSA wishes to stress the importance of forward-looking, comprehensive climate change disclosure, with governance at the forefront of efficient and transparent disclosure. The CSA initiative is ongoing at this time.

Voluntary Disclosure in Mandatory Filings

Notwithstanding the lag in applicable regulations, companies are voluntarily (perhaps with shareholder pressure) moving toward better disclosure of their climate risks. Directors' duties and responsibilities are often being judged with the benefit of hindsight based on what is reasonable to expect in the circumstances (including having regard to developing trends among peers and within the industries and markets in which companies operate). As a result, Canadian boards will increasingly be required to provide greater oversight and attention to the consideration of ESG systemic risks and mitigation strategies.

In Canada, industry developments are likely to put increased pressure on issuers to disclose their sustainability performance. In 2015, the Toronto Stock Exchange (TSX) launched three climate change indices designed to track the environmental impact of the relative carbon emissions of TSX-listed companies. In recent years, the Governance Professionals of Canada (formerly the Canadian Society of Corporate Secretaries) has, through its Annual Governance Awards, recognized Canadian companies that have implemented best practices in sustainability.

More formal regulation is expected in the not-too-distant future and, in the meantime, increased pressure by investors for comprehensive and transparent disclosure will likely continue to result in greater focus on these matters and increased involvement by boards and senior management in understanding and managing the issues.

Our Take

BOARDS SHOULD DEVELOP AND OVERSEE A CLIMATE CHANGE ASSESSMENT AND DISCLOSURE PROCESS

As a starting point, it is critical that the board, in coordination with senior management, understands the climate-related risks applicable to the business, identifies the challenges and opportunities such risks create for its business and stakeholders, and develops a strategy or solutions to address relevant ESG factors under different climate scenarios. The climate strategy should be articulated in conjunction with the overall risk management framework of the company, with particular emphasis on matters such as reductions of greenhouse gas emissions, energy efficiency, water use and other climate change factors applicable to the business. Here, we set out some practical steps that boards and their management teams can consider taking to better understand, identify, monitor and mitigate ESG-related risks.

- **Establish a dedicated committee to focus on the issues.** Boards with risk management and/or environmental/sustainability committees should review their committees' terms of reference to ensure that ESG-related challenges and solutions are properly addressed. For companies where climate change may have significant impacts on their businesses or stakeholders, boards may wish to establish dedicated climate change committees. In either case, a properly comprised committee can be invaluable to advancing work in this area – it may be tasked with evaluating the impact of ESG factors on the business, tracking peer group and industry developments, developing recommendations for a formal climate strategy or policy, overseeing climate change strategies, identifying emerging issues related to climate change, developing and reviewing disclosure practices and generally acting as a resource for the full board to ensure an understanding of climate-related risks.

- **Consider the UN SDGs to generate dialogue.** For companies still in their infancy when it comes to climate-related risk identification and mitigation, consider using the UN SDGs or similar reference points to help frame discussions around climate-related issues at both the management and board levels. The SDGs and other available frameworks can provide clear categories of factors and issues that may be relevant to your organization. The board can start by charging appropriate members of management to delve into, and report back on, the issues and their applicable relevance and priorities, having regard to the business and strategies.

- **Engage with shareholders, where appropriate.** As part of broader engagement initiatives being undertaken with investors, boards should consider soliciting investor feedback on climate change issues as part of broader discussions over risk management and strategy. Consider shareholders' views on the company's ESG-related strategies and the form and content of the company's disclosure practices in this area. For issuers with significant institutional investors who are continuing to develop climate-related initiatives and guidelines, ensure you understand those stakeholders' views, given investors' increased engagement with companies and regulators on the topic.

- **Update risk management policies and practices.** Issuers with enterprise risk management policies should consider reviewing and updating their practices to expressly consider climate-related risks and assign responsibility for assessing and monitoring those risks, in consultation with outside advisors and experts. The mandate of the board of directors should also be reviewed to ensure that appropriate oversight of sustainability and climate change risks is provided for.

- **Consider building climate change into financial reporting.** With the SASB and other reporting standards available to assist public companies with quantifying sustainability risks and their potential impact on businesses, boards and senior management can also gain insights into the relevance of ESG-related risks to their businesses. For example, consider having the finance team quantify the impact of key sustainability issues on the business, its supply chain, employees and other stakeholders in its financial reporting in order to identify material risks to the business.

02

Board-Shareholder Engagement Continues to Gain Traction

The demand for board-shareholder engagement is on the rise in Canada and is not likely to dissipate, even though many companies are still reticent. Public companies without formal policies are under increasing pressure from institutional investors, asset managers and governance watchdogs to facilitate direct engagement with non-executive directors on a variety of strategic and governance-related topics. Based on engagement trends we observe in Canada and the United Kingdom, engagement can come in many forms and in varying degrees of aggressiveness. In this section, we focus on some recent developments from around the globe and explore best practices and guidelines for boards to develop effective shareholder engagement initiatives while managing selective disclosure risks.

02 Board-Shareholder Engagement Continues to Gain Traction

In Canada and globally, demands and initiatives to facilitate direct engagement between public company boards and major investors continue to rise. Many of Canada's largest public companies have already adopted formal engagement policies; for those that have not, institutional investors, asset managers and governance watchdogs continue to advocate for more active and ongoing collaborative engagement with non-executive directors. While many boards remain reticent to engage, fearing that the risks of selective disclosure and tipping are too great to outweigh the benefits, the reality is that board-shareholder engagement remains a hot topic in corporate governance and is a practice likely to continue unabated. Issuers should prepare for this demand by having their boards discuss the pros and cons of engagement and, at a minimum, develop a framework that addresses the "5 Ws" of engagement – who, what, where, when and why. Doing so is critical to understanding shareholders' views and concerns, and can make the difference between success and failure in shareholder votes on contested and uncontested director elections, say-on-pay votes and major corporate changes or transactions.

Canadian and Global Engagement Efforts Continue to Grow: Are You Prepared to Engage?

Board-shareholder engagement can make the difference between success and failure in shareholder votes.

Board-shareholder engagement continues to gain momentum in Canada. Although traditional forms of shareholder engagement such as annual general meetings and investor relations outreach are by no means obsolete, institutional investors, in particular, are increasingly interested in directly engaging with the boards of public companies. Major institutional investors such as BlackRock and Vanguard engage with the boards and management of 800 to 1,500 companies each year. In Canada, this momentum has been further spurred by the Canadian Coalition for Good Governance's (CCGG) *2017 Stewardship Principles*, which encourage institutional investors to engage with boards on various issues, including governance, board composition and executive compensation.[15] The CCGG principles follow on the heels of the Institute of Corporate Director's (ICD) 2016 guidance to Canadian public company boards to develop engagement approaches with shareholders. Many of Canada's largest public issuers have already adopted some form of engagement policy, and issuers are increasingly finding themselves called on to facilitate investor engagement with non-executive directors, and not only with management.

Shareholder engagement by the boards of public companies in the United States and the European Union is also on the rise. In the United States, Ernst & Young's review of 2017 proxy statements showed that the proportion of S&P 500 companies disclosing shareholder engagement rose from just 6% in 2010 to 72% in 2017, with 29% of those companies mentioning director involvement.[16]

PricewaterhouseCooper's (PwC) 2016 *Annual Corporate Directors Survey* noted that 54% of boards engage directly with their investors.[17] This continued rise in engagement is partly due to high-profile efforts commenced in 2014 by the U.S. Shareholder-Director Exchange (SDX) when it published its SDX Protocol containing guidance to encourage boards to adopt a policy on the way they will approach engagement and wrote to all companies on the Russell 1,000 urging them to adopt or endorse the SDX Protocol.

In the European Union, the amendments to the European Commission's proposal to revise the Shareholders' Rights Directive came into force in June 2017. The amendments include measures aimed at promoting long-term shareholder engagement and transparency between public companies and their shareholders, which may further foster board-shareholder engagement.

Benefits and Risks to Boards of Engaging with Investors

Board-shareholder engagement has many benefits for public companies.

1. **Engagement alerts boards and senior management to major concerns of their shareholders.** As a result, companies are better armed to proactively anticipate and address pressures from activist shareholders and to avoid, or at least prepare for, possible proxy fights.
2. **Engagement provides an opportunity to instill confidence in shareholders** about the board and its strategic direction and to secure the support of the company's largest institutional investors. Building such relationships and trust can be particularly useful when a board is later confronted with shareholder proposals or demands and the board can turn to shareholders with which it has already established a relationship.
3. **Engagement can also provide boards with valuable business insights or force them to re-examine existing strategies.** PwC's 2016 *Annual Corporate Directors Survey* found that about 80% of directors believe that shareholder activism has compelled companies to evaluate strategy and improve capital allocation.[18]
4. **Engagement can also provide insights into how well an issuer's strategies and plans are being communicated to shareholders.** Sometimes nothing is wrong with the plan, but the disclosure on a particular topic lacks transparency or is misunderstood.

Despite these benefits, many boards are reluctant to engage. Perhaps the most common rationale for not engaging beyond regularly scheduled disclosures and AGMs is a concern over selective disclosure and tipping. Canadian securities laws generally prohibit issuers and their insiders (e.g., directors, officers and 10%-plus shareholders) and others in a "special relationship with an issuer"

LGIM's Experience

Legal & General Investment Management (LGIM), based in the United Kingdom, is one of Europe's largest asset managers and a major global investor, with total assets under management of €1,090 billion as of June 2017. LGIM is wielding its influence by directly and collaboratively engaging with companies both in the United Kingdom and globally on a variety of issues to highlight key challenges and opportunities, as well as holding management accountable for their decisions.

In 2016 LGIM held 500 meetings with 293 companies on a variety of environmental, social and governance topics – the top five themes discussed were board composition (including diversity, refreshment, quality and skills), pay, company strategy, director nomination and succession, and climate change. Nearly 40% of those meetings were with companies outside the United Kingdom; in North America, LGIM cast votes in respect of a total of 632 companies and for 65% of those companies, did not support at least one resolution on which it voted.[19]

According to its 2016 *Corporate Governance Report* (LGIM's 2017 report had not yet been published at the time of writing this report), while discussions with board members is one aspect of its active engagement efforts, its engagement does not stop there, particularly if this does not lead to the appropriate outcome. In addition to meeting with independent directors and board chairs, and having collective meetings with boards, LGIM speaks to other investors, raises concerns with and encourages policy changes by regulators, casts votes against companies' resolutions and their directors, supports shareholder-requisitioned resolutions, raises concerns in the UK Investors Forum (developed to facilitate collective engagements among institutional investors), and publicly discusses concerns with the media.[20]

from trading securities with knowledge of material undisclosed information and from tipping or selectively disclosing that information.

Concern over selective disclosure and tipping is a common rationale for not engaging beyond regularly scheduled disclosures – although this concern is valid, it is manageable.

In addition, Canadian corporate and securities laws generally restrict persons from soliciting proxies on behalf of an issuer without a management information circular (with the scope of conduct falling within the definition of "solicitation" being quite broad). There are also cases in which investors will be concerned about engaging for fear they could be tainted with material undisclosed information that, in turn, would compromise their desired flexibility to buy or sell shares due to insider trading restrictions.

Although these concerns are valid, they are manageable. By establishing an engagement framework in advance, boards can position themselves to provide ongoing engagement with their investors while minimizing the risks of a potential misstep under corporate and securities laws. Such an engagement framework would include determining when to engage and with whom, identifying the participants to the engagement, preparing participants for engagement by setting the topics that are "on and off the table," scripting answers and maintaining an ongoing understanding of the issuer's plans and disclosure record. In fact, given the types of governance and high-level strategy-related issues that investors are most keen to engage on (as discussed below), the risks of tipping material non-public information should be quite low if engagement initiatives are well-planned and not *ad hoc*. Moreover, engagement does not always have to be about sharing information — often, important insights can be gleaned through "listen only" meetings held with investors to collect their feedback and concerns without having to divulge any sensitive or material information.

Shareholder Engagement Best Practices and Guidance: Preparedness Is Key

While boards need to navigate certain complexities when engaging directly with shareholders, the demand for engagement is on the rise and is not likely to dissipate. Here are seven best practices that boards should keep in mind when developing their shareholder engagement initiatives. As mentioned above, guidance has also been developed by the ICD and CCGG in Canada and the SDX in the United States, which offer additional resources for companies looking to customize a framework that is most suitable to their particular circumstances.[21]

1. **Have a formal policy or framework in place.** Having a formal policy or a framework that sets out the board's approach to shareholder engagement, including whether, when and how the board plans to engage with investors, is critical. Provide clear guidelines on which topics can be properly addressed by the board and which should be referred to senior management. Generally, the board is best positioned to discuss issues such as the company's governance, risks and internal controls, executive compensation and succession planning. Other important topics include company strategy, climate change, board composition and diversity, CEO performance and director tenure. Establish engagement processes for regular business cycles and for potential crises. In-house legal counsel and corporate secretaries can help ensure that the board's approach does not conflict with the company's disclosure practices and policies. The policy or framework should be clearly communicated internally and to shareholders.

2. **Aim for ongoing communication.** Delineate clear and simple communication channels for board-shareholder engagement and communicate these to all board members, management and the investor relations team. Establish and publicize a key contact for shareholders to schedule a meeting with the board representatives. Some matters may require follow-up by the board – for example, if any shareholder proposals are implemented or after shareholder votes. Proactively engage with shareholders to provide updates and to collect feedback. For a more informal communication avenue, attend conferences in which your major shareholders participate. Consider using social media and electronic shareholder forums for regular communication with all shareholders, not just major shareholders.

3. **Monitor changes in investor ownership.** Stay updated on the issuer's most significant shareholders using stock-monitoring services, management briefings and proxy advisors, if required. Be aware of their stake in the issuer and their investment strategies, rationales and track records. Proactively engaging with major new shareholders can help boards manage shareholder activism. It can also help maximize success in say-on-pay votes and director elections, as well as votes on bylaw amendments, stock option plans and major corporate transactions.

4 **Adopt different formats for communicating with different shareholders.** The format of meetings may differ with different shareholders. Separate meetings may be effective when the board wants to secure support from a major shareholder or if there is significant divergence in perspectives and/or objectives among a group of shareholders. Roundtable discussions may be optimal for meetings with major institutional investors with aligned interests and/or concerns. Consider virtual meetings for retail shareholders or when a significant number of your major shareholders are unable to attend.

5 **Focus on your long term strategy.** Shareholder activists are often perceived as being shorter-term oriented, while the board, management and many institutional investors tend to focus on the longer term. When engaging with shareholders, understand their time horizons and investment rationales, and emphasize the advantages for shareholder returns by discussing the long term, as well as explaining shorter-term plans. This may be particularly critical if the company has been underperforming recently. If possible, explain your dividend strategy to shareholders and how it ties in with the company's other strategies and goals.

6 **Have the right team and be prepared.** Consider which board members are best suited to engage with shareholders on the topics for discussion. Is it the chair of the board, the chair of the governance committee, the chair of the compensation committee or another board member? Many investors desire engagement with non-executive directors. Consider whether it would be helpful to also have management present at the meeting – this is often not appropriate when CEO performance and executive compensation are the topics under discussion. To be adequately prepared, board members will often require additional information on operational aspects of the business as well as on the shareholders they are meeting and their concerns. Ensure that your team is well-apprised of what can and cannot be disclosed to shareholders to avoid selective disclosure and tipping – this means providing participants in the engagement with real-time information on the company's key plans and the issuer's disclosure record. Consider having the issuer's investor relations professional and corporate secretary present at the meeting to ensure that the agreed-upon agenda and protocols are respected.

7 **Annually review and revise your engagement practices.** Request feedback from your major shareholders on your engagement practices, as well as on your disclosure concerning those practices, and adjust them as required. Compare the effectiveness of your board-shareholder engagement practices and communications with peers through rankings and social media. Annually review your board-shareholder engagement practices and regularly discuss the outcome of outreach programs.

03

How Investors Are Getting Their Demands to the Table: Shareholder Proposals, Proxy Access and Requisitioned Meetings

Issuers continue to face proposals on a variety of policy- and governance-related topics. In 2017, two major Canadian banks faced the first-ever proxy access bylaw proposals in Canada. Now that proxy access has arrived, we expect that more Canadian issuers will face pressure to facilitate proxy access in some form. Here we examine the important legal issues surrounding proxy access and advise issuers on how to update their processes to facilitate shareholder input into director nominations. We also discuss recent developments in shareholder requisition rights and question whether courts are becoming more inclined to protect shareholders' proposal and requisition rights.

03

How Investors Are Getting Their Demands to the Table: Shareholder Proposals, Proxy Access and Requisitioned Meetings

The emphasis on shareholder democracy and engagement over the past several years has promoted a growth in different governance processes designed to facilitate investors' (and other stakeholders') input into the policies and leadership structures of public companies. Formal activist campaigns (discussed under "Shareholder Activism and Proxy Contests: Current Trends and Legal Developments") and "majority voting" and "say-on-pay" votes provide obvious means for shareholders to express dissatisfaction with the companies in which they invest. But beyond those mechanisms, a smaller subset of shareholders also continue to make use of corporate law shareholder proposal and requisition rights to promote changes in issuers' practices or policies. Importantly, as predicted in our *Davies Governance Insights 2016*,[22] in 2017 for the first time we saw the use of the shareholder proposal right to put forward the first-ever proxy access bylaw proposals at two major Canadian banks – with somewhat mixed results. In this section, we provide an update on proxy access trends in Canada, as well as some important legal issues and trends relevant to the proposal and requisition rights that have arisen in 2017.

Shareholder Proposals: Issuers Still Face Proposals over Governance and Policy Issues

Shareholders of Canadian corporations have long had the ability to use the shareholder proposal regime to submit to a corporation notice of any matter that the investor proposes to raise at a shareholders' meeting, including nominations for the election of directors. Any business validly submitted by way of a proposal must be included in the issuer's management proxy circular for its annual general meeting (AGM), subject to compliance with prescribed requirements under the applicable corporate statute.

This year saw the use of the shareholder proposal right to put forward the first-ever proxy access bylaw proposals at two major Canadian banks.

Although an issuer is typically not required to implement a proposal even if approved by a majority of shareholders, failing to do so or to at least engage with shareholders where relatively high levels of support for a proposal are achieved may have negative consequences for the issuer.

Shareholder Proposal Top Trends and Topics in 2017

As discussed in our prior reports, 2015 saw a surge in the number of shareholder proposals. In 2016 and 2017 numbers reverted to more moderate and consistent levels. That said, the number of issuers receiving shareholder proposals has remained fairly constant year over year. And, importantly, over the past four years we see that financial institutions are not the only targets of these proposals, as was historically the case. Rather, a variety of issuers continue to face proposals on policy- and governance-related topics.

The most common topics presented by shareholder proposals in 2017 included the following:

- improving gender representation on the board, in senior management or generally;
- requiring an advisory say-on-pay vote on executive compensation or seeking corrections to deficiencies in compensation policies or practices;
- tax-related proposals, such as seeking to have the issuer withdraw from tax havens or jurisdictions with low tax rates;
- requiring separate disclosure of voting results by classes of shares and related disclosures; and
- streamlining and simplifying financial information and financial reporting.

