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The Nomination of Corporate Directors: The Case for Well Delineated Responsibilities

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"The pension funds, while legally "owners", are economically "investors" – and, indeed, often "speculators". They have no interest in the enterprise and in its welfare. In fact, in the United States at least they are "trustees", and are not supposed to consider anything but immediate pecuniary gain…."

Peter F. Drucker,
The New Realities, 1990

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Table of Contents

Introduction

The Canadian Coalition for Good Governance (CCGG) advocates amendments to corporate laws and securities regulations that would give shareholders, under certain conditions, the right to place their nominees for director and a statement in support thereof in the company's proxy material in the same location and with the same prominence as the corporation's nominees, an approach commonly referred to as "proxy access".[1] CCGG suggests that to be eligible a shareholder or group of shareholders acting in concert would need to own three percent or more of an issuer's shares if its market capitalization is $1 billion or more, and five percent for a corporation with a market capitalization of less than $1 billion.[2] Such shareholders' nominations would be limited to the lesser of three directors or 20 percent of the directors.[3] CCGG is emphatic that no minimum holding period should be required as long as the nominating shareholders own the shares on the date "at which the shareholder nominees are proposed for election".[4] In addition, barring a majority vote to the contrary, the solicitation costs incurred by the nominating shareholders would be borne by the corporation.[5]

The proponents of proxy access argue that proxy access is a fundamental right of shareholders and that the challenge should lie in the election, not the nomination.[6] Such a privilege is not extended to shareholders of American corporations which gives credence to the on-going campaign for proxy access through private ordering that is unfolding in the United States.[7] However, in Canada, shareholders holding five percent of voting

1 Canadian coalition for good governance, *Shareholder Involvement in the Director Nomination Process: Enhanced Engagement and Proxy Access,* Policy paper, Toronto, May 2015.

2 *Ibid*, p. 13.

3 *Ibid*, p. 14.

4 *Ibid*, p. 24.

5 *Ibid*, p. 16.

6 *Ibid*, p. 18.

7 North Dakota mandated proxy access by statute for publicly traded corporations in 2007: *North Dakota Publicly Traded Corporations Act*, ND Cent Code, § 10-35 (2007). The statute provides that a shareholder or group owning 5 percent of the stock for a period of two years can include nominees in the corporation's proxy statement. The *Delaware General Corporation Law* (DGCL) was amended in 2009 to allow, but not require, a Delaware corporation to adopt bylaws that provide that if the corporation solicits proxies for the election of directors, shareholders have the right, subject to

shares already enjoy the right to place nominations for the Board of Directors on the corporate proxy statement, provided that they have owned the specified number of shares during "a six month period immediately before the day" on which the proposal is submitted.[8] Accordingly, the suggestion that adopting the CCGG proposal will improve corporate governance and enhance the value of Canadian corporations cannot be accepted at face value.

I. A Clash of Conception in Corporate Governance

The uniformity of the basic legal characteristics of the business corporation across jurisdictions is remarkable. These characteristics are: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. The substantial benefits that stem from this legal scaffolding are diluted somewhat by its inherent weaknesses which take the form of potential conflicts between (i) managers and shareholders, (ii) controlling and minority shareholders, and (iii) shareholders as a class and non-shareholder constituencies of the firm such as creditors and employees. In addition to these endogenous agency situations, corporations may become embroiled in exogenous conflicts stemming from the heterogeneity of their shareholders whose common interest in enhancing share value is pitted against significant private interests pursued by some shareholders. Because the separation of ownership and control has a strong efficiency justification, much of corporate law and securities regulation aim at reducing the scope of value-reducing forms of opportunism amongst different constituencies[9] and, hence, minimize the leakage that may occur from these distinct conflicting situations while, at the same time, protecting from encroachment the delineation of responsibilities critical to the corporate form.

Inherent to the functioning of socio-economic institutions is the competition between constituencies to obtain changes in the design of

certain procedure or conditions, to include shareholders' nominees for director in the Corporation's proxy material. *Delaware General Corporation Law,* Del Code, tit 8 § 1 (2009).

8 *Canada Business Corporation Act*, RSC 1985, c C-44 [*CBCA*], s 137(4); *Canada Business Corporations Regulations*, SOR/2001-512, s 46.

9 Stephen M Bainbridge, *Corporate Governance after the Financial Crisis* (Oxford, UK: Oxford University Press, 2010) at 204-208, 238-241.

the regulatory framework tilted to their advantage. There is, of course, substantial merit to a process that draws expertise and competition in the formulation of public policy; the challenge is to maintain the right balance in order to avoid capture by a constituency and ensure socially optimal results. The proxy access movement is the last volley in the debate between two conceptions of the governance of publicly owned corporations.[10] On one side of the debate is the model that relies mainly on the role of the board of directors as the steward of the corporation; on the other side lies the shareholder-centric model which favors the direct participation of shareholders in a growing range of corporate decisions.

The first conception partakes in a long legal tradition in common law countries making the board of directors responsible for the stewardship of corporations and the key organ of governance.[11] In addition to charting corporate strategy, the board is chiefly responsible for monitoring managerial performance, overseeing key risks, providing accountability, preventing conflicts of interest, balancing competing demands on the corporation and achieving an adequate return for shareholders. While the powers assigned to the board are large, directors are subject to two duties in the performance of their role: a fiduciary duty to act in the best interests of the corporation and the duty to act with the care, diligence and skill of a reasonably prudent person in comparable circumstances. In the United States, the Courts have affirmed that corporate directors have a "fundamental duty and obligation to protect the corporate enterprise, which includes stockholders",[12] a clear statement that, in the eyes of the Courts, the two are not identical. The jurisprudence in Canada is to the same effect: "the directors' duty is clear – it is to the corporation […] and it is not confined to short-term profit or share value".[13] It is now well established that the fiduciary duty of directors vis-à-vis the corporation encompasses the duty to treat fairly and equitably the stakeholders affected by the actions of the corporation.

10 T Henderson, "Two Visions of Corporate Law" (2009) 77 Geo Wash L Rev 708 at 722-727.

11 *CBCA*, *supra* note 8 at s 102(1) states: " Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation. "

12 *Unocal Corp v Mesa Petroleum Co*, 493 A (2d) 946 at 954 (Del 1985).

13 *BCE v 1976 Debentureholders*, 2008 SCC 69, [2008] 3 S.C.R. 560 at para. 37 and 38.

In order to effectively fulfill their responsibilities, boards must have a fair degree of independence from management and large shareholders. Independent board members are expected to play an important role in areas where the interests of management, the corporation and shareholders may diverge. To be effective, it is important that directors be viewed as credible stewards by members of the organization, an essential quality that is singularly absent from the discourse on governance rectitude.[14] Directors must be able to make decisions free from conflicts of interest or confused loyalties. In judicial reviews of corporate actions, Courts have given increasing weight on whether independent directors made the relevant decisions because it provides "strong evidence that the transaction meets the test of fairness".[15] The operative concept is the business judgment *rule* which "expresses the need for deference to the business judgement of directors as to the best interests of the corporation"[16] so long as it lies within a range of reasonable alternatives and the directors have exercised their duty of care.

It is this foundation to the structure of stock corporations that supporters of the shareholder-centric model are attempting to overturn. Professor Lucian Bebchuk, the instigator of the Shareholder Rights Project at Harvard Law School, has been a leading proponent of the view that shareholders should have the right to control the material decisions of the corporation in which they invested.[17] Reminiscent of the CCGG proposal, Professor Bebchuk has argued in academic papers and before the SEC that shareholders should have the right to assert their control on corporate decisions regardless of the length of time they have owned the shares and whether their objective was a short-term trading gain or the long-term value of the corporation.[18] In a sharp rebuttal, Delaware Supreme Court Chief Justice Leo E. Strine suggests that Professor Bebchuk's "crusade for ever more stockholder power may not actually be beneficial to ordinary

14 For an excellent exposé on the matter, see Yvan Allaire, *L'indépendance des administrateurs : Un enjeu de légitimité*, Prise de position 3, Institut sur la gouvernance d'organisations privées et publiques (Hereafter : « IGOPP »), Montreal, 2008.

15 *Weinberger v UOP Inc*, 457 A (2d) 701 at 709, para 7 (Del 1983).

16 *BCE v 1976 Debenture holders, supra* note 13 at para 140.

17 See for instance Lucian A Bebchuck, "The Case for Increasing Shareholder Power" (2005) 118 Harv L Rev 833; Lucian A Bebchuck, "The Myth that Insulating Boards Serves Long-Term Value" (2013) 113 Colum L Rev 1637.

