DAVIES INSIGHTS

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GOVERNANCE

Davies Governance Insights

2016

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Executive Summary

The major theme of this sixth annual edition of *Davies Governance Insights* is the rise in importance of direct communication between boards of directors and public companies' shareholders, commonly referred to as shareholder engagement. In the current environment where the focus of sophisticated investors ranges across a wide spectrum of governance issues and long-term and shorter-term investment objectives, the benefits for an issuer of director-shareholder engagement are significant. Shareholder engagement can greatly assist a board in understanding how the balance of different, often conflicting, shareholder objectives and time horizons is represented among the issuer's shareholder base and, by extension, how to deal effectively with pressure from investors to change a company's governance or strategy. Engagement with a broad cross-section of a company's shareholders also facilitates a board's understanding of how its major shareholders may feel about various issues today's boards are charged with managing – including enhancing board composition and effectiveness, whether to facilitate some form of proxy access, improving board diversity, resolving compensation issues and responding to investor feedback on other plans or proposals being pursued by the issuer – all topics and trends we discuss in this report. It also assists in developing compromise solutions, which can prevent investor concerns from developing into public fights.

Another key message in this year's *Davies Governance Insights* is the need for issuers to continue to push hard to achieve greater diversity, not just on their boards but throughout their leadership ranks. Taking meaningful steps to grow the diversity of an issuer's leadership group not only expands the pool of individuals with an in-depth understanding of a company's strategies and challenges from which board and executive candidates may be selected but also sets the stage for more effective decision-making by boards and management and improved company performance. We believe the regulatory approach in this area will start to become significantly more prescriptive and stringent unless issuers show meaningful progress in their diversity objectives, beyond just articulating a desire to do so.

A final key theme of *Davies Governance Insights 2016* is the broad range of issues and risks which boards of directors must ensure are being appropriately managed – the rise in the number and complexity of issues faced by boards makes performing director duties more onerous than ever. From topics such as director "overboarding" to proactive succession planning, managing bribery and foreign corruption and cybersecurity risks, and considering and responding to shareholder proposals, each board must remain focused on ensuring the company has the expertise available to understand, manage and mitigate a wide range of issues and risks, and to identify and respond to new challenges as they emerge.

This edition provides boards, general counsel and investors with important information about the top governance developments and trends we observed in 2016, including "our take" — practical advice at the end of each chapter focusing attention on the steps that should be taken or considered in response to the various issues.

Our corporate governance experts can help your board, committees and senior management customize the right solutions to remain in compliance with current corporate governance trends and requirements. For assistance or more information on any of the issues raised, contact one of our experts listed under "Key Contacts" at the end of this report.

For details concerning our research methodology and the source of data relied on for purposes of our analysis, see "Database and Methodology" near the end of this report.

01 Shareholder Engagement: Boards Must Set Priorities and Establish a Framework

01 Shareholder Engagement: Boards Must Set Priorities and Establish a Framework

Shareholder engagement by public companies continues to increase. Shareholder-director engagement has become one of the main focal points for institutional investors and others and is now widely considered a key component of good corporate governance practices. Boards should discuss and map out a framework for engagement that works for the company, including whom they will engage with and when, and appropriate topics for engagement.

Developments in Canada: Warming up to shareholder engagement

The evolution in Canada's corporate landscape has led shareholders and Canadian public company boards alike to review their current approaches to shareholder engagement. These changes include a more intense focus on issuers' corporate governance practices, greater degrees of active investment management by institutional investors, a rise in activist investing and proxy contests, the increased use of proxy advisory services, and more and more institutional investors developing their own voting guidelines. Historically, engagement was limited to annual and quarterly disclosures and filings and, perhaps, engagement at annual general meetings (AGMs) or annual investor days. Today, those interactions are viewed as a minimum baseline effort and, increasingly, significant investors are expressing their desire to directly engage with Canadian issuers' directors, on a variety of governance-related topics.

In this climate, investors, proxy firms and other market participants are emphasizing the importance of improving and increasing the dialogue between directors and shareholders. Institutional Shareholder Services (ISS), Glass Lewis & Co. (Glass Lewis) and Kingsdale Shareholder Services Inc. (Kingsdale), panellists at Kingsdale's April 2016 Governance Summit, highlighted these trends and agreed that nuanced approaches to engagement can be a powerful proactive defence against activism and shareholder dissatisfaction.

The Canadian Coalition for Good Governance (CCGG) also continues to advocate for enhanced engagement and ongoing dialogue with shareholders — as discussed below in "Proxy Access: Flood in the United States Yet to Spill Over into Canada", engagement can go so far as giving investors director nomination rights in the form of proxy access bylaws.[1] To date, proxy access has not achieved the level of broad-based support in Canada that we are seeing in the United States; however, increasingly, engagement includes at least discussing board composition and obtaining feedback on management's director nominees from investors. Some Canadian issuers have specifically included a procedure for investors to provide, albeit informally, proposed nominees for inclusion on board "evergreen" lists in their engagement policies.

In March 2016, the Institute of Corporate Directors (ICD) published guidance to help boards of Canadian public companies develop an engagement approach to corporate governance between directors and significant shareholders. The ICD endorsed the 2014 U.S. Shareholder-Director Exchange (SDX) Protocol, which we discussed in detail in *Davies Governance Insights 2015*.[2] SDX encourages boards

01 Shareholder Engagement: Boards Must Set Priorities and Establish a Framework

> **The ICD views the lack of a standard shareholder engagement framework as one of the greatest obstacles to increased dialogue between directors and significant shareholders of Canadian public companies.**

to adopt a clear policy on the way they will approach engagement, identify potential engagement topics and seek out and prepare for investor engagement. The ICD viewed the lack of a standard framework as one of the greatest obstacles to increased dialogue between directors and significant shareholders of Canadian public companies. ICD's guidance is in many ways consistent with the SDX Protocol but designed to account for the unique aspects of Canada's markets, and it contemplates issuers adopting a proactive and consistent shareholder engagement strategy involving regular meetings between shareholders and board members.[3]

Global developments: Shareholder engagement is a focal point

As in Canada, shareholder engagement by public companies in the United States and the European Union has continued to increase over the past year and has become a focal point.

In July 2016, a group of 12 U.S. CEOs, including those from GE, Berkshire Hathaway and major institutional investors such as BlackRock and Vanguard, released an open letter titled *Commonsense Corporate Governance Principles*.[4] According to these principles, directors have a responsibility to engage in robust communications with the company's shareholders on key governance and shareholder issues. PwC's *2015 Annual Corporate Directors' Survey* noted that 69% of U.S. company directors now say they participate in direct communication with institutional shareholders, compared with 62% in 2012.[5] Sixty percent of directors surveyed say their companies have established or discussed protocols regarding permissible topics for discussion between directors and shareholders, as well as the process by which shareholders can request direct dialogue with the board.[6] PwC's analysis of 2016 U.S. proxy statements revealed that 64% of 100 S&P 500 companies disclosed that they engaged with shareholders, with the same number reporting that they took some action as a result of the engagement.[7] Further, and as discussed below in "Proxy Access: Flood in the United States Yet to Spill Over into Canada", shareholder proposals on proxy access are expected to increase in the United States, prompting recommendations for additional shareholder engagement in this area.[8]

In the European Union, the European Parliament adopted amendments to the European Commission's proposal to revise the Shareholders' Rights Directive, introducing new measures aimed at encouraging engagement between publicly traded companies and their shareholders that will take effect in 2016.[9]

Shareholder engagement, and particularly engagement between shareholders and directors, is increasingly a global trend that can be expected to gain momentum into 2017. With Canadian shareholders becoming much more proactive and shareholder engagement being one of the top issues for investors, the need for a proper shareholder engagement strategy, whether formal or informal, is critical. However, there is no one-size-fits-all solution, and many companies are developing their own context-based approach.

Below are some important considerations to bear in mind as Canadian issuers start to formulate an approach to shareholder engagement.

Engagement between shareholders and directors is expected to gain momentum into 2017.