TABLE 3-1: NUMBER OF SHAREHOLDER PROPOSALS, ISSUERS AND AVERAGE "FOR" VOTES

	2017	2016	2015	2014
Number of proposals	46	47	65	49
Number of issuers receiving proposals	22	24	26	18
Number of financial institutions receiving proposals	7	7	7	9
Average percentage of votes cast "FOR" (all proposals)	18%	14%	19%	10%
Average percentage of votes cast "FOR" (excluding proposals approved by shareholders)	12%	7%	11%	10%

03

How Investors Are Getting Their Demands to the Table: Shareholder Proposals, Proxy Access and Requisitioned Meetings

Generally, 2017 did not produce significant new trends or issues compared with 2016, except for the first-ever "proxy access" proposals being made, as discussed below under "Proxy Access: Are the Floodgates in Canada Now Open?" The top 2017 proxy season trends include the following:

- **Board diversity is still important.** Proposals aimed at improving an issuer's leadership diversity remain popular, albeit less so than in 2016. For example, of the 46 proposals made, three (2016: eight) TSX Composite Index and SmallCap Index issuers faced proposals to adopt a policy and report on board diversity. Restaurant Brands International Inc., which faced such a proposal in 2016, faced yet another proposal in 2017 (also discussed under "Diversity Still Lacking in Canadian Public Companies: Top Trends and Steps to Improve Your Leadership").
- **Three proposals received majority shareholder approval.** As in 2016, three proposals put to three different issuers received majority approval; in two such cases (Bombardier Inc. and Transat A.T. Inc.), the approvals received overwhelming shareholder support at 99% (relating to proposals to disclose voting results in both numbers and percentages). The third proposal (put to The Toronto-Dominion Bank), relating to proxy access, received just over majority approval, and is discussed further below.
- **Most proposals still fail, but shareholder support is rising.** Although most proposals typically do not achieve majority approval, shareholder support is on the rise. The average percentage of votes cast "for" all proposals made in 2017 was 17.8%, up from 13.8% in 2016. Among 43 of the 46 proposals that were voted upon but did not receive majority approval, the average level of support was higher than in 2016 at 12.4% (2016: 7%).
- **Number of withdrawn proposals continues to be high.** Consistent with 2016, in addition to the 46 proposals put forward to shareholders in 2017, another 27 proposals were put forward but withdrawn prior to the issuer's AGM. The relatively high number of withdrawn proposals in 2016 (24) and in 2017 (27) supports our continued view that engagement between investors and issuer's boards and/or senior management can help pre-empt or resolve concerns giving rise to proposals and more aggressive forms of shareholder activism.

Although by no means a trend, issuers should take note that in 2017 two issuers received three proposals relating to requests to identify and/or report on climate, social and/or environmental risks. This is a notable continuation of the developments witnessed in 2016 when one of two climate change–related proposals received an overwhelming 98% of the votes "for" (Suncor Energy Inc.). As discussed under "Getting Ready for Climate Change: Risk Identification, Management and Disclosure Trends," climate-related risk management and disclosure are increasingly being demanded of public companies.

Shareholder Proposals: A Tool to Nominate Directors?

As noted at the outset, shareholders of Canadian corporations can use the shareholder proposal regime to submit nominations for the election of directors. Despite the continued push by the shareholder community in the United States and Canada for improved proxy access over the past several years (discussed below), shareholder proposal provisions have rarely been used in Canada for director nominations. This is likely due to four factors:

1. The deadline for submitting a proposal typically occurs four to six months before a meeting date and has often passed before an activist shareholder has firmed up its plans to take action.
2. The statutory word limitation (500 words) on shareholder proposals is not conducive to advocacy.
3. Shareholders with 5% of the shares already have the right to requisition a shareholders' meeting, the deadline for which typically occurs much later than the deadline for submitting a proposal.
4. Mere inclusion of nominees in an issuer's proxy circular and proxy card is generally not viewed as being sufficient to give an activist any significant likelihood of success unless the initiative is accompanied by a robust solicitation effort, causing activists to prefer mailing their own circular.

Despite the above drawbacks, the shareholder proposal mechanism remains a potentially useful tool for a shareholder wishing to put nominees up for election in the least expensive way possible. This could be particularly effective for a significant shareholder or group of shareholders who are not dependent on a broad public solicitation to win support for a dissident board slate. The use of the proposal mechanism to nominate directors may also become more attractive in the near future, if the proposed amendments to the CBCA are implemented. Proposed amendments to the CBCA regulations would change the prescribed period to at least 90 days before the anniversary of the prior year's *meeting date* (instead of 90 days before the anniversary date of the notice of meeting sent for the prior year's meeting). This proposed change would allow for later submissions of shareholder proposals and may lead to greater use of the proposal mechanism for director nominations.

Engagement between investors and issuer's boards and/or senior management can help pre-empt or resolve concerns giving rise to proposals and more aggressive forms of shareholder activism.

Proxy Access: Are the Floodgates in Canada Now Open?

In addition to the shareholder proposal right discussed above, and perhaps in part due to some of the identified drawbacks in the utility of the shareholder proposal mechanism for nominating directors, other initiatives have been underway in Canada over the past two years to enhance shareholder access to the director nomination process. As discussed in greater detail in last year's *Davies Governance Insights 2016*,[23] proxy access was a top governance issue in the United States in the 2015 U.S. proxy season and, since then, has been under focus in Canada.

However, not all market participants believe proxy access, or at least the U.S.-style proxy access that has developed, is an appropriate or necessary tool for the Canadian market. Many argue that proxy access is unnecessary given Canada's distinct legal regime, which already allows for some form of proxy access: as discussed above, most corporate statutes permit shareholders holding a certain percentage of voting shares to submit a proposal with nominations for the election of directors to be included in management's proxy circular, or to requisition a meeting of shareholders at which they can propose director nominees. Distinctions between Canada's corporate laws and Toronto Stock Exchange (TSX) rules, on the one hand, and the United States' rules, on the other, also render "classified" or "staggered" boards virtually non-existent in Canada, with the result that directors can be removed at each AGM by the shareholders.

Not all market participants believe proxy access, or at least the U.S.-style proxy access that has developed, is an appropriate or necessary tool for the Canadian market.

Many also cite important differences between the Canadian and U.S. markets – such as the smaller size of the Canadian market, smaller market capitalizations of Canadian issuers and the fact that shares of Canadian issuers tend to be less liquid – all of which magnify the influence of institutional investors in Canada and, together with shareholders' other statutory rights, obviate the need for proxy access. In addition, the rise in shareholder engagement in both Canada and the United States over the past few years means that many institutional investors already have the opportunity to provide input into a wide range of governance and policy matters through regular discussions with boards and/or management. Accordingly, issuers and investors should carefully consider whether (and why) they support proxy access and, if they do, what the most appropriate form is for an issuer in the particular circumstances – which will vary.

In May 2015, the Canadian Coalition for Good Governance (CCGG), the leading Canadian governance advisory group, released its policy statement on proxy access, bringing it to the forefront of then-new governance initiatives 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 matter of course as a principle of good corporate governance.[24] CCGG's policy statement encourages Canadian companies to voluntarily adopt proxy access policies as a means of enhancing direct shareholder engagement and improving the composition of Canadian boards. In many respects, CCGG's proxy access proposal is consistent with the standard that has evolved in the United States. However, there are some important differences, including that CCGG recommends that a shareholder's nomination right should not be conditioned on the shareholder holding shares for any prescribed period of time prior to the nomination.

Amendments were recently proposed to Ontario's *Business Corporations Act* (OBCA) in a private member's bill to make proxy access a statutorily entrenched right for shareholders of corporations incorporated in Ontario. If the proposed amendments are adopted (which is unclear at the time of writing this report),[25] the OBCA would allow registered or beneficial shareholders to nominate a single director nominee if they hold at least 3% of the shares or 3% of the class or series of shares entitled to vote at a meeting. If such a proposal is submitted, the corporation's proxy card must include the shareholder's nominee, and the shareholders are entitled to choose a person from their number to chair the meeting.

Legal Developments in Shareholder Requisition Rights: *Koh v Ellipsiz Communications Ltd.*

One powerful right that shareholders of Canadian corporations enjoy is the right of holders of 5% or more of the issued voting shares to requisition the directors to call a shareholders' meeting.[26] On receiving a valid requisition proposing proper shareholder business — most commonly, the removal and election of directors — the directors must, within 21 days, call a meeting of shareholders to transact the business stated in the requisition.[27] A shareholder requisition (and a shareholder proposal) can be legitimately rejected by the board where, among other things, (1) the primary purpose of the meeting or of the proposal is to "enforce a personal claim or redress a personal grievance" against the corporation, its officers, directors or securityholders; or (2) the primary purpose of the meeting or the proposal "does not relate in a significant way to the business and affairs of the corporation."

Canadian courts have historically held shareholders to a high standard of technical compliance in submitting requisitions and have demonstrated a

Proxy Access Proposals at Canadian Banks: A Win and Almost a Win

Despite the flood of proxy access proposals that have emerged in the United States in the past few years, no Canadian issuer had faced a shareholder proposal for or adopted proxy access until this year, when two of Canada's largest banks — Royal Bank of Canada (RBC) and The Toronto-Dominion Bank (TD Bank) — received proposals to adopt a proxy access bylaw. The proposals were submitted to each bank by the same shareholder, asking that their respective boards adopt a bylaw similar to the most typical U.S.-style proxy access bylaw, allowing shareholders to nominate directors if they beneficially own 3% or more of the bank's outstanding common shares continuously for three years.

The boards of both TD Bank and RBC recommended that shareholders vote against the proposals for a number of reasons. ISS and some major institutional investors supported the proposals, resulting in the TD Bank proposal narrowly passing at its AGM on March 30, 2017, with 52.2% shareholder support. However, one week later, the same proposal was narrowly defeated at RBC's AGM on April 6, 2017, with 53.2% shareholder votes cast against. Both banks have announced that they intend to defer their decisions whether, and if so in what form, they will implement proxy access. Both banks also confirmed a commitment to continue the dialogue with stakeholders over the next year to consider a proxy access regime that may be appropriate for them and will revert to their shareholders in their 2018 proxy circulars.

The recent two-stage ruling in *Koh v Ellipsiz Communications* suggests that courts may now be less inclined to allow issuers to reject a requisition on technical grounds, instead giving the benefit of the doubt to the requisitioning shareholder.

propensity to invalidate requisitions on technical grounds, making the effective use of this right not quite as powerful as it appears.[28] The recent two-stage ruling in *Koh v Ellipsiz Communications Ltd. (Koh)*, however, suggests that courts may now be less inclined to allow issuers to reject a requisition on technical grounds, instead giving the benefit of the doubt to the requisitioning shareholder.[29]

In *Koh*, the requisitioning shareholder – Mr. Koh, a director and the single largest shareholder (42%) of Ellipsiz Communications Ltd. (Ellipsiz), a publicly traded OBCA corporation – requisitioned a meeting to, among other things, remove and replace three directors on the five-member board, as well as have himself appointed chair of the corporation and its operating subsidiary and be given responsibility for negotiating acquisitions and financings for the corporation. The board concluded that Mr. Koh was pursuing an unduly "personal" agenda and that his request for a shareholders' meeting should be refused. The motions judge at first instance agreed with the board. On appeal, the Ontario Divisional Court reversed this finding by concluding that Mr. Koh's requisition involved matters integral to the business and affairs of the corporation, and that the meeting should be permitted to proceed.

While the Divisional Court and the original motions judge reached different conclusions regarding the propriety of the requisition request itself, the following principles relating to shareholder meeting requisitions emerged from the two-stage ruling, which can also be applied in the shareholder proposal context:

- A shareholder's right under the OBCA to requisition a meeting is "a 'fundamental right' in respect of corporate governance." Because the right is "a substantive one," it "is not lightly to be interfered with."
- The language of the OBCA requiring it to be "clearly apparent" that the requisition is motivated by a personal claim or personal grievance sets "a very high threshold" for the application of the exception; "any doubt regarding the application of the exception should be resolved in favour of the meeting being held." The onus of proof rests on the board to establish that one of the statutory exceptions applies.
- In refusing the requisition, the directors do *not* enjoy the protection of the business judgment rule and must be "correct" in determining that an exception applies and justifies their disregarding the shareholder's request.

- The existence of "an element of personal interest in the matter" is not a sufficient basis to reject a requisition; the OBCA requires that the "primary purpose" of the requisition be the enforcement of a personal claim or the redressing of a personal grievance. In order to determine whether the "primary purpose" of the requisition is the assertion of a personal claim or a personal grievance, a corporation's directors must look beyond the language of the proposed resolutions and must assess "objective evidence" of the shareholder's purpose.
- Only "personal claims" or "personal grievances," as opposed to mere "personal interest," should be considered by a board in determining whether to accept a requisition.

Although it remains to be seen whether this two-stage ruling decided under the OBCA marks a significant milestone in the law or is limited to the facts, the principles espoused by the courts appear to have broad and authoritative application in many future disputes in which a dissident shareholder or group of shareholders seeks to requisition a meeting or make a shareholder proposal. A corporation's board must therefore carefully assess its legal obligations in accepting or rejecting such a request. Similar to other contexts, such as being faced with director nominations under advance notice bylaws, issuers should act in manner that is commercially reasonable and not tactical or intended to thwart a shareholder seeking to exercise fundamental shareholder rights.

Issuers should act in manner that is commercially reasonable and not tactical or intended to thwart a shareholder seeking to exercise fundamental shareholder rights.

Our Take

ISSUERS SHOULD DISCUSS MECHANISMS FOR FACILITATING SHAREHOLDER INPUT INTO DIRECTOR NOMINATIONS

Although we do not anticipate an explosion of proxy access proposals in Canada in the 2018 proxy season, Canadian issuers are likely to face more pressure, in some form, to facilitate greater shareholder input into the director nomination process. Some of that pressure is likely to be in the form of a proposal, given that two of Canada's largest banks have faced such proposals, one of which narrowly passed with majority shareholder approval, combined with the fact that proxy access remains a leading governance issue. However, proxy access, in its varying forms, is one but not the only way of facilitating this and may in fact not be the right means of doing so. As an alternative, some issuers are instituting engagement policies and processes that expressly allow shareholders to, albeit more informally, provide input into director nominations to the board and/or its chair, including putting names forward for consideration by the issuer's nominating committee.

One thing is certain – boards will find it prudent to solicit feedback from shareholders on their board size, composition and effectiveness, ideally well in advance of their AGMs, in order to understand, and respond to, shareholder views on their leadership structures. RBC's and TD Bank's responses to their proxy access proposals anticipated before their 2018 AGMs will also provide greater insight into whether proxy access has arrived in Canada and potential next steps for other Canadian issuers. In the meantime, boards should take the time to understand and deliberate the pros and cons associated with proxy access to determine whether there are elements that may be relevant to their organization, or more suitable alternatives. Doing so may very well pre-empt proposals for proxy access or negative votes on their directors in future elections.

04

Shareholder Activism and Proxy Contests: Current Trends and Legal Developments

To date in 2017, there have been fewer formal proxy contests in Canada than in 2016, although dissident shareholders have enjoyed higher rates of success than last year. However, the number of proxy contests alone does not convey the full measure of shareholder activism. Many public companies continue to engage privately with activists, implementing changes where a convincing case is made, before a dispute ever enters the public arena. Interesting legal developments have also taken place in 2017, requiring boards to be particularly careful when crafting defensive tactics in the face of a proxy contest. Here we discuss current trends and legal issues in shareholder activism and take an in-depth look at the thoughtful Mantle Ridge proxy campaign that led to iconic railroader Hunter Harrison's move from CP Rail to CSX Corporation.

04 Shareholder Activism and Proxy Contests: Current Trends and Legal Developments

Types of Proxy Contests in 2017

Of the 19 proxy contests that have emerged in the first seven months of 2017, six (or 32%) were transaction-related. Thirteen fights (or 68%) involved campaigns aimed at replacing all or a portion of the target issuers' boards, with the vast majority of those involving minority dissident slates rather than efforts to replace a majority or more of the board. Issuers in the materials sector faced a relatively higher degree of activism, followed by issuers in the information technology sector and real estate industry. The resource and energy sector, which has traditionally been the focus of activist campaigns in the past few years, was a less popular target this year. However, given the composition of Canada's equity markets, we expect issuers in the materials, resource and energy and IT markets will continue to be popular targets of activist proposals.

In updating this report annually, we review the number of proxy contests over the past year. Until 2015, we noted a significant increase in the number of proxy contests. However, since then, the number of proxy contests has declined from the peak levels reached in 2015, with a reversion to what appears to be a mean level of shareholder activism based on the number of proxy contests to date. As of the end of July 2017, we had seen only 19 formal proxy contests, down from 33 in 2016 and 55 in 2015.[30]

Although shareholder activism is manifesting itself less frequently in the form of proxy contests, we continue to observe a robust level of activism in its quieter form, with shareholders and boards engaging privately to effect change and reconcile their competing views on corporate strategy and governance. Boards are clearly becoming more receptive to engaging with both significant shareholders and activist investors. Activists are increasingly achieving their objectives without the need for a public threat of a contest; furthermore, some boards and management teams are even finding it fruitful to bring activists into the tent (with appropriate confidentiality agreements in place) so that the shareholder can play a consultative role regarding the board as it develops its strategy, evaluates its governance structure or negotiates a transaction.

Despite the decline in the number of proxy contests, dissidents have had a robust success rate in 2017 to date, winning 58% of their campaigns (compared with 33% in 2016), the highest dissident win rate in several years (although measuring success in proxy contests is never a perfect science).

Although the number of contested shareholders meetings was low this year, the few that we observed have involved some interesting legal developments with respect to defensive tactics employed by the targets' management teams, which we discuss below.

→ Regulators Intervene in Eco Oro Minerals Private Placement

The dissident shareholders in the Eco Oro Minerals Corp. (Eco Oro) proxy contest scored a notable victory in June 2017 when a panel of the Ontario Securities Commission (OSC) ordered the unwinding of a private placement that had the effect of increasing the number of shares in management-friendly hands on the eve of the record date for a contested shareholders' meeting.[31]

The Eco Oro saga began in February 2017, when dissident shareholders of Eco Oro sought to replace the incumbent board of directors by requisitioning a shareholders' meeting. Eight days before the record date for the meeting, which the company scheduled for April 2017, management issued new shares by way of an early conversion of debt held by a number of Eco Oro noteholders and shareholders known to be supportive of the incumbent board. These shareholders were asked to sign (and did sign) support letters pledging their support for the election of management's nominees at the meeting. As a result of the private placement, the supporting shareholders increased their ownership from 41% to approximately 46% of the outstanding common shares, with the 5% margin likely to be decisive in ensuring defeat of the dissident shareholders in the proxy contest.

The Eco Oro private placement had been approved by the Toronto Stock Exchange (TSX) in accordance with its rules for preclearance of private placements; the TSX had accepted the Eco Oro counsel's assurances that the transaction would not "materially affect control" of Eco Oro and thus would not require shareholder approval. Notably, the issuance of common shares resulting from the conversion of debt was completed without advance public disclosure.

On application from the dissident shareholder, the OSC set aside the TSX's approval of the private placement, cease-traded the subject shares and ordered the transaction to be reversed unless approved by shareholders (excluding the subject shares held by participants in the private placement). The effect was to sterilize the voting rights of the newly issued shares. At the OSC's hearing, TSX staff gave evidence that the circumstances of the private placement, including the existence of a proxy contest and the impact of the placement on the likely outcome of the contest, had not been disclosed by Eco Oro's counsel.