18 Lucian A Bebchuck, Alon Brav & Wei Jiang, "The Long-Term Effects of Hedge Fund Activism" (2013) 113, 115 LA Colum L Rev 1085 at 1152.

investors, and that his contention – that further empowering stockholders with short-term investment horizons will not compromise long-term corporate value – is far from proven".[19] Indeed, several academics have drawn attention to serious deficiencies in the methodology and analyses put forward by Professor Bebchuk to build his case, notably his contention that activist hedge funds' attacks on corporations are beneficial to targeted corporations and should be encouraged.[20]

There is a fundamental distinction between "shareholder engagement", which purports to involve a constructive dialogue between the corporation and shareholders on a range of topics including performance, strategy, risk oversight and disclosure, executive compensation, and corporate governance, and "shareholder activism", where some shareholders proactively attempt to impose changes on the management and the board and to change the direction pursued by a corporation, including proposals to merge, divest, undergo a drastic reorganization or sell the corporation to the highest bidder. The drift towards a regime where activist fund managers will interfere with decisions that are properly within the realm of corporate strategy and governance finds its source in the institutionalization of savings and the "separation of ownership from ownership" that results, coupled with the shrinking time horizon that governs the decisions of a substantial proportion of asset managers. It is clearly a power struggle between the board of directors and activist managers of institutionalized pools of money. The naked threat of some large U.S. public pension funds that they will retaliate by voting against directors of companies opposing proxy access proposals without regard for any other consideration, including superior performance, is a stark indication that

19 Leo E Strine Jr., "Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law" (2014) 114:2 Colum L Rev 449 at 449.

20 Recent academic articles challenging the analysis and arguments put forward by Professor Bebchuk include Martin Lipton, "Empiricism and Experience; Activism and Short-Termism; the Real World of Business", Harvard Law School Forum on Corporate Governance and Financial Regulation, October 2013; Yvan Allaire, *The case for and against activist hedge funds*, Institute for governance of private and public organisations (Hereafter: "IGOPP"), Montreal, 2014; Yvan Allaire & François Dauphin, *Still unanswered questions (and new ones) to Bebchuk, Brav and Jiang*, IGOPP, 2015; Martin Lipton, "The Threat to the Economy and Society from Activism and Short-Termism", Harvard Law School Forum on Corporate Governance and Financial Regulation, January 2015.

the proxy access campaign in the form advocated by CCGG belongs to the second category.[21]

Institutionally, the Securities and Exchange Commission (Hereafter: "SEC") and Canadian Securities Commissions have generally leaned towards the *shareholder-centric* model. They are generally supportive of measures that would reapportion the current balance of corporate decision-making power between shareholders and the boards.[22] The SEC initially proposed a proxy access rule in 2003 and again in 2007.[23] In August 2010, the SEC adopted Rule 14a-11 mandating shareholder proxy access for the nomination of directors which became effective in November 2010.[24] Although authorized under section 971 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Hereafter: "Dodd-Frank"),[25] SEC Rule 14a-11 was struck down by the U.S. Court of Appeal of the District of Columbia in 2011, citing concerns that the rule might hurt minority investors at the expense of "investors with a special interest".[26]

The shareholder-centric model rests on the flawed premise that public corporations are the property of their shareholders. Corporations are "legal persons" that own themselves. Shareholders own shares that entitle them to certain rights such as the right to receive dividends and to vote on various issues. The corporation personhood gives shareholders the benefit of limited liability; creditors cannot enforce their claims against the shareholder's assets, and are limited to the corporation's assets. Corporations benefit from the lock-in equity capital which allows them to pursue long-term projects. Shareholders of public corporations that want their money

21 *Shareholders threaten boards over proxy access*, *USA Today* (27 January 2015). Around 100 US companies are facing shareholder proposals in the 2015 proxy season asking them to adopt proxy access procedures that would permit shareholders meeting certain conditions to add their candidates to management's proxy materials.

22 See, for instance, Mary Jo White (SEC Chair), "Remarks to the Corporate Counsel" (Remark delivered at the Say-on-Pay Workshop Conference, SEC, 2 November 2011).

23 SEC, *Proposed Rule: Security Holder Director Nominations*, 17 CFR § 240, 249 and 274, Release Nos 34-48626; IC-260206; File No S7-19-03, (2003) and Shareholder Proposal, 17 CFR § 240, Release No 34-56160; IC-27913; File No S7-16-07, (2007).

24 SEC, *Facilitating Shareholder Director Nominations*, 17 CFR § 200, 232, 240 and 249, Release Nos 33-9136; 34-62764; IC-29384; File No S7-10-09, (2010).

25 US, Bill HR 4173, *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Hereafter: "Dodd-Frank"), 111th Cong, 2010, s 971.

26 *Business Roundtable v S.E.C.*, 647 F (3d) 1144 at 1152 (DC Cir 2011).

back must sell their shares. These characteristics respond to the economic exigencies of modern business enterprises and explain to a large extent why business corporations have been engines of growth.

In contrast, American and Canadian Courts have taken a more holistic view of publicly-owned corporations. It is well-established that common law rules are, in fact, efficient in those areas of law that regulate corporate and commercial behavior.[27] In asserting the predominant role of the board of directors in the governance of corporations, their decisions are congruous with the considerable body of common law precedents and with the notion that shareholder wealth maximization provides the most ethical and socially acceptable frame of reference to protect the property rights of the different constituencies, consistently with the other obligations of the corporation as well as its relationship with other constituencies in terms of contractual privacy – not share price. Within these constraints, directors owe a duty of loyalty to shareholders as a class with regard to the financial performance of the corporation since "they are the only claimants to the cash flows of the firm whose only economic interests in the firm are residual".[28] Corporate law recognizes this situation by conferring almost always exclusive voting rights to common shareholders and by imposing a duty of care on directors and officers.[29] The tensions between the shareholder-centric model privileged by securities regulators and institutional investors and the view held by the Courts are evident in

27 Richard A Posner, "Wealth Maximization Revisited" (1985) 2 Notre Dame JL Ethics & Pub Pol'y 85 at 85-105; Francesco Parisi, "Positive, Normative and Functional Schools in Law and Economics" (2004) 18 Eur JL & Econ 259. These conclusions are also supported by the large body of research on the impact of legal origins which concludes that the legislation in common law countries is generally superior to that of countries with other legal traditions for economic and commercial outcomes. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, "The Economic Consequences of Legal Origins" (2008) 46:2 Journal of Economic Literature 285 at 285-332.

28 Jonathan R Macey, "A Close Read of an Excellent Commentary on *Dodge v. Ford*" (2008) 3 Virginia Law & Business Review 163 at 186.

29 *CBCA, supra* note 8 at s 122 (1) stipulates that when exercising their powers and discharging their duties, every director and officer shall: "(a) act honestly and in good faith with a view to the best interests of the corporation; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

the evolution of take-over rule regulations over the last decades where the former prefers an open market for corporate control.[30]

Shareholders generally agree with the Courts. For instance, in the 'say on pay' debate, the recent consultation on the European Commission Green Paper on the EU Corporate Governance Framework, showed a small majority in favour of listed companies' remuneration policies and remuneration reports being put to a mandatory vote of the shareholders.[31] However, most of the respondents who favoured a mandatory vote indicated that the vote should only be advisory and should not bind the board. Clearly, advisory votes are seen as a meaningful way of sending a strong signal to the board about the views of shareholders on the issues. Making a shareholders vote on such a matter binding upon the board was considered a step too far. Unless shareholders were to become more actively engaged in ownership, an intrusion in a matter within the ambit of a board to decide was not considered helpful because the decision needed to give appropriate weight to all the relevant factors and circumstances, including shareholders' views, that affected the corporation.[32] The CCGG proxy access proposal raises similar issues.[33]

Executives and managers of institutional funds are prone to portray themselves as "real" owners of the public corporations in which the funds are invested. This is a blatant case of mistaken identity; they are the agents of the persons who have the economic stake in the investee corporations, the custodians of the funds placed in their care.[34] Their interests as agents are not necessarily aligned with the interests of long-term investors. This gives rise to conflicts of interest between (i) the managers of institutional funds and their beneficiaries, and (ii) within the asset management organ-

30 Steven M Davidoff Solomon, *The SEC and the Failure of Federal Takeover Regulation* (Berkeley Law Scholarship Repository, Winter 1-1-2007) at 265.

31 EUROPEAN COMMISSION, *Feedback Statement: Summary of Responses to the Commission Green Paper on the EU Corporate Governance Framework*, Brussels, 2011, p. 10.

32 *Ibid.*

33 Yvan Allaire & François Dauphin, *Who should pick board members?, Proxy Access by Shareholders to the Director Nomination Process*, Policy Paper No 8, IGOPP, Montreal, 2015, p. 29-31.

34 Several institutional funds have rules that prohibit portfolio managers and senior executives to hold shares of companies in which these funds are invested. In contrast, most listed corporations require directors to hold a certain amount of shares while in office.

izations. The large body of regulations presently on the books aimed at (i) protecting investors, (ii) maintaining fair, orderly and efficient markets, (iii) facilitating capital formation, and (iv) regulating the practices concerning portfolio composition and the operations of investment advisers and funds, constitutes a strong indication of the pervasiveness of these agency issues.

The fiduciary duties of fund managers are towards the persons that have invested money in their funds. Their primary responsibility is to obtain the best investment returns subject to the parameters stated by the depositors and the rules that govern their activities. Like other minority shareholders, they do not generally owe any duty to other shareholders or the corporations in which they may have invested.[35] Their interests are not necessary congruent with the interests of other shareholders – as between shareholders with short-term investment horizons compared to those with long-term horizons – let alone other stakeholders of the corporations and they need not care if there are conflicts. Indeed, it is observed that the median stock holding period of institutional investors is two years or less.[36] The corporate form shields them from the responsibilities assumed by directors. It is seldom the case that minority shareholders will be criticized and blamed for the actions of the corporations in which they have invested. The corporations, their management and board of directors are held accountable in the public domain as well as before the law whereas investors will simply trade their shares. Therefore, the power of shareholders to nominate directors through the proxy access mechanism proposed by CCGG would not be accompanied by corresponding accountability nor would it be consistent with the limited liability afforded to shareholders by the corporate form.