OUR TAKE: BOARDS MUST DEVELOP AN APPROACH TO SHAREHOLDER ENGAGEMENT

Shareholder engagement offers boards the opportunity to gain insight into significant shareholders' priorities and concerns, while building relationships that may be leveraged later should the need arise — for example, in any future proxy battle, say-on-pay vote, contested director election or other forms of activism. Here are seven key principles that boards should strive to observe when developing an approach to shareholder engagement.

1. **Develop a shareholder engagement framework or policy.** As a best practice, consider developing and adopting a written policy on how the board intends to engage with its shareholders and communicate it to your shareholders. The board's engagement efforts are intended to complement, not displace, the CEO's, management's and investor relations professionals' primary responsibilities in this area. In the absence of a formal policy, boards should at least consider developing a framework for engagement that sets out the parameters for whether, when and how they will engage with investors, both in the regular course of business and when faced with investor demands to do so or in special situations.

2. **Communicate continually with shareholders.** Effective shareholder engagement involves ongoing communications with shareholders, rather than reliance on scheduled shareholder events, such as AGMs or quarterly and annual public disclosures. Those channels are largely now considered only a baseline; investors expect frequent dialogue. Communication protocols should be simple and accessible, and key contacts should be established and disclosed to shareholders. The board, management and investor relations professionals should be kept well apprised of the "rules of engagement".

3. **Know your shareholders.** Through management briefings, and with the assistance of proxy solicitors when appropriate, the board should be updated on the company's most significant shareholders, including the size of their share positions (including any material short positions), their investment rationales, their general investment strategies and track records, the structure of their decision-making processes, how they vote their shares and whether they involve proxy advisory firms, as well as any material policy guidelines or restrictions established by the investors.
4. **Use different approaches and formats.** In formulating an approach to shareholder engagement, a board should consider the format of meetings with different types of shareholders. Individual meetings may be preferable to group meetings when there is a high level of divergence in shareholder perspectives and/or objectives or when the board desires to build goodwill with a significant shareholder. Group meetings, perhaps even web-based, may be more appropriate when the board chooses to engage with smaller shareholders or those with common interests or concerns. In any case, the framework should be flexible and take into account the unique circumstances of the company, including during different business cycles.
5. **Prepare for meetings.** Adequate preparation before meetings is critical. Being prepared not only maximizes the effectiveness of the communications but also assists the board in managing the potential risks of engagement, such as selective disclosure and tipping. Participating board members should be briefed by management and, in some cases, legal counsel before meetings. Attendees should have good information on the shareholders they are meeting, understand their issues of concern and be armed with potential responses prior to scheduled meetings.
6. **Define the issues/topics for discussion.** Director-shareholder engagement is most effective on governance-related topics such as board oversight of the company's strategy, risks and internal controls, the board's composition and decision-making processes, succession planning and executive compensation. The CEO and/or other members of the management team should not be present for discussions on CEO compensation or performance but can be present for other discussions. In most instances, operational matters are best left for management to discuss. Market-sensitive or material non-public information that will not be discussed should be identified. It would be prudent to clarify expectations regarding confidentiality with shareholders in advance.
7. **Regularly review your shareholder engagement strategies.** Boards should keep a record of their engagement activities and investor communications. Follow-up with shareholders and providing transparency on engagement are also key – engagement does not stop once the discussion has been held.

Solicit feedback from engaged shareholders, where possible, and review engagement strategies at the board level at least annually and reuse as needed.

As companies develop their approach to shareholder engagement, both the ICD guidance and the SDX Protocol provide useful road maps of important elements that the board and/or governance committee should consider. If your organization is considering a shareholder engagement strategy or policy, our team of governance experts can assist to ensure that you strike the right balance and do not inadvertently run afoul of corporate and securities laws.

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Active Investing, Proxy Contests and Long-Term Capital

Shareholders in public companies vary dramatically in their investment goals and strategies, from long-term capital institutions to active institutional investors to activist-focused funds. All have strong arguments for their approach but various shareholders may advocate at their investee companies for fundamentally different strategies. Boards must engage with the full spectrum of their shareholders to understand better how to balance these competing interests.

Activism, performance and governance

One of the challenges faced by public companies and their boards remains the fact that shareholders are not a monolithic class. Not all institutional investors have the same objectives; some advocate for long-term investing, others for active investing, and not all activist investors are focused solely on short-term gains. Shareholders and their interests and priorities vary, and boards and senior management of public companies will continue to face different and often conflicting demands.

Active investing continues to be a major investment sector in 2016 in Canada as elsewhere. While this year has seen a decline in public proxy contests (discussed below), other techniques to achieve board change such as non-public activist efforts, though difficult to quantify, are on the rise in Canada.

Replacing a portion of an issuer's board is one of the many objectives sought by active investors. Other outcomes activist investors may seek include promoting or blocking a particular transaction or encouraging management to return capital to shareholders through stock buy-backs, dividends and other near-capital returns, such as by decreasing spending on research and development or on employment. Activist investors vary widely in their objectives and approaches, which makes it very important for boards to engage with their shareholders and understand their perspectives.

In 2016, we saw a significant decline in proxy contests, with 21 campaigns publicly announced by the end of August 2016, compared with 55 in 2015.

Proxy contests decline

The year 2016 in Canada saw a significant decline in the number of proxy contests, with only 21 campaigns having been publicly announced as of the end of August 2016, compared with 55 in the year 2015.[10] Consistent with past years' trends discussed in our *Davies Governance Insights* reports, management wins continue to represent a slight majority of the cases, and activist shareholders are increasingly seeking minority board representation, rather than to replace a majority of directors or to compel or defeat a transaction. Also consistent with prior years, public proxy contests in Canada continue to be focused primarily on the resource sector and on Canada's smaller-market-cap companies.

In addition to being influenced by changes in market and economic conditions, the decline in proxy contest numbers is largely due to activists increasingly seeking only "short slate" board representation in their campaigns and to the growing trend of increased engagement by boards with their investors. This latter trend has, in turn, been driven partly by past public successes by activists,

which have motivated boards to engage privately and implement changes where a convincing case is made by the activist. The result is that shareholder concerns are now frequently voiced and negotiated behind the scenes, and board representation or other changes are agreed to between the activist and the issuer without a public announcement or formal proxy contest. In effect, the result is board renewal or some other activist "win" driven by the shareholder without the need to launch a formal contest or take the dispute public. And the influence of activists, coupled with the increased focus of regulators, investors and other market participants on corporate governance and shareholder democracy, has prompted many public companies to be proactive in addressing perceived problems in advance, in an effort to ward off activist overtures before they even arise.

Key activism trends and issues

Recently, in *Davies Shareholder Activism and Proxy Contests: Issues and Trends*,[11] we discussed the activism trends in Canada and some of the principal issues and challenges faced by both activists and target companies. In our report, we also highlighted notable differences between Canadian and U.S. activist campaigns and the legal environment in which activists operate. For more details, please consult our report by clicking *here*. Topics covered include:

- the right to requisition a shareholders' meeting
- stake-building and beneficial ownership reporting
- group formation: insider trading and joint actor characterization
- selective disclosure
- empty voting
- short slate proposals
- limited private proxy solicitation and advance notice bylaws
- public proxy solicitation and the broadcast exemption
- compensation arrangements for director nominees
- universal proxies
- vote buying: soliciting dealer fees in proxy contests
- regulatory developments with respect to proxy advisory firms

Institutional investors and long-term capital

In response to the rise in activist activity over the past 10 to 15 years, particularly in the United States but also in Canada and globally, a small but influential group of market participants are publicly urging companies and their boards to readopt a greater emphasis on long-term profitability. In the United States, large institutional shareholders BlackRock, State Street, Berkshire Hathaway, Vanguard and a number of other major institutions are publicly articulating their perspectives and expectations on matters that they perceive as being critical to refocusing on long-term interests. For example, long-termism is one of the major themes underlying the *Commonsense Principles of Corporate Governance*, released this past summer by those and other significant investors, as well as by major U.S. issuers GE, General Motors Company and Verizon. The stated purpose of those principles is to provide a framework for "sound, long-term-oriented governance".[12] The principles include several recommendations intended to foster a renewed focus on long-termism, including a suggestion that boards should consider whether providing earnings forecasts is appropriate or does more harm than good.

A small but influential group of market participants is advocating for issuers to refocus on long-term strategy and value creation.