In reaching its decision to require an unwinding of the transaction unless approved by Eco Oro's shareholders, the OSC focused on whether the issuance of the private placement shares would "materially affect control" of Eco Oro. Although the private placement would not have created any single 20% shareholder or combination of shareholders acting together, the OSC noted that whether a placement affects control requires a broader contextual analysis. The OSC rejected the argument that the TSX control analysis should consist of a bright-line 20% ownership test. Instead, the OSC applied a theory of "enduring control" in which the TSX must consider the impact of the issuance of shares, even if a small number, on the outcome of a particular shareholder vote, consistent with the wording of the TSX's rules and prior TSX commentary on the topic. Moreover, although the OSC's decision was not grounded in its public interest jurisdiction (but rather on its authority to review TSX decisions), the OSC found that the TSX's failure to consider the impact of a share issuance on a transient vote was inconsistent with the public interest, stating that "the public interest requires an evaluation of whether an issuance of shares by a listed issuer is for the purpose of entrenching management in the face of a proxy contest." In coming to its decision, the OSC criticized Eco Oro for making inadequate disclosure to the TSX such that the TSX was either unaware of or "failed to absorb" important facts in determining whether to approve the private placement.

By July 2017, only 19 formal proxy contests had taken place in Canada, down from 33 in 2016 and 55 in 2015.

The decision has broad implications for shareholder activism in Canada, signalling the OSC's willingness to intervene in proxy contests to preserve the fairness of the vote. The OSC's reasons emphasized that whether a board should be reconstituted is a decision to be made by the shareholders without management being permitted to manipulate the vote. To allow a vote to be tainted by such conduct "would directly affect the integrity of Ontario capital markets, contrary to the [OSC's] mandate and the public interest."

The OSC decision in *Eco Oro* is also notable because of the remedy fashioned, essentially an "unscrambling of the egg" – requiring the unwinding of the private placement unless approved by shareholders and sterilizing the voting rights of the newly issued shares pending such approval. While the OSC has explicit power to cease-trade shares, the OSC has no express authority to make orders with respect to voting or to order the unwinding of a transaction. However, in its decision, the panel noted the absence of any alternative adequate remedy and concluded that there was little prejudice to the purchasers in unwinding the transaction because the purchase price for the shares had been satisfied through the conversion of debt.

The *Eco Oro* decision will likely lead to greater scrutiny by TSX staff of such transactions. We also expect to see significantly circumscribed instances in which the TSX will permit a private placement to close without a prior public announcement (and waiting period to allow objections to emerge). And we may see the TSX more frequently impose a requirement to obtain shareholder approval of private placements. Moreover, the *Eco Oro* decision is further evidence of the recently observed trend of the OSC's taking action to preserve the fairness of the vote in the proxy contest arena. Notably:

> **The OSC found that the TSX's failure to consider the impact of a share issuance on a transient vote was inconsistent with the public interest.**

- With respect to the OSC's perception of the public interest, issuers who undertake a private placement in the face of a contested vote must be prepared to defend the bona fide nature of its business purpose (clearly, the OSC found Eco Oro's position wanting in this regard, in part because the private placement did not result in any new funds being invested in Eco Oro and did not result in any covenant relief as the class of convertible debt remained outstanding).
- The considerations that the OSC will apply in the public interest context will be fact-specific. However, parallels can be drawn from the OSC's analysis in reviewing private placements by issuers in the context of contested takeover bids, including most recently in *In the Matter of Hecla Mining Company and Dolly Varden Silver Corporation*.[32]
- The OSC clearly believes it has the flexibility to fashion a remedy to effectively sterilize voting rights and unwind a transaction. However, the unique facts of *Eco Oro* arguably presented little practical downside to imposing such a remedy. It is difficult to predict whether a similar remedy

will be as readily imposed in more complex or grey circumstances and at what point it would become, in the eyes of the OSC, impractical to do so.

Renewed Scrutiny of Soliciting Dealer Fees in Proxy Contests – a.k.a. "Vote Buying"

One of the most high-profile proxy contests in 2017 was PointNorth Capital's (PointNorth) successful campaign to replace six of eight directors on the board of TSX-listed issuer Liquor Stores N.A. Ltd. (Liquor Stores).

During the course of the campaign, it had become evident that institutional shareholder sentiment was generally in favour of PointNorth. However, Liquor Stores had a large retail base of "objecting beneficial owners" who were not identifiable or reachable by the company's proxy solicitors. Purportedly in an effort to reach these shareholders and in the name of "shareholder democracy," as well as to convince them to support management, Liquor Stores retained Scotia Capital Inc. to form a soliciting dealer group. Under the terms of the arrangement, Liquor Stores agreed to pay brokers within the soliciting dealer group compensation for proxies voted in favour of management's nominees, conditional on all of management's nominees being elected.

The practice of paying soliciting dealer groups only for management votes is controversial in proxy contests for board control. In 2013, Canadian issuer Agrium Inc. implemented a similar compensation mechanism to defend against a proxy contest initiated by JANA Partners LLC, leading to significant criticism of the practice by Agrium's institutional shareholders and corporate governance organizations, including the Canadian Coalition for Good Governance.

PointNorth criticized Liquor Stores' formation of the soliciting dealer group, accusing the board of an "unethical act of desperation" to keep the incumbent board in place and using the company's money to buy votes for their own re-election in violation of the board's fiduciary duties. Proxy advisory firms Glass Lewis & Co. (Glass Lewis) and Institutional Shareholder Services, Inc. (ISS) separately condemned the practice. Glass Lewis, having previously recommended re-electing the incumbent board, changed its position and recommended that shareholders withhold their votes from the chairman of the board "in order to convey a strong rebuke of such behavior."

PointNorth applied to the Alberta Securities Commission (ASC) seeking an order to halt the "vote-buying scheme" and reprimand the board of Liquor Stores for approving it. Following a hearing, the ASC declined to intervene, noting that there was no specific rule prohibiting the practice and finding that insufficient

The *Eco Oro* decision is further evidence of the recently observed trend of the OSC's taking action to preserve the fairness of the vote in the proxy contest arena.

evidence had been provided to suggest that the practice is "clearly abusive" to capital markets.[33] Despite being unsuccessful with the ASC, the objections to the soliciting dealer arrangement appeared to further weaken institutional shareholder support for the incumbent board, and PointNorth was ultimately successful in winning all six of the eight board seats it had sought in the contest.

The objections to the soliciting dealer arrangement weakened institutional shareholder support for the incumbent board – PointNorth was ultimately successful in winning six of the eight board seats.

In 2013 we wrote about the use of vote buying by Agrium in the JANA Partners' proxy contest. At the time, we predicted that, whatever the legality of the practice, institutional shareholder opposition to the tactic would likely result in the practice being abandoned for board contests. Indeed, we are not aware of other instances in which the tactic has been employed since Agrium, until its re-emergence in the Liquor Stores campaign this year. We understand that the lack of any rulemaking by securities regulators following the Agrium contest was in part attributable to regulators' expectation that boards would not resort to this tactic again in light of the widespread and negative public and shareholder reaction in Agrium. However, now that we have seen the tactic employed yet again, coupled with the ASC declining to intervene on public interest grounds, rule-makers may feel compelled to address the issue. Future cases employing soliciting dealer fees in the context of a proxy contest may also see such tactics being challenged before the courts under the "oppression remedy" or before different securities regulators, despite the ASC's decision in the *Liquor Stores* case.

Spotlight: Iconic Railroader Hunter Harrison Joins CSX Corporation

Since September 2015, CSX Corporation (CSX), a leading U.S. rail-based transportation company with its shares listed on the Nasdaq, had been focusing on a succession plan for its chief executive officer, Mr. Michael Ward. Following the unexpected departure in September 2015 of CSX's former president and chief operating officer, Mr. Oscar Munoz, who was next line for CEO, Mr. Ward publicly announced his intention to stay on as CEO until 2018.

Meanwhile, on January 18, 2017, Mr. E. Hunter Harrison resigned from all positions held by him at Canadian Pacific Railway Limited (CP Rail), including as CP Rail's chief executive officer, more than four years after securing that position as part of Pershing Square Capital Management's highly successful proxy contest. CP Rail agreed to relax certain restrictive covenants that applied to Mr. Harrison, including his non-competition obligations, in exchange for the forfeiture by Mr. Harrison of earned compensation, benefits and equity awards totalling approximately $90 million.

That same day, Mr. Harrison also entered into a consulting agreement with an affiliate of Mantle Ridge LP (Mantle Ridge), an investment firm led by Paul Hilal, a former Pershing Square investment professional who had played a key role in the CP Rail proxy contest. Under that agreement, among other things, Mantle Ridge agreed to pay Mr. Harrison $84 million for his forgone compensation, benefits and equity awards earned at CP Rail and an additional tax gross-up payment that could reach $23 million, depending on Mr. Harrison's tax position (referred to as the Extraction Cost). Mantle Ridge's obligation to pay the Extraction Cost would fall away if Mantle Ridge were to find suitable employment for Mr. Harrison and his new employer assumed that obligation.

CP Rail publicly announced Mr. Harrison's resignation and the limited waiver of his non-compete. The same day, Mantle Ridge quietly informed CSX that it owned about 4.9% of CSX's common stock and Mr. Harrison was eager to become the next CEO of CSX. The following day CSX's stock price increased by almost 25% from $36.88 to $45.61, presumably on speculation that Mr. Harrison would likely become the next CEO of CSX.

Mantle Ridge subsequently met with the full 12-member CSX board of directors. Mantle Ridge proposed that Mr. Harrison become the CEO for a term of four years. It also proposed that CSX (1) bear the entire Extraction Cost; (2) appoint six new directors to the CSX board – Mr. Hilal, Mr. Harrison and four mutually agreeable independent directors; and (3) decrease the board size from 17 to 14 directors following the 2017 CSX annual shareholders' meeting (AGM). CSX refused to bear the

Mr. Harrison's widespread recognition as a legendary railroader, Mantle Ridge's effective strategy and vigorous shareholder and media outreach campaign, the stock markets' immediate enthusiastic endorsement of Mr. Harrison, and the CSX board's conscientious engagement with Mantle Ridge all contributed to the successful outcome of this campaign.

Extraction Cost, but was prepared to (1) appoint Mr. Harrison as CEO for a two-year term; (2) appoint Mr. Hilal, Mr. Harrison and three mutually agreeable independent directors to the CSX board, increasing the board size to 17 directors; and (3) have four incumbent CSX directors retire over three years (including Mr. Ward, who would cease to be a director after the 2017 AGM). Unable to reach a deal, the parties continued to negotiate.

On February 14, 2017, CSX announced that it would hold a special meeting in March to seek shareholder guidance on Mantle Ridge's proposals. CSX characterized the economic costs of Mantle Ridge's employment-related proposals as "extraordinary in scope" and also expressed concern over Mantle Ridge's gaining effective control of CSX.[34] Mantle Ridge issued a carefully crafted public response urging CSX to resolve the issues instead of waiting for a shareholder vote.

Ultimately, the special meeting was not necessary. On March 6, 2017, CSX and Mantle Ridge reached an agreement under which Mr. Harrison became CEO of CSX for a four-year term. Five new directors were appointed to the CSX board effective immediately – Mr. Hilal, Mr. Harrison and three new independent directors proposed by Mantle Ridge.[35] Three incumbent CSX directors would complete their service by the 2017 AGM, reducing the board from 16 to 13 directors. The last outstanding issue – whether CSX should bear the Extraction Cost – would be put to a shareholder advisory vote at the AGM and the board would make its final determination shortly thereafter.[36] Mantle Ridge and Mr. Harrison separately agreed that if the CSX board decided against paying the Extraction Cost and Mr. Harrison chose to remain CEO, Mantle Ridge's obligation to pay the Extraction Cost would fall away and Mr. Harrison would be obligated to repay the amount of the Extraction Cost previously paid to him by Mantle Ridge.

Mantle Ridge then began an extraordinarily restrained campaign to solicit "yes" votes on the shareholder advisory resolution. Mantle Ridge's campaign focused on the certainty that Mr. Harrison would resign as CEO if CSX refused to bear the Extraction Cost, and the potentially adverse consequences that Mr. Harrison's resignation would have on the market value of CSX common stock. The CSX board chose to remain neutral on this subject and did not make a recommendation.

Mantle Ridge's strategy succeeded. At the AGM held on June 5, 2017, 93% of the votes submitted favoured CSX paying the Extraction Cost. The CSX board approved the Extraction Cost payments 11 days later. Mr. Harrison's widespread recognition as a legendary railroader, Mantle Ridge's effective strategy and vigorous shareholder and media outreach campaign, the stock markets' immediate enthusiastic endorsement of Mr. Harrison, and the CSX board's conscientious engagement with Mantle Ridge all contributed to the successful outcome of this campaign.

Increasing Challenges for Negotiated Transactions

The spectre of shareholder opposition has always hung over negotiated M&A transactions. Deal counsel are wary of potential shareholder opposition and the risks that it can pose to deal completion. Nonetheless, historically the success rate for negotiated M&A transactions has been extremely high and the proxy advisory firms rarely issue negative recommendations. This trend may be changing.

Over the last three years, ISS has recommended against a growing number of uncontested M&A transactions. ISS recommended against 1.4% Canadian M&A transactions in 2014, 1.6% in 2015, 3.2% in 2016 and 4.1% so far in 2017.[37] The rising trend indicates ISS's greater scrutiny of transactions, particularly with respect to related party transactions. Transactions faced with negative recommendations from ISS include Milestone REIT's proposed acquisition by Starwood Capital Group, INFOR Acquisition Corp.'s proposed acquisition by ECN Capital Corp. and Rayonier Advance Materials Inc.'s acquisition of Tembec Inc.

Over the last three years, ISS has recommended against a growing number of uncontested M&A transactions.

In its report on the Milestone REIT transaction, ISS highlighted that the "fact pattern in the transaction indicates speed and certainty were prioritized over price." ISS also cited low deal multiples and governance "red flags" arising from the "lack of a market check and management incentives." The Milestone REIT transaction ultimately closed with a small bump in price and changes to management payouts.

The Rayonier Advanced Materials Inc. (Rayonier) acquisition of Québec forestry firm Tembec Inc. (Tembec) faced stiff shareholder opposition. Spearheaded by long-time shareholder Oaktree Capital Management (Oaktree), a number of shareholders vocally opposed Rayonier's $4.05 per share offer. Oaktree, with significant shareholder support, took issue with the flawed and poorly timed sale process leading up to the proposed sale of Tembec, which it referred to as "piecemeal" and "undisciplined," as well as with the material gap between Rayonier's offer price and Tembec's intrinsic value, rendering the transaction opportunistic and unfair to Tembec's shareholders. Oaktree's thoughtful and vigorous articulation of these concerns resulted in ISS reversing its earlier positive recommendation with a new recommendation that shareholders vote against the transaction.

Oaktree also raised concerns that a significant Tembec shareholder who had been named in Tembec's press release as being supportive of the transaction had sold its shares on the record date for the meeting without making it clear in its public filing whether it still intended to vote the shares. This is commonly referred to as "empty voting" whereby the shareholder holds and exercises the right to vote without having any economic interest in the outcome. The Tembec transaction highlighted both a disclosure issue and a fairness issue relating to empty voting of a significant block of stock in a contested transaction. Following a complaint through the securities commissions, the issue was resolved with the former shareholder giving a public assurance that it would not cast votes on the transaction. Subsequently, in order to finally win over shareholders and reclaim ISS support, Rayonier increased its price substantially to $4.75 per share.

Our Take

RESPONSE STRATEGIES MUST BE CAREFULLY CRAFTED

Today's shareholders are taking an increasingly active role in strategic, governance and transaction-related issues. Whether shareholders are seeking a seat at the board table or demanding input into an issuer's operations and strategy, shareholder activism continues as the new normal and will remain a feature of Canadian public markets. As companies' chief stewards, boards cannot abdicate their decision-making responsibility and are often faced with difficult decisions when confronting quiet or public campaigns from engaged shareholders. As a starting point, every board should periodically test the company's vulnerability to activism and plan for ways to engage with shareholders.

The recent new trend of dissidents' increased success rates in formal proxy contests, together with the lessons emerging from the *Eco Oro*, *Liquor Stores* and Tembec cases, highlight the extreme care that boards must exercise when determining how to respond. Defensive tactics that appear to lack bona fide purposes, compromise the fairness of a voting process and/or otherwise undermine shareholders' fundamental franchise are likely to prompt legal challenges in the courts or before securities regulators, as well as negative reactions from proxy advisory firms, institutional investors and the media. Moreover, as *Liquor Stores* demonstrates, even if such controversial or aggressive tactics are "legal," their use can overshadow an issuer's key messages and become the determining factor in the outcome of a campaign.

You can read more about these and other trends and legal issues in proxy contests and shareholder activism in Davies' June 2017 report titled *Shareholder Activism and Proxy Contests: Issues and Trends*.[38]

05

Diversity Still Lacking in Canadian Public Companies: Top Trends and Steps to Improve Your Leadership

Under the current comply-or-explain disclosure regime, progress in improving gender diversity among the leadership of Canada's public companies continues to be slow, at least when measured in the short term. Meanwhile, as evidence accumulates for the strong business case for taking action, large institutional shareholders are making demands of boards and are demonstrating a willingness to express their discontent over a lack of diversity through shareholder proposals and/or by voting against director nominees. Proposed legislative amendments may soon require disclosure on diversity other than gender. Now, more than ever, companies need to stay at the forefront of these issues. Here find Davies' thoughts on what general counsel and the nominating and governance committees of Canadian issuers can do to continue to advance diversity within their organizations.

Since the introduction, in January 2015, of Canada's comply-or-explain disclosure regime on gender diversity for Canadian boards and executives, little change has taken place in female representation at Canadian companies. Gender gridlock remains as women continue to be significantly under-represented relative to their male counterparts. This despite the fact that we constantly read media reports quoting governance watchdogs, think tanks, regulators and governments calling on corporate leaders in Canada, the United States and around the world to take action, all suggesting that diversity remains a top governance concern and can improve company performance on various metrics. We also increasingly see investors turning an eye toward, and becoming more vocal about, matters of gender diversity at the corporations in which they invest. Clearly the focus on gender diversity is not waning so Canadian companies need to continue taking actionable steps in the face of increasing pressure from shareholders and regulators.

Update on Gender Diversity Data and Trends

Since the proposal and implementation of the Ontario Securities Commission's (OSC) comply-or-explain disclosure requirements under National Instrument 58-101 – *Disclosure of Corporate Governance Practices* (NI 58-101), we have been closely tracking developments in this area. Our previous editions of *Davies Governance Insights*[39] have provided extensive data analysis about issuers' progress toward meeting diversity measures. Over the past four years, our message continues to be the same – progress is very slow, and meaningful improvements in gender parity are lacking.

If the current pace continues, it will take another 20 years to achieve gender parity among directors of Canadian issuers.

When we look at the numbers year over year, we see that although the representation of women is increasing, the pace is sluggish. If the current pace continues, with women making up only 19.2% of boards of TSX Composite Index and SmallCap Index issuers as of the 2017 proxy season (2016: 17.7%), it will take another 20 years to achieve gender parity among directors of Canadian issuers. Only slightly more than half of Canadian issuers in our study universe have adopted written diversity policies and, overall, few have established targets, although nearly half of the TSX 60 issuers now have targets. Discouragingly, the past year also saw a slight percentage decrease in the number of female board chairs since 2016, no improvement in the number of female lead directors and a decline in the number of women chairing audit, compensation, and governance and nominating committees of SmallCap Index issuers. Not only do fewer women hold leadership roles on boards than men, but women continue to be appointed to multiple boards more frequently than men – that is, the group of women being appointed to boards tends to be drawn from the same pool of existing female directors to a greater extent than is the case for men.[40] The selected comparative data in Table 5-1 for the 2017 proxy season demonstrate the incremental progress over the last four years.

