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Discussion Paper: The Quality of the Shareholder Vote in Canada

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Disponible en anglais seulement

Reason for the Paper

As a firm, we have extensive experience with shareholder meetings. Some of these meetings are routine, others involve proxy battles, the approval of important transactions or votes on governance matters such as shareholder rights plans or stock option plans. Together with our clients, we have encountered a variety of obstacles in making sure that votes are cast and counted at the meeting in question. We know others have had similar experiences. As a result, we have become concerned with the quality of the shareholder vote in Canada.

Because the results of shareholder meetings are important to our clients and to the capital markets generally, we decided as a firm to devote the time and resources necessary to understand the issues that might compromise the integrity of those results.[1] Our intention was to then engage in discussions with others who share our interest in the quality of the shareholder vote with a view to improving the system.

The first thing we discovered was that very few people understand how the proxy voting system works from end to end. Recognizing that without a common understanding of the system itself, the capital markets community would not be in a position to identify and resolve the problems that prevent that system from being effective, we took a step back. We decided to first work to bring together the information necessary to establish that common understanding.

Following 16 months of research and discussions, we have produced a paper that describes the history, mechanics and policy issues relevant to the proxy voting system. For aspects of the system in which we are not directly involved, we have asked for the assistance of organizations integral to the operation of the system. With very few exceptions, those organizations not only answered our questions, but provided us with further information that they felt would be relevant to this project. To the extent that interested parties have further information that would improve the discussion in this paper, we hope that they will share it with us so that everyone can benefit from the common base of knowledge.

We are releasing the paper initially as a discussion paper with the hope that those with an interest in the integrity of the proxy voting system will take the time to read it and provide us with their thoughts. We have offered some suggestions for next steps on which we also invite comment. Based on the further comments we receive, we will post updated versions from time to time and will ultimately produce a final paper.

Elements of an Effective System

In our view, an effective proxy voting system must satisfy at least the following five criteria:

- investors must be in a position to make an informed decision about how to vote or how to direct that their votes be exercised and must therefore have adequate time to review the proxy materials;
- investors must be able to cast their votes or provide voting instructions in accordance with rules that are clearly explained, impartially applied and practical for investors to follow;

- if an investor casts a vote or provides voting instructions in accordance with the established rules, that vote must be given its full weight at the shareholder meeting in question;
- votes attached to the securities of an issuer should be cast by those investors who hold the economic interest associated with those securities; and
- there must be sufficient transparency in the voting system so that both issuers and investors are confident that the system works.

Issues with design and operation of the proxy voting system create a reasonable apprehension that the system may not consistently meet these criteria. These issues, combined with public examples of the system failing in each of these areas, have compromised confidence in the effectiveness of the proxy voting system among many of its stakeholders.

Features of the System

The following is a summary of the features of the proxy voting system that are relevant to the discussion in this paper:

- ***Investors Hold Their Interest Indirectly*** – Most investors (both retail and institutional) hold their interest in shares indirectly, through one or more intermediaries. The issuer therefore has no direct relationship with most of its investors.
- ***Shares Held in Fungible Bulk*** – Each intermediary holds shares in "fungible bulk". "Fungible" means that each share is identical and so it does not matter to the investor whether it has invested in one share as opposed to another share. "Bulk" means that the intermediary has a position in the aggregate of all the shares in which it holds an interest for its clients.
- ***OBO Status*** – Investors have the right under Canadian securities law to elect not to allow their intermediaries to disclose their identity to the issuer. The investors who do so are referred to as "OBOs" (Objecting Beneficial Owners). Those who allow their intermediaries to disclose their identity to the issuer are "NOBOs" (Non-Objecting Beneficial Owners).
- ***Unreconciled Records*** – The records submitted by intermediaries in connection with shareholder meetings are often not reconciled to eliminate positions relating to shares that have been loaned or should otherwise not be available to be voted.
- ***System is Operated by Third-Party Service Providers*** – The machinery of the proxy voting system is operated by third-party service providers. Transfer agents and proxy solicitors act on behalf of issuers, proxy agents act on behalf of intermediaries and proxy advisors act on behalf of investors.
- ***System is Complicated*** – The proxy voting system involves a number of different parties and at least as many different systems and data bases. It is susceptible to administrative and technological errors.
- ***System is Not Transparent*** – How communications flow between issuers and investors is not visible to any of them. The lack of transparency means that when an error occurs, it will often not be discovered – and therefore will not be rectified.
- ***Vote Confirmation Not Provided*** – The proxy voting system, as it currently operates in Canada, does not provide to an investor confirmation that the investor's voting instructions were translated into a vote that was counted at the shareholder meeting. Vote confirmation is possible in concept, but requires cooperation from everyone through whose hands the communications between the issuer and investors pass. Alternatively, one provider would need to control each of the steps of the communication process required to provide vote confirmation.
- ***Dominant Role of Broadridge*** – The proxy agent for almost all of the intermediaries in Canada is Broadridge. Accordingly, Broadridge is responsible for all of the mailings and tabulation of voting instructions for a very significant percentage of investors in every public company in Canada. Proxy agents are not regulated in Canada.
- ***Votes May Be Cast by Persons with No Economic Interest in the Issuer*** – Votes may be cast by persons who have no economic interest in the issuer. This may occur because the person sold its interest prior to the meeting, or as a result of derivative instruments that allow a person to acquire a right to vote with no economic exposure to the share being voted.