Separately, Larry Fink, the CEO of BlackRock, continues his engagement campaign with the CEOs of S&P 500 companies to implement a strategic framework for long-term value creation. To generate sustainable returns over time, Fink suggests that companies need to revisit and curtail inflated dividend payouts in favour of long-term investments, such as reallocating funds to research and development.

The "short term" versus "long term" debate also received amplified attention this year in the U.S. presidential campaign, when Hillary Clinton advocated proposals to combat "quarterly capitalism" through mechanisms such as capital gains tax reform, and linked short-termism to broader concerns about the growing income disparity gap.[13]

In Canada, an initiative called Focusing Capital on the Long Term (FCLT) was co-founded in 2013 by the Canada Pension Plan Investment Board (also a signatory of the U.S. *Commonsense Principles of Corporate Governance* initiative) and McKinsey & Company. Its aim is to combat short-term strategies perceived to be entrenched in today's markets, with a view to advancing practical actions to focus business and markets on the long term. FCLT argues that the "relentless focus on short-term performance and hypersensitivity to the current news cycle" have distorted asset prices and market volatility in general, which in turn undermines corporate investment, holds back economic growth and lowers

returns for savers.[14] FCLT lays part of the blame for this short-termism on boards themselves, not just shareholders. FCLT founders Mark Wiseman and Dominic Barton believe, among other things, that boards should battle short-termism by doing the following:[15]

- Ensure boards select the right members with a diversity of opinion, proven experience and functional expertise, with an emphasis on identifying individuals with a track record for independent thinking.
- Spend more time on value-added topics such as long-term strategy and less time on "non-value adding governance items of which there are many".
- Engage with long-term investors and facilitate discussions about long-term strategies and metrics, not just short-term issues such as compensation and say-on-pay.
- Compensate directors for long-term performance and pay directors more for the additional time they need to spend performing their duties, but structure that compensation in the form of long-term incentives, such as significant equity investments in the companies they manage.

Six of the world's largest institutional investors released a statement supporting the LTVC Index, and several committed to allocate about US$2 billion to funds tracking the index.

FCLT's mission led to the launch in January 2016 of a newly formed S&P Long-Term Value Creation Global Index (LTVC Index) in cooperation with six of the world's largest institutional investors and in collaboration with the S&P Dow Jones indices. The LTVC Index is designed to select and track companies selected through qualitative and quantitative analyses. Qualitative criteria for inclusion in the LTVC Index factor in the effectiveness of corporate governance through a demonstrated ability to manage both current and future economic and governance opportunities and risks by focusing on a long-term strategy. The quantitative criteria consider a company's sustained history of financial quality and long-term investment returns.

Six of the world's largest institutional investors released a statement in support of the LTVC Index, and several have committed to initially allocate about US$2 billion to funds tracking the index. As of June 2016, the LTVC Index tracked over 240 diverse companies across 10 sectors, including consumer staples, industrials, healthcare and financials. The LTVC Index includes some Canadian companies such as Royal Bank of Canada, Telus and Canadian National Railway. Over 100 institutional investors have devoted funds to the LTVC Index, including pension funds and asset managers; however, it remains inaccessible to retail investors. A proposal has also been made in the United States to establish a long-term stock exchange with listing requirements intended to correlate to long-term profit sustainability.[16]

OUR TAKE: BOARDS AND ALL MAJOR SHAREHOLDERS SHOULD ENGAGE AND UNDERSTAND EACH OTHER'S PERSPECTIVES, REGARDLESS OF PERCEIVED TIME HORIZONS

In light of the diversity of priorities and objectives of today's investors, and the conflicting demands these may place upon boards, it is increasingly important that boards and investors engage in dialogue to understand each other's goals and perspectives. While, in practice, a company's largest institutional shareholders are more likely to hold a long-term perspective and may, given their size, resources and shareholdings, incline boards to become more aligned with their views as opposed to those held by the rest of their investor base, boards need to carefully consider the goals and priorities of all major shareholders, in both the near term and the long term. This means listening to all significant investors with short- and long-term objectives, including activist investors, and thoughtfully considering the relative pros and cons of their proposals for the business, in the context of management's current strategies and plans.

In addition to spending more time engaging with investors, boards should ensure that they are allocating sufficient time on their agendas to discuss and develop responses to investor feedback, and to identify and articulate their own internally developed strategies. Having quarterly board meetings to discuss typical annual disclosures and quarterly reporting may, for many investors, be perceived as being insufficient and falling short of directors' duties to the company and its investors.

Boards need to carefully consider the short- and long-term goals and priorities of all major shareholders.

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Proxy Access: Flood in the United States Yet to Spill Over into Canada

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Proxy Access: Flood in the United States Yet to Spill Over Into Canada

In contrast to Canadian issuers' experience to date, large U.S. issuers are increasingly expected to have proxy access measures in place. Boards of Canadian issuers should be aware of this trend and continue to focus their efforts on shareholder engagement, including investor feedback on their board composition and director nominations. Canadian issuers can expect to face more pressure from their investors, whether through demands for proxy access or in other forms, to facilitate shareholder input into the director nomination process.

Issuers will face increased pressure to facilitate shareholder input into director nominations

Shareholders elect directors. But management usually nominates the directors put forward to shareholders for election. "Proxy access" is one means by which significant shareholders (or groups of shareholders) can formally insert themselves directly into the director nomination process – by having their nominees included in management's proxy materials. Proxy access has risen in prominence because it gives those investors a say in director nominations without the expense of having to mount a dissident proxy campaign. In the United States, issuers frequently face proposals by their investors (both formally and via back-channel engagements) to adopt proxy access bylaws; the 2015 proxy season was described as the year the U.S. "proxy access floodgates" opened. To date, this trend has not yet emerged in Canada, but Canadian boards should remain cognizant of the issue. We expect that Canadian issuers will face increased pressure to facilitate direct shareholder involvement in the director nomination process, whether through formal shareholder proposals (in the longer term) or through shareholder engagement mechanisms (in the short term).

Proxy access gives significant investors a say in director nominations without the expense of mounting a dissident proxy campaign.

U.S. experience: Floodgates open for proxy access

As we described in *Davies Governance Insights 2015*,[17] proxy access was the top corporate governance issue in the 2015 U.S. proxy season. According to a recent report by Ernst & Young LLP, in 2016 proxy access was the most common subject of shareholder proposals for U.S. issuers.[18] In a recently published market survey, a major U.S. law firm predicts that in the coming year, a majority of S&P 500 issuers will have adopted proxy access measures.[19]

The recent history of proxy access in the United States began in 2010, when the U.S. Securities and Exchange Commission (SEC) adopted a formal proxy access rule. Opponents successfully challenged, and the U.S. Court of Appeals struck down, the rule. Then, in late 2014, New York City Comptroller Scott M. Stringer, on behalf of the New York City pension funds he oversaw (valued at US$160 billion), announced a campaign dubbed the "Boardroom Accountability Project".[20] As part of the campaign, he submitted proxy access proposals to 75 U.S. issuers. The proposals were based on the defunct SEC rule and contemplated that shareholders collectively holding 3% of an issuer for at least

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three years could nominate up to 25% of the board using management's proxy materials. The campaign was remarkably successful: the number of U.S. issuers that have adopted proxy access has gone from just four before the campaign[21] to over 240 today.[22]

The number of U.S. issuers that have adopted proxy access as a result of 2014's Boardroom Accountability Project has gone from just 4 to over 240 today.

The most typical U.S. proxy access bylaw imposes the following criteria in order for a shareholder (or shareholder group) to be eligible to have its director nominee(s) put forward in management's proxy materials:

- minimum ownership threshold of 3%
- minimum holding period of three years
- maximum cap on shareholder appointees to the board of between 20% and 25%
- maximum limit of 20 shareholders in a nominating group

A majority of U.S.-style proxy access bylaws also include clauses that restrict the use of proxy access in the wake of a proxy contest. Many also include provisions requiring nominating investors to hold full economic and voting ownership of the subject shares, count incumbent investor nominees for purposes of determining the maximum number of investor nominees eligible in any given year and prohibit the resubmission of investor nominees who previously failed to receive a prescribed level of shareholder support for their election. Less consistently, some bylaws also require loaned shares to be recalled (or be subject to a right of recall) to qualify toward calculating the minimum share ownership threshold.