TABLE 5-1: DIVERSITY PROGRESS OVER PAST FOUR YEARS

Diversity progress/measures	2014	2015	2016	2017
Board seats of Composite and SmallCap Index issuers held by women	12.3%	15.1%	17.7%	19.2%
Board seats of TSX 60 issuers held by women	20.1%	23.1%	24.6%	26.3%
Composite and SmallCap Index issuers with written diversity policies	8.6%	37.1%	48.0%	51.3%
Composite and SmallCap Index issuers with female board chairs	3.2%	3.8%	4.4%	4.28%
Composite and SmallCap Index issuers with targets	3.2%	11.1%	16.1%	18.7%
TSX 60 issuers with targets	10.0%	28.3%	35.0%	46.7%
Newly elected women directors on Composite and SmallCap Index issuers	–†	26.2%	24.8%	24.1%

† Note: Comparative data is not available for the 2014 proxy season.

In its most recent review (September 2016) of issuers' compliance with the comply-or-explain regime, the Canadian Securities Administrators (CSA) concluded that issuer size and industry are the most significant indicators for adopting policies (or the lack thereof) aimed at increasing female board and executive representation.[41] Consistent with prior years, utilities and retail industries had the most women on boards, whereas mining, oil and gas, and technology industries continue to have the greatest number of issuers with no women on their boards. And while we have seen modest improvements in the number of issuers that have put forward at least one or two women for election to boards of TSX Composite and SmallCap issuers in 2017 and a modest decrease in the number of such issuers that did not put any women up for election in 2017, again, progress is very slow.

TABLE 5-2: ISSUERS THAT PUT FORWARD ONE, TWO OR NO FEMALE DIRECTORS

Diversity progress/measures	2015	2016	2017
TSX Composite and SmallCap issuers that put forward at least one woman for election to the board	68.1%	76.6%	80.2%
TSX Composite and SmallCap issuers that put forward at least two women for election to the board	37.1%	44.4%	47.6%
TSX Composite and SmallCap issuers that put no women forward for election to the board	31.9%	23.4%	20.0%

While we have not witnessed significant increases in the number of women on boards, in board or committee leadership positions or in senior management since the introduction of the increased disclosure requirements in 2015, there are legitimate reasons for this slow pace. Board and executive positions are, necessarily, roles that are not subject to high-volume turnover. The data for the 2017 proxy season show that among issuers listed on the TSX Composite and SmallCap indices, the average tenure of a director is 13.6 years (15 years is the median and mode director tenure); the average retirement age is about 73 years (75 years old is the median and mode retirement age). Moreover, of the 3,272 board seats available at issuers on those indices in 2017 and 2016, each year only about 9% of all board seats were for directors being nominated for the first time.

As we have discussed in past reports in the context of debates over whether issuers should adopt term limits or retirement policies, while boards can benefit from the fresh and diverse perspectives that result from turnover, boards rely on consistency among their members over periods of several years by retaining directors that serve for long periods of time and are familiar with the company's business, industry, stakeholders, opportunities and challenges. The loss of seasoned and knowledgeable directors, particularly in the turbulent financial, credit, equity and commodity markets of the past few years, can have negative consequences for companies. It should therefore come as no surprise that the comply-or-explain disclosure regime has not yet produce massive leaps toward

The Google Example

Google's controversial dismissal of software engineer James Damore illustrates the current divide in attitudes toward diversity. Mr. Damore wrote and distributed a memo arguing that biological differences between men and women explain the gender gap among tech workers. The memo has generated significant public discussion about the merits of the author's views, the effect of corporate culture and working practices, and the need for open discussion on diversity policies. Perhaps most significantly, the memo drew attention to the apparent gap between companies' formal commitments to diversity and actual impacts.

Despite the strong business case for diversity, the issue remains a subject of debate both among the public and within public companies. Companies such as Google and many other reporting issuers are making significant financial investments in diversity and inclusion that often fail to achieve expected results.[42] In the tech sector, in particular, studies suggest that little meaningful progress has been made. In both the United States and Canada, the average percentage of women working in the tech industry has consistently hovered around 20% to 30%.[43]

While it is unclear whether the opinions expressed in the Damore memo represent outlier viewpoints or some wider set of shared beliefs, boards should be aware that calls for open discussions regarding company diversity policies are likely to continue. Boards should be prepared to make a case for diversity, maintain internal dialogue on the issue and critically analyze company diversity initiatives to ensure that they are generating real results.

gender parity, particularly since diversity is only one of several criteria boards must take into consideration when recruiting and nominating directors. And if the goal is to improve gender diversity while also maximizing effective decision-making and ensuring a company's strategies and plans are being achieved, we should expect that goal to take time. Issuers are not likely to increase the size of their board solely to increase the representation of women. Nor are they likely to let go of valuable and highly skilled directors in the name of diversity. Instead, it would seem reasonable that women and other candidates representing diversity will be considered as and when a need for board refreshment arises. Similarly, for executive positions, many issuers are actively promoting diversity and inclusiveness through changes in their employment equity policies, enhancements in recruiting and mentoring programs, implementing diversity and inclusiveness training and awareness, and adopting other processes designed to, over time, educate employees, create a culture of inclusiveness and attract and promote more diverse candidates – all processes that take time before yielding measurable results.

From our perspective, while it is important to continue to monitor year-over-year changes in board and executive diversity, focusing on annual percentage changes does not tell the whole story. Instead, a longer-term view is necessary. While issuers should continue to take meaningful steps to improve diversity among their leadership and more broadly within their organizations, it is premature to conclude that Canada's comply-or-explain approach is not working or that Canada's issuers are not making important changes. Revisiting the representation of women on boards and in board and executive leadership positions in five years' time is likely to produce a much more accurate – and meaningful – barometer.

Growing Investor Engagement

We also continue to see growing demand by large institutional shareholders for increased representation of women on boards. In 2017 alone, Vancouver-based Shareholder Association for Research and Education (SHARE), which works on behalf of investors seeking governance improvements at companies, has sponsored diversity proposals at four Canadian companies – Canfor Corp.; Constellation Software Inc.; Restaurant Brands International Inc. (RBI), the parent company of Tim Hortons and Burger King; and Morguard Corporation. Although none of the proposals achieved majority approval by the shareholders, the proposals did incite action by the targeted companies. The shareholder proposal put forward to Canfor Corp. received only 32% shareholder support but resulted in the company committing to develop a diversity policy by the end of the year. Similarly, Constellation Software Inc. committed to address board diversity issues in a "meaningful way" after 42% of its shareholders voted in favour of the shareholder proposal. Even though the proposal submitted to

RBI was rejected by shareholders at the company's annual general meeting, the board agreed to amend its new-director nomination process to consider diverse candidates. Lastly, the proposal submitted to Morguard Corporation was subsequently withdrawn when the company announced that a formal diversity policy would be ready for next year's proxy circular and that a female board nominee would be forthcoming.

The shareholder diversity proposal is only one way investors are sending a message to issuers; SHARE has indicated that it treats shareholder proposals as a last resort. That being said, shareholder proposals focused on board diversity are increasingly being made in both Canada and the United States, with some U.S. data suggesting they are becoming increasingly successful. Importantly, even when those proposals fail or are withdrawn, they and the engagement that goes along with them appear to be driving action by many of the targeted companies. By listening to investors and staying out in front of the issue, companies may pre-empt shareholder proposals; perhaps more important, taking steps to improve diversity may also improve company performance.

Some predict that as evidence grows in support of increased representation of women on boards, investors, including large fund managers, will increasingly focus on the issue and become more vocal. Their focus will most typically be through engagement with the companies in which they invest; however, where companies fail to take meaningful action to improve diversity, investors are also prepared to express their discontent by voting against directors.

Where companies fail to take meaningful action to improve diversity, investors are prepared to express their discontent by bringing shareholder proposals or voting against directors.

Legislative Developments in Canada: CBCA and OBCA to Require Diversity Disclosure

In 2016, the federal government proposed amendments to the *Canada Business Corporations Act* (CBCA) and its regulations that would require public corporations to provide annual disclosure on gender diversity consistent with the comply-or-explain approach under NI 58-101. However, the amendments go one step further than NI 58-101 by also requiring disclosure on diversity *other than gender* among directors and members of senior management.

Under the proposed CBCA amended regulations, federally incorporated public companies would be required to disclose whether they have adopted a written policy relating to "diversity other than gender" among the directors and members of senior management and, if so, include a short summary of its objectives and key provisions. If no such policy has been adopted, the corporation must disclose why it has not done so. The Ontario government proposed similar amendments to its *Business Corporations Act* (OBCA) in the

Institutional Investors Pushing Progress

In March 2017, State Street Global Advisors, which is among the largest passive managers in the world, issued new gender diversity guidance to more than 3,500 companies that it invests in across the United States, United Kingdom and Australia. The guidance is designed to increase the number of women on corporate boards.[44] The firm announced that, as an institutional investor, it would vote against corporate boards that do not make sufficient progress in increasing women within their ranks in the next year. Other institutional investors, such as BlackRock Advisors and Vanguard Group, have said they prefer to "engage privately with companies" as opposed to voting for or against a shareholder proposal, although again, in 2017 we saw them vote against directors at companies lagging in diversity.[45] Other investors are actively writing letters to, and demanding action from, the companies in which they invest.

spring of 2017. While proposed amendments to the OBCA regulations have not yet been released, it is reasonable to expect they will be consistent with the proposed CBCA amendments if implemented.

Canadian regulators are clearly moving forward with increased regulation, and if the proposed amendments to the CBCA and OBCA are any indication, the focus on diversity is not likely to stop at gender differences – diversity of age, sexual orientation, race and ethnicity, as well as with respect to disability, geography and skill set will also become priorities. Moreover, if current trends continue, Canadian issuers may be faced with more stringent requirements, including targets or even quotas for meeting gender diversity goals, as was threatened by the Ontario government in 2016.

Developments at the SEC: Are Diversity Disclosure Reforms Coming?

In the United States, the direction of gender diversity initiatives is somewhat in flux due to leadership changes at the Securities and Exchange Commission (SEC). Before stepping down in early 2017, SEC Chair Mary Jo White announced that SEC staff was preparing a recommendation to include "more meaningful" board diversity disclosures on board members and nominees. Following this recommendation, in February 2017, the Advisory Committee on Small and Emerging Companies (Advisory Committee) recommended to the SEC that the current regulations be amended to require emerging privately held small businesses and publicly traded companies with less than US$250 million in market capitalization to "describe, in addition to the disclosure of their policy with respect to diversity, if any, the extent to which their boards are diverse."[46] The Advisory Committee's recommendation goes beyond gender diversity and also includes disclosure regarding race and ethnicity of each board member or nominee as self-identified by the individual.

It is uncertain how the leadership change at the SEC will affect board diversity initiatives, although current SEC Chair Jay Clayton has indicated that "disclosure practices are evolving" and that he will "monitor this issue."[47]

Top Three Steps to Improve Diversity

So what can general counsel and the nominating and governance committees of Canadian issuers do to stay at the forefront of the issues and advance diversity among their organizations? Here are the top three steps that we think issuers should take or at a minimum discuss and evaluate over the next year:

1. **Adopt a written board diversity policy, and if already adopted, set measurable objectives to advance diversity.**
   - Make a commitment and take meaningful steps to implement it.
   - Review progress toward objectives on an ongoing basis and continue to adapt the framework to the issuer's ongoing needs.
   - Consider implementing targets. Targets as part of board and executive composition, as well as in key performance indicators for key business units, may be helpful.

2. **Establish a skills matrix and robust board assessment practices.**
   - Develop a skills or competency matrix to identify the skills and expertise needed to be effective stewards.
   - Go beyond gender to consider other relevant elements of diversity for your organization.
   - Consider other skills relevant to your organization that may improve the diversity of candidates.

3. **Set new principles for decision-making and establish tone at the top.**
   - Commit to including women nominees on every slate and engage search firms to search for women candidates.
   - Have corporate leaders, not just the human resources department, engaged in implementing and monitoring diversity initiatives.
   - Look for built-in biases in your hiring, promotion, mentoring and training programs, as well as in organizational policies and governance practices.
   - Look beyond, and expand, current director or executive member networks.

06

Dual-Class Share IPOs Get Investors Fired Up

A recent wave of Canadian and U.S. IPOs used varying forms of dual-class share structures, allowing founders, executives and early investors to gain access to public equity while maintaining control of the companies. Wary of the governance challenges these structures create, critics continue to question their appropriateness. Meanwhile, Canadian and U.S. regulators continue to take a hands-off approach, preferring to rely on disclosure and market discipline to manage these governance issues. We examine the recent developments in this area and offer governance guidelines for companies considering going public with or maintaining dual-class share structures.

Discussion about dual-class shares has intensified recently in Canada and the United States, spurred largely by a wave of IPOs embracing them. In Canada, companies such as Freshii Inc., Aritzia Inc., Shopify Inc. and Canada Goose Holdings Inc. have all gone public in the last few years with a similar share structure: Class A subordinate voting shares were sold to the public with one vote per share, whereas Class B multiple voting shares, with 10 votes per share, were retained by insiders such as founders, executives and/or early investors who wanted to maintain control of the companies, but nonetheless gain access to public equity. In the United States, dual-class share structures have also featured in several prominent initial public offerings (IPOs), with the most recent Snap Inc. IPO renewing the debate over the appropriateness of these structures.

Dual-class structures are often touted as buffers against short-termism.

"For" and "Against" Dual-Class Stock: Preventing Short-Termism or a Governance Failure?

For entrepreneurs, dual-class share structures make taking companies public much more attractive, avoiding losing control of their long-term strategy. These structures can serve as buffers against short-termism, allowing management to avoid excessively catering to quarterly expectations. They are also perceived by some as forcing investors to focus on other performance metrics beyond just stock price. Dual classes and dual-class share structures also reduce vulnerability to hostile takeovers and the opportunism sometimes attributed to activist investors who are perceived as being keen to make short-term gains on the stock.

These structures are not a new phenomenon in the Canadian or U.S. capital markets. Blue-chip companies on the TSX 60, including names such as Fairfax Financial Holdings Limited, Onex Corporation and Rogers Communications Inc. have similar structures, with voting ratios ranging from about 1:50 to 1:625. In the United States, several technology, media, financial services and transportation companies have dual-class structures, including Berkshire Hathaway Inc., Coca-Cola Bottling Co., Nike, Inc., CBS Corporation and Swift Transportation Company. And there are many success stories of public companies that have thrived under a dual-class structure, significantly outperforming single-class companies.[48]

Despite the benefits these structures can offer, critics point to the governance challenges that they can perpetuate: self-enrichment, nepotism and management entrenchment. For some, particularly institutional investors and some academics, dual-class structures represent serious governance failures. TSX-listed issuer Bombardier Inc., which has been facing intense criticism over its management, performance, operations and executive compensation, is a case in point. In most single-share structure companies, such widespread disapproval as that faced by Bombardier over leadership, governance practices and performance would result in shareholder activism to shake up the board and management. However, in Bombardier's case, public shareholders hold only subordinated shares that carry one vote per share and the Beaudoin-Bombardier family holds multiple voting shares, with 10 votes per share. As a result, the family controls 54% of the total votes, which means that it dictates almost all major corporate decisions, including who gets elected to the board. At the company's most recent annual general meeting in May 2017, Mr. Pierre Beaudoin was reappointed as a non-executive chairman, and a compensation plan for the executive team that boosted salaries and bonuses by around 50% was also approved.

Canadian and U.S. Regulators' Hands-Off Approach, Despite Investor Demands for Action

To date, Canadian securities regulators have taken a hands-off approach. They prefer to rely on disclosure by companies about their capital structure and the market's discipline to address governance challenges associated with dual-class share structures, as investors choose whether or not to invest in any particular company.

Critics point to the governance challenges that dual-class structures can perpetuate: self-enrichment, nepotism and management entrenchment.

Similarly, other than the Toronto Stock Exchange (TSX) coattail requirement (which effectively entitles subordinated voting shares to participate in a takeover bid for multiple voting shares) imposed in the 1980s, the TSX has also stayed away from imposing restrictions or requirements on dual-class shares. And so as a result, Canadian institutional investors have weighed in. Both the Canada Pension Plan Investment Board (CPP) and the Ontario Teachers' Pension Plan are on record as endorsing the one-share-one-vote principle. CPP has made clear that it does not support dual-class share structures and it promotes the principle of one vote per share.[49] It considers dual-class share structures to be contrary to good governance and recommends that companies with existing dual-class share structures ensure that all shareholders are able to exit on the same terms and conditions in the event of a change of control transaction.[50] It also recommends that companies with such structures collapse them on terms that are in the best long-term interests of the corporation.[51]

In 2013, the Canadian Coalition for Good Governance (CCGG) released a list of best practices and principles for both existing and newly created dual-class share companies. Much of CCGG's advice is endorsed by many investors today, including the following:[52]

- Reporting issuers should not have non-voting common shares, and the maximum voting ratio of multiple voting shares to subordinated voting shares should be no more than 4:1.
- Dual-class share structures should be collapsed when considered appropriate by the board and, if practicable, the exact time or event should be as set out in the company's articles.
- No premium should be paid to shareholders with multiple voting shares upon collapse of the dual-class share structure.
- Holders of multiple voting shares should not be entitled to nominate the entire slate of directors to the board. Subordinated voting shares should have some input.
- The holder of a multiple voting share should not be entitled to enter into a derivative transaction to monetize the superior voting right share.
- All reporting issuers that have dual-class share structures (whether listed or not) should have coattails to ensure that all common shares are treated equally upon a change in control of the company.

SNAP's IPO in March 2017 tested the limits of the U.S. market's tolerance for dual-class share structures.

In the United States, the Council of Institutional Investors (CII) has adopted a similar policy,[53] indicating that it supports the one-vote-per-share principle and that it expects companies that have already adopted dual-class share structures to phase them out through sunset provisions. Although dual-class share structures are less common in the United States than in Canada, they have featured prominently in several IPOs, such as those of Facebook, Inc. and Alphabet Inc. (formerly Google). Snap Inc.'s (SNAP) IPO in March 2017 tested the limits of the U.S. market's tolerance for dual-class share structures. At an investor advisory committee meeting at the Securities and Exchange Commission (SEC) in March (just days after the SNAP IPO) to discuss dual-class stock, representatives of CII and several institutional investors (including State Street Global Advisors and CalSTRS) that remain strongly opposed to these share structures called on the SEC to stop companies from limiting the voting rights of shareholders. Although many believe U.S. regulatory intervention by the SEC will not be forthcoming, it is clear that SNAP's IPO has many institutional investors fired up over the issue.

SNAP's IPO was unprecedented due to the company's offering of common shares entirely devoid of voting rights. The IPO raised over US$3.4 billion and saw share prices soar over 44% on the first day of trading. Although the public was clearly eager to own a piece of the technology unicorn, many large institutional investors expressed serious apprehension regarding only non-voting shares being offered to the public. In particular, a letter from CII to the executives of SNAP urged the company to adopt a single-class structure so as not to deny outside shareholders a voice.[54] Unconvinced, SNAP went ahead with its proposed multi-class share structure in the largest tech IPO since Alibaba went public in 2014. CII then asked leading index providers to exclude from their indices SNAP and other companies in the future that have non-voting shares. In August 2017, S&P Dow Jones indices responded, indicating that they would exclude from the S&P Composite 1500/S&P 500 companies whose public shares make up less than 5% of the total voting power class (although it grandfathered some large dual-class companies such as Alphabet, Facebook and Berkshire Hathaway).