The growing practice of companies listed on the Toronto Stock Exchange (Hereafter: TSX) of assigning responsibility for the nomination of directors to an independent nominating committee is an effective means of ensuring that boards have the appropriate set of functional,

35 The Courts have made exceptions to this rule imposing a fiduciary duty of loyalty similar to that of directors where shareholders are in a "controlling" position, that is, they have the ability to control the company's board of directors, in freeze-out transactions or in non-arm's-length transactions on unfair terms to the corporation.

36 Yvan Allaire, "Does hedge fund "activism" create long term shareholder value? " (Presentation at the annual meeting of the Center for corporate governance delivered at the Conference Board of New York, November 2014).

personal and social competencies to perform their role in plotting the course that is in the best interest of the corporation and, when required, to reconcile or arbitrate between divergent or conflicting interests.[37] Because they have an intimate knowledge of the workings of the board and of the behaviour and contribution of individual directors, a nominating committee composed of independent directors is better positioned to identify the needs, competencies and experience required to provide strategic counsel and effective oversight while ensuring the cohesiveness of the board and its ability to operate as a collegial body. The arguments put forward by CCGG give short shrift to the challenges inherent in the constitution of the team with the requisite expertise, diversity and chemistry to work in a productive, independent and collaborative manner.[38]

The U.S. experience with cumulative voting provides ample reason to pause.[39] The evidence shows that this voting mechanism, designed to give greater influence to minority shareholders, results in divided boards and leads to adversarial relations between the "majority" directors and the minority of shareholder nominees.[40] The same holds true where board members have been elected as a result of a proxy fight by hedge funds or other activists. The effects are an increase in interpersonal conflicts, a reduction in trust between directors, trust being key to effective board decision making, and a reduction in information flowing to the board as a whole. The end result is not better governance.

The above is not to say that the point-of-view of institutional investors on governance practices is unimportant; on the contrary. There has been a marked increase in company-investor engagement on governance topics in recent years. For instance, the number of S&P 500 companies disclosing their engagements with institutional investors in their proxy statement has increased from 6 percent in 2010 to more than 50 percent

37 Yvan Allaire & Stéphane Rousseau, *To govern in the interest of the corporation: What is the board's responsibility to stakeholders other than shareholders?,* IGOPP, Montreal, 2014, p. 22.

38 Stephen M Bainbridge, "Why a Board? Group Decision making in Corporate Governance" (2002) 55 Vand L Rev 1.

39 Cumulative voting allows each shareholder to aggregate the votes to which the shareholder is entitled and then cast them for each director nominees in whatever number the shareholder so chooses.

40 Stephen M Bainbridge, *Corporate Governance after the Financial Crisis, supra* note 9 at 230.

since 2014.[41] Several large U.S. corporations have endorsed the "SDX Protocol", a 10-point guideline for direct engagement between long-term institutional shareholders and directors.[42] Confirmation that boards have the skill sets, expertise and composition diversity needed to perform their stewardship role and oversee the key risks confronting the corporation, including environmental and social risks, is a legitimate shareholder demand. Thus, corporations would be well-advised to explain their board composition in a compelling way by showing explicitly the link between the qualifications of individual directors, the corporation's strategy, the risks it faces and how the board, as a whole, is the right fit in light of the corporation's specific circumstances. Providing more disclosure around the director recruitment process and how candidates are sourced and vetted would mitigate concerns about the recruitment process being insular. Coupled with rigorous board and individual directors' performance evaluations, the above would raise the bar with respect to accepted norms of board quality and effectiveness while avoiding the disruptive risks to market integrity inherent to the CCGG proposal.[43]

II. A Feeble Case for Mandating Proxy Access in Canada

Unconvincing Arguments

The argument that universal proxy access for shareholder director nomination in the form advocated by CCGG is necessary in Canada to promote better boards is unfounded. Firstly, proxy contests are not required to prompt director turnover or removal since the evidence is to the effect that directors who receive a greater negative or abstention vote at non-contested elections are less likely to remain on the board in the

41 EY Center for Board Matters, *Four takeaways from proxy season 2015*, June 2015, online: <http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2015> (consulted on November 7th 2015).

42 SDX Protocol, online: <http://www.sdxprotocol.com/what-is-the-sdx-protocol/> (consulted on January 3rd 2016).

43 In a recent international survey of corporate directors, Bonnie Gwin found that 38 percent of directors indicated that their Boards had removed underperforming board members in the past few years. Bonnie W Gwin, *Generational Dynamics: How boards tackle succession* (Boston: Heidrick & Struggles Board of Directors, 2015) at 2.

following year.[44] The increased departure rate is observed for both inside and independent directors, a pattern exemplified by the celebrated case of Michael Eisner at the Walt Disney Company.[45] The voting pattern in director elections reflects the shareholders' assessment of performance: the higher rate of board member turnover observed after poor performance provides strong evidence that "directors seem to heed the message to the negative vote and resign their position".[46] Moreover, shareholder nominations are often withdrawn before they reach a vote because corporations often seek to reach an agreement with large investors to avoid a contested election.[47]

In January 2014, the TSX amended the listing obligations to require that all TSX listed issuers (other than majority controlled issuers) adopt a majority voting policy for the election of directors.[48] The timing of the CCGG proposal suggests that it presumes that the majority voting policy whereby each nominated director must obtain a plurality of votes, a measure CCGG has publicly advocated since 2006,[49] is unlikely to have any meaningful impact on the selection and composition of a board of directors. The evidence is to the contrary. An examination of the impact of majority voting during the 2006-2011 period in Canada concludes that there exists a "positive relationship between majority voting and overall board independence" and that the difference in the proportion of independent directors between companies with majority voting and those without majority voting is significant.[50]

Secondly, Canadian legislation contains explicit provisions giving shareholders, under certain circumstances, the right to have their nominee directors and a brief note in support – 500 words in length – included in

44 Ian D Gow, Sa-Pyung Sean Shin & Suraj Srinivasan, "Consequences to Directors of Shareholder Activism" (2014) Harvard Business School Working Paper No 14-071 at 16.

45 Bainbridge, *Corporate Governance after the Financial Crisis, supra* note 9 at 217.

46 Gow, Sean Shin & Srinivasan, *supra* note 44 at 31.

47 Jun Yang, Wang Zengxiang & An Yunbi, *An Empirical Analysis of Canadian Shareholder Proposals*, (business, 2009) [unpublished] at 27-28, online: <http://dx.doi.org/10.2139/ssrn.1510248>.

48 *TSX Company Manual*, § 461.3.

49 Canadian Coalition for Good Governance, *CCGG Policy. Majority Voting Policy*, Toronto, March 2011, p. 5.

50 Sophie Langlois, *Majority Voting in Canada 2006-2011*, Clarkson Centre for Business Ethics and Board Effectiveness (Hereafter: CCBE), Toronto, 2012, p. 2.

the corporation proxy material at no cost to them, a right absent from U.S. corporate law.[51] Thirdly, to date, activist shareholders have adopted another route – proxy contests – to replace some or all the directors of Canadian public corporations. The data on proxy contests aimed at the board of directors of Canadian corporations carried-out between 2008 and 2014 show that activist shareholders were totally or partially successful in 52 percent of the 114 proxy contests.[52] The mechanism is potent. It has been observed that proxy contests have significant adverse career consequences for incumbent directors since, following the contest, they experience a decline in the number of directorships in the targeted and non-targeted corporations.[53]

The argument that the rules and costs of mounting an effective proxy contest under Canadian rules are too burdensome and onerous for shareholders to use this mechanism *as a matter of course* is valid. But it is precisely the point: it is not meant to be used "as a matter of course" but in circumstances where significant changes are deemed of sufficient importance to justify such an initiative by disgruntled or active shareholders. These provisions strike a balance between competing principles and interests: (i) protecting the central role of the board as steward of the corporation and the right of shareholders to effect changes to the board, if and when it fails to perform; and (ii) protecting minority shareholders from the actions of a group of shareholders acting in concert. A change in Canadian law allowing shareholders holding from 3 to 5 percent of the shares on the "election" date to nominate the lesser of three directors or 20 percent of the board at no cost to them would unhinge that delicate balance.

Sound policy making requires that the overall regulatory framework and its effectiveness in protecting minority shareholders' interests be considered prior to prescribing structural changes. In support of its position,

51 The sole exception is North Dakota state law: *North Dakota Publicly Traded Corporations Act*, supra note 7.

52 Author's calculation based on the results of the studies of proxy contests completed in Canada during the 2008-2014 period. Aaron Atkinson, Dan Batista & Brad Freelan, *Études sur les courses aux procurations au Canada,* Fasken Martineau, 2013, 2014 and 2015.

53 Vyacheslav Fos & Margarita Tsoutsoura, "Shareholder Democracy in Play: Career Consequences of Proxy Contests" (2013) 114:2 Journal of Financial Economics 316 at 319, online: <http://ssrn.com/abstract=2293953> (consulted on November 7th 2015).