With the flood of proxy access proposals, proxy advisory firms ISS and Glass Lewis have adopted U.S. voting guidelines on acceptable proxy access measures (they can be found here and here, respectively).[23]

Despite the rising prevalence of proxy access bylaws in the United States, we understand that no shareholder has yet used a proxy access right to nominate a director.[24]

Canadian experience: Only talk of a flood

The Canadian experience has been different and no "flood" has yet emerged here, although there is no question that the topic has been seriously discussed over the past two years, and proxy access is gaining traction with some institutional shareholders in Canada. And we believe the focus in Canada on proxy access will grow in coming proxy seasons.

Proxy access is generating considerable debate in Canada; in May 2015, CCGG proposed its own proxy access standard,[25] and in October 2015, the Institute for Governance of Private and Public Organizations published a paper opposing any new proxy access standards.[26] Despite these discussions and debates, during the 2016 Canadian proxy season, not a single shareholder proposal to implement proxy access was put forward for a vote by shareholders of a Canadian issuer on the Composite Index or SmallCap Index. In our view, two principal factors account for this lack of proxy access proposals.

First, the legal regime in Canada is distinct from that of the U.S. Most Canadian corporate laws already include some form of proxy access. For example, the *Canada Business Corporations Act* (CBCA) and most provincial corporate statutes permit shareholders holding at least 1% or $2,000 worth of the issuer's voting shares for at least six months to submit a shareholder proposal with nominations for the election of directors. Subject to certain exceptions, the issuer is required to include or attach the proposal to management's proxy circular. The nomination can also include a supporting statement of up to 500 words. In addition, shareholders holding 5% or more of the shares entitled to vote at a meeting can requisition the issuer to call a special meeting; activist investors have frequently used this requisition right over the past several years to nominate their proposed directors in lieu of some or all of management's nominees. Although these mechanisms do not align perfectly with the proposed proxy access mechanism advocated by CCGG, they nevertheless provide powerful tools to investors. Moreover, the frequently cited impediments to shareholders exercising their director nomination rights in the United States, such as staggered boards, are, in practice, non-existent in Canada in light of Canadian corporate laws and Toronto Stock Exchange (TSX) rules prohibiting the practice.

Proxy access continues to generate considerable debate in Canada.

Second, while discussions concerning proxy access to date have typically followed the U.S. formulation, there are significant distinctions between the Canadian and U.S. markets, which may suggest that U.S.-style proxy access is not appropriate for the Canadian market. The smaller Canadian market, smaller market capitalizations of Canadian issuers and the fact that shares of Canadian issuers tend to be less liquid and more frequently controlled by significant investors than is the case in the United States serve to magnify the influence of institutional shareholders in Canada. These unique qualities of the Canadian market also make it easier for institutional investors to meet the relevant 5% ownership threshold to requisition a meeting or the 1%/$2,000 threshold to submit a shareholder proposal to nominate directors. As a result, these investors carry significant clout in Canada, and issuers may already be more prone to pay attention to their concerns.

03 Proxy Access: Flood in the United States Yet to Spill Over Into Canada

So does all of this mean that proxy access is an issue that Canadian boards can ignore? We think not. Despite the lack of Canadian proxy access proposals in the past two proxy seasons, the issue remains under focus and investors continue to seek ways to have more meaningful input into the director nomination process and to better understand how those views are taken into account by the companies they own.

Shareholders are demanding more meaningful access to the director nomination process.

OUR TAKE: BOARDS SHOULD SEEK SHAREHOLDER INPUT INTO BOARD COMPOSITION AND DIRECTOR NOMINEES

Proxy access has gained considerable traction in the United States. Boards of Canadian issuers should keep abreast of these U.S. developments. If proxy access gains momentum north of the border, boards will benefit from the lessons learned in the United States.

Whether or not proxy access measures are implemented, boards should avoid being taken by surprise by the nomination of a director by a shareholder. Shareholders are increasingly demanding more meaningful input into the director nomination process, in some form. Failure to facilitate or even consider these desires or to develop appropriate ways to respond to them can result in adverse consequences, including shareholder proposals, criticism from investors and proxy advisory firms, reputational damage, proxy contests and low (or less than majority) levels of support for management's director nominees. We recommend that Canadian boards and their general counsel consider the following actions to mitigate the risks of such outcomes.

1. **Implement a shareholder engagement policy.** Effective communication is vital. Consider implementing a comprehensive shareholder engagement policy, and keep it updated. These policies can and increasingly do include guidance for investors on how they can provide input into the director nomination process and how the issuer will consider and respond to that feedback. For example, some issuers allow investors to submit director nominees for inclusion in "evergreen" lists maintained by their board. See "Shareholder Engagement: Boards Must Set Priorities and Establish a Framework" above for more details.
2. **Engage with shareholders.** Once the issuer has adopted a shareholder engagement policy, or even in the absence of a formal policy, the board should ensure that it is actually engaging with the issuer's major shareholders to understand their views on various governance topics, including board composition and effectiveness. As discussed in

"Shareholder Engagement: Boards Must Set Priorities and Establish a Framework", facilitating direct shareholder engagement remains one of the top governance concerns for many investors, and, in our view, boards should consider implementing an engagement process in some form (which will vary from issuer to issuer).

3. **Implement a robust director evaluation and nomination process.** Ensure that the director nomination process implemented by the nominating committee is robust and defensible. Management's board nominees should reflect an appropriate depth and breadth of experience and diversity, and the nominating committee should take into account input from shareholders when selecting director nominees. Only high-calibre individuals who will be able to effectively supervise management of the issuer should be nominated. Once nominated, the board as a whole and each individual director should be subject to a rigorous evaluation process and, as part of that process, feedback should be considered from shareholders regarding the composition and effectiveness of the issuer's board members.

4. **Use management's proxy circular as a communication tool.** In addition to providing shareholders with prescribed information, the proxy circular is a valuable tool that can be used to effectively communicate with shareholders. Use the proxy circular to provide greater transparency about the issuer's director nomination process, including (1) how the nominating committee or particular directors participate in shareholder engagement activities and (2) how shareholder input factors into assessing and recommending director nominees for consideration by the board and shareholders.

04

Shareholder Proposals: Canadian Issuers Face Shareholder Proposals on a Variety of Topics

04

Shareholder Proposals: Canadian Issuers Face Shareholder Proposals on a Variety of Topics

Over the past three years, a greater number of Canadian public companies have faced shareholder proposals on a variety of topics. In contrast to historical practices, no longer are financial institutions the primary targets. Perceived deficiencies in issuers' gender diversity and executive compensation practices continue to be the most common topics of shareholder proposals put to Canadian companies. More issuers can expect to face shareholder proposals, particularly if they have ongoing deficiencies in key areas under investor scrutiny.

Shareholder proposals continue as a tool for expressing shareholders’ views

In 2016, shareholders of Canadian public companies continued to be active in making their views known through the use of the shareholder proposal regime under Canadian corporate law. When an issuer receives an eligible shareholder proposal (typically made by a shareholder holding over 1% of the outstanding voting securities with a fair market value of at least $2,000 and held for at least six months), the issuer must include it in its management proxy circular and agenda for its upcoming AGM. However, shareholder proposals need only be presented as recommendations. A board is not legally compelled to implement a proposal even if it is approved by a majority of shareholders; in practice, however, this may have negative implications for the issuer.

The following were the most common topics presented by shareholder proposals in Canada in 2016:

- increasing female representation on the board, in senior management or generally
- streamlining and simplifying financial information and financial reporting
- disclosing voting results separately for each class of shares
- requiring an advisory "say-on-pay" vote on executive compensation, or seeking corrections to perceived deficiencies in compensation policies or practices
- paying a fair share of taxes
- establishing term limits on directors’ tenure

As Table 4-1 indicates, although 2015 saw a surge in the number of shareholder proposals, in 2016 their number has reverted to the more moderate levels witnessed in previous years. However, the number of issuers receiving shareholder proposals has remained relatively constant year over year. Perhaps the most important trend we have observed over the past three years is that financial institutions are no longer the main targets of shareholder proposals, as was historically the case. In today’s market, a variety of issuers in different industries are facing shareholder proposals on governance-related and other topics, with the principal areas under investors’ focus being issuers’ lack of board and/or executive diversity and deficiencies in executive compensation practices.

