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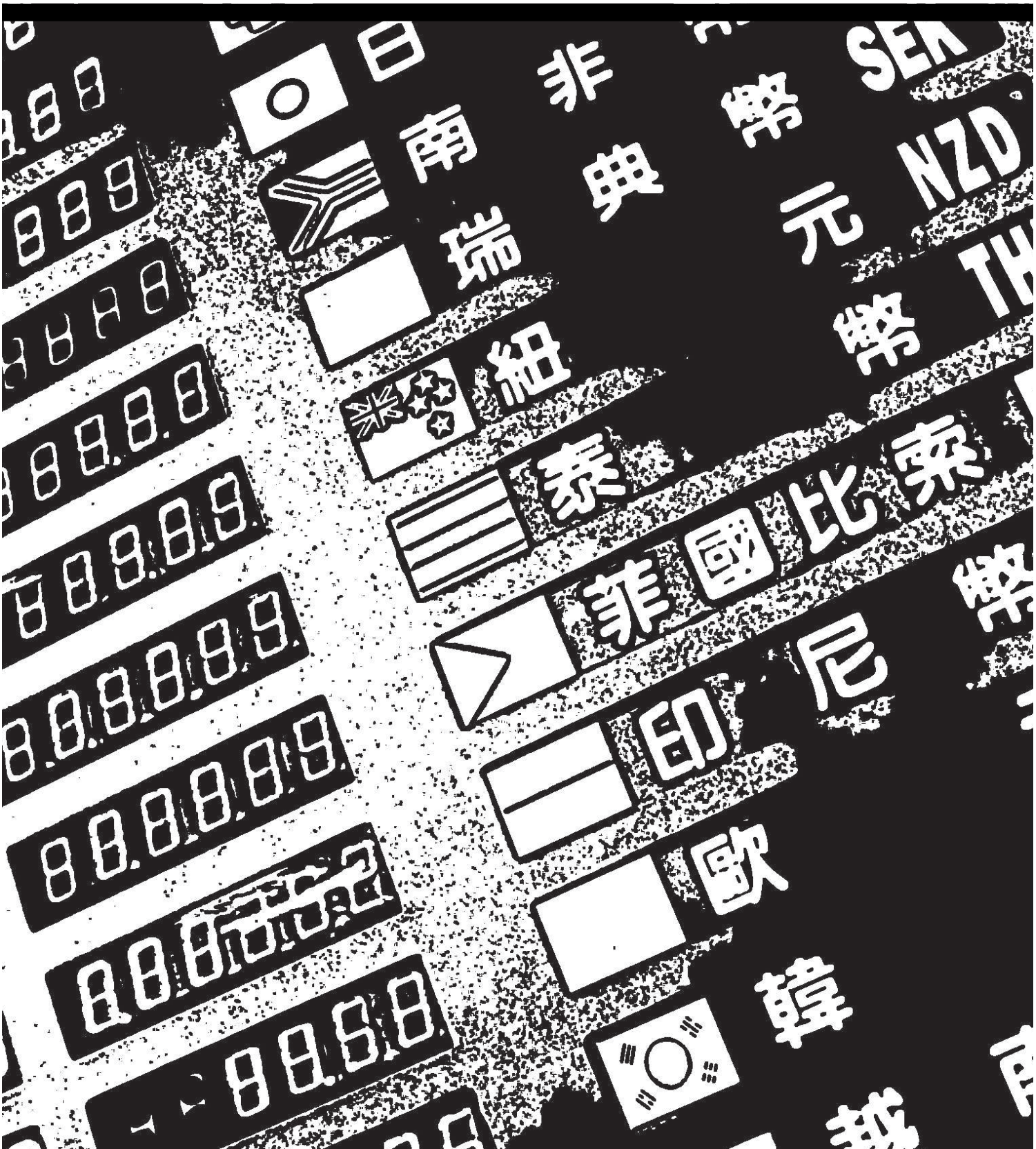

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Shareholder activism in Canada: tools, motivations and current issues