CCGG lists six countries where "variations on the right of proxy access (is) a matter of course".[54] The World Bank 2015 edition of *Doing Business* reports on three measures of minority investor protections.[55] The indices pertain to (i) shareholders' rights and role in major corporate decisions; (ii) governance structure, and (iii) corporate transparency. Canada ranks seventh out of 189 economies worldwide; no country, cited by CCGG as an example to emulate, fares better.

Protecting Minority Investors

		Indexes			
Country	**Rank**	**Protecting minority rights (0-100)**	**Extent of conflict of interests regulation (0-10)**	**Extent of shareholder governance (0-10)**	**Strength of minority investor protection (0-10)**
Australia	71	56.67	6.0	5.3	5.7
Brazil	35	62.50	5.7	6.8	6.3
Germany	51	59.17	5.0	6.8	5.9
Italy	21	66.67	6.0	7.3	6.7
Sweden	11	63.33	6.3	6.3	6.3
United States	25	65.83	8.3	4.8	6.6
Canada	**7**	**72.50**	**8.7**	**5.8**	**7.3**

Source: World Bank, Doing Business 2015

The inclusion of Sweden and Italy as examples to emulate is interesting. In both countries, corporate control is highly concentrated and dominated by a few individuals or families. Italy has one of the least developed stock markets among developed economies. In Sweden, about 64 percent of listed firms have one shareholder with at least a 25 percent shareholding.[56] In addition, the widespread use of dual-class shares, pyra-

54 Canadian Coalition for good governance, *supra* note 1, p. 7.

55 World Bank Group, *Protecting Minority Investors*, Doing Business Project, 2015, online: <http://www.doingbusiness.org/data/exploretopics/protecting-minority-investors> (consulted on November 8th 2015).

56 Organisation for Economic Co-Operation and Development (OECD), *Corporate Governance Factbook*, 2015, p. 14.

miding, cross-ownership and voting caps, provides effective control mechanisms over a large proportion of total Swedish market capitalization by two families, means that CCGG would vehemently oppose such use should it become the norm for TSX listed companies.[57] Yet, Sweden ranks eleventh in the World Bank index of protection of minority investors. It is a reminder that the governance arrangements of social organizations are strongly influenced by the culture and values of the ambient society. Clearly, the gestalt of "family capitalism" differs from that of "casino capitalism" that characterizes large segments of American capital markets.

In terms of governance, it is also worth recalling that in most continental European countries, employees are granted Board representation, notably in Germany and Sweden. Their presence at the table has a definite influence on board deliberations.

The *Singapore Companies Act*[58] contains provisions concerning the rights of shareholders to propose nominee directors through the Corporation's proxy circular akin to the ones contained in Canadian legislation. The Singaporeans are well aware of the proxy access movement in the United States; no change to the jurisdiction's current regime is presently contemplated, and for cause. Singapore ranks third in the World Bank rating of markets on the Protecting Minority Investors Index. Their high ranking, as well as that of Canada compared to the countries singled-out as examples to emulate by CCGG, are indicative of the fact that governance is not a unidimensional function, that the various elements or measures taken or promoted to improve governance are often substitutes. This prompts an optimization of governance strategies that reflects the particulars of the regulatory framework and the ambient environment. It explains why the evidence shows that imposing one-size-fits-all prescriptive governance choices is a sub-optimal approach; it does not

57 Together the Wallenbergs, through Investor AB, and Handelsbanken, through Industrivärden, controlled about 55% of the total Swedish stock market value with a combined ownership investment valued at about 6% of the total stock market. Magnus Henrekson & Ulf Jakobsson, "The Swedish Model of Corporate Ownership and Control in Transition" (2003) The Research Institute of Industrial Economics Working Paper No 593 at 28.

58 Republic of Singapore, *Companies Act*, (Cap 50, 2006 Rev Ed Sing), s 177 (Calling a meeting), s 178 (Articles as to right to demand a poll).

improve governance but generally raises costs,[59] often inordinately on smaller corporations, which have different needs and resource constraints.

In defense of its position that no minimum holding period be required, CCGG states that "a holding period requirement for proxy access in effect creates two classes of shareholders, which is a concept CCGG does not support", citing approvingly Australia that does not require a holding period.[60] The concept of a holding period is not foreign to Canadian corporate law. The *Canadian Business Corporations Act* and the Regulations adopted under the Act provide that to be eligible to submit a proposal for inclusion in a proxy, a shareholder must have owned the specified number of shares during a "six month period immediately before the day on which it submits the proposal".[61]

In this matter, CCGG is singularly at odds with the trend observed in other developed markets. In France, following the "Florange Act",[62] in force since July 2014, the default rule for exchange-listed corporations is that shareholders having held shares in a corporation for two years or more are entitled to a double-voting right. In Italy, the 2014 *Growth Decree*[63] eliminates a decades-old prohibition on multiple voting shares and grants investors who have held shares in excess of two years double voting rights. In May 2015, the European Parliament's committee on legal affairs adopted a proposal to amend the Shareholders' Rights Directive to recognize shareholders who have held the shares for no less than two years by granting them additional voting rights, tax incentives, loyalty dividends or loyalty shares.[64] In the United States, the now vacated SEC Rule 14a-11 mandating shareholder proxy access for the nomination of directors specified that eligibility required that a shareholder, or group of share-

59 Kay S Benjamin & Cindy M Vojtech, Office of Financial Research, *Corporate Governance Responses to Director Rule Changes* by the U.S. Department of Treasury (Washington: Office of Financial Research 2015) at 36.

60 Canadian Coalition for Good Performance, *supra* note 1, p. 18.

61 *CBCA*, *supra* note 8 at s 137; *Canada Business Corporations Regulations*, SOR/2001-512, s 46.

62 *Loi nº 2014-384 du 29 mars 2014 visant à reconquérir l'économie réelle*, JO, 1 april 2014, 6627.

63 *Law Decree of June 24 2014*, published in the Official Gazette No 144, June 24 2014.

64 On the proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards to encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards to certain elements of the corporate governance statement (COM(2014)0213–C7 0147/2014–2014/021(COD)).

holders, needed to own 3 percent or more of an issuer's shares and **needed to have owned the shares for at least 3 years.**[65] Whether or not CCGG agrees with these safeguard measures, it would be well-advised to give more weight to the concerns and factors that have prompted them.

The suggestion that the proposed legislative measure is of little consequence because it will seldom be used strains credibility. If such is the case, how does the proposal address CCGG's assertion that "the nominee slate tends to reflect the board's, or in some cases still the CEO's network of relationships and perspective"?[66] CCGG's assertion is contradicted by evidence. The Clarkson Centre for Business Ethics and Board Effectiveness' (Hereafter: "CCBE") studies reveal that only 6% of large public firms indicate that directors' networks were an important factor in directors' selection; 81% prioritized executive experience on their boards.[67] These findings are comparable to those obtained in the United States. The requirement that the nomination process be run by a committee of independent directors has led to increased reliance on external sources for director recruitment, individuals recommended by the CEO accounting for less than 10 percent of director nominations.[68] More fundamentally, how will the executives of institutional investors select their nominees? Are we to believe that these executives do not have a "preferred" network of relationships and perspectives? The nomination process followed by exchange listed corporations is increasingly transparent and subject to normative rules. There is no suggestion that such safeguards are contemplated by CCGG. This is not a trivial issue in light of studies of social network connections between mutual fund managers and corporate board members that show that they constitute an important conduit for the transfer of beneficial information.[69] The series of convictions for insider trading in the Galleon Group affair serves as a reminder that no group in society has a monopoly on virtue.

65 SEC, *Facilitating Shareholder Director Nominations*, *supra* note 24.

66 Canadian Coalition for Good Governance, *supra* note 1, p. 1.

67 M Fullbrook, *Optimizing Board Skills and Meeting Effectiveness*, Clarkson Centre SME Toolkit #1, CCBE, Toronto, 2011, p. 3.

68 Corporate Governance Committee, "Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities" (2009) 65 Bus Lawyer 107 at 130-131.

69 L Cohen, A Franzzini & CJ Malloy, "The Small World of Investing: Board Connections and Mutual Fund Returns" (2008) Harvard Business School Working Paper No 08-055 at 976-977.

In the final analysis, the econometric analyses of the direct wealth impact of the S.E.C. proxy access proposal show that it is marginal at best. The CFA Institute estimates that the potential impact on the market capitalization of a rule that would prescribe proxy access for the nomination of directors of publicly-owned corporations is in the order of 0.023 percent to 1.134 percent of total U.S. market capitalization.[70] Other studies report a negative potential impact: firm values decreased in response to SEC proposed regulations to facilitate shareholders' ability to nominate director candidates.[71] The results are consistent with the view that mandatory universal proxy access regulations would increase the power of certain activists and corporate raiders at the expense of other shareholders and, because such a rule lowers the cost of waging proxy contests, it affects "firms with previously non-activist shareholders even more than firms with activist shareholders".[72] In light of CCGG's no holding period proposal, it needs to be noted that the studies that examine the impact of the potential use of proxy access by special interest groups to promote their narrow interest conclude that giving "certain types of shareholders greater control might actually detract from shareholder value".[73] There is also evidence that the impact of proxy access differs according to the size of the corporation. An event study found that the shareholder wealth effects of the SEC's adoption of the proxy access rule in August 2010 (now vacated) for a subset of 392 firms in the S&P 500 which, at the time, had an average market capitalisation of $19.943 billion was a positive abnormal return of 0.83 percent.[74] Another study of the same event with a portfolio of 980

[70] CFA Institute, *Proxy Access in the United States: Revisiting the Proposed SEC Rule*, 2014:9, p. 5.