TABLE 4-1: NUMBER OF SHAREHOLDER PROPOSALS, ISSUERS AND AVERAGE "FOR" VOTES

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

Low levels of support for shareholder proposals

Despite the rise in the number of issuers facing proposals over the past three years, in 2016 there were only three successful proposals, compared with eight in 2015. Table 4-2 sets out those proposals put to shareholders this year that received more than 50% of the votes in their favour.

TABLE 4-2: SHAREHOLDER PROPOSALS WITH MAJORITY SUPPORT IN 2016

Issuer	Shareholder proposal	% votes "For"
Cogeco Inc.	Disclosure of Voting Results per Share Category	93.0%
Suncor Energy Inc.	Report on Climate Change	98.0%
Transat A.T. Inc.	Disclose Corrections Made in the Executive Compensation Policy	100.0%

The average percentage of votes cast "For" shareholder proposals in 2016 was 13.8%. However, this average was partly skewed because of the three successful proposals being approved by shareholders with overwhelming support. Among the remaining proposals not approved by shareholders, the average level of

support was lower this year, at 7%, compared with 11% last year and less than 10% in prior years.

Although 47 shareholder proposals were put forward in the 2016 proxy season, consistent with prior years, they were made by only a handful of organizations. In some cases, the proposers chose one or two issues and put the same proposal forward to a number of issuers. In other cases, the proposal was tailored to the specific issuer.

One trend we have not yet observed in Canada but are witnessing in the United States is the rise in shareholder proposals seeking to have issuers adopt proxy access bylaws to allow director nominations by shareholders holding a minimum percentage of shares, up to a certain number or percentage of the issuer's board seats. We discuss this topic earlier in this report under "Proxy Access: Flood in the United States Yet to Spill Over into Canada".

> **Although 47 shareholder proposals were put forward in the 2016 proxy season, consistent with prior years, they were made by only a handful of organizations.**

Number of withdrawn shareholder proposals on the rise

Beyond the 47 proposals that proceeded to a shareholder vote in 2016, an additional 24 proposals made to 11 issuers were withdrawn before each issuer's AGM, compared with nine withdrawn proposals made to seven issuers in 2015.[27] These proposals focused on the following topics:

- recommending an approach to corporate philanthropy
- concerning some aspect of executive compensation
- requiring disclosure of political spending and lobbying
- requesting that the issuer implement a diversity policy
- reporting on the steps to improve customer service
- establishing limits on directors' tenure
- proposing that the issuer pay a fair share of income taxes
- simplifying financial information
- disclosing voting results separately for each class of shares

The rise in the number of withdrawn shareholder proposals may be due to increased shareholder engagement, as public companies face more demands to facilitate direct engagement between the investor and the issuer's board and/or senior management. As a result of these trends, it is likely that proponents of shareholder proposals are enjoying more opportunities to engage in dialogue

with the issuer and successfully reaching agreement with the board on the topic of the proposal before taking it to a shareholder vote. In almost all cases of withdrawn proposals, the issuers indicated that proposals were withdrawn "after discussions with the issuer". Despite this, withdrawn proposals were still often included in the management proxy circular alongside the issuer's response.

! OUR TAKE: MORE ISSUERS ARE LIKELY TO FACE SHAREHOLDER PROPOSALS ON VARIOUS TOPICS

> An effective shareholder engagement policy is one of the most important tools to forestall shareholder proposals.

In today's markets, boards of Canadian public companies in all industries should expect a higher likelihood of receiving shareholder proposals, given that investors are increasingly sophisticated, have greater resources and access to information, and are demanding more input into the governance and operations of the companies in which they invest. This is particularly the case where public companies exhibit perceived deficiencies in areas under scrutiny by investors, such as a lack of gender diversity in their leadership or overly risky or excessive executive compensation practices.

Boards are advised to engage with proponents of shareholder proposals, give the proposals due consideration and address the relevant issues in the management proxy circular as a means of communicating with the shareholder base at large. One of the most important tools to forestall shareholder proposals is to have an effective shareholder engagement policy, allowing boards to identify and respond to investor concerns before investors take more formal action to have their voices heard.

05
Gender Diversity: It's Time to Get on Board

05 Gender Diversity: It's Time to Get on Board

Gender diversity has been one of the top governance issues under the spotlight in Canada for the past several years. Despite greater disclosure required of issuers in this area, the progress in increasing the number of women on boards and in executive positions remains slow, and regulators are calling for more action. General counsel and governance committees should consider taking more steps to improve the diversity of their corporate leadership, including adopting a board diversity policy and considering whether aspirational targets are necessary.

Lack of gender diversity remains a top governance issue

Now over a year into Canada's "comply or explain" disclosure regime on gender diversity for Canadian boards and executives, many companies have taken some steps to improve their leadership diversity and have been providing enhanced disclosure about what they are doing to promote the representation of women. However, the rate of progress in this area remains slow. Canadian securities regulators and governments remain focused on the issue and continue advocating for more concrete action; they are generally unhappy with the lack of formal processes that Canadian companies have put in place to implement meaningful change. Investors are also becoming more vocal and demanding that companies do more to improve their leadership diversity. Canadian companies can therefore expect to face increased pressure to do more than pay lip service to the importance of diversity within their organizations. Actionable steps are needed in the wake of regulators' threats that more stringent requirements, including targets, may be introduced if companies fail to take the issue more seriously.

Canadian companies can expect to face increased pressure to do more than pay lip service to the importance of diversity within their organizations.

Women remain significantly under-represented

Over the past several years, our *Davies Insights*[28] reports have discussed the heightened focus by investors and regulators on improving gender diversity in Canadian public companies. Those prior editions detailed the background and developments in this area, citing studies and research supporting the business case for improving diversity. In *Davies Governance Insights 2015*, we provided extensive data and analysis about issuers' progress in improving gender diversity, as well as the relative strengths and weaknesses of their practices following the increased comply-or-explain disclosure requirements implemented by the Ontario Securities Commission (OSC) and most other Canadian securities regulators in 2015.

Comparing issuers' practices from year to year, we can clearly see that progress remains slow. Women remain under-represented among boards and executives of Canadian public companies relative to their proportion of the population, the number of women graduating from university and other metrics. In addition, Canada is still lagging behind many other advanced economies, falling from 6th place (in 2009) to 15th (in 2015) out of 23 industrialized economies in terms of gender diversity on corporate boards, according to a report from the Canadian Board Diversity Council. And much of the blame is alleged to lie at the feet of

05 Gender Diversity: It's Time to Get on Board

Canada's resource-centric economy, where women typically have the lowest levels of representation in leadership.[29]

Against this backdrop, what really are the key trends that Canadian boards and general counsel need to know? First, improving gender diversity has been a major focus of the federal and provincial governments, securities regulators and institutional investors for years. Why? Simply put, women hold a relatively small proportion of board and executive positions among public companies, despite constituting over 50% of the overall population. That reality has become unacceptable to many. Second, market participants' focus on the issue is not waning – in fact, it continues to grow and Canadian issuers now face even greater pressure to implement formal processes and procedures to both improve upon and monitor their progress in achieving diversity goals. Finally, the focus on diversity is not likely to stop at gender differences; there will be increasing pressure to improve diversity more generally. If companies are struggling today to increase the number of women in leadership positions, they can expect greater challenges ahead as calls to improve racial, ethnic and sexual orientation diversity loom on the horizon.

For these and other reasons, doing nothing is no longer acceptable – Canadian companies need to accept the call to action, and many Canadian issuers must take more meaningful steps.

If the current trends continue with only marginal year-over-year improvements in the number of women represented on boards and executives, we can expect more stringent requirements. These may include mandatory targets and formal board renewal mechanisms, eliminating the flexibility that companies currently enjoy in crafting an approach to diversity that best suits their and their stakeholders' needs.