Also ahead of SNAP's IPO, the Investor Stewardship Group (ISG) – a collective of U.S. and international institutional investors and asset managers with more than US$20 trillion invested in the U.S. equity markets – in January 2017 issued baseline expectations for good corporate governance in which they urged U.S. companies to embrace the one-share-one-vote principle. ISG, which includes members such as BlackRock, CalSTRS, State Street and Vanguard, wants every institutional investor and asset management firm investing in the United States to sign on to its framework, which goes into effect in 2018.[55] The principles provide, among other things, that U.S. listed companies should adopt a one-share-one-vote standard and avoid adopting share structures that create unequal voting rights among their shareholders; they also state that boards of companies that already have dual- or multiple-class share structures are expected to review these structures on a regular basis or as company circumstances change, and establish mechanisms to end or phase out controlling structures at the appropriate time, while minimizing costs to shareholders.

Global Regulatory Approaches to Dual-Class Stock

Stock exchanges play an integral regulatory role in other jurisdictions. Both the Hong Kong and Singapore stock exchanges currently prohibit the listing of companies with dual-class shares.

While institutional investors in Canada and the United States are playing a key role in reducing the incentives for companies to use dual-class share structures (or at least vocally advocating against them), in other jurisdictions, stock exchanges play an integral role. Both the Hong Kong and Singapore stock exchanges currently prohibit the listing of companies with dual-class shares. But in light of intense international competition for listings, both jurisdictions are now reconsidering their one-share-one-vote policy with the possibility of allowing dual-class share structure companies to list, subject to protections such as a mandatory sunset clause. In the United Kingdom, dual-class share structures are discouraged but not prohibited outright. For example, the London Stock Exchange permits companies with dual-class share structures to be listed on the High Growth Market, but not on the standard market, premium market or alternative investment market.[56] Elsewhere, some European Union countries have adopted other approaches to discourage the investor short-termism that dual-class stock structures are touted as mitigating – for example, offering time-based or loyalty voting shares, through which longer-term investors obtain more votes for holding shares over longer periods of time.

Our Take

DUAL-CLASS SHARE STRUCTURES REQUIRE CAREFUL CONSIDERATION AND DISCLOSURE

Companies that have dual-class share structures or that are considering going public with dual-class share structures should consider following governance principles:

1. **Disclose the reasons why the structure is important.** The board should explain annually to shareholders, in a clear and transparent manner, in the company's disclosure materials why the continued existence of a dual-class share structure is necessary and appropriate. In doing so, justify why the voting ratio of the multiple voting shares to subordinated voting shares is in the best interests of the company and its shareholders.

2. **Periodically review the structure.** The company's board of directors should periodically review whether maintaining a dual-class share structure is in the best interests of the company and the shareholders as the company's circumstances change. Is there legislation that requires a certain amount of Canadian ownership or control? Is it because the founder continues to bring a unique contribution that justifies maintaining control that is disproportionate to the equity? If the founder retires, is the structure still justified or should it be dismantled?

3. **Consider a sunset clause.** A typical sunset clause would stipulate that once a company goes public with multiple classes of shares, the structure would only stay in place for a specified amount of time (e.g., the first five years or until the founder turns 65 or retires) unless holders of subordinate voting shares elect to keep it in place.

4. **Consider a periodic vote.** Continuation of a dual-class share structure could be subject to a periodic vote by the holders of subordinated voting shares. Holding a vote may assuage investor concerns over the appropriateness of the structure.

5. **Extend the coattail provision.** As it stands now, most coattail provisions apply only in the context of takeover bids. Companies could consider voluntarily extending this provision to include other change of control situations, thereby ensuring shareholders with limited or no voting rights otherwise have a say on fundamental or transformative transactions.

07

Compensation Issues and Trends: Annual Shareholder Input into Compensation Practices Continues as Executive Compensation Rises

Shareholders continue to advocate for input on the pay of top executives, both before and after annual shareholders' meetings. Many issuers continue to face criticism over their executive pay practices, typically due to perceived excessive pay increases, pay-for-performance misalignments and peer group disconnects. Here we examine current Canadian trends and issues in executive and director compensation and offer our advice on what issuers should be doing to meet these challenges. In the United States, this year's second-ever say-on-pay frequency vote reveals that most shareholders continue to strongly favour annual say-on-pay votes. Meanwhile, the U.S. administration's desire for financial reform contributes to debate over the issues. Are annual say-on-pay votes in jeopardy? We discuss both sides of the ongoing debate over the optimal frequency of say-on-pay and examine the impact of say-on-pay on executive compensation in the United States.

While the number of say-on-pay votes held in Canada in 2017 has now plateaued, shareholders continue to advocate for annual input on executive compensation practices. In the United States, although annual say-on-pay votes continue to be preferred by the majority of investors, this year's second-ever vote on the frequency of a say-on-pay vote generated some debate over whether annual votes are necessary or appropriate (discussed under "Say-on-Pay in the U.S.A."). Generally, we are witnessing greater engagement with shareholders on compensation practices, both before and after shareholder votes. With continuing increases in the levels of overall executive compensation and shareholder discontent over perceived misalignments between pay and performance, understanding shareholders' and proxy advisory firms' views on executive and director compensation practices remains more important than ever.

Canadian Say-on-Pay Votes Plateau, but Still the Norm

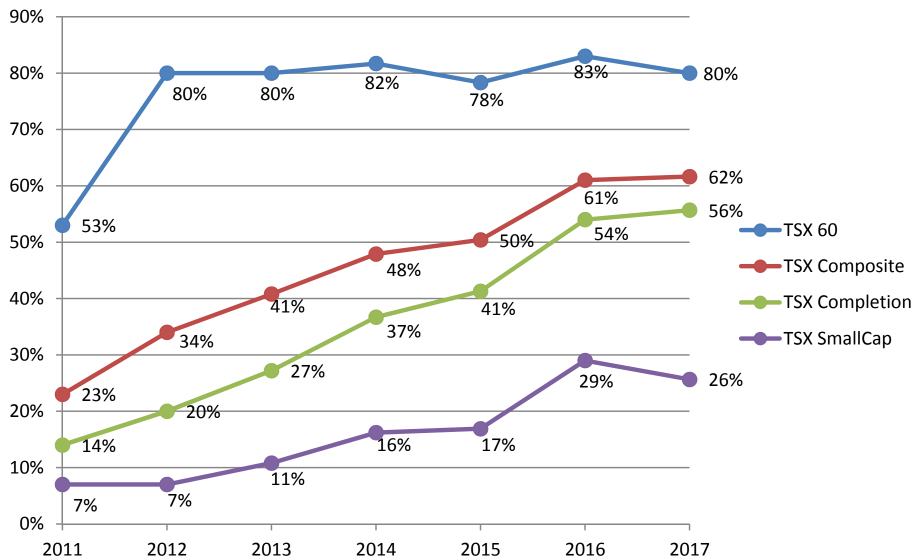
After reaching a peak in 2016, the incidence of non-binding say-on-pay shareholder votes on executive compensation in Canada has plateaued in 2017. Figure 7-1 shows the adoption rates of say-on-pay votes by issuers on the TSX 60, Composite, Completion and SmallCap indices since the inception of say-on-pay voting in 2009. As can be seen, the rate of adoption of say-on-pay votes on the TSX Composite Index remained relatively constant year over year. Small and mid-cap issuers and those on the TSX 60 witnessed a modest, relatively insignificant reversal of the steady upward trend in say-on-pay voting that we had observed between 2011 and 2016; for the first year since 2011, the percentage of companies holding annual say-on-pay votes has decreased slightly to 26% on the SmallCap Index (2016: 29%) and to 80% on the TSX 60 (2016: 83%).

For the first year since 2011, the rate of growth of say-on-pay votes on the TSX SmallCap Index and TSX 60 has stalled.

07

Compensation Issues and Trends: Annual Shareholder Input into Compensation Practices Continues as Executive Compensation Rises

FIGURE 7-1: INCIDENCE OF SAY-ON-PAY VOTES AMONG TSX COMPOSITE INDEX AND SMALLCAP INDEX ISSUERS (2011–2017)



Despite the plateauing or modest decline in annual say-on-pay votes in 2017, shareholders continue to push regulators to mandate say-on-pay voting on top executives' compensation, as is currently the case in the United States and other jurisdictions.[57] We fully expect that annual advisory votes on executive compensation will remain the norm in Canada for the foreseeable future. As discussed in prior reports, we may also witness occasional say-on-pay votes being held for director compensation practices.

In addition, with trends elsewhere in the world leaning in favour of greater disclosure and transparency of executive pay, particularly in response to the continued growth of executive pay packages, Canadian issuers might start to face demands to provide more information on their compensation practices beyond that already required to be disclosed in proxy circulars. For example, as we discussed in 2015, in the United States, the Securities and Exchange Commission (SEC) introduced rules requiring publicly traded corporations to start providing additional information on pay disparities in 2018. At the end of August 2017, the government of the United Kingdom announced a series of reforms relating to executive pay and worker representation. Once the new laws are implemented, expected to be by June 2018 and effective for 2019, about 900 U.K. listed companies will be required for the first time to annually publish and explain annual pay ratios between their chief executives and average U.K. worker. The reforms will also include establishing the world's first public register to "name and shame" listed companies in the United Kingdom, where a fifth of investors have objected to executive annual pay packages. The Financial Reporting Council, the U.K. governance watchdog, will also introduce amendments to the U.K. *Corporate Governance Code* next year, encouraging listed firms to represent employee interests at the board level. Listed companies will be required to assign a non-executive director to represent employees, create an employee advisory council or nominate a director from the workforce or explain why they have decided not to do so.[58]

Issuers should consider engaging with their investors and stakeholder groups on their compensation and governance practices in advance of AGMs.

Compensation Practices Still Facing Criticism in 2017

As the voting results on say-on-pay resolutions demonstrate, in 2017 shareholders continued to voice their concerns over Canadian issuers' compensation practices and disclosure. The main practices facing criticism are perceived excessive pay increases, pay-for-performance misalignments and peer group disconnects.

Most say-on-pay resolutions enjoyed relatively strong support, consistent with the prior two years. In 2017, 18 TSX-listed issuers holding say-on-pay votes received shareholder approval levels under 85%, compared with 22 in 2016 and 18 in 2015.[59]

Also consistent with the 2016 proxy season, in 2017 a large majority of issuers that experienced the lowest levels of shareholder support are those that received negative vote recommendations by Institutional Shareholder Services, Inc. (ISS) and/or Glass Lewis & Co. (Glass Lewis). This should serve as a reminder to all issuers of the hard line that proxy advisory firms take on perceived pay-for-performance misalignments and the influence those firms wield in shareholder voting.

In 2017, three issuers on the TSX Composite and SmallCap indices experienced failed say-on-pay votes this proxy season: Primero Mining Corp., Eldorado Gold Corp. and TransAlta Corp. Fourteen other issuers on those indices received between 60% and 80% shareholder approval.

Consistent with failed votes in prior years, a common theme in these three cases, as well as several of the other say-on-pay votes that received less than 80% shareholder support, is the presence of one or more of the following three factors:

- an anomalous increase in executive compensation (including special one-time payments) when compared with prior year(s);

- a misalignment between executive compensation and the issuer's performance (including, but not limited to, stock performance); and/or
- excessive executive compensation compared with the issuer's peer groups.

In response to failed votes or low levels of shareholder support, issuers confronted with investor dissatisfaction over compensation practices typically announce that they intend to engage with their investors to receive feedback on their executive compensation policies and will evaluate future compensation policies, procedures and decisions in that context. Typically, the issuers have not committed to any particular course of action immediately after the meeting, but instead, undertake to take a closer look at the issues and engage with investors over the following year.

Beyond Say-on-Pay: For Some Issuers, Investor and Broader Stakeholder Engagement May Be Critical

Although say-on-pay votes are the norm in Canada and the United States, and can provide issuers with meaningful insight into investors' views on their compensation practices, reliance on say-on-pay votes alone is often not enough in today's governance culture. The presence or absence of advance engagement, planning and disclosure on compensation practices may have a serious impact on an issuer and its reputation (see "Board-Shareholder Engagement Continues to Gain Traction" for more information).

Take, for example, Canadian issuer Bombardier Inc., which attracted considerable public scrutiny after making executive compensation increases that were perceived to be unacceptable in the circumstances. This, even though Bombardier's 2017 advisory say-on-pay vote actually received about 94% shareholder approval.[60] It is unclear from the public record whether advance engagement on its compensation practices featured prominently in its governance practices; however, after public outcry over the compensation increases, it subsequently announced its decision to defer more than half of the payments the executives were supposed to receive until the company met its performance objectives for long-term success and delivered value to its shareholders and the people of Québec and Canada.[61]

Of course Bombardier's dual-class share structure, which limits public shareholders' voting rights, combined with the fact the company had received significant Québec and Canadian federal government loans totalling about $1.37 billion in 2017, fuelled the fire over the issues; nevertheless, there may be lessons we can take from this example. In part, the Bombardier case suggests that engagement on various issues, including compensation, remains critically important. In advance of their shareholder meetings, issuers should consider engaging with their investors and, in some cases, broader stakeholder groups, having regard to their compensation and governance practices and broader contexts and communities in which they operate. Doing so may save an issuer and its board from damaging media attention and stakeholder attacks.

Say-on-Pay in the U.S.A.

The 2017 U.S. proxy season was only the second time that most U.S. public companies held a shareholder advisory vote on the desired frequency of holding a say-on-pay vote. Annual say-on-pay votes, which facilitate shareholder engagement and enhance transparency, continue to be preferred by the majority of shareholders, although such frequent say-on-pay votes are not universally accepted as necessary or appropriate. However, say-on-pay may have led to both a decrease in the rate of growth in median CEO pay and a moderating effect on the 90th percentile of the CEO pay market in the United States, despite the continued rise in CEO compensation. Some institutional investors' preference for less frequent say-on-pay votes, as well as the new U.S. administration's desire for financial reform, may put future annual say-on-pay votes in jeopardy.

The 2017 U.S. proxy season was only the second time that most U.S. public companies held a Say-on-Frequency Vote.

SECOND U.S. SAY-ON-FREQUENCY VOTES HELD DURING THE 2017 PROXY SEASON

While say-on-pay votes in Canada are not mandatory but have become the norm, in the United States, the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank Act) requires that U.S. public companies conduct a shareholder advisory vote on the compensation packages of their top executive officers (Say-on-Pay Vote). Separately, under the Dodd-Frank Act, such companies must also conduct a shareholder advisory vote every six years on the frequency with which the Say-on-Pay Vote should be held (Say-on-Frequency Vote). The initial Say-on-Frequency Votes took place in 2011 and so the 2017 U.S. proxy season was only the second time that most U.S. public companies held a Say-on-Frequency Vote.

The Say-on-Frequency Vote affords shareholders of U.S. public companies the opportunity to vote for annual, biennial or triennial Say-on-Pay Votes. According to a report published by the Council of Institutional Investors (CII) using data from Institutional Shareholder Services, Inc. (ISS), during the 2011 U.S. proxy season 41% of all boards at Russell 3000 companies recommended biennial or triennial Say-on-Pay Votes.[62] Shareholders at the time chose to ignore the recommendations of their boards and overwhelmingly supported annual Say-on-Pay Votes. Over 76% of shareholders voted for annual Say-on-Pay Votes across Russell 3000 companies and, with very few exceptions, companies adopted Say-on-Pay Votes at the frequency preferred by the majority of their shareholders. Six years later, shareholders continue to strongly favour annual Say-on-Pay Votes, as demonstrated by data from ISS, published at the end of the 2017 proxy season. Among the Say-on-Frequency Vote results catalogued by ISS, shareholders endorsed an annual frequency at 91% of companies.[63]

PROS AND CONS OF ANNUAL VERSUS LESS FREQUENT SAY-ON-PAY VOTES

On the one hand, having an annual Say-on-Pay Vote is beneficial because it allows shareholders to assess whether pay structures and levels are aligned with business performance on a yearly basis and because it gives shareholders a consistent channel through which to provide input on compensation decisions. Shareholder preference may also skew toward an annual Say-on-Pay Vote on the basis that annual voting enhances transparency, facilitates shareholder engagement and provides for administrative and procedural consistency.

Yearly Say-on-Pay Votes may unduly increase focus on the short term and lead to greater costs and complexity.

While in most cases, the preference of U.S. shareholders for a yearly Say-on-Pay Vote aligns with the preferences of asset managers, pension funds and proxy advisory firms and is consistent with say-on-pay practices in many other jurisdictions, including Canada, there is still room for debate regarding a Say-on-Pay Vote's optimal frequency. Yearly Say-on-Pay Votes may unduly increase focus on the short term and lead to greater costs and complexity. With continued focus on, and debate over, "short-termism" versus "long-termism" and the call by some influential U.S. and Canadian institutional investors for public companies to refocus on long-term-oriented governance and performance, annual Say-on-Pay Votes are not universally accepted as necessary or even appropriate. Critics of annual Say-on-Pay Votes include BlackRock and American Century Investment Management. BlackRock typically recommends a triennial Say-on-Pay Vote and advises shareholders to express their dissatisfaction regarding executive pay by voting against members of the compensation committee during director elections, rather than in the Say-on-Pay Vote. Similarly, American Century Investment Management generally supports the triennial option, although it will consider management recommendations for an alternative approach.

Moreover, a recent ISS survey[64] that polled non-investors such as corporate issuers, banks, consultants and board members, as well as investors, found that fewer than half of non-investor respondents favoured an annual Say-on-Pay Vote, and almost one-third of non-investor respondents felt that the frequency of the Say-on-Pay Vote should depend on company-specific factors, such as the size of the company, its financial performance, the presence of recent problematic executive pay practices and the level of shareholder support for the Say-on-Pay Votes at past meetings. In contrast, two-thirds of investor respondents surveyed favoured across-the-board annual say-on-pay votes, although 17% of investor respondents indicated that they believe the frequency should depend on company-specific factors, of which financial performance and the presence or absence of recent problematic pay practices were flagged by the greatest number of investors. And even though annual say-on-pay votes are the norm in the United States, consistent with the views of some institutional investors discussed above, several corporate respondents in the survey argued that annual votes focus too much attention on short-term results or short-term fluctuations in pay.[65]

> **Almost one-third of non-investor respondents felt that the frequency of the Say-on-Pay Vote should depend on company-specific factors.**

Impact of U.S. Say-on-Pay Votes on CEO Compensation

With this Say-on-Pay Frequency Vote milestone having been reached in 2017, the impact that Say-on-Pay Votes have had on executive compensation can be assessed. A recent study conducted by Pay Governance LLC, an advisor to compensation committees, analyzed pay level trends before and after the implementation of the Dodd-Frank Act's say-on-pay regulations.[66]

The study found that although CEO pay has continued to rise in recent years, Say-on-Pay Votes may have led to both a decrease in the rate of growth in median CEO pay and a stagnation of CEO pay increases for CEOs with pay packages in the 90th percentile. Following the introduction of shareholder votes on executive compensation, the data shows that (1) the rate of increase of median CEO pay has slowed, and (2) there has been a compression in the overall distribution of CEO pay indicated by a narrowing ratio between CEO pay at the 90th and 10th percentiles.