- ***Power of Proxy Advisory Firms*** – Many institutional investors use the research services and proxy voting platforms offered by proxy advisory firms. As a result, proxy advisory firms have the ability to influence the way in which their clients (typically institutional investors) vote.
- ***Regulatory Engagement*** – The proxy voting system is regulated primarily under securities law. That regulation ends when investors give their voting instructions to their intermediaries. How the votes are tabulated and proxies are cast is completely unregulated. Moreover, securities regulators do not monitor compliance with those aspects of the system that they do regulate.

Key Issues That Need to Be Addressed

The problems with the proxy voting system are so layered and complex that, in our view, a number of issues must be addressed before effective solutions can be proposed. The issues that we have identified as being the most immediate are set out below.

- ***Access to Information*** – There is not enough information available about the proxy voting system to allow an independent party to either prove that systemic problems exist or provide the confidence that they do not. Most of the information about the operation and effectiveness of the system resides with third-party service providers (transfer agents, proxy agents, proxy advisors and proxy solicitors) who have a great deal invested in the system and whose business interests would be affected by any change in the system. We hope this paper will contribute to a better understanding of the issues among issuers and investors. However, a more comprehensive audit of the system must be conducted by a task force of subject matter experts appointed by the government or by securities regulators.
- ***Movement Away from Paper-Based System*** – Some of the problems in the proxy voting system will be eliminated when issuers are no longer obligated to provide hard copies of their proxy materials to their investors. There will always be some investors who prefer paper versions of the materials, but there is a point at which the cost to the issuer and the mechanical complications outweigh the importance of providing the materials in the medium of choice to the investor. Canadian regulations need to do to more to encourage the transition away from paper-based materials. Notice-and-access is a step in this direction, but the recent proposals by the CSA are only a first – and quite tentative – step towards a true paperless system.
- ***Revisiting the Commitment to the OBO Concept*** – One of the hallmarks of the Canadian (and US) proxy voting system is that investors may elect to conceal their identity from the issuer (the OBO/NOBO system). The fact that issuers cannot communicate directly with many (today almost half) of their investors makes the communication process much more complicated.
- ***Problems Created by Intermediary Files That Are Not Reconciled for the Purpose of Proxy Voting*** – Intermediaries (brokers, banks, custodians) are required to create a list of their clients who are entitled to vote at a shareholder meeting, together with the number of shares held by those clients. However, those lists are often "unreconciled". They have not been adjusted to eliminate, for example, shares that have been loaned. The loaned shares will therefore still appear on the list prepared by the lender's intermediary for voting purposes, and will appear on the list prepared by the borrower's intermediary for voting purposes. As a result, the vote attaching to a single share may be voted more than once.
- ***Issues Related to Broadridge's Place in the Market*** – Almost all of the intermediaries in Canada have outsourced their responsibilities in connection with communications between issuers and investors to Broadridge. Broadridge has played a leading role in improving and streamlining the proxy voting system in Canada. However, Broadridge is not subject to regulation in Canada and neither issuers nor investors have a line of sight into how Broadridge has handled the voting instructions from investors in connection with any particular meeting.
- ***Deciding Whether Empty Voting Matters and How to Deal With It*** – There is no question that empty voting occurs. The problem is that there is no way to determine how extensive it is. If it has no real impact on the outcome of a shareholder vote, perhaps there is no reason to focus on it. If, however, it were shown that it happens more than rarely and could have a material impact on the results of a shareholder vote, then the basis of shareholder decision making may come into question.

- ***Power of the Proxy Advisory Firms*** – Many institutional investors rely heavily on the recommendations of proxy advisory firms in deciding how to vote their proxies. Some issuers feel that the degree of de facto reliance gives proxy advisory firms the power essentially to dictate governance practices. Others are concerned that the proxy advisors do not understand issues specific to that issuer or even that they get some things wrong in their analysis. Finally, some are concerned with conflicts of interest where a proxy advisor both sells governance consulting services to issuers and provides voting recommendations to investors. A better understanding of the role and methods of proxy advisory firms is needed. In addition, issuers need a forum in which to articulate their concerns - a forum that would be capable of providing responses and solutions that alleviate the current concerns.
- ***Responsibilities of Investors*** – Do investors have any responsibilities to the issuers in which they invest or to the capital markets generally? Should they be expected to vote? If so, how do they reconcile securities lending with their proxy voting policies? These issues are receiving increased focus and in some cases affect other issues addressed in the paper. Institutional investors should engage actively in the issues facing the proxy voting system and the role that they play.
- ***Engagement of Securities Regulators*** – Securities regulators must acknowledge the importance of an effective and reliable proxy voting system. They should be championing a comprehensive review of the system and be prepared to regulate aspects of the system in which they have not been involved.

Download our guide.

[1] Researching and writing this paper was a project undertaken by Davies Ward Phillips & Vineberg LLP and not on behalf of any client or other party. We received extensive support from a number of individuals and firms who are connected to the proxy voting system and without whose assistance this paper would not have been possible. Since some would prefer not to be named, we have thanked everyone privately. The views expressed in this paper are our own.

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Les renseignements et commentaires fournis aux présentes sont de nature générale et ne se veulent pas des conseils ou des opinions applicables à des cas particuliers. Nous invitons le lecteur qui souhaite obtenir des précisions sur l'application de la loi à des situations particulières à s'adresser à un conseiller professionnel.

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