→ Investors and regulators are demanding more action in light of issuers' slow progress

As we reported in *Davies Governance Insights 2015*, while some progress has been made each year in improving gender diversity among Canadian corporate leaders, women remain significantly under-represented relative to their male counterparts. In addition, the majority of Canadian issuers have yet to implement a formal board diversity policy, which is perhaps the easiest way to set the tone at the top and advance female representation. Moreover, few issuers have established targets to promote women's advancement, yet another area in which securities regulators remain displeased with the performance of Canadian

issuers. The selected comparative data in Table 5-1 for the 2016 proxy season show that progress in this area remains slow compared with that in the two prior years.

TABLE 5-1: SELECTED COMPARATIVE GENDER DIVERSITY DATA (2014-2016)

Diversity progress/measures	2014	2015	2016
Women holding board seats of Composite and SmallCap Index issuers	12.3%	15.1%	17.7%
Women holding board seats of TSX 60 issuers	20.1%	23.1%	24.6%
Composite and SmallCap Index issuers with written diversity policies	8.6%	37.1%	48.0%
TSX 60 issuers with written diversity policies	20.0%	65.0%	70.0%
Composite and SmallCap Index issuers with female board chairs	3.2%	3.7%	4.4%
Composite and SmallCap Index issuers with targets	3.2%	11.1%	16.1%
TSX 60 issuers with targets	10.0%	28.3%	35.0%

These metrics, for many, highlight the poor performance of Canadian issuers in this area. So what is the reason? In the first year of securities regulators' increased comply-or-explain disclosure requirements, many issuers that disclosed they had not adopted a written board diversity policy or implemented formal processes (such as targets or other measures designed to increase diversity) most frequently stated that they did not do so because nominations and appointments to the board and executive positions are based on merit. Many also indicated that they had not adopted a policy or targets because they needed to maintain flexibility in their processes. However, governments, regulators and investors are questioning just how or why merit and flexibility would be compromised by processes that are typically designed to be flexible.

Issuers can and should seek ways to promote the advancement of women by implementing clearer processes and goals that would expand the pool of candidates from which boards and executives are traditionally selected, while ultimately still making appointments based on merit. Failing to do so is particularly surprising when, almost yearly, studies are released showing that the presence of women in corporate leadership positions may in fact improve economic performance. For example, in February 2016, the Peterson Institute for International Economics released the results of a global survey of 21,980 firms

Issuers should seek ways to promote the advancement of women via processes that expand the pool of candidates, while still making appointments based on merit.

in 91 countries, indicating that the diversity of skill offered by women benefits these firms.[30]

If the numerous studies released over the past decade outlining the business case for having more women in leadership are not sufficiently persuasive, perhaps the fact that many investors subscribe to these findings and expect to see greater diversity in the companies in which they invest will be. Diversity is one of several areas that some institutional investors have identified as being key to making their investment and voting decisions.

Consider also the rise of "impact investing" funds that include diversity as a key strategy. In early 2016, State Street Global Advisors announced the introduction of the SPDR Gender Diversity Index ETF (ticker symbol "SHE"), with the goal of achieving market-rate returns by investing in U.S. companies that are leaders in advancing women through gender diversity on boards and in management. The SHE fund tracks an index of 125 to 150 stocks culled from the Russell 1000 Index issuers that score high on a scale of gender metrics. In April 2016, the Bank of Montreal became the first Canadian mutual fund dealer to offer a mutual fund that invests exclusively in companies with female leadership: the fund will invest only in companies that have 25% female directorship or have a female CEO. BMO cited not only consumer demand as a reason for introducing the product but also sound investment strategy. According to BMO's chief investment officer, "companies with diverse boards or women CEOs actually outperformed others."[31]

We have also witnessed a significant rise in the number of Canadian issuers that are facing demands by their investors to improve their leadership diversity. Increasingly, a broader range of companies in various industries are facing shareholder proposals or less formal calls to implement formal diversity measures. For example, in the 2016 proxy season, eight Composite and SmallCap Index issuers faced shareholder proposals aimed at improving these issuers' leadership diversity in some manner – and none of these were Canadian financial institutions, historically the main targets of shareholder proposals. This compares with only three issuers in those indices that faced diversity-related proposals in 2015. Prominent examples of companies subject to shareholder proposals in 2016 included Restaurant Brands International Inc. and BCE Inc.; others, like Dollarama Inc., faced less formal investor demands to increase the number of women on their boards.[32] And while no such proposal has been passed by shareholders to date, we see the level of shareholder support for these proposals rising in comparison with prior years. For more information about shareholder proposals, see "Shareholder Proposals: Canadian Issuers Face Shareholder Proposals on a Variety of Topics" above.

Shareholder initiatives like these can be expected to continue, with more issuers facing greater pressure to adopt written diversity policies, implement targets and take other steps such as implementing formal recruitment and

advancement policies and renewal mechanisms to increase diversity. Based on Catalyst's research, done in conjunction with the Rotman School of Management and outlined in its 2016 report to the Ontario government, boards with higher renewal rates are more diverse, issuers with board term limits are more gender-diverse than those without, and boards that explicitly state they consider women when recruiting new board positions are more diverse than those that do not.[33]

Based on these findings, in 2016 Catalyst developed recommendations to the Ontario government designed to accelerate the pace of diversity in Ontario. These include setting specific targets for female directors by the end of 2017, establishing at least one type of board renewal mechanism, putting in place a written board diversity policy and addressing gender equality at all levels of organizations. All of the Catalyst recommendations have been accepted by the Ontario government, which has created a Women in Business Steering Committee to monitor and oversee companies' progress. Specifically, the Ontario government is pushing for 40% targets for government agencies and 30% for all other companies. The federal and Ontario governments and the OSC have all intimated that targets or even quotas may be the next step if issuers do not start showing meaningful improvements in their level of diversity.

Targets or quotas and more stringent disclosure requirements may be on the horizon if issuers do not make meaningful progress in increasing female representation.

In June 2016, U.S. SEC Commissioner Mary Jo White said at a conference that her agency would propose a rule requiring issuers to disclose more information about board diversity. According to White, the proportion of minority directors has stagnated at 15% for the largest public companies in the United States. While there has been no indication of what regulations may be put in place, White has called the current level of board diversity in the United States "unacceptable" and appears to be focused on making the issue a priority before she leaves office next year.

OUR TAKE: TOP FIVE STEPS CANADIAN ISSUERS SHOULD TAKE TO IMPROVE DIVERSITY

General counsel and the nominating and governance committees of Canadian public companies have an important role to play in advancing diversity among their organizations and in communicating those strategies to their stakeholders. Doing so will help demonstrate compliance with the OSC's comply-or-explain disclosure model and may alleviate investors' and regulators' concerns about the lack of progress in this area. It may also improve company-wide performance.

Here are the top five steps that, in our view, should be taken, or at least discussed and evaluated, over the next year by the board of directors or a designated committee with the input and involvement of senior management.

1. **Adopt a written board diversity policy.** Develop and adopt a board diversity policy and take meaningful steps to implement it, establish measurable objectives under it, and continue to monitor its effectiveness. The policy does not need to compromise a company's flexibility in pursuing its strategies and objectives but rather should complement those efforts. Most policies adopted by issuers to date remain fluid and provide guidance and objectives, rather than fixed regimes, while still ensuring that appointments are based on skill and merit. Consider updating your nominating and appointment policies to lay out how gender and other diversity criteria are considered in recruiting, identifying and selecting board and executive nominees. For example, some companies require that female-only board recruits be identified and interviewed before their male counterparts, while others require that a certain percentage of female candidates be included among the pool of nominees.

2. **Consider adopting targets.** Even issuers that have adopted a diversity policy should consider establishing targets for the representation of women at the board level and/or among executive ranks; even if aspirational, targets can evolve over time and help drive change. For example, consider establishing an achievable objective for female representation by some future date, and increase the targets over time (*e.g.*, "Our goal is to have at least 25% of the board represented by female candidates by the year 2018, and 30% of the board represented by female candidates by 2020").