[71] Ali C Akyol, Wei Fen Lim & Patrick Verwijmeren, "Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations" at 32, online: <http://ssrn.com/abstract=1526081> (consulted on November 8th, 2015).

[72] Letter from David F Larcker, Gaizka Ormazabal & Daniel J Taylor, "The Regulation of Corporate Governance", (2010) to SEC, re: File No S7-10-09, Release No 34-60089, Facilitating Shareholder Director Nominations at 31.

[73] Jonathan B Cohn, Stuart Gillan & Jay C Hartzell, *On Enhancing Shareholder Control: A (Dodd-) Frank Assessment of Proxy Access*, (business law, 2013) [unpublished] at 5, online: <http://ssrn.com/abstract=1742506>.

[74] Joanna Tochman Campbell et al, "Shareholder Influence over Director Nomination via Proxy Access: Implications for Agency Conflict and Stakeholder Value" (2012) 33:12 Strategic Management Journal at 1431-1451.

small corporations with a market capitalization not exceeding $125 million, found a negative abnormal return of 0.75 percent.[75]

III. A Truncated View of the Canadian Stock Market

The debates in Canada about securities regulations and the rules pertaining to corporate governance are dominated by Canadian financial institutions and strongly influenced by the nature and tone of those occurring in the United States. The tendency is to promote centralization and uniform policies regardless of the fundamental characteristics of our capital markets: its heterogeneity, the larger proportion of public companies controlled by the founders and their families and the much larger proportion of small or micro-capital companies.[76] In October 2015, there were 4369 companies listed on U.S. exchanges with a total market capitalization of $26 trillion.[77] In the much smaller Canadian economy, there were 3692 Canadian companies listed on the TSX and the TSX Venture with a total market capitalization of $1.9 trillion, a reflection of the prevalence of much smaller Canadian listed companies.[78] These structural differences should shape the nature of the debate and policy proposals put forward;[79] unfortunately, this is rarely the case. Several factors explain this situation.

Canadian companies inter-listed on a U.S. exchange account for about 60 percent of the market capitalization of Canadian corporations listed on the TSX and TSX Venture.[80] 65 of the 100 largest Canadian companies

75 T Stratmann and JW Verret, "Does Shareowner Proxy Access Damage Share Value in Small Publicly Traded Companies? " (2012) 64:6 Stan L Rev 1431 at 1462.

76 This centralist view was particularly manifest in the debate concerning the national securities commission initiative. See Pierre Lortie, *Securities Regulation in Canada at a Crossroads* (business law, University of Calgary, The School of Public Policy, 2010) online: <http://www.policyschool.ucalgary.ca/sites/default/files/research/lortie-online.pdf>.

77 World Federation of Exchanges, *Monthly Reports*, London: UK, Table 1.1. Equity, October 2015.

78 TSX, *MIG Report*, February 2015.

79 Christopher Nicholls, "The Characteristics of Canada's Capital Markets and Illustrative Case of Canada's Legislative Response to Sarbanes-Oxley" in *6 Canada Steps Up: Final Report* (Toronto: Task Force to Modernize Securities Legislation in Canada, 2006) 127.

80 Pierre Lortie, *supra* note 76 at 32.

listed on the TSX are dual-listed in the United States.[81] The equity holdings of institutional investors are heavily concentrated in those companies. Since inter-listed companies have made the decision to submit to U.S. securities regulations, the ideal situation for them is to have Canadian regulations harmonized with U.S. regulations. Their importance within the Canadian economy allows them to exert a significant influence on the terms and tone of the debate and on the attitude of some securities regulators with respect to these matters. Not surprisingly, the policies advocated by Canadian institutional investors often echo those promoted by their American brethren.

We have seen this in the debate concerning the proposal, promoted particularly by the Ontario Securities Commission (OSC) with strong support from institutional investors, to adopt the original Sarbanes-Oxley (SOX) regulations and impose its requirements on all Canadian public companies.[82] Sound public policy would question whether the incremental compliance costs were worth the beneficial results the U.S. Congress assumed would flow from implementation of the SOX rules and whether circumstances in Canada warranted the same heavy regulatory regimen.

The cost of implementing the original SOX rules – notably Section 404, which requires that CEOs and CFOs certify that internal accounting and control procedures comply with these rules and that their external auditors attest to these procedures – are considerable by any standard. Indeed, studies have estimated that 40% to 70% of the SOX compliance costs were related to external auditor attestations of the control systems.[83] The Alberta and British Columbia Securities Commissions were particularly concerned with the heavy cost burden and disproportionally negative impact of SOX on smaller firms since, to a large extent, the cost of compliance is fixed.

In the end, the Canadian Securities Administrators achieved a consensus on a harmonized body of regulations that embody the main governance features of SOX, but generally avoid SOX's overly elaborate and costly impositions. The Canadian regulations contain specific carve-outs of certain requirements for venture issuers and for issuers with controlling

81 *Ibid.*
82 *Ibid at* 25-27.
83 *Ibid* at 26.

shareholders, while eliminating the burdensome requirements of Section 404 of SOX.[84] It took some time and much wrangling among securities commissions to achieve this consensus, but no one can deny that a regulatory structure that forces so much disciplined attentiveness to the distinctive features of Canada's capital markets has produced a more efficient regime and saved the great majority of Canadian issuers substantial compliance costs.

With the passage of time, it is now possible to assess the net effect of SOX, and whether or not it has achieved its proclaimed objectives. The empirical studies conclude that "capital markets generally perceived SOX as imposing higher costs than benefits to foreign issuers from countries, like Canada, which already boasts strict governance, accounting, and securities regulation regimes".[85] The SEC Advisory Committee established to assess the regulatory system for smaller companies under U.S. securities laws concluded that "the costs imposed on smaller public corporations by a number of SOX provisions significantly exceeded any benefit the provisions provided to investors".[86] In response, the *Dodd-Frank Act* includes an exemption from SOX for all publicly traded companies with a market capitalization of less than $75 million.[87] Notwithstanding the changes introduced in the United States aimed at reducing the disproportionate burden on smaller companies, research on SOX regulations' net social welfare remains, on balance, inconclusive.[88]

The bias of Canadian institutional investors towards large corporations permeates throughout the CCGG position paper.[89] For instance, it

84 The Canadian response to SOX is embedded in the following regulatory instruments: *Multilateral Instruments 52-109* (CEO and CFO certifications); *52-110* (Audit Committees); *National Instruments 52-108* (Auditor Oversight), *58-101* (Disclosure of Corporate Governance Practices), and *58-201* (Corporate Governance Guidelines).

85 Stephanie Ben-Ishai, "Sarbanes-Oxley Five Years Later: A Canadian Perspective" (2008) 39:3 Loy U Chicago LJ 469 at 471.

86 SEC Advisory Committee on Smaller Companies, *Final Report to the United States Securities Exchange Commission*, Washington, 2006, Appendix A, p. A-1.

87 Dodd-Frank, *supra* note 25.

88 John C Coates IV & Suraj Srinivasan, "SOX after Ten Years: A Multidisciplinary Review" (2014) John M. Olin Center for Law, Economics, and Business, Harvard Business School Discussion Paper 758 at abstract, Accounting Horizons, [forthcoming in 2015], online: <http://www.law.harvard.edu/programs/olin_center/papers/pdf/Coates_758.pdf>.

89 Canadian coalition for good governance, *supra* note 1, p. 9.

gives prominence to the decision of GE to voluntarily amend its by-laws to require the corporation to include in its management proxy circular the director nomination proposals submitted by shareholders; an example, presumably, every sensible Canadian board should emulate. Unsaid is the fact that the eligibility conditions in the GE By-Law include: (i) a requirement that the shareholders have owned at least 3 percent of the common shares of the corporation continuously during the preceding 3 years, a condition CCGG opposes; (ii) that the group of shareholders must not include more than 20 shareholders; (iii) that no person may be a member of more than one group of persons constituting an eligible shareholder, (iv) that, contrary to the CCGG proposal, the cost of soliciting proxies in favor of the shareholders' nominees shall not be borne by the corporation, and (v) that a shareholder nominated director that fails to obtain 25 percent of the votes cannot be proposed for nomination for the next two annual meetings of shareholders.[90] Nor is there any indication that size matters. The market capitalization of GE is about $310 billion; hence, $9.3 billion in GE common shares held continuously for 3 years is required to qualify.[91] There are only two institutional shareholders that hold more than 3 percent of GE: The Vanguard Group (5.7%) and SSga Funds Management (3.7%).[92] They both manage large mutual funds and ETFs complexes. In comparison, the median market capitalization of the companies forming the S&P/TSX 60 is about $11.0 billion (i.e. the largest is $113.1 billion and the smallest is $2.3 billion)[93]. More significant is the fact that about 80 percent of Canadian companies listed on a Canadian exchange have a market capitalization inferior to $250 million.[94]

IV. Key Issues inherent to the CCGG Proposal

A fundamental dictum in the design of securities regulations is that perceptions about the integrity of capital markets are heavily influenced

90 General Electric Company By-Laws, s VII, § F, amended and restated by the Board of Directors on February 6, 2015, online: <https://www.ge.com/sites/default/files/GE_by_laws.pdf> (consulted on November 8th 2015).