Unsurprisingly, Say-on-Pay Votes have also led to increased attention by shareholders and proxy advisors on the highest-paid S&P 500 CEOs, which may have further contributed to the moderating effect on the 90th percentile of the S&P 500 CEO pay market.

What's Next in U.S. Say-on-Pay Votes: Annual Compensation Votes May Decline

Despite the obvious advantages that the Dodd-Frank Act's say-on-pay regulations offer shareholders, the new U.S. administration's desire for financial reform may put the Say-on-Pay Vote (or at least annual such votes) in jeopardy. On June 8, 2017, the House of Representatives passed a revised version of the

Financial CHOICE Act (FCA). The FCA would repeal or modify significant portions of the Dodd-Frank Act and addresses a wide range of other financial regulations. Among the provisions that the FCA proposes to repeal is the requirement that U.S. public companies afford shareholders the opportunity to approve executive compensation at least once every three years. Further, the FCA would only require a shareholder vote when executive compensation of an issuer has materially changed from the previous year.

The bicameral nature of the United States legislature requires that the FCA also be approved by the Senate before it becomes law, and the chances of the Senate passing the bill in its current form appear low. A variety of interest groups, including CII, have expressed strong opposition to the bill and may continue to lobby against the FCA until the upcoming Senate vote. However, it is clear that the current U.S. administration has set its sights on the executive compensation framework as part of its broader efforts to deregulate the capital markets, which may in turn trigger changes in both say-on-pay and some compensation practices in the United States.

CEO Compensation: Total Compensation Is Up, Despite Scrutiny

Surveys point to an increase in total direct CEO compensation levels and a shift in favour of longer-term compensation vehicles.

Although the last several years witnessed a steady increase in the reported average cash compensation (salary plus bonus) paid to CEOs of TSX Composite Index and SmallCap Index issuers, 2017 saw a reversal of that trend, with cash compensation levels remaining the same or lower than 2016. However, at the same time, surveys are pointing to an increase in total direct CEO compensation levels and a shift in favour of longer-term compensation vehicles such as stock awards and other long-term incentives:[67]

- CEO total direct compensation: up 4.2% to $12.5 million.
- Stock awards: up 4.3% to $6.3 million.
- Total long-term incentives: up 4.4% to $8.8 million.

TABLE 7-1: CEO CASH COMPENSATION (IN $ MILLIONS)

	TSX 60	Completion Index	SmallCap Index
2017	$2.87	$1.45	$0.89
2016	$3.09	$1.52	$0.94
2015	$3.10	$1.46	$0.86
2014	$3.06	$1.54	$0.87
2013	$2.76	$1.34	$0.83
2011	$2.88	$1.37	$1.22

Director Flat-Fee Retainers Peak, Replacing Meeting Fees

The steady growth in director compensation in the form of retainer amounts that we have discussed in our prior *Davies Governance Insights* reports in the last several years has stalled in 2017, most noticeably among issuers on the TSX 60, as shown in Table 7-2.

TABLE 7-2: AVERAGE DIRECTOR RETAINERS OF CANADIAN ISSUERS (2015–2017)

Index	2017	2016	2015
TSX 60	$152,545	$167,470	$137,400
Composite Index	$108,980	$112,966	$92,787
Completion Index	$94,458	$93,452	$77,314
SmallCap Index	$62,140	$64,359	$52,348

The percentage of issuers paying directors a retainer in the form of a flat fee only, without any additional attendance-related fees, has increased significantly since 2016.

At the same time, the percentage of issuers paying directors a retainer in the form of a flat fee only, without any additional attendance-related fees, has increased significantly since 2016, consistent with the trend observed in prior years.

TABLE 7-3: PERCENTAGE OF ISSUERS PAYING DIRECTORS FLAT FEE ONLY, WITH NO ADDITIONAL ATTENDANCE-RELATED FEES (2015-2017)

Index	2017	2016	2015
TSX 60	52%	48%	45%
Composite Index	51%	43%	35%
Completion Index	50%	41%	32%
SmallCap Index	40%	33%	30%

This shift away from paying meeting fees in favour of the retainer-only option can be linked to both the expanding list of issues and responsibilities faced by directors of Canadian public issuers and the increased shareholder scrutiny of directors. These trends have also led to a substantial increase in the time required for a director to do his or her job properly. Against this backdrop, a retainer-only program for compensating directors may often be preferable from a governance perspective, given that directors' duties and responsibilities arise throughout the company's fiscal year, not just at regularly scheduled board meetings. The retainer-only approach can be extremely beneficial for issuers focused on controlling and budgeting for potentially significant compensation costs in the face of turbulent credit, commodity and securities markets and an ever-expanding list of issues being placed before boards.

Our Take

BOARDS SHOULD MONITOR COMPENSATION TRENDS AND ENGAGE WITH INVESTORS

Given the compensation trends described above, as well as the general governance climate favouring shareholder democracy, issuers and their boards will continue to be held to a high standard in making and explaining their compensation decisions. As executive pay continues to rise, Canadian public companies may also face demands to provide more extensive disclosure on executive pay, consistent with trends emerging in the United States and the United Kingdom.

Issuers contemplating significant increases in, or changes to, their compensation practices, including one-time or special awards or arrangements, should consider advance engagement with shareholders to elicit their views and, ideally, their support, ahead of their annual shareholders' meetings.

Issuers should also consider the broader context and communities in which they operate, to determine whether broader stakeholder engagement may be appropriate in some cases.

Moreover, as discussed in greater detail in *Davies Governance Insights 2016*,[68] it remains important that compensation practices focus on the long term and include metrics designed to align pay with company performance, having regard to the relatively stringent pay-for-performance metrics established by proxy advisory firms.

08

Is "True Majority Voting" on the Horizon?

Proposed amendments to the *Canada Business Corporations Act* and Ontario's *Business Corporations Act* will, if implemented, mandate "true majority voting" for all federal and Ontario public corporations and significantly limit a board's discretion to appoint an undersupported director. Recent TSX guidance on its majority voting standard now sets a high threshold for the exceptional circumstances in which corporations can reject the resignation of a director who fails to get majority shareholder approval. Are the corporate law changes in this area a solution without a problem? Read Davies' take on how your company may be affected.

In 2016 and 2017, the much-anticipated proposed amendments to the *Canada Business Corporations Act* (Bill C-25)[69] (CBCA Amendments) and the Ontario *Business Corporations Act* (private member's Bill 101)[70] (OBCA Amendments) were released. These proposed amendments would have the effect of implementing true majority voting for public companies governed by the federal or Ontario corporate statutes, as well as have the potential for "sudden death" director elections. In 2017, the Toronto Stock Exchange (TSX) also released additional guidance on its majority voting requirements, which, pending any corporate law changes, are likely to establish a high bar for TSX-listed issuers that propose to keep directors on their boards despite those individuals having received less than a majority of votes "for" their election.

Proposed CBCA and OBCA Amendments Threaten Sudden Death Director Elections

Majority voting is firmly entrenched in Canada, at least for non-majority-controlled TSX-listed issuers. The main issues that have been discussed since the TSX implemented majority voting in 2014 surround the appropriate "exceptional circumstances" that boards may rely on as the basis to reject the resignation of a director who fails to receive a majority of "for" votes (referred to as an undersupported director) and whether corporate laws should be amended to mandate true majority voting.

The proposed CBCA Amendments contemplate, among other things, changing the current corporate law plurality voting standard to a majority voting standard requiring that, each year, directors of CBCA public companies be elected annually by the shareholders. In uncontested elections, each director would only be elected *as a matter of law* (and not merely as a matter of policy) if the number of votes cast in his or her favour represents a majority (50% plus 1) of the votes cast "for" that individual by the shareholders. In contrast to the current TSX majority voting requirements (discussed below), a board would be prohibited from relying on its corporate law right to fill a vacancy on the board by appointing an undersupported director except in two limited circumstances, which are prescribed under the draft regulations proposed in connection with the CBCA Amendments: (1) if that director is needed on the board to satisfy CBCA (not securities law) independence requirements or (2) if that director is needed to satisfy CBCA Canadian residency requirements. In all other cases, a director who fails to receive a majority of "for" votes would not be eligible to remain on the board and would immediately cease to be a director, without any transition period. The CBCA Amendments would apply to all federally incorporated public companies, including those listed on the TSX Venture Exchange (TSXV), even though the TSX majority voting standard does not apply to TSXV-listed companies. The proposed OBCA Amendments would similarly

Except in very limited circumstances, affected boards will be prohibited from appointing an undersupported director to fill a board vacancy if the CBCA and OBCA Amendments are adopted.

mandate majority voting for all public corporations incorporated in Ontario, with some nuanced differences.

For many, the hard-line approach proposed under these corporate law amendments is untenable. They would eliminate virtually all board discretion to retain an undersupported director on the board and contemplate no transition period to find a replacement director. Moreover, many believe the proposed amendments may be a solution in need of a problem. For example, over the past three years, the number of directors of TSX Composite and SmallCap Index issuers that have received less than majority approval has been quite small, declining from 10 directors of three issuers in 2015, to three directors of two issuers in 2016, and only one director of one issuer in 2017; the incidence of those undersupported directors remaining on the board is also increasingly rare. So-called zombie directors are seemingly no longer an issue. In fact, among those indices issuers, the only case in 2016 and 2017 in which an undersupported director had his resignation rejected and remained on the board occurred this year, when a director of Endeavour Silver Corp. received only 48% "for" votes. In that case, after the director tended his resignation, the issuer's board decided to reject it. The basis for the rejection was that the corporate governance and nominating committee had reviewed the reasons for which it believed the director had not received a majority of "for" votes and determined that the low shareholder vote was due to a negative recommendation made by "a proxy advisory firm" that considered the director to be overboarded by virtue of sitting on the boards of six public companies (note that ISS had recommended voting in favour of the subject director).[71] In response, the director resigned from certain other board positions to eliminate the overboarding, and remained on the Endeavour board.

> Over the past three years, the number of directors of TSX Composite and SmallCap Index issuers that have received less than majority approval has been quite small.

TSX Guidance on Majority Voting: Exceptional Circumstances Must Meet a High Threshold

Under the current TSX rules, all TSX-listed issuers other than majority-controlled corporations, must have a majority voting policy and disclose the results of that vote. Each director is required to get more "for" than "withhold" votes (still a plurality standard), failing which the director is required to tender his or her resignation for acceptance by the board, and the board must accept the resignation absent "exceptional circumstances." To date, however, some issuers have relied on the exceptional circumstances carve-out to allow directors who fail to receive a majority of "for" votes to remain on the board, despite the will of shareholders to the contrary. In response to these occurrences and debate over the appropriateness of the so-called exceptional circumstances, the TSX stated in its March 2017 staff notice that reliance on exceptional circumstances must meet a high threshold[72] – for example, the resignation of that director would result in the issuer not being in compliance with corporate or securities laws or commercial agreements, where the subject director is a member of a key active special committee, or majority voting is being used for a purpose inconsistent with the policy objectives underlying the TSX's majority voting requirements. Factors that would *not* be relevant to determining whether exceptional circumstances exist include the director's qualifications, length of service, attendance at meetings, experience or contributions to the issuer.

The TSX has reviewed, and will continue to review, issuers' majority voting policies and may require changes if these policies do not comply with the TSX's requirements. In the meantime, the TSX notice also includes the following additional guidance, which issuers should review with their legal counsel to ensure their policies are compliant:

- **Directors must tender resignation immediately.** Policies should require a director to tender his or her resignation immediately if not elected by a majority of votes. It is not sufficient to provide that the director is "expected to resign."
- **Boards must decide within 90 days.** The time frame for a board to decide whether or not to accept a resignation must be within 90 days of the shareholders' meeting.
- **Issuers must provide TSX with news release.** Policies should require the issuer to provide the TSX with a copy of the news release containing the board's decision regarding a director's resignation.
- **Undersupported directors must not participate in decision-making.** An undersupported director should not participate in any meeting at which his or her resignation or a related resolution is considered. This means that the director must not attend any meetings, subject to certain exceptions where attendance is necessary to satisfy quorum.

The TSX's March 2017 staff notice states that reliance on exceptional circumstances must meet a high threshold.

Implications for Canadian Issuers

With the tightening of the TSX's interpretation of its majority voting standard, issuers will find themselves with far less latitude to reject the resignation of a director who fails to receive majority shareholder approval – and can expect the TSX to become involved if they propose to do so. As early as the 2018 proxy season, issuers incorporated federally and in Ontario may also find themselves with little to no discretion to decide whether or not to accept the resignations of undersupported directors who fail to receive majority shareholder approval. Although many question the hard-line approach to majority voting that is being proposed by the corporate regulators, at the time of writing this report, the CBCA Amendments have passed third reading in the House of Commons and await second reading in the Senate. While also the subject of criticism for their broad, sweeping changes and inconsistency with securities regulations, the OBCA Amendments have been referred to a standing committee after their second reading in the Ontario Legislative Assembly.

Beyond Succession Planning: How Does Majority Voting Affect Your Organization?

In the meantime, with majority voting under focus by corporate regulators and the TSX, public issuers may wish to consider some practical steps.

1. **Issuers should review their majority voting policies to ensure they comply with the TSX's rules.**

2. **Boards should carefully consider whether their current succession planning processes would be sufficient if they were to lose one or more directors.** Evergreen lists alone may not be enough if a board is faced with (i) the urgent need to identify and replace key skills that could be lost because of a director's failure to obtain majority approval and (ii) the absence of non-recurring exceptional circumstances to justify keeping the director on the board. Also consider the optimal board size from the perspective of the board's effectiveness if, for example, more than one director was not re-elected, leaving the issuer with a skeleton board.

3. **Boards should be proactive in thinking about the impact corporate law changes would have on board composition.** Assuming that corporate law changes will be implemented in some form, how would the independence of the board and its committees under securities laws be affected? As currently crafted, the CBCA and OBCA Amendments may not allow a board to retain an undersupported director if needed to satisfy securities law independence requirements, which have a different standard from those established under corporate laws. Also consider whether the loss of one or more Canadian directors, beyond the 25% residency requirements under the CBCA, might affect the issuer's foreign private issuer status in the United States. Finally, consider the impact of the TSX's guidance and proposed corporate law amendments on any existing change of control provisions under employment, credit and other commercial agreements – would the loss of one or more directors under majority voting inadvertently trigger those provisions?

4. **TSXV company boards should think about their appropriate board composition.** TSXV companies could also be affected by corporate changes, even though they are currently exempt from the TSX's majority voting requirements. TSXV company boards should therefore also proceed with advance thinking about their optimal board size and composition in the event that they face true majority voting in the future.

5. **Boards should consider engaging with shareholders well in advance of annual general meetings to solicit their views on the board's composition and its members' relative strengths, skills and abilities.** Given the prevalence of recent years' activism and past criticism of some issuers' reliance on exceptional circumstances to keep undersupported directors on the board, engagement would be a prudent and proactive step. For more details on board-shareholder engagement see "Board-Shareholder Engagement Continues to Gain Traction."

09

Other Important Governance Issues and Trends Under Focus

In 2017, several legal developments and proposed regulatory changes emerged that affect a variety of governance issues and processes, including the following: (1) advance notice bylaws; (2) "notice-and-access" reporting for CBCA companies; (3) reducing regulatory burdens for issuers; (4) CSA protocols for proxy voting; (5) personal liability for oppressive corporate conduct; and (6) enhanced governance and disclosure obligations in conflict of interest transactions. In this final part of our report, we summarize important changes either already in effect or pending that in-house counsel, corporate secretaries, management and boards should be aware of, as they may impact governance-related policies and practices. We also include guidance aimed at helping boards and management minimize the risks of facing investor or regulatory challenges.

Additional background about many of these topics is available in our prior years' reports, including *Davies Governance Insights 2016*.[73]

09 Other Important Governance Issues and Trends Under Focus

1 UPDATE ON ADVANCE NOTICE BYLAWS: IS YOUR BYLAW COMPLIANT?

As discussed in greater detail in *Davies Governance Insights 2015*,[74] an advance notice bylaw requires a shareholder to provide advance notice to an issuer if it wishes to propose nominees to the board. This tactic has become fairly commonplace in Canada and is recognized as a legitimate tool to eliminate the risk of issuers being ambushed with nominees from the floor at a shareholders' meeting. This year, the Toronto Stock Exchange (TSX) reiterated the purpose of such policies – consistent with past guidance from Institutional Shareholder Services, Inc. (ISS), Glass Lewis & Co. (Glass Lewis) and the Canadian courts – providing guidance on when advance notice bylaws or policies may be viewed as having the effect of frustrating or circumventing the director election process and attracting scrutiny from the TSX.

With almost 57% of TSX Composite and SmallCap issuers (up from 51% in 2015) now having advance notice requirements, most market participants recognize the legitimacy of such tools (typically in the form of a bylaw) for fostering transparency and informed decision-making by providing shareholders with reasonable notice of, and information about, a contested election of directors. Importantly, however, this legitimacy generally applies only where the bylaws are reasonable in scope and are applied by issuers in a commercially reasonable manner. Past guidance by the Ontario courts in 2014 and revised guidance issued by ISS and Glass Lewis in 2014/2015 provide insight into the acceptable features of an advance notice requirement, and when the proxy advisory firms are likely to support, or recommend against, an advance notice bylaw. Ultimately, advance notice requirements should only be used 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.[75]

Unacceptable Advance Notice Provisions

Advance notice provisions are not acceptable to the TSX, ISS or Glass Lewis if they require nominating shareholders:

- to be present at the meeting,
- to provide unduly burdensome or unnecessary disclosure,
- to complete questionnaires,
- to make representations,
- to submit agreements, or
- to give consents beyond those that would be required from management or board nominees.

Earlier this year, the TSX weighed in on the issue and provided further guidance on what features of advance notice bylaws will and will not be viewed as acceptable.[76] Consistent in many ways with ISS's and Glass Lewis' voting guidelines, in the TSX's view, advance notice bylaws that frustrate or circumvent shareholders' rights under the TSX's prescribed director election requirements will be considered a failure to comply with those requirements.

The TSX also provides its views on the appropriate minimum and maximum notice periods (if any) that are acceptable for providing notice under such provisions. Lastly, it expects boards to be able to waive any provisions of an advance notice bylaw.

We are aware that several issuers' advance notice requirements do not meet ISS's and Glass Lewis' and/or the TSX's requirements. Boards that have bylaws in place should review them with counsel to ensure they are compliant and, if not, amend them sufficiently in advance of their next shareholders' meeting. Issuers contemplating adopting an advance notice bylaw should seek legal advice before doing so and, again, ensure shareholders are given ample notice of any such requirements that are being adopted before their next annual meeting. The consequences of having a non-compliant bylaw can be serious, including triggering negative vote recommendations by ISS and Glass Lewis concerning the bylaw, director elections or significant transactions being submitted to shareholders for approval. In light of these policy perspectives and past court decisions, issuers should also ensure they apply advance notice requirements in a commercially reasonable manner that is neither tactical nor intended to thwart a shareholder seeking to exercise its fundamental shareholder franchise to elect board nominees.

The consequences of having a non-compliant advance notice bylaw can be serious, including triggering negative vote recommendations by ISS and Glass Lewis concerning the bylaw, director elections or significant transactions being submitted to shareholders for approval.