3. **Establish a skills matrix and robust board assessment practices.** While many issuers disclose that they have "robust" director assessment processes in place, the reality is that these processes often lack definition and are little more than annual questionnaires and one-on-one meetings. Developing skills or competency matrices to identify the balance of

skills and expertise needed by your board to be effective stewards of the company, and carefully reviewing directors' performance against those requirements, provides a good starting point for assessing the relative diversity of your leadership, as well as identifying where gaps lie. Also consider whether the skills matrix has built-in biases — for example, given the multitude of issues faced by boards, it is not necessarily the case that all director candidates need to have CEO or corporate board experience to be effective; consider other skills relevant to your organization that may facilitate improving the diversity of candidates considered.

4. **Assess gender equity at all levels.** General counsel and senior management should work together to better understand the diversity of their executive team and larger workforce and identify the relative strengths and weaknesses of programs in place. Consider working closely with your human resources team and others in the organization to do a deep dive into the organization's policies and practices relating to internal and external recruiting programs, management training, mentoring, pay equity, maternity and paternity leave, community outreach, and diversity and inclusiveness training. Doing so will assist you in determining what level of diversity is appropriate for your organization and where there may be barriers to advancing diversity.

5. **Provide clear public disclosure about your diversity practices.** Clear disclosure is critical to providing transparency about your company's efforts to enhance diversity and is also key to effective shareholder engagement, another area under scrutiny by investors. In-house counsel should take the lead in crafting disclosures that go beyond boilerplate statements by clearly describing, among other things, the directors' diverse attributes (*e.g.*, by using and disclosing a skills matrix) and providing concrete examples of how gender diversity initiatives tie into director and executive identification, selection and advancement (*i.e.*, don't just say you consider women in these appointments; explain how they are considered). Issuers should also monitor and disclose, at least annually, the steps taken to improve the representation of women in leadership positions (*e.g.*, recruiters are required to include at least 50% of women in the candidate pool, external search firms are used to identify candidates outside of the board's existing network, etc.).

06 Compensation Issues and Say-on-Pay

Canada's largest issuers continued to face shareholder discontent about executive pay practices in 2016. This discontent is exacerbated by the reluctance of some boards to meaningfully engage with shareholders regarding compensation. Canadian issuers are not required to have say-on-pay votes to determine shareholder support for their compensation practices, but the majority of issuers now voluntarily hold an annual say-on-pay vote. Although the outcome of a say-on-pay vote is not binding, if the results are weak, most boards will make changes — sometimes significant — to their compensation program design.

Adoption of “say-on-pay” by Canadian issuers continues to rise

The number of say-on-pay resolutions put forward by issuers to their shareholders continued to grow in 2016 — for the first time, a majority of TSX-listed issuers now hold say-on-pay votes. Among TSX 60 issuers, 83% put forward say-on-pay resolutions in 2016 (compared with 78% in 2015). The percentage of issuers putting forward say-on-pay votes was 61% in 2016 (2015: 50%) on the Composite Index and 29% (2015: 17%) on the SmallCap Index. Given the intense media scrutiny say-on-pay votes receive, as well as mounting pressure from various shareholder groups, we can expect the number of Canadian issuers adopting say-on-pay votes to continue to rise in the coming years.

Say-on-pay trends in 2016

Consistent with prior years, say-on-pay resolutions tabled by Canadian issuers typically enjoyed strong support in 2016. On average, these resolutions put forward by TSX issuers were supported by about 92% of shareholders, consistent with the average shareholder support in 2015. Canadian issuers on the TSX 60 recorded median support of about 95% on their say-on-pay votes to date in 2016, again consistent with last year.

For those companies that had perceived deficiencies in their compensation program design or misalignments in pay for performance, shareholders and proxy advisory firms are not hesitating to express their discontent by voting against say-on-pay resolutions and, in some cases, directors serving on the compensation committee. In 2016, 22 TSX-listed issuers holding say-on-pay votes received approval levels under 85%, compared with 18 TSX-listed issuers in 2015. The issuers receiving less than 85% support in 2016 are listed in Table 6-1.

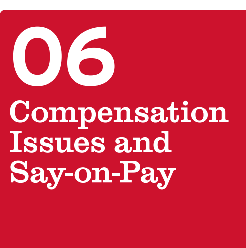


TABLE 6-1: CANADIAN ISSUERS RECEIVING LESS THAN 85% SHAREHOLDER APPROVAL OF A 2016 SAY-ON-PAY RESOLUTION

Issuer	Say-on-pay approval (%)	ISS recommendation
Crescent Point Energy Corp.	31.0%	Against
Ultra Petroleum Corp.	39.4%	Against
Canadian Pacific Railway Limited	49.9%	Against
Copper Mountain Mining Corporation	61.8%	Against
Valeant Pharmaceuticals International, Inc.	62.4%	Against
Alamos Gold Inc.	65.3%	Against
Sherritt International Corporation	65.9%	Against
Aralez Pharmaceuticals Inc.	66.7%	Against
RioCan Real Estate Investment Trust	67.1%	Against
Ballard Power Systems Inc.	72.5%	For
Ensign Energy Services Inc.	73.6%	For
Baytex Energy Corp.	74.1%	For
Teck Resources Limited	74.8%	Against
Aimia Inc.	76.9%	For
Manulife Financial Corporation	77.4%	For
Goldcorp Inc.	77.7%	For
BlackBerry Limited	78.1%	Against
Element Financial Corporation	80.3%	For
SunOpta Inc.	81.1%	For
Ritchie Bros. Auctioneers Incorporated	82.6%	Against
Stantec Inc.	82.7%	For
Magna International Inc.	83.4%	For

Source: ISS Voting Analytics Database.

CEO compensation continues to rise

Consistent with trends we observed in prior years, in 2016, CEO compensation at Canadian public companies continued on the rise. In addition to increases in base salaries, bonuses and stock option grants, awards of share-based compensation also increased significantly. The following are the median pay changes for CEOs of Canada's 100 largest companies in 2015 over 2014:[34]

- base salaries up 7%
- bonuses up 0.4%
- salary and bonus combined up 2.5%
- share-based awards up 20%
- stock option grants up 11%
- total compensation up 12.6%

Given the decrease in total shareholder returns of Canadian public companies in 2016 and the average increase in CEO pay packages, it is not surprising that shareholders have continued to express their discontent by voting "No" on say-on-pay resolutions. While CEO pay typically tracks total shareholder return at the majority of Canada's largest 100 companies, the companies that received lower levels of support for their say-on-pay votes in 2016 have tended to be those that had a disconnect (often significant) between pay and performance. For example, Teck Resources Limited disclosed a 26.5% increase in its CEO's total direct compensation while total shareholder return for the company decreased by 65%.

As discussed in greater detail in *Davies Governance Insights 2015*,[35] the discussion relating to compensation issues continues to focus mainly on the alignment (or lack of alignment) between executive pay and company performance — that is, whether there is an appropriate balance between short- and long-term incentives and whether those incentives are aligned with maximizing shareholder value.

Issuers that are perceived to have excessive or overly risky compensation programs and/or pay-for-performance misalignments can expect to continue to face negative voting recommendations from ISS and Glass Lewis, in light of the proxy advisers' increasingly strict quantitative tests, as well as lower levels of shareholder support on say-on-pay resolutions. Directors serving on the compensation committees of companies with these perceived compensation

deficiencies can also expect to be at a higher risk of receiving "Withheld" votes against their re-election to the board.

Director retainers continue to grow, replacing meeting fees

On average, and consistent with the trends we have observed in prior years, director compensation, and particularly retainer amounts, for all issuers on the TSX indices we track continued to rise in 2016, as shown in Table 6-2.

TABLE 6-2: AVERAGE RETAINERS OF CANADIAN ISSUERS (2015-2016)

Index	2016 average retainer amount	2015: average retainer amount
TSX 60	$167,470.63	$137,400.37
Composite Index	$112,966.56	$92,787.43
Completion Index	$93,452.76	$77,314.73
SmallCap Index	$64,359.17	$52,348.31

Canadian institutional investors are advocating for a greater portion of directors' compensation to be in the form of share-based awards, tied to long-term company performance.

The impetus for the continued increase in director compensation, specifically retainer fees, is largely attributable to the expanding list of issues and responsibilities faced by directors of Canadian public issuers, which has led to a substantial increase in the time required for a director to do his or her job properly. This trend also reflects a shift away from paying meeting fees in favour of the retainer-only option. A retainer-only program for compensating directors is often preferable from a governance perspective, given that directors' duties and responsibilities arise throughout the company's fiscal year, not just at board meetings.