In Canada over the past decade, there has been a marked shift away from the traditional corporate standard of director primacy, based on the concept of separating ownership and control of a corporation, towards increased activism by shareholders desiring greater influence over the governance and stewardship of a corporation. Since the financial crisis of 2008, shareholders have put particular emphasis on director accountability and executive compensation practices. Shareholders have achieved increasing success at influencing operations and policies of corporations using a variety of means, ranging from direct and ongoing interaction with management and boards, to shareholder proposals and voting campaigns, to full-out proxy battles for control over boards. Adding to the increased sophistication and aggressiveness of recent shareholder activism has been the emergence of key third party players such as proxy advisory firms and institutional shareholder advisory groups – the former having gained prominence based on expertise of the proxy solicitation process and the analysis of, and communications with, a corporation's shareholder base and the latter having gained prominence based on the reliance that institutional shareholders place on their researched voting recommendations on matters put before shareholders.

This article explores three 'hot' issues related to director accountability and executive compensation that have gained recent prominence in Canadian shareholder activism: majority voting; slate elections; and shareholder say on pay. Prior to exploring these issues, the tools used by shareholder activists and the different motivations of shareholder activists are discussed.

Tools used by shareholder activists

In its most basic form, shareholder activism is a process of ongoing and direct communication with the corporation on matters that concern shareholders. To this effect, it is becoming more and more prevalent, particularly given recent years of increased shareholder activism, that corporations adopt and maintain an ongoing and proactive shareholder communications programme to address shareholder concerns and ensure ongoing shareholder support of the corporation's policies and incumbent board. However, where shareholder activists and the corporation cannot agree, or where shareholder activists desire to usurp discussions with management or the board, there are a number of legal tools that are available to shareholders under Canadian laws that allow activists to take their case directly to all the shareholders of the corporation, or even replace the board of a corporation with activist nominees. Shareholder proposals, shareholder requisitioned meetings and proxy battles to replace a sitting board are deceptively easy to initiate under Canadian law, as all that is required is a small percentage of shareholdings to commence such processes. However, these tools require strict compliance with highly technical rules in order to sustain the process through to the desired result, for both the activist shareholder and the target corporation. As a result, experienced legal counsel and third party advisers such a proxy solicitations firms are becoming more and

more prevalent as key players influencing the outcome of sensitive and often high-stakes engagements between shareholder activists and corporations. Often, a corporation is in a position where it has to react in a matter of hours. During a proxy battle, there is generally no time or room for lawyers, communications advisers or investment bankers to learn how to run the process.

Motivations of shareholder activists

Generally, the tools by which a shareholder activist elects to interact with the target corporation will reflect the motivations of the particular shareholder activist, which is critical information for the target corporation in assessing its response. The motivations of shareholder activists can generally be divided into three categories: activism to advance corporate social responsibility; activism to improve corporate governance; and activism as an investment strategy. For activists motivated by corporate social responsibility (typically non-governmental organisations), annual general meetings represent a forum to have voices heard and, in some cases, generate publicity for their cause. The tools employed by activists motivated by corporate social responsibility include ongoing discussions (or confrontations) with the corporation, and the use of shareholder proposals, which cover issues such as gender equity, political donations and environmental matters.

Activists motivated by improving corporate governance (typically institutional shareholders) are generally interested in governance issues such as executive compensation, director accountability and independence of boards and committees. Activists motivated by improving corporate governance also engage in ongoing discussions with the corporation and use shareholder proposals as a means of forcing corporations to adopt corporate governance practices. An example of a successful use of shareholder proposals to effect a change in corporate governance practices is the recent adoption of say on pay, or advisory votes on compensation, by at least 14 Canadian companies in response to a bombardment of shareholder proposals in 2009.

Finally, shareholder activists motivated by investment strategy (eg famed investors Kirk Kerkorian and Carl Icahn) are interested in high returns and will use aggressive activist mechanisms against their target corporations by taking significant equity positions in such targets and demanding changes designed to improve corporate performance, generally measured by the corporation's share price. Activists motivated by investment strategy typically do not hesitate to engage in a proxy battle to take control of a target's board.

The remainder of this article is devoted to issues that are generally advocated by shareholder activism directed at corporate governance improvements.