91 NYSE, *Stock Quotes*, online: <www.nyse.com>.

92 NASDAQ.com, *GE ownership-summary*, 21 November 2015, online: <NASDAQ.com>.

93 TMX Indices, *Profile – S&P/TSX 60 Index*, 21 November 2015.

94 Pierre Lortie, *Securities Regulations in Canada: The Case for Effectiveness*, Study No 19, Institute for Research on Public Policy, October 2011, p. 17.

by the behaviour and actions of actors that "exploit the system" in ways that are considered unfair or outrageous. These actions may nevertheless be lawful. The design of regulations must seek to discourage such behaviour and, to the extent possible, encourage practices that strengthen confidence in the fairness and integrity of markets. The prevalence of "greenmail"[95] in the United States and the trading of corporate control at a premium without equal treatment for minority shareholders are two examples of practices which, although legal at the time, had a negative effect on market perception. The SEC proxy access rule-making history, and the more than 500 comment letters it received on its proposal, indicate that the potential for abuse was a major concern that needed to be addressed in the design of the rule. CCGG gives little weight to the wide-ranging consequences and risks associated with its proposal which differs in critical ways from the design of tentative regulations and the practices observed in the United States. In a nutshell, the CCGG proposal lacks the balance necessary to protect the integrity of the Canadian stock markets.

Size Matters

Size is inversely correlated to a firm's vulnerability to activist shareholders' threats and hostile take-overs. The evidence points strongly to smaller firms being easy prey for activists. Proxy contests are significantly more frequent in small publicly held companies than inthose with a large market capitalization. In their study of the WSJ – FactSet Activism Scorecard for the years 2010-2011, Allaire and Dauphin found that "the median company targeted by activist is fairly small (market cap = $148M; revenues = $201M)".[96] In Canada, the data shows that, since 2008, activist shareholders were much more successful in winning board-related proxy contests directed against small companies than large capitalization firms.[97] For the great majority of Canadian listed corporations, a 5 percent ownership threshold is easily within the reach of one or a small group of

95 Spencer Klein & Enrico Granata, ""Greenmail" Makes a Comeback", Harvard Law School Forum on Corporate Governance and Financial Regulation, January 2014, online: <http://www.mofo.com/~/media/Files/PDFs/2014SummitSupplementalMaterial.pdf>.

96 Yvan Allaire & François Dauphin, "The Game of Activist Hedge Funds: Cui bono? " (2015) IGOPP Working Paper at 10, online: <https://igopp.org/the-game-of-activist-hedge-funds-cui-bono/>.

97 Aaron Atkinson, Dan Batista & Brad Freelan, *Étude sur les courses aux procurations au Canada*, Fasken Martineau, 2013, p. 12.

shareholders. During the 2005 to 2014 period, 87 percent of the targets of a Canadian hostile takeover bid were companies with a market capitalization smaller than $1 billion.[98]

The empirical evidence suggests that mandatory proxy access as proposed by CCGG would be detrimental to a large segment of Canadian listed companies. For corporations with a market capitalization of $100 million or less, Dow, Shin and Srinivasan find no evidence of positive risk-adjusted returns over periods of up to 36 months following the appointment of an activist investor to the board.[99] The CCGG proposal, devoid of any minimum holding period, compounds the problem. The studies confirm this point: even with its safeguards, the application of the SEC proposed proxy access rule to firms with less than $75 million in market capitalization resulted in **negative** wealth effects.[100] These were magnified when firms had investors holding 3 percent or more interest.

Holding Period

A key mechanism to prevent the highjacking of proxy access by activists and interest groups is a share ownership holding period. Comment letters to the SEC in support of a short holding period (i.e. one year or less) came mostly from labor unions, public employee pension funds, hedge funds and, interestingly, proxy advisory firms. CCGG goes one step further by opposing any holding period requirement.[101]

The absence of a holding period would leave the Canadian market wide open for activists, hedge funds and interest groups. Shareholder proposals on environmental topics represent a significant proportion of proposals submitted to a vote in the United States.[102] Already, the proportion of shareholder proposals on social, ethical and environmental issues is larger in Canada than in the United States.[103] These matters are bound to take greater salience in the upcoming years. Close to 200 U.S. assets and

98 Aaron Atkinson & Brad Freelan, *Canadian Hostile Takeover Bid Study*, Fasken Martineau, 2015, p. 3.

99 Gow, Sean Shin & Srinivasan, *supra* note 44 at 31.

100 Stratmann & Verret, *supra* note 75 at 1460.

101 Canadian coalition for good governance, *supra* note 1, p. 16 and 17.

102 The Conference Board, "Director Notes: Shareholder Proposals on Social and Environmental Issues", notes delivered on December 2014 at 4.

103 Yang, Zengxiang & Yunbi, *supra* note 47 at 15.

investment managers are signatories to the United Nations Principles for Responsible Investment Initiative, committing to incorporating sustainability considerations into their investment decision-making and ownership practices. The tribulations of the new pipelines or mine development projects and the concerted campaigns of environmental pressure groups against forest companies in Canada should erase any doubt that, given the tools, environmental activists and their sympathisers – Canadian and foreign – will make use of lax provisions in the rules governing proxy access.

The now vacated SEC Rule 14a-11 mandating shareholder proxy access for the nomination of directors specified that to be eligible a shareholder, or group of shareholders, needed to own 3 percent or more of an issuer's shares and **needed to have owned the shares for at least 3 years.** Coincidently with the adoption of the proxy access rule, the SEC amended Rule 14a-8[104] in a manner that allows shareholders to submit a proxy access proposal for inclusion in a company proxy.[105] Since 2012, a total of 151 proxy access proposals were submitted by shareholders to Russell 3000 Index Companies.[106] The main lesson from these contests is that the proxy access proposals that obtained a majority of the votes were those that mirrored the SEC's now-vacated rule (i.e. 3 percent of stock for 3 years) whereas proposals that strayed from the SEC's formulation were generally defeated.[107] All proposals with a shorter holding period were defeated. Clearly, shareholders hold a very different view of long-term shareholders versus transient ones and a substantial proportion of U.S. shareholders do not agree with the contention that the form of proxy access promoted by CCGG will have a positive impact on the performance of the corporations

104 SEC, *supra* note 24.

105 *Securities Exchange Act of 1934*, 15 USC § 78a, rule 14a-8(i)(9), allows a company to exclude a shareholder proposal that "directly conflicts" with a management proposal. Some companies have relied on this exclusion to reject shareholder demands for inclusion of a proxy access proposal in the proxy. This interpretation of the rule is presently under review by the SEC staff.

106 The Russell 3000 Index is comprised of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. At the end of February 2015, the average and median market capitalization of these companies was $115.3 billion and $1.554 billion, respectively.

107 The CFA Institute reports that the average shareholder support for proposals with the SEC's vacated Rule 14a-11 ownership requirement of 3 percent for 3 years in 2013, 2013 and 2014 was 53 percent: CFA Institute, *supra* note 70, p. 12. The EY Center for Board Matters, *supra* note 41 reports that about 60 percent of the proposals that had gone to a vote as at June 2015 had secured majority support.

in which they are invested. In this regard, it is noteworthy that proxy access proposals were voted down at corporations such as Apple, Coca-Cola, Exxon-Mobil, Walt Disney and PACCAR. Fidelity, the huge mutual fund company, generally votes against proxy access; Vanguard has indicated that the firm had supported only nine of the about 60 proposals that had been voted on in the first five months of 2015.[108]

It is well documented that seeking directorships in target firms is an important mechanism by which activists seek to implement the actions they demand. The recent proxy contest between the board of directors of DuPont, led by the company CEO, Ellen Kullman, and Trian, Nelson Peltz hedge fund, is a case in point. Trian, which owned 2.7 percent of DuPont's shares, sought to break-up and add debt to DuPont as a means of increasing its share price. In light of the CCGG proposal, it is noteworthy that Trian believed that it needed only four directors, including Nelson Peltz, to take control of the affairs of Dupont. Interestingly, ISS issued a favorable recommendation for the Trian nominees whereas it is reported that BlackRock, Vanguard and State Street voted in favor of the DuPont nominees. These investment managers have recently voiced concerns about the trend toward short-termism whereas ISS's advice on many ballot items is shown to follow the lead of special-interest investors. Although it recommended supporting Trian, ISS made statements to the effect that it "could not fault DuPont on corporate governance".[109] California State Teacher's Retirement System (CalSTRS), which generally supports activists and is an investor in Trian, voted for Trian nominees whereas the California Public Emplolyees Retirement System's (CalPERS) vote sided with management.

Since activist directors join a given board to carry-out a specific agenda, their role on the board differs from that of other directors. Their behavior and actions often reflect conflicts of interest and the pursuit of a self-interested investment strategy. When they obtain board representation, the observed consequences are: "increased divestiture, decreased acquisition activity, higher probability of being acquired, lower cash balances, higher payout, greater leverage, higher CEO turnover, lower CEO

108 Gretchen Morgenson, "Mutual Fund Giants Vote to Keep the Insiders In", *The New York Times* (29 May 2015), online: <http://www.nytimes.com/2015/05/31/business/fund-giants-resist-proxy-access-board-shake-ups.html?_r=0>.