2 NOTICE-AND-ACCESS FOR CBCA COMPANIES: FEDERAL STATUTE FACING MODERNIZATION

Since 2013, many Canadian reporting issuers have enjoyed the option of using "notice-and-access" under National Instrument 51-102 – *Continuous Disclosure Obligations* (NI 51-102) and National Instrument 54-101 – *Communication with Beneficial Owners of Securities of a Reporting Issuer* (NI 54-101) as a potentially more cost-effective method of making proxy-related meeting materials and annual financial statements accessible to their investors. If this method is relied on, issuers may send a streamlined notice containing prescribed information to investors, with a link to a non-SEDAR website for the complete materials, rather than mailing a comprehensive written package of proxy-related materials to shareholders.

While many viewed notice-and-access as a welcome change in securities laws, the existing provisions of the *Canada Business Corporations Act* (CBCA) make it difficult for CBCA-governed public companies to rely on notice-and-access. Specifically, the CBCA generally requires a corporation to send its shareholders a notice of meeting, form of proxy and management information circular, as well as copies of its annual financial statements and auditors' report. Copies of those documents must also be sent to intermediaries, who in turn must provide the materials to beneficial shareholders and seek their voting instructions. Although the CBCA contemplates documents being provided to shareholders in electronic form, certain pre-conditions to doing so, notably the need to obtain the addressee's written consent to electronic delivery, render reliance on notice-and-access under NI 54-101 practically impossible for CBCA-governed issuers.

The existing provisions of the CBCA make it practically impossible for CBCA-governed public companies to rely on notice-and-access.

As part of the broader initiative under Bill C-25 to modernize the CBCA, discussed elsewhere in this report (e.g., amending the CBCA to introduce majority voting and to require prescribed diversity-related disclosures), the CBCA Amendments also contemplate changes to facilitate notice-and-access under NI 51-102 and NI 54-101 for federally incorporated public companies. If adopted, the CBCA Amendments would permit CBCA public companies that meet the requirements of, and are using, notice-and-access under NI 51-102 and NI 54-101 to make proxy-related materials and annual financial statements available to registered and beneficial shareholders under that notice-and-access regime, eliminating the requirement to obtain investors' prior written consent to electronic delivery or the need to seek exemptive relief from the CBCA Director. It is anticipated that this change will be embraced by many issuers and will serve to give federally incorporated companies access to the streamlined and more cost-effective mode for delivering meeting materials to their investors.

3 CSA CONSIDERS REDUCING REGULATORY BURDENS ON ISSUERS

On April 6, 2017, the Canadian Securities Administrators (CSA) released Consultation Paper 51-404 – *Considerations for Reducing Regulatory Burden for Non-Investment Fund Reporting Issuers*. The purpose of this CSA consultation paper is to identify and consider areas of securities legislation applicable to non-investment fund reporting issuers that could benefit from a reduction of undue regulatory burden, without compromising investor protection or the efficiency of the capital market. The paper focuses on considering options to reduce the regulatory burdens associated with both capital raising in the public market (i.e., prospectus-related requirements) and the ongoing costs of being a reporting issuer (i.e., continuous disclosure requirements).

The CSA consultation paper set out five possible options to reduce such regulatory burdens:

1. Expand the application of streamlined rules to smaller reporting issuers (currently only available to TSX Venture Exchange issuers).
2. Reduce the regulatory burdens associated with the prospectus rules and offering process.
3. Reduce ongoing disclosure requirements.
4. Eliminate overlap in regulatory requirements under NI 51-102.
5. Enhance electronic delivery of documents.

Further details of the various proposals are available in our Davies bulletin dated April 10, 2017, titled *The CSA Considers Reducing Regulatory Burdens for Reporting Issuers*.[77]

The comment period was scheduled to close on July 7, 2017, but given the feedback the CSA received from several stakeholders, the CSA considered it would be beneficial for stakeholders to have additional time to review the consultation paper and prepare comments. The comment period was therefore extended to July 28, 2017. Following receipt of all comments, it will undoubtedly take some time for the CSA to review and consider all of the comments before it issues a response, so stay tuned for further developments on this front later this year. In the interim, it should be noted that the CSA had previously considered and abandoned semi-annual reporting on several occasions, despite the ongoing debate over the effect of quarterly reporting on long-term value creation. Given the multitude of issues and countervailing considerations involved in each of the above proposals, we do not expect any significant changes to issuers' reporting obligations along the lines contemplated above in the near term; however, given the CSA's continued focus on the issues, it remains an area that issuers and their legal counsel should stay abreast of.

4 OSC RELEASES FINAL PROTOCOLS ON PROXY VOTING INFRASTRUCTURE TO IMPROVE THE PROXY PLUMBING

Concerns about market participants and the functioning of the proxy voting system in both Canada and the United States have attracted a great deal of attention over the past several years. In 2010, our firm published a white paper on the Canadian proxy voting system, titled *The Quality of the Shareholder Vote in Canada*.[78] 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.

In response to identified deficiencies, over the past few years the CSA has focused on developing solutions to provide greater accuracy, reliability and transparency in the proxy voting infrastructure. In particular, as we discussed in prior years' governance reports, the CSA has been working in consultation with industry experts to address perceived issues in the proxy voting infrastructure, including concerns with overvoting, missing votes, pro-rated votes and the lack of communication, transparency and end-to-end vote reconciliation and confirmation in proxy voting. The CSA's work in this area culminated in its January 2017 publication of four non-binding protocols that delineate the roles and responsibilities of the key entities involved in the meeting voting reconciliation process and provide guidance on the operational processes that those entities should implement to make the proxy voting system more accurate, reliable and accountable.[79]

09 Other Important Governance Issues and Trends Under Focus

Four non-binding protocols delineate the roles and responsibilities of the key entities involved in the meeting voting reconciliation process and provide guidance on operational processes intended to make the proxy voting system more accurate, reliable and accountable.

The CSA intends to monitor key players' implementation of the protocols (which is entirely voluntary) over the 2017 and 2018 proxy seasons and will assess whether additional regulatory measures are warranted.

In the meantime, it is clear that although the protocols, if adopted by the key entities involved in the proxy voting system, may foster some level of increased consistency in the practices of meeting tabulators and intermediaries, the fact remains that no comprehensive solution is on the horizon to resolve the problems that plague the proxy voting infrastructure. Issuers and investors alike can still expect to face potential problems in the tabulation of proxy votes that risk having serious consequences, particularly in the case of closely contested votes. Board chairs should ensure they understand the proxy voting and tabulation mechanics in both contested and uncontested meetings and are actively involved, including with the advice of proxy solicitation firms where appropriate, to maximize the accuracy and transparency of the proxy voting process.

5 OFFICERS AND DIRECTORS MAY FACE PERSONAL LIABILITY FOR OPPRESSIVE CORPORATE CONDUCT: TIMELY GUIDANCE FROM THE SUPREME COURT OF CANADA

Canadian officers and directors are well aware that their conduct in managing and supervising the corporation is subject to scrutiny on a number of levels. One risk that every officer and director must remain conscious of is the possibility that his or her decision-making and role in the business and affairs of the corporation may be found to be "oppressive" (that is, may violate the statutory "oppression remedy" provisions contained in virtually all Canadian corporate legislation). Allegations of oppression – asserted by aggrieved securityholders, creditors or other "proper" complainants – are most frequently brought against corporations or dominant shareholders. If a claim is established – usually through proof that the corporation, the majority shareholder or the board has frustrated or undermined the complainant's "reasonable expectations" – the court possesses sweeping discretion to frame a remedy that is appropriate in the circumstances. The relief is most commonly granted against the shareholder responsible for the oppression or against the corporation itself, but there are instances in which directors and officers can face personal liability for oppressive conduct.

Canadian courts have (albeit infrequently) imposed personal liability directly against individual officers or directors whose conduct has attracted the court's censure. In a recent ruling (*Wilson v Alharayeri*),[80] a unanimous panel of the Supreme Court of Canada (SCC) both affirmed the propriety of imposing an oppression order against an implicated individual and provided guidance on the circumstances in which a personal sanction may be imposed.

The SCC made clear in *Wilson* that the discretion to impose personal liability for oppressive conduct must be assessed on a case-by-case basis (the facts of the *Wilson* decision are summarized briefly below). The Court also provided more general (and non-exhaustive) guidance that may prove useful to officers, directors and corporate legal advisors in conducting corporate affairs:

- **Bad faith is more likely to create personal liability.** Although intentional misconduct is not a prerequisite to an oppression finding, an officer or director who has acted in "bad faith" is more likely to face personal liability than one who can show that he or she was motivated exclusively by a concern for the corporation's best interests.
- **Receipt of personal benefits increases liability risk.** An officer or director who enjoys a direct personal benefit resulting from the impugned conduct may face an increased risk of being found individually liable – even if otherwise acting in good faith – should the conduct ultimately be characterized as oppressive.
- **A more active role in oppressive conduct can attract liability.** An officer or director who plays a more extensive and substantive role in originating, championing or implementing the oppressive conduct may be more likely to face personal censure than would another whose role was less central.
- **Certain types of conduct increase risks.** The likelihood of personal liability being imposed may increase in certain cases – for example, when the oppressive conduct fosters an increase in corporate control by the implicated officer or director; when the conduct constitutes a breach by the individual of a personal duty or his or her misuse of corporate power; or when imposing a remedy against the individual avoids imposing a remedy against the corporation, thereby averting prejudice to other (innocent) stakeholders.

In some instances, directors and officers can face personal liability for oppressive conduct.

At the centre of the SCC's ruling in *Wilson* was an allegation by a significant minority shareholder that four of the corporation's seven directors had personally engaged in oppressive conduct by excluding him from participating in a share conversion and subsequent private placement. Because of his exclusion, the minority shareholder's position within the corporation was diluted. Although the minority shareholder had been excluded because of his own historical misconduct – committed at a time he served as director, president and CEO of the company – this could not be validly used to justify the oppressive treatment he suffered. Of the four defendant directors, the SCC imposed personal liability on only two, each of whom had played an active role in preventing the complainant from converting his securities and had benefited individually from

> An order under the oppression remedy may validly be made against an officer or director personally in circumstances in which (1) the individual was implicated in the oppressive conduct and (2) the imposition of personal liability is "fit in all the circumstances."

the impugned course of conduct. The defendants were found personally liable to pay compensation to the complainant in an amount equivalent to his losses.

In framing the overarching principles to be considered by future courts, the SCC confirmed that an order under the oppression remedy may validly be made against an officer or director personally in circumstances in which (1) the individual was implicated in the oppressive conduct and (2) the imposition of personal liability is "fit in all the circumstances." The SCC suggested that this latter prerequisite could be assessed under an array of factors. The case serves as an important reminder of the utility of the oppression remedy in a variety of circumstances and the need for boards and management to ensure they establish the proper processes, with the benefit of legal advice, when evaluating or pursuing transactions or policies that could create conflicts of interest or have divergent impacts on different stakeholders.

6 BOARDS BEWARE: REGULATORS ARE ACTIVELY MONITORING RELATED PARTY TRANSACTIONS

Much attention has been given to the necessity and role of independent committees in corporate transactions, as well as the purpose and scope of fairness opinions this past year, following the decisions of the Yukon courts in first rejecting, and then ultimately approving, ExxonMobil Corporation's takeover of InterOil Corporation by plan of arrangement.[81] More detailed information about the *InterOil* cases is available in our bulletins titled *Yukon Appeal Court's InterOil Decision Based on Cold, Hard and Questionable Facts* and *InterOil Take 2: Yukon Court Doubles Down on Requirement for Fixed-Fee Financial Adviser Engagements*.[82] In July 2017, staff of the Ontario, Québec, Alberta, Manitoba and New Brunswick securities regulatory authorities offered guidance on the role of boards and special committees and on their processes and disclosure obligations in conflict of interest transactions.[83] The notice is helpful in that it provides clear and considered guidance on the requirements of Multilateral Instrument 61-101 – *Protection of Minority Security Holders in Special Transactions* (MI 61-101), and the role to be played by special committees in such transactions, as well as on the use of and disclosure appropriate in respect of fairness opinions.

The notice applies only to a subset of MI 61-101 transactions – namely, transactions that give rise to substantive concerns as to the protection of minority securityholders. These are "material conflict of interest transactions" (e.g., insider bids, issuer bids, business combinations and related party transactions), which staff of the securities regulatory authorities will actively review in real time during the pendency of a material conflict of interest transaction.

Although the formation of a special committee of independent directors is mandated by MI 61-101 only in the context of insider bids, staff indicates in the notice that it is of the view that a special committee is advisable for *all* material conflict of interest transactions.

In summary, the guidance notes that a well-run special committee process will include the following factors:

- the early formation of a special committee (which may in certain cases be required to play an active role in negotiating the transaction from the outset);
- a broad and robust special committee mandate, including considering alternative transactions or maintaining the status quo;
- the exclusion of non-independent persons from decision-making deliberations;
- the hiring of independent advisors to the committee;
- committee supervision over or direct conduct of negotiations;
- accurate record-keeping; and
- non-coercive conduct on the part of interested parties.

In addition, if a fairness opinion is obtained, the notice reminds special committees that advisors are not a substitute for a committee's own considered judgment of a transaction's merits and provides additional guidance to boards and committees on financial arrangements, methodology and disclosures pertaining to fairness opinions.

More detailed information is available in our July 31, 2017 bulletin titled *Boards Beware: Regulators Actively Monitoring Related Party Transactions*.[84] Although the notice does not address many M&A transactions that are not subject to MI 61-101 but may nonetheless give rise to the appearance of conflicts of interest, the notice's guidance is instructive on a broader basis. In any potential conflict of interest transaction, the notice highlights the importance of boards obtaining legal advice about their duties and responsibilities early on to ensure the right governance processes are put in place. It may also be prudent for boards to consider following the notice's guidance in determining the best processes, disclosure practices and advice to be obtained in other potential conflict of interest transactions.

The notice indicates that an independent special committee is advisable for *all* material conflict of interest transactions.

7 ONTARIO COURT OF APPEAL UPHOLDS CONVICTION FOR CONSPIRACY TO BRIBE FOREIGN PUBLIC OFFICIALS

The *Karigar* case serves as an important reminder to boards and management of the potentially severe implications of corruption allegations and convictions, and the importance of having a comprehensive anti-corruption compliance framework in place.

As reported in our *Davies Governance Insights 2014*,[85] in May 2014, Nazir Karigar was sentenced to three years in prison under Canada's *Corruption of Foreign Public Officials Act* (CFPOA) for his role in a scheme to offer bribes to Indian officials on behalf of a Canadian technology company. Karigar was the first individual sentenced under the CFPOA. His conviction was notable not only for the length of the prison term imposed but also because the conviction was based upon a conspiracy to offer bribes: the Crown did not prove that any bribes were actually paid, and the relevant contract was not even awarded to the firm Karigar represented. The case serves as an important reminder to boards and management of the potentially severe implications of allegations and convictions under the CFPOA and corresponding legislation outside Canada, and the importance of having a comprehensive anti-corruption compliance framework in place.

On July 6, 2017, the Ontario Court of Appeal upheld Karigar's conviction. The Court confirmed that a conspiracy to offer a bribe to a foreign public official is sufficient to establish an offence under the CFPOA.

The *Karigar* case, as well as other corruption investigations and proceedings in Canada and abroad over the past several years, illustrate the far-reaching implications of allegations and convictions under these laws. We continue to recommend that boards adopt and implement various tactics as part of a broader anti-corruption strategy to protect their companies against the potentially devastating impact of missteps. For more information about Canada's anti-bribery laws and corruption investigations, as well as steps issuers can take to mitigate corruption risk, see *Davies Governance Insights 2016* and *Davies Governance Insights 2015*.[86]

More detailed information about the *Karigar* case is available in our July 19, 2017 bulletin titled *Ontario Court of Appeal Upholds Conviction for Conspiracy to Bribe Foreign Public Officials*.[87] The Court of Appeal's endorsement of a broad reading of the CFPOA, along with the duration of the sentence imposed by the trial judge, is a timely reminder that the Canadian government takes bribery of foreign public officials by Canadians very seriously. Domestic and international businesses must take care to adopt appropriate compliance policies on anti-corruption legislation.

Database and Methodology

The quantitative analysis in this report is based on data provided by ISS Corporate Solutions, Inc., and drawn from the 2017 management information circulars of 374 issuers on the Toronto Stock Exchange (TSX), which are included in one (or both) of the S&P/TSX Composite Index and the S&P/TSX SmallCap Index as at May 31, 2017. There are a total of 1,500 issuers listed on the TSX. Although the 374 Composite Index and SmallCap Index issuers included in our study make up only 25% of all TSX-listed issuers, they represent 81% of the total market capitalization on the TSX.[88]

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

Composite Index: The S&P/TSX Composite Index (referred to as the Composite Index) comprises 250 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. Five of the 250 Composite Index issuers did not issue proxy circulars for the relevant period discussed; accordingly, our analysis is based on 245 Composite Index companies.

Two components of the Composite Index are 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 190 issuers. (Our analysis includes only 185 of the issuers on the Completion Index because, as noted above, five issuers on the Completion Index did not issue proxy circulars during the period covered.)

SmallCap Index: The S&P/TSX SmallCap Index (referred to as the SmallCap Index) includes 192 issuers, 62 of which also meet the market capitalization eligibility criteria and are part of the Composite Index.[89] (Our analysis includes only 191 of the issuers on the SmallCap Index because one issuer did not have a circular.)

The number of issuers and specific constituents of the two indices covered in our study universe change periodically. This factor may in some cases affect comparisons of data points year over year.

Where we reference a corporate statute in this report, we are referring to the *Canada Business Corporations Act*, unless otherwise stated.

Contributors

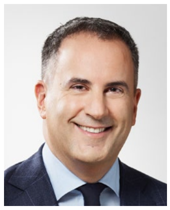
Researching and writing this report is an annual project undertaken by Davies Ward Phillips & Vineberg LLP and not on behalf of any client or other person. The information contained in this report should not be relied upon as legal advice.

William M. Ainley
Toronto

Anthony Alexander
Toronto

Jessica Bullock
Toronto

Rachel Charney
New York



Olivier Désilets
Montréal

Scott D. Fisher
New York

Ivana Gotzeva
Toronto

Jennifer F. Longhurst
Toronto

Jeffrey Nadler
New York

Patricia L. Olasker
Toronto

Poonam Puri
Toronto

Franziska Ruf
Montréal

Key Contacts

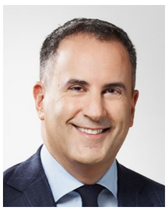
If you would like to discuss any of the issues raised in this report or would like to receive more information, please contact any of the individuals listed below or visit our website at www.dwpv.com.

TORONTO

Patricia L. Olasker
polasker@dwpv.com
416.863.5551

MONTRÉAL

Franziska Ruf
fruf@dwpv.com
514.841.6480



Olivier Désilets
odesilets@dwpv.com
514.841.6561

NEW YORK

Jeffrey Nadler
jnadler@dwpv.com
212.588.5505

Notes

Introduction and Overview

1 For more information, visit *http://www.governanceprinciples.org/* and *http://www.fcltglobal.org/*.

Getting Ready for Climate Change: Risk Identification, Management and Disclosure Trends

2 See *Davies Governance Insights 2016*, online at *https://www.dwpv.com/en/Insights#/article/Publications/2016/Davies-Governance-Insights-2016*; *Davies Governance Insights 2015*, online at *https://www.dwpv.com/en/Insights#/article/Publications/2015/Davies-Governance-Insights-2015; Davies Governance Insights 2014*, online at *https://www.dwpv.com/en/Insights#/article/Publications/2014/Davies-Governance-Insights-2014*.