Majority voting

Voting for directors at most Canadian corporations is currently based on a plurality system, whereby shareholders cannot vote against directors at director elections. Rather, shareholders are only entitled to vote 'for' or 'withhold' their vote for director nominees. In a plurality system, 'withhold' votes do not count, and where the number of directors nominated for election equals the number of available seats on the board, a director could technically be elected with only one 'for' vote, which could come from the director himself. Journalist Duncan Hood's analysis in a 2009 edition of Macleans magazine is an oft-quoted critique of the plurality system of director elections: Hood hypothesises that if politicians were selected in the same manner that corporate directors are, 'it would be like introducing new rules for our next federal election that state you can either vote for Stephen Harper, or not at all. And as long as one person votes for him, he wins'. Further, even though a withhold vote in a plurality system is unlikely to prevent a director from being elected, shareholder activism targeted at individual directors often takes the form of 'withhold-the-vote' campaigns, as the symbolic loss of votes and the surrounding publicity are often a desired result for activists. Alternatively, activists may pressure a corporation to adopt a system of majority voting, or a derivative thereof, which is usually accomplished by a shareholder proposal to require that the corporation adopt some sort of majority voting policy. The Canadian Coalition for Good Governance estimates that currently there are 140 Canadian corporations and trusts that have adopted some form of majority voting policy, and many of the corporations that ultimately adopted a majority voting policy have done so due to varying degrees of activist pressure.

Majority voting can either be binding or non-binding. Under a binding majority vote, a director must obtain 50 plus one per cent of the votes cast for him or her in order to be elected to the board. Binding majority voting is often

criticised on the basis that such a system runs the risk of an insufficient number of directors being elected to govern the corporation. As a result, most majority voting policies are in actuality a modified director resignation policy, whereby directors who obtain less than a majority of 'for' votes must tender their resignations to the board, which then decides whether or not to accept such resignation. This non-binding type of majority voting is often referred to as a 'Pfizer-style' election, after the American company that first adopted it. Although the adoption of 'Pfizer-style' elections are a move closer to majority voting, many activists, including the Shareholder Association for Research and Education (SHARE), continue to advocate the adoption of a binding majority voting system, arguing that the potential problems created by majority elections are more than outweighed by the benefits of allowing shareholders to hold their board of directors accountable. Essentially, SHARE argues that the goal of director elections is for shareholders to actually elect directors, rather than simply confirming the choices of the board, and ultimately, a 'Pfizer-style' election gives the final word on director elections to the board and not to the shareholders.

Nonetheless, the criticism still remains that an activist 'withhold-the-vote' campaign against a corporation with a binding majority voting system can be potentially destructive to the corporation, particularly where such activists do not present alternative candidates, and particularly given the fact that the motivations of such activists (who are themselves for the most part unaccountable to the shareholders or the corporation) may be to pressure the corporation into short-term behaviour such as a high dividend policy or share buy-back programme. Still, it should be acknowledged that British companies elect directors by binding majority vote, and the British experience is that board vacancies as a result are rare.

Slate elections

Corporate and securities laws in Canada allow directors to be nominated and voted on as a slate, and where slate ballots are used, the only option available to shareholders is to vote 'for' or 'withhold' on the entire slate of director nominees, with no opportunity to vote on directors individually. It is estimated that between 40 and 50 per cent of the corporations listed on the Toronto Stock Exchange present a slate of directors rather than individual directors for elections. Slate ballot elections are often criticised as they tend to insulate individual directors from shareholder disapproval. This leads to the perception that individual directors cannot be held accountable in instances, for example, where a director has a poor attendance record at director meetings, or where a director is a member of a committee that is responsible for the implementation of corporate policy that shareholders do not agree with (eg a member of the compensation committee responsible for executive compensation, or as a member of an ad hoc committee, which recommended an unpopular transaction). Although the number of corporations that continue to use slate ballots for elections has declined consistently over the past several years, shareholder advisory groups such as RiskMetrics continue to monitor and develop recommendations in connection with the use of slate ballots.

RiskMetrics currently includes cautionary language in its analysis for corporations that use slate ballots, and in its 2010 Canadian Corporate Governance Policy Update, RiskMetrics has adopted the policy that it will recommend a withhold vote in the 'double trigger' circumstances where (1) slate elections are used, and (2) RiskMetrics has identified corporate governance or executive compensation standards that fall short of acceptable practices. Included in RiskMetrics' unacceptable corporate governance practices are: less than a majority of independent board members; less than a majority of independent directors on key committees; insiders on key committees; and, less than 75 per cent director attendance without acceptable reason. Included in RiskMetrics' unacceptable executive compensation practices are: abnormally large bonus payouts without justifiable performance linkage or proper disclosure; excessive perks; options backdating; employee loans; and poor disclosure practices. The RiskMetrics policy does not apply to contested elections.