109 "Proxy Adviser Backs Two Trian Board Seats at DuPont", *The Wall Street Journal* (April 27 2015).

compensation, and reduced investment".[110] Seeking to identify where "activism causes real change", Allaire and Dauphin (2015) find that it "is pretty clear that the much vaunted "improvements" in operating performance (ROA, ROE, Tobin's Q) result mainly from some basic financial manœuvres (selling assets, cutting capital expenditures, buying back shares, etc.)"[111] and that the short-term increase in share price observed results from "wealth transfer rather than wealth creation".[112]

Despite safeguards incorporated into the SEC proxy access formulation, the U.S. experience is to the effect that proxy access is viewed by special interests as a very accessible mechanism to obtain board representation to pursue their own agenda without having to shoulder the cost of a proxy context.[113] In 2015, the 75 companies targeted with proxy access proposals by the New York City Comptroller,[114] an elected official which manages the City's pension funds, were chosen to focus attention on issues of climate change, board diversity and CEO remuneration. This phenomenon is not unique to the United States. In Canada, a significant proportion of shareholder proposals are submitted by coordinated shareholder groups and religious groups.

110 Gow, Sean Shin & Srinivasan, *supra* note 44 at 31.

111 Allaire & Dauphin, "The Game of Activist Hedge Funds: Cui bono? ", *supra* note 96, p. 36.

112 Yvan Allaire & François Dauphin, *"Activist" Hedge Funds: Creators of Lasting Wealth? What do the Empirical Studies Really Say?,* IGOPP, Montreal, July 2014, p. 2.

113 A reading of the comment letters to the SEC with regard to the proposed Rule 14a-11 leaves little doubt that this aspect is a key motivation in support of proxy access for activist shareholders. SEC, "Comments on proposed Exchange Act Rule 14a-11", Legislative comment, 2009.

114 See New York City Comptroller office, *Boardroom Accountability Project*, New York, 2014, online: <http://comptroller.nyc.gov/boardroom-accountability> (consulted on January 3rd 2016).; see also Press Release of Scott M. Stringer, Comptroller of New York (6 November 2014) *NYC Pensions Funds Launch National Campaign To Give Shareowners A True Voice In How Corporate Boards Are Elected: New York City Pension Funds File 75 Proxy Access Shareowner Proposals to Kick Off the Boardroom Accountability Project,* online: <https://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-pension-funds-launch-national-campaign-to-give-shareowners-a-true-voice-in-how-corporate-boards-are-elected>.

Subsidizing Solicitation Activities

Subsidization of the solicitation activities would significantly reduce the cost incurred by shareholders to nominate director candidates; so contrived, the proposed proxy access mechanism opens the door to a plethora of proxy contests.

Proxy contests command the attention of the board and executives and the resources of the corporation. They must not be wasted on futile endeavours that provide no meaningful benefit to investors or other significant stakeholders even if they are clothed in the shareholders' rights vocabulary. Corporations cannot be governed by referenda as if they were direct democracies. Shareholders and asset managers have no fiduciary responsibility vis-à-vis other shareholders, the corporation and its stakeholders; they have no particular standing to impose their will on corporate officers and directors who, by law, are subject to fiduciary accountability.

In a comprehensive review of the impact of widely used indices of good governance, Bhagat, Bolton and Romano conclude that despite widespread belief in the importance of governance mechanisms for resolving agency problems, "the empirical literature investigating the effect of individual corporate governance mechanisms on corporate performance has not been able to identify systematically positive effects and is, at best, inconclusive".[115]

[115] Sanjai Bhagat, Brian Bolton & Roberta Romano, "The Promise and Peril of Corporate Governance Indices" (2007) European Corporate Governance Institute Working Paper No 89/2007 at 12: Their finding are to the effect that "the bulk of the empirical studies investigating whether firms in compliance with the best governance practices of comply or explain regimes are superior performers than non-fully compliant firms find that compliers do not outperform noncompliers." (at 63) Similarly, Daines, Gow and Larcker conclude that the ratings of ISS/Risk Metric, Governance Metrics International and the Corporate Library do not provide useful information for shareholders and that "the absence of cross-sectional correlation is consistent with a high degree of measurement error in the rating processes across firms." Robert M Daines, Ian D Gow & David F Larcker, "Rating the Ratings: How Good Are Commercial Governance Ratings? " (2009) Rock Center for Corporate Governance at Stanford University, Working Paper Series No 1 and Stanford University School of Law, Law & Economics Research Paper Series, Paper No. 360 at 47, online: <http://ssrn.com/abstract=1152093> (consulted on November 8th 2015).

As indicated above, the impact of activists' initiatives does not generally lead to a sustained superior wealth appreciation. Indeed, hedge fund indexes show that their returns are inferior to a broad market index.[116] Such results have prompted the U.S. Labor Department of Employee Benefits Security Administration (Hereafter: "EBSA") to issue an Interpretive Bulletin warning pension funds that their fiduciary responsibilities precluded them from using "their plan assets to support or pursue proxy proposals for personal, social, legislative, regulatory, or public policy agendas which have no clear connection to increasing the value of investments used for the payment of benefits or plan administrative expenses".[117] A lesson must also be drawn from the change in direction adopted by CalPERS. Once the leading U.S. pension fund publicly challenging corporations' governance policies and performance, it has shunned its activist methods and investment strategies in favor of engagement with corporate directors and management. Part of the reason behind this change may well be that its activist portfolio underperformed by a wide margin when compared to its "non-hostile" portfolio in all one, three and five year periods.

Hence, it is an essential safeguard to market integrity that shareholders favoring particular corporate action bear the costs of their campaign. One does not need to be well-versed in the "tragedy of the commons" to understand that the CCGG proposal with respect to the assumption by the corporation of the soliciting costs incurred by a nominating shareholder

116 The following comparisons exclude the fees paid to hedge funds by investors which further reduces their returns: HFRX Indices Peformance Tables

Hedge Fund Index	Years	Returns (%)	S&P 500 returns
HRF Activits	2013	13	32.4
HRF Activist	2014	4.8	13.7
Barclays Hedge Fund	2014	2.89	13.7

117 *Interpretive Bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines*, 29-9 CFR § 2509.08-2 (2011), online: <https://www.law.cornell.edu/cfr/text/29/2509.08-2>. See also U.S. Department of Labor, *Interpretive Bulletin 08-2 (DOL Reg Sec 2509.08-2)*, 73 Fed Reg 61731 (2008).; ERISA Advisory Opinion No 2007-07A, December 21, 2007.; OIG Department of Labor Report, *Proxy Voting May Not Be Solely for the Economic Benefit of Retirement Plans*, Rpt No 09-11-001-12-121, U.S. Department of Labor, Office of Inspector General, Washington, 2011, online: <http://www.oig.dol.gov/public/reports/oa/2011/09- 11-001-12-121.pdf.> (consulted on November 8th 2015).

will encourage activist interventions that are unlikely to be in the general interest of shareholders. Moreover, the CCGG proposal does not contemplate a threshold vote resubmission requirement to weed-out proposals that shareholders do not countenance.[118]

Perverse Incentives

The stated objective of improving the quality and performance of the board posits that proxy access directors integrate well within the board. The best indication that this has occurred would be for these directors to be included in as the corporation's proxy nominees in subsequent years. The possibility for a company to remain open to cumulative annual access proxy contests could lead to an effective "take-over" of the board by interest groups, unless re-nominated proxy access directors are counted in the limit. Failing this, boards will be encouraged to deny re-nomination to proxy access directors, an outcome that would breed division and dysfunctional board dynamics. CCGG has recognized this issue and amended its previous proposals to provide that "shareholders would not be able to nominate another three directors of 20 percent of the Board in the following years so long as the previously nominated directors, if elected, remain on the board".[119]

Notwithstanding the above rule, proxy access would still open the way to the exploitation of the process for control or other peculiar purposes, unless the rules prohibit certain behaviors and practices that have no relationship whatsoever with the stated objective. Here, CCGG is silent. Provisions that restrict the ability of shareholders to communicate with one another and therefore constrains solicitation in favor of director candidates, unless done in the open in accordance with present rules, are given short shoulder in the CCGG proposal despite the fact that they are considered essential in protecting market integrity and, therefore, constitute a

118 *Securities Exchange Act of 1934*, *supra* note 105 at rule 14a-8(i)(12), 17 CFR § 240.14a-8(i)(12) provides that a company may exclude a proposal that obtained less than 3% if proposed once within the preceding 5 calendar years, less than 6% if proposed twice within the preceding 5 calendar years, or less than 10% if proposed 3 or more times within the preceding 5 calendar years; the term of the exclusion is for 3 calendar years from the last time in which the proposal was included in the firm's proxy material. Online: <https://www.law.cornell.edu/cfr/text/17/240.14a-8> (consulted on November 8th 2015).