3 Ontario Teachers' Pension Plan, "Climate Change: Separating the Real Risks for Investors from the Noise," online at *https://www.otpp.com/documents/10179/20936/-/7726319b-b1cf-4bbc-8775-7e3c6f28a858/Separating+the+Real+Risks+for+Investors+from+the+Noise.pdf*. See also Ontario Teachers' Pension Plan, "Climate Change," online at *https://www.otpp.com/investments/responsible-investing/perspectives/climate-change*.

4 RBC Global Asset Management, "Approach to Responsible Investment" (January 2016), online at *http://www.rbcgam.com/corporate-governance-and-responsible-investment/pdf/approach-to-responsible-investment.pdf*.

5 PSP Investments, "Investing Responsibly: 2017 Responsible Investment Report" (2017), online at *http://responsibleinvestmentreport.investpsp.com/assets/medias/pdf/PSP-RIR-2017-complete.pdf*.

6 Climate Disclosure Standards Board, "Climate Change Reporting Framework: Advancing and Aligning Disclosure of Climate Change-Related Information in Mainstream Reports" (October 2012), online at *http://www.cdsb.net/sites/cdsbnet/files/cdsb_climate_change_reporting_framework_edition_1.1.pdf*.

7 See *http://www.un.org/sustainabledevelopment/sustainable-development-goals/* for more information.

8 Securities and Exchange Commission, *Commission Guidance Regarding Disclosure Related to Climate Change* (February 8, 2010).

9 Mindy S. Lubber, "While the SEC Ignores Climate Change Risks, Others Step Up," *Huffington Post* (April 11, 2016).

10 Alimentation Couch-Tard Inc., "Alimentation Couche-Tard Announces its results for its First Quarter of Fiscal Year 2018" (September 6, 2017).

11 Federal Court of Australia, Notice of Filing (August 8, 2017), online at *http://envirojustice.org.au/sites/default/files/files/170807%20Concise%20Statement%20(as%20filed).pdf*.

12 Lisa Anne Hamilton, "Latest Red Flag for Investors: Climate Lawsuit for the Commonwealth Bank of Australia," *Center for International Environmental Law* (August 15, 2017), online at *http://www.ciel.org/latest-red-flag-investors-climate-lawsuit-commonwealth-bank-australia/*.

13 See *http://www.barrick.com/responsibility/environment/energy-climate-change/default.aspx*.

14 Gold Fields Limited, "Climate Change Policy Statement" (February 2017), online at *https://www.goldfields.co.za/pdf/about-us/corporate-governance/standards-and-principles/policies/climate-change-policy.pdf*; Vale SA, "Climate Change Mitigation and Adaptation Policy (GLOBAL)" (2012), online at *http://www.vale.com/EN/aboutvale/sustainability/links/LinksDownloadsDocuments/climate-change-mitigation-and-adaptation-policy.pdf*; Newmont Mining Corporation, "Beyond the Mine: Our 2016 Social and Environmental Performance" (2016), online at *http://sustainabilityreport.newmont.com/2016/*.

Board-Shareholder Engagement Continues to Gain Traction

15 Canadian Coalition for Good Governance, "Stewardship Principles" (May 2017), online at *http://admin.yourwebdepartment.com/site/ccgg/assets/pdf/stewardship_principles_public.pdf*.

16 Ernst & Young, "EY Center for Board Matters: 2017 proxy season review" (June 2017), online at *http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf*.

17 PricewaterhouseCoopers LLP, "PwC's 2016 Annual Corporate Directors Survey: The swinging pendulum: Board governance in the age of shareholder empowerment" (October 2016), online at *https://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/assets/pwc-2016-annual-corporate--directors--survey.pdf*.

18 Legal & General Investment Management, "2016 Corporate Governance Report: Active ownership: Positive engagement to enhance long-term value" (2016), online at *http://www.lgim.com/library/capabilities/CG_Annual_Report_2016-full.pdf*.

19 *Ibid.*

20 *Ibid.*

21 See Institute of Corporate Directors, "ICD Guidance for Director-Shareholder Engagement" (March 2016), online at *https://www.icd.ca/getmedia/b2bf5cc8-324d-4b5c-842f-1af40026fe5b/ICD_Engagement_Paper_EN.pdf.aspx*; Canadian Coalition for Good Governance, "Engagement with Shareholders" (September 2010), online at *http://www.ccgg.ca/site/ccgg/assets/pdf/model_policy_on_engagement_with_shareholders.pdf*; U.S. Shareholder-Director Exchange, "Shareholder-Director Exchange Protocol" (2014), online at *http://www.sdxprotocol.com/what-is-the-sdx-protocol/*.

How Investors Are Getting Their Demands to the Table: Shareholder Proposals, Proxy Access and Requisitioned Meetings

22 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2016/Davies-Governance-Insights-2016*.

23 *Ibid.*

24 Canadian Coalition for Good Governance, "CCCG Policy: Shareholder Involvement in the Director Nomination Process: Enhanced Engagement and Proxy Access" (May 2015).

25 Bill 101, *Enhancing Shareholder Rights Act, 2017* (OBCA Amendments). The OBCA Amendments were debated in March 2017 during their second reading in the Ontario Legislative Assembly. There has been criticism of the bill centred on its proposed broad sweeping changes, potential unintended consequences and inconsistency with current securities regulation. At the time of writing this report, the OBCA Amendments had been referred to the Standing Committee on Finance and Economic Affairs for review.

26 If adopted, the OBCA Amendments would reduce the share ownership threshold for requisitioning a meeting to 3%, from 5%, of the voting shares for shareholders of OBCA corporations.

27 CBCA, s. 143.

28 See *Wells v Bioniche Life Sciences Inc.* 2013 ONSC 4871 (Ont. SCJ); *Marks v Intrinsyc Software International* 2013 ONSC 727 (Ont. SJC).

29 2017 ONSC 3083 (Ont. Div. Ct.), reversing 2016 ONSC 7345 (Ont. SCJ).

Shareholder Activism and Proxy Contests: Current Trends and Legal Developments

30 Proxy contest data in this section provided by Kingsdale Advisors.

31 *Eco Oro Minerals Corp. (Re)*, (2017) 40 OSCB 5321 (*Eco Oro*).

32 *Re Hecla Mining*, 2016 BCSECCOM 359 and *Re Hecla Mining Company* (2016), 39 OSCB 8927.

33 *PointNorth Capital Inc. (Re)*, 2017 ABASC 121.

34 See Exhibit 99.1 to Form 8-K, furnished by CSX to the SEC on February 15, 2017, online at *https://www.sec.gov/Archives/edgar/data/277948/000095010317001453/dp73030_ex9901.htm*.

35 Mr. Ward resigned from his position as CEO and chairman of the CSX board. Mr. Harrison replaced Mr. Ward as a director (and CEO). Hence, the CSX board size increased by only four directors.

36 Specifically, CSX shareholders would vote on whether CSX should (i) reimburse MRG the portion of the Extraction Cost that MRG had already paid to Mr. Harrison, and (ii) assume the obligation to pay Mr. Harrison the balance of the Extraction Cost owed to him by MRG.

37 *Supra* note 30.

38 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2017/Shareholder-Activism-and-Proxy-Contests-Issues-and-Trends*.

Diversity Still Lacking in Canadian Public Companies: Top Trends and Steps to Improve Your Leadership

39 See *Davies Governance Insights 2016*, online at *https://www.dwpv.com/en/Insights#/article/Publications/2016/Davies-Governance-Insights-2016)*; *Davies Governance Insights 2015*, online at *https://www.dwpv.com/en/Insights#/article/Publications/2015/Davies-Governance-Insights-2015*); *Davies Governance Insights 2014*, online at *https://www.dwpv.com/en/Insights#/article/Publications/2014/Davies-Governance-Insights-2014*); and *Davies Insights: Women on Boards*, online at *https://www.dwpv.com/en/Insights#/article/Publications/2014/Davies-Insights-Women-on-Boards*).

Notes

40 ISS Governance Insights, "More Women in the Boardroom, But Not in Charge" (June 23, 2017).

41 CSA Multilateral Staff Notice 58-308 – *Staff Review of Women on Boards and in Executive Officer Positions – Compliance with NI 58-101 Disclosure of Corporate Governance Practices* (September 28, 2016).

42 Google spent a total of $264 million on diversity and inclusion in 2014 and 2015, but women continue to represent around 31% of the overall Google workforce and 20% of technical staff; Christopher Mims, "What the Google Controversy Misses: The Business Case for Diversity; Google memo assumes Silicon Valley is already a meritocracy, but true meritocracies require diversity," *The Wall Street Journal* (August 13, 2017), online at *https://www.wsj.com/articles/what-the-google-controversy-misses-the-business-case-for-diversity-1502625603*.

43 Catherine Ashcraft, Brad McLain and Elizabeth Eger, "Women in Tech: The Facts," *National Center for Women & Information Technology* (2016), online at *https://www.ncwit.org/sites/default/files/resources/womenintech_facts_fullreport_05132016.pdf*, 6; Dominique Dionne-Simard, Diane Galarneau and Sébastien LaRochelle-Côté, "Insights on Canadian Society: Women in Scientific Occupations in Canada," *Statistics Canada* (2016), online at *http://www.statcan.gc.ca/pub/75-006-x/2016001/article/14643-eng.htm*.

44 State Street Global Advisors, "Enhancing Gender Diversity on Boards" (March 7, 2017), online at *https://www.ssga.com/na/ca/permitted-client/en/investment-goals/environmental-social-governance-esg/enhancing-gender-diversity-on-boards.html*.

45 "Tired of 'male, pale and stale' on corporate boards, investors are pushing for diversity," *Financial Post* (March 9, 2017), online at *http://business.financialpost.com/executive/tired-of-male-pale-and-stale-on-corporate-boards-investors-are-pushing-for-diversity/wcm/63698a33-7369-49dc-bc36-9249144ac103*.

46 SEC Advisory Committee on Small and Emerging Companies, "Recommendation Regarding Disclosure of Board Diversity" (February 16, 2017).

47 Ning Chiu, "Congressional Lawmakers Push SEC Chairman to Focus on Board Diversity Disclosure," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (July 6, 2017), online at *https://corpgov.law.harvard.edu/2017/07/06/congressional-lawmakers-push-sec-chairman-to-focus-on-board-diversity-disclosure/*.

Dual-Class Share IPOs Get Investors Fired Up

48 The Council of Institutional Investors has published a list of U.S. listed dual-class companies listed on the Russell 3000, online at *http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf*.

49 Canada Pension Plan Investment Board, "Proxy Voting Principles and Guidelines" (November 10, 2016), 13, online at *http://www.cppib.com/documents/1464/ProxyVoting_Principles_and_Guidelines_Nov2016EN.pdf*.

50 *Ibid*.

51 *Ibid*.

52 Canadian Coalition for Good Governance, "Dual Class Share Policy" (September 2013), online at *http://www.ccgg.ca/site/ccgg/assets/pdf/dual_class_share_policy.pdf*.

53 Council of Institutional Investors, Dual-Class Stock, various resources online at *http://www.cii.org/dualclass_stock*. See also Ross Kerber, "U.S. investor group urges halt to dual-class structures in IPOs" (March 23, 2016), *Reuters*, online at *http://www.reuters.com/article/us-usa-ipo-votingrights-idUSKCN0WP1Q0*.

54 Council of Institutional Investors letter to Snap Inc. "Re: Proposed Multi-Class Structure for post-IPO Snap Inc." (February 3, 2017), online at *http://www.cii.org/files/issues_and_advocacy/correspondence/2017/02_03_17_SNAP_IPO.pdf*.

55 Investor Stewardship Group, "Corporate Governance Principles for US Listed Companies" (2017), online at *https://www.isgframework.org/corporate-governance-principles/*.

56 Enoch Yiu, "Multiple-market structure can help attract start-ups, says London Stock Exchange chief," *South China Morning Post* (November 17, 2016), online at *http://www.scmp.com/business/companies/article/2046948/multiple-markets-can-help-attract-start-ups-says-london-stock*.

Compensation Issues and Trends: Annual Shareholder Input into Compensation Practices Continues as Executive Compensation Rises

57 Craig Wong, "Advocates urge 'say-on-pay' votes for execs as annual meeting season heats up," *The Toronto Star* (April 24, 2017), online at *https://www.thestar.com/news/world/2017/04/24/advocates-urge-say-on-pay-votes-for-execs-as-annual-meeting-season-heats-up.html*.
See also Canadian Coalition for Good Governance (CCGG), in a submission to the OSC commenting on the OSC's 2016-2017 Statement of Priorities, urged the OSC to prioritize making annual advisory say-on-pay votes mandatory for all TSX and TSXV listed issuers. CCGG noted that Canada is an outlier among developed nations in not having a mandatory advisory say-on-pay vote, and requiring advisory say-on-pay votes would be consistent with the OSC's stated priority to improve "alignment with international standard setting to deliver regulatory solutions that meet the needs of Ontario's market and participants." See also Canadian Coalition for Good Governance, "Re: Ontario Securities Commission ("OSC") Draft 2016-2017 Statement of Priorities" (April 25, 2016), online at *http://admin.yourwebdepartment.com/site/ccgg/assets/pdf/OSC_Draft_2016-2017_Statement_of_Priorities.pdf*.

58 Department for Business, Energy & Industrial Strategy and The Rt Hon Greg Clark MP, "Business Secretary Greg Clark has set out the government's corporate governance reforms to enhance the public's trust in business" (August 29, 2017), online at *https://www.gov.uk/government/news/world-leading-package-of-corporate-governance-reforms-announced-to-increase-boardroom-accountability-and-enhance-trust-in-business*.

59 Source: ISS Voting Analytics Database.

60 Bombardier Inc., "Report of Voting Results pursuant to Section 11.3 of National Instrument 51-102 – Continuous Disclosure Obligations (NI 51-102)" (May 11, 2017), online on SEDAR at *http://sedar.com/DisplayProfile.do?lang=EN&issuerType=03&issuerNo=00001177*.

61 Nicole Thompson and Morgan Lowrie, "Bombardier Inc. executives defer half of their $32.6 million compensation after uproar over pay hike," *Financial Post* (April 3, 2017), online at *http://business.financialpost.com/news/transportation/bombardier-inc-executives-defer-half-of-their-32-6-million-compensation-after-uproar-over-pay-hike*. See also Bombardier Inc., "Bombardier's Chief Executive Officer Makes Statement Adjusting 2016 Compensation for Senior Executive Officers" (April 2, 2017), online at *http://www.bombardier.com/en/media/newsList/details.binc-20170402-bombardiers-chief-executive-officer-makes-statemen.bombardiercom.html*.

62 Council of Institutional Investors, "Say-on-Pay Frequency: A Fresh Look" (December 2016), online at *http://www.cii.org/files/publications/misc/12_22_16_SOP_Frequency_Report_Formatted.pdf*.

63 Institutional Shareholder Services, Inc., "United States 2017: Proxy Season Review: Compensation" (September 7, 2017).

64 Institutional Shareholder Services, Inc., "2016-2017 ISS Global Policy Survey: Summary of Results" (September 29, 2016), online at *https://www.issgovernance.com/file/policy/2016-2017-iss-policy-survey-results-report.pdf*.

65 *Ibid* at 7.

66 Ira Kay (managing partner at Pay Governance LLC), "Did Say-on-Pay Reduce or 'Compress' CEO Pay?" *Harvard Law School Forum on Corporate Governance and Financial Regulation* (March 27, 2017), online at *https://corpgov.law.harvard.edu/2017/03/27/did-say-on-pay-reduce-or-compress-ceo-pay/*.

67 Korn Ferry Institute, "Korn Ferry Hay Group 2016/2017 CEO Compensation Study" (May 24, 2017), online at *https://www.kornferry.com/institute/korn-ferry-hay-group-2016-2017-ceo-compensation-study*.

68 Online at *https://www.dwpv.com/en/Insights/Publications/2016/Davies-Governance-Insights-2016*.

Is "True Majority Voting" on the Horizon?

69 Bill C-25, *An Act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act, and the Competition Act* (CBCA Amendments).

70 Bill 101, *Enhancing Shareholder Rights Act, 2017* (OBCA Amendments).

71 "Endeavour Silver Completes Review of Director's AGM Election Status," Endeavour Silver Corp. press release (June 12, 2017).

72 TSX Staff Notice 2017-0001 (March 9, 2017), online at *http://tmx.complinet.com/en/display/display.html?rbid=2072&element_id=1082*.

Notes

Other Important Governance Issues and Trends Under Focus

73 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2016/Davies-Governance-Insights-2016*. See also *https://www.dwpv.com/en/Insights#/article/Publications/2015/Davies-Governance-Insights-2015*.

74 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2015/Davies-Governance-Insights-2015*.

75 *Orange Capital, LLC v Partners Real Estate Investment Trust*, 2014 ONSC 3793 (Ont. SCJ).

76 TSX Staff Notice 2017-0001 (March 9, 2017), online at *http://tmx.complinet.com/en/display/display.html?rbid=2072&element_id=1082*.

77 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2017/The-CSA-Considers-Reducing-Regulatory-Burdens-for-Reporting-Issuers*.

78 Online at *https://www.dwpv.com/Sites/shareholdervoting/media/The-Quality-of-the-Shareholder-Vote-in-Canada.pdf*.

79 CSA Staff Notice 54-305 – *Meeting Vote Reconciliation Protocols* (January 26, 2017), online at *http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170126_54-305_meeting-vote.htm*.

80 *Wilson v Alharayeri*, 2017 SCC 39 (*Wilson*).

81 *Re InterOil Corporation*, 2017 YKSC 16; *Re InterOil Corporation v Mulacek*, 2016 YKCA 14; *Re InterOil Corporation v Mulacek*, 2016 YKSC 54.

82 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2016/Yukon-Appeal-Courts-InterOil-Decision-Based-on-Cold-Hard-and-Questionable-Facts* (December 2, 2016); online at *https://www.dwpv.com/en/Insights#/article/Publications/2017/InterOil-Take-2* (March 3, 2017).

83 Multilateral CSA Staff Notice 61-302 – *Staff Review and Commentary on Multilateral Instrument 61-101, Protection of Minority Security Holders in Special Transactions* (July 27, 2017), online at *https://www.osc.gov.on.ca/documents/en/Securities-Category6/csa_20170727_61-302_sn-staff-review.pdf*.

84 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2017/Boards-Beware-Regulators-Actively-Monitoring-Related-Party-Transactions*.

85 Online at *https://www.dwpv.com/en/Insights#/article/Publications/2014/Davies-Governance-Insights-2014*.

86 *Supra* note 73.

87 Online at *https://www.dwpv.com/en/Insights/Publications/2017/Ontario-Court-of-Appeal-Upholds-Conviction-for-Conspiracy-to-Bribe-Foreign-Public-Officials*.

Database and Methodology

88 As at May 31, 2017, based on data provided by Market Intelligence Group.

89 To qualify for the Composite Index, an issuer must, at the time of determining eligibility, (a) represent a minimum weight of 0.05% of the index and (b) have a minimum volume-weighted average share price of at least $1.00. 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.

Toronto
155 Wellington Street West
Toronto, ON M5V 3J7
TEL 416.863.0900

Montréal
1501 McGill College Avenue
26th Floor
Montréal QC H3A 3N9
TEL 514.841.6400

New York
900 Third Avenue
24th Floor
New York, NY USA 10022
TEL 212.588.5500

dwpv.com

DAVIES