Say on pay

Shareholder say on pay usually refers to an advisory vote on compensation, which is a non-binding resolution placed annually before the shareholders of a corporation and voted on to approve the corporation's compensation arrangements, which are described in the information circular distributed to shareholders in advance of the shareholder meeting. Companies may also adopt a formal

policy on shareholder say on pay, and at least one advisory group, the Canadian Coalition for Good Governance, has developed a model say on pay policy.

Advisory votes on compensation have been in existence in the United Kingdom since the early 2000s and in the United States since 2006. However, advisory votes on compensation will appear on Canadian corporation proxy ballots for the first time this year, following years of pressure from activist groups which culminated in 2009 with numerous shareholder proposals being presented to senior Canadian corporations requesting the adoption of advisory votes on compensation. In accordance with Canadian securities laws, corporations that received valid shareholder proposals duly placed the proposals before their shareholders at their respective annual general meetings. The proposals were passed at several large institutions, which ultimately led to at least 14 Canadian companies, including the major banks, agreeing to begin giving shareholders a non-binding vote on compensation packages in 2010.

In the United States, advisory votes on compensation are already mandatory for companies receiving federal bailout funds, and recently, House Financial Services Committee Chair Barney Frank introduced the 'Frank bill' to amend securities laws in the United States to require that public companies provide shareholders with an advisory vote on executive compensation. Shareholder activists in Canada are seeking to convince the Canadian Securities Administrators to follow suit and enact new regulations that would compel public companies to adopt advisory votes on compensation. It may be the case, however, that the Canadian Securities Administrators do not have the appetite for corporate governance initiatives at the moment, given the recent postponement of the Canadian Securities Administrators' initiative to overhaul corporate governance.

The adoption of advisory votes on compensation does not come without criticism, which includes the argument that advisory votes on compensation usurp the authority of the board's compensation committee that presumably is populated with persons qualified to consider the complexities of executive compensation and that has resources available to it that shareholders do not (however, one may find it difficult to conclude that Robert Verdun and his shareholder activist investor group MEDAC lack sophistication or resources to engage major Canadian corporations). An additional criticism is that advisory votes (for or against) do not provide useful guidance as to how to improve compensation policies. Finally, if compensation is approved by an advisory vote, the question remains open as to whether the board can then shelter behind shareholder approval and argue that shareholders can no longer complain about executive compensation.

For its part, RiskMetrics has released its guidance on advisory votes on compensation in its 2010 Canadian Corporate Governance Policy Update. RiskMetrics will recommend voting on a case-by-case basis, considering a number of factors in determining its recommendation to Canadian corporations. It is interesting to note that the factors that RiskMetrics analyses (which include the evaluation of peer group benchmarking, company performance and executive pay trends over time, and mix of fixed and variable compensation) appear to be closely tied to the new executive compensation disclosure requirements for Canadian public companies. Generally speaking, RiskMetrics will look at how a corporation's executive compensation is linked to performance, the corporation's compensation practices, and the board's communication and responsiveness to shareholders in considering its voting recommendations on advisory votes on compensation.

Conclusion

Increased shareholder activism, fuelled by the availability of legal tools to promote activist agendas, outrage over recent global economic events, and the emergence of sophisticated counsel and third party entities as key advisers, has led to the diminished pre-eminence of traditional corporate concepts of director primacy and the separation of ownership and control. There may be little that can be done to prevent action from activists who are diametrically opposed to the corporation's business, or activists who are aggressive investment strategists. However, there is really no substitute for good governance, good corporate disclosure, and a genuine and proactive shareholder communications programme. Taking such measures provides the right environment to ensure ongoing shareholder support for management and the incumbent board. Experienced counsel and advisers can assist with the development and implementation of such measures, and when push comes to shove and shareholder activists use the tools available to them under Canadian laws to force their hands, experienced counsel and advisers are essential in achieving desired outcomes.