119 Canadian Coalition for good governance, *supra* note 1, p. 15.

common feature of the securities regulatory framework throughout developed markets. In the event where Canadian corporate law was amended to include a mandatory proxy access rule aligned with the CCGG proposal, it would need to:

– limit the number of shareholders that could be solicited to create a nominating group or that could participate in a nominating group;

– limit the number of nominating groups any single shareholder could join to one;

– limit the right of shareholders to nominate director candidates in successive years if they failed to obtain a minimum number of votes (i.e. % of the votes).[120]

– Define the circumstances where a corporation is not required to include a shareholder nominee in the proxy circular.[121]

120 The recently adopted proxy access bylaw by Prudential includes the following provision: "*Any Shareholder Nominee who is included in the Corporation's proxy materials for a particular annual meeting of shareholders but either (i) withdraws from or becomes ineligible or unavailable for election at the annual meeting, or (ii) does not receive at least twenty-five percent (25%) of the votes cast "for" the Shareholder Nominee's election, will be ineligible to be a Shareholder Nominee pursuant to this Section 15 for the next two (2) annual meetings.*" The bylaw was approved by a majority of shareholders: Prudential Financial Inc., *SEC Filings: Form 8-k,* Newark, 2015, p. 31, online: <http://goo.gl/scMjdf> (consulted on November 8th 2015).

121 Such provisions in U.S. corporations proxy access by-laws generally include: (i) the nominee or the nominating shareholder participates in the solicitation of any nominee other than the nominee or Board nominees; (ii) the nominee serves as a director at more than four other public companies; (iii) the nominee becomes a party to a compensatory or other financial arrangement with a person or entity other than the Corporation in connection with such nominee's candidacy for director or service or action as a director, unless the terms of such arrangement have been disclosed and are acceptable to the Corporation; (iv) the nominee is not independent under any applicable independence standards; (v) the nominee has been an officer or director of a competitor within the past three years; (vi) the nominee is the subject of a pending criminal proceeding or has been convicted in a criminal proceeding within the past 10 years; or (vii) the nominee or the nominating shareholder has provided false or misleading information to the Corporation or breached any of their respective obligations under the by-laws.

Transparency

Shareholders using proxy access will generally do so in the pursuit of a particular agenda. Some may be benign, even helpful, such as to promote competent diversity on the board, while others are likely to not be in the shareholders' interest. However, the evidence indicates that the former is rarely the case. In the United States, activist investors secured at least one board seat in roughly 70 percent of all proxy fights held from January 2009 and May 2014.[122]

The CCGG proposal includes a caveat: shareholders nominating directors by a proxy access mechanism should be required to make a representation that they are "not seeking control".[123] This approach is much too narrow for comfort. Control is generally defined as the power to change the board or to direct the affairs of the company. By design, the cap on the number of directors that could be elected through the proxy access mechanism is limited to the lower of three or 20 percent of the number of directors on the board. Yet, in practice, hedge funds and other activist shareholders that wrought major structural changes in corporations usually have a toehold of about 8 percent of the shares and seek to appoint three or four directors on the target board.[124] To be effective, the prohibition would need to encompass the lack of intent to change or influence control of the corporation.

Proponents of the shareholder-centric model are adamant that directors and management must be transparent in their communications, requiring increasingly more detailed divulgation of information and intent. These rules need to apply to all since, as it is asserted, they are deemed fundamental to the integrity and efficiency of capital markets. Hence, when a shareholder or group informs a corporation of its intent to avail itself of the proxy process, it should be required to file a statement with the corporation and securities commissions having jurisdiction explaining its motivations and objectives. The nominating shareholder

122 Ted Allen, *2014 Proxy Season: Lessons Learned*, National Investor Relations Institute, June 2015, p. 14.

123 Canadian Coalition for good governance, *supra* note 1, p. 15.

124 Alon Brav et al, "Hedge Fund Activism, Corporate Governance, and Firm Performance" (2008) 63:4 The Journal of Finance 174.; Ronald J Gilson & Jeffrey N Gordon, "The Agency Costs of Agency Capitalism Activist Investors and the Revaluation of Governance Rights" (2013) 113 Colum L Rev 863 at 899.

should also be required to make representations regarding its compliance with applicable laws, including compliance with proxy solicitation rules and participation only in the solicitation of the shareholder's nominees or board nominees. This statement should fully comply with the applicable disclosure requirements.The shareholder submitting the proposal should also assume liability under the securities laws for the communications with the shareholders and for the information provided for inclusion in the proxy. Moreover, the nominating shareholder should be required to indemnify the corporation, its officers and directors for liabilities arising from the shareholder's nomination and comply with all other rules and regulations applicable to any solicitation in connection with the annual meeting of shareholders.

Directors' Independence

Proponents of mandatory proxy access rules argue that their goal is to improve the quality and performance of the board of directors.[125] If such is indeed the case, why is the proposal silent on safeguards that are critical to avoid misuse of the mechanism?

For instance, nominated directors should be independent vis-à-vis the nominating shareholder or group, which would include the absence of any voting commitments or special compensation or other financial arrangements in connection with the nominee's candidacy for or service as a director. Absent independence requirements, concerns regarding special interest directors and control implications take a whole new dimension. In the United States, corporate activists were well aware of the implications since they vehemently opposed such a requirement.[126]

Competencies of Shareholder-nominated Directors

The implicit statement in the CCGG proposal is that corporations should simply accept shareholders' nominees and ensure that the proposals be "set out fairly and on equal footing with company nominees".[127] A major strand of efforts to strengthen the performance of corporations is focused on the competence of corporate directors and their capabilities

125 Canadian Coalition for good governance, *supra* note 1, p. 4 and 25.
126 SEC, "Comments on proposed Exchange Act Rule 14a-11", *supra* note 113.
127 Canadian Coalition for good governance, *supra* note 1, p. 15.

and experience to address the challenges confronting the Corporation. Proxy access does not negate this critical need. The CCGG proposal is silent about the nominating procedure it envisages.There is no mention that the Nominating Committee of the board should have adequate time to assess shareholder-nominated candidates, meet with the prospective director(s) and provide its recommendations to the board. Nor is it recognized that the board may have strong and valid reasons to oppose the election of certain nominees, that it is its fiduciary responsibility to convey these reasons to all shareholders and that the proxy statement is an appropriate vehicle to do so. The U.S. Court of Appeal for the District of Columbia was clear that a board would have not only the right – but the duty – to oppose shareholder proxy nominees that it believed inappropriate[128].

At the corporation's request, shareholder nominees should be required to submit completed and signed questionnaires required of corporation directors and provide any additional information necessary for the board's evaluation and determination of director independence, competencies and related party transactions. Each director nominee to be named in the proxy statement should also be required to provide a written consent to be named and to serve as a director if elected, as well as the contingent resignation required under the majority voting provisions of the corporation's by-laws. The nominee should also sign an undertaking to comply with applicable laws and stock exchange requirements and the policies and guidelines applicable to the corporation's directors, including corporate governance, conflicts of interest, confidentiality, stock ownership, and trading policies and guidelines.

Conclusion: Boards Matter

The concerns expressed by CCGG for the quality and independence of boards of directors of publicly-owned companies are valid public policy matters. The issue is not about the stated goal but about the method advocated. *As shown above,* the United States stood at the 25th rank with respect

[128] The Court agreed with the American Bar Association's Committee on Federal Regulation of Securities comments that: "If the [shareholder] nominee is determined [by the board] not to be as appropriate a candidate as those to be nominated by the board's independent nominating committee…, then the board will be compelled by its fiduciary duty to make an appropriate effort to oppose the nominee, as boards now do in traditional proxy contests." *Business Roundtable v S.E.C.*, *supra* note 26 at paras 36-37.

to the regulatory framework to protect minority investors compared to Canada, at 7th place.[129] But despite its low ranking, the quantitative evaluation of the net wealth effects of the SEC proxy access proposal is marginal, at best, and detrimental for smaller corporations. Since the CCGG proposal does not have the safeguards inherent to the rule considered in the U.S. econometric studies, its negative effects are likely to be substantial. Its adoption would open Pandora's box where the main losers are likely to be minority shareholders and economic growth in Canada which, in turn, would invite regulatory interventions to correct excesses, likely to undermine one's confidence in the market. Clearly, there are ways to promote board quality and to encourage boards to adopt a high standard of corporate governance, more in line with the role and fiduciary duties of directors.

It is undisputable that shareholders have a compelling interest in the quality of the board selection process. The majority voting rule is a powerful accountability mechanism. CCGG notes that "the rise of the independent nominating committee … has increased the levels of independence and quality of boards of directors…"[130] A requirement that corporations "establish expertise and experience profiles desirable for the board and adopt a nomination procedure, taking into account the skills and competencies that the board as a whole should possess, as well as the skills and competencies of the existing director and of each new candidate"[131] and inform shareholders of its procedure, would go a long way towards insuring the overall quality of board members.

Shareholders' input on governance matters is useful for strengthening the overall environment for good governance policies and practices, and convey their expectations to the boards of Canadian corporations. The objective of creating sustainable and financially sound enterprises that offer long-term value to shareholders is best served through a constructive relationship between shareholders and the boards of corporations, respecting the division of roles and responsibilities existing between the corporation's shareholders, board of directors and management, but certainly not by usurping their respective roles and substituting one for the other.

129 World Bank Group, *supra* note 55.

130 Canadian Coalition for good governance, *supra* note 1, p. 1.

131 Caisse de dépôt et placement du Québec, *Policy on the principles governing the exercise of voting rights of public companies*, Québec, nº 5.4, p. 5.