We expect we will continue to see a rise in total directors' fees in the coming years. While there are many legitimate reasons justifying this rise in fees, boards should carefully consider the components of their director compensation packages. Increasingly, Canadian institutional investors are advocating for more of directors' compensation to be in the form of share-based awards, which tie directors' compensation to long-term company performance. Many investors and other market participants are also becoming more supportive of requiring that directors acquire and maintain some minimum equity ownership in the issuer

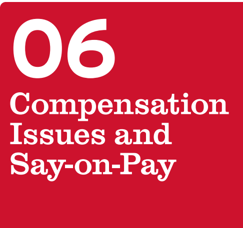
(usually formulated as a multiple of their annual retainers), for as long as the director serves on the board.

Additional information about how CEOs and directors are compensated and past years' key trends, which continued in 2016, can be found in *Davies Governance Insights 2015*.

! OUR TAKE: BOARDS SHOULD BE AWARE OF EMERGING TRENDS AND GUIDANCE IN COMPENSATION

Canadian issuers and their boards can expect to continue to be held to a high standard in making and explaining their compensation decisions and ensuring those decisions are aligned with performance. Boards should be aware of the following key trends from the 2016 proxy season.

1. **Votes against say-on-pay due to poor corporate performance.** The weak revenue and earnings performance in 2016 did not lead to lower total annual compensation. Shareholders have continued to express their frustration with the lack of nexus between pay and corporate performance. Canadian Pacific Railway Ltd. recorded 50.1% shareholder votes "Against" its perceived excessive executive pay practices in the wake of its fallen share price. Goldcorp Inc. had 22.3% of votes cast "Against" its executive pay practices for 2015, while Teck Resources Ltd. recorded a 25.2% "No" vote.[36] Boards that experience low say-on-pay approval levels should carefully re-evaluate the company's executive compensation practices; merely providing increased disclosure in the following proxy year is unlikely to adequately address shareholder concerns.
2. **Increased scrutiny of performance metrics.** Rather than simply relying on the voting recommendations of ISS and Glass Lewis, more shareholders have started analyzing performance metrics and goals in-house to ensure that corporate performance is not lagging behind executive pay. Shareholders are becoming increasingly wary of any deviation from previously established performance criteria, including lowered performance goals and waivers of performance thresholds. Shareholder misperception regarding a correlation between pay and performance can be avoided by providing expanded disclosure and engaging with shareholders, particularly where the compensation committee or board has overridden previously established performance criteria.



3. **Taking the long-term view.** Shareholder dissatisfaction with executive pay is rarely limited to a single one-year period. Many proxy advisers and institutional investors focus on a longer time horizon to evaluate the relationship between pay and performance. Despite strong share performance in the applicable proxy year, a "No" vote may still be cast if executive compensation has risen during a prolonged historical period of poor share returns. Boards should ensure that the disclosure regarding compensation governance is robust and adequately explains the compensation committee's decision-making process, including the historical context for performance-related bonuses.

4. **Executives as owners.** Shareholders are putting greater pressure on companies to restrict key executives from selling shares awarded to the executive throughout the term of his or her active employment and for a period of up to two years after termination of employment. When a company implements restrictions on the sale of shares, executive interests will be better aligned with those of its long-term shareholders. Boards may wish to consider implementing restrictions on the sale of shares by executives to ensure the company's compensation practices are aligned with shareholder preferences.

07 Majority Voting: Lower Tolerance for Undersupported Directors

07
Majority Voting: Lower Tolerance for Undersupported Directors

The year 2016 saw the first cases of boards of directors accepting the resignations of directors who failed to get a majority of "For" votes under their majority voting policies. The historical practice of Canadian issuers allowing directors to remain on the board despite receiving less than majority shareholder approval is waning. When directors receive less than majority shareholder support for their re-election, boards should carefully consider whether "exceptional circumstances" truly exist; boards will increasingly be required to accept that director's resignation.

Undersupported directors leave the boardroom

Majority voting replaces the historical practice of electing directors on a plurality basis, where in an uncontested election a director could be elected even if more shares are "Withheld" than voted "For" the nominee. Under a majority voting policy, that director nominee would be required to tender his or her resignation for consideration by the board of directors.

Davies has been monitoring developments in majority voting since our first edition of *Davies Governance Insights* in 2011. Until the 2016 proxy season, in all cases when a director did not receive the requisite shareholder approval, he remained on the board.[37] Even when the issuer had majority voting policies, as required by the rules of the TSX for issuers other than controlled companies, and the undersupported director tendered his resignation, the resignation was ultimately rejected by the board. In so doing, boards have relied on a typical provision of majority voting policies that allows a director to remain on the board if "exceptional circumstances" exist.

The so-called exceptional circumstances (sometimes referred to as "special circumstances") have been the subject of some debate, as discussed in *Davies Governance Insights 2015*[38] and our prior years' reports. Critics have claimed that a board's unilateral reliance on this exception renders majority voting policies quite meaningless. In fact, it is one of the primary reasons that many institutional investors, shareholder advisory firms and governance watchdogs have continued to push for stricter requirements under the TSX rules and amendments to corporate statutes in Canada in order to either eliminate such exceptions altogether or, at minimum, prescribe those limited exceptional circumstances in which it would be permissible for boards to override a shareholder vote to the contrary.

In the wake of this debate, 2016 saw the trend reversed. There have been two reporting issuers on the TSX Composite and SmallCap indices whose directors received less than 50% of votes "For" their election (two directors of Nobilis Health Corp. and one director of Performance Sports Group Ltd.). In both instances, the undersupported directors tendered their resignations. In each case, the board reviewed, considered and accepted the resignations, pursuant to the terms of the issuer's majority voting policy.

We view these results as a positive development and consistent with the ultimate goal of true majority voting: to establish a mechanism by which directors who receive a majority of "Withheld" votes are removed from the board in accordance with the will of the shareholders. This is not to say that there will never be "exceptional circumstances" in which a director who fails to achieve a

Boards that experience relatively lower levels of support for one or more directors should carefully consider the voting results and engage with shareholders.

majority "For" vote should remain on the board. There may be legitimate cases where independence requirements or the balance of skills on an issuer's board would be compromised by the immediate removal of a director, or where the strategies or strategic relationships of an issuer could be undermined as a result of the loss of a director.

In all cases, boards that experience less than majority votes in favour of one or more directors should carefully consider the voting results and engage with shareholders to understand the reasons underlying them. In fact, as we discuss elsewhere in this report under "Shareholder Engagement: Boards Must Set Priorities and Establish a Framework", engaging with shareholders in advance of AGMs to obtain their views on the board's composition and effectiveness and the performance of individual directors can be effective in preventing low or inadequate levels of support for individual directors. Doing so can also help to communicate important messages about why a potentially poorly supported director remains critical to a board in the company's short or long term.

! OUR TAKE: "EXCEPTIONAL CIRCUMSTANCES" WILL BE RARER, AND MORE UNDERSUPPORTED DIRECTORS' RESIGNATIONS WILL BE ACCEPTED

Directors who receive less than a majority of "For" votes for their election should no longer expect to have their resignations rejected and to continue serving on the board. Boards should give careful thought to the circumstances in which it would be reasonable to reject a resignation tendered by an undersupported director and should interpret the "exceptional circumstances" in a narrow manner consistent with the underlying goals of majority voting and investor expectations.

If your board faces low levels of support or less than majority votes "For" a director's election, you should engage with your shareholders to understand why and try to resolve the issue. In some cases, it may be appropriate to allow the director to remain on the board for a fixed period of time (e.g., one more year). During that transition period, the board can engage in a robust director identification and selection process to find a replacement who brings the necessary skills and expertise to the company. This process will allow for an orderly changeover on the board while still being responsive to the views of the shareholders. In conjunction with your board succession plan and majority voting policy, boards should also consider the following measures.

1. **Develop an "evergreen" list of directors.** Maintaining "evergreen" lists of potential director candidates, drawn from different sources and comprising individuals with different skills and experiences relevant to the company's needs, is a prudent practice. Evergreen lists should be reviewed and updated, at least annually. Consider creating a process for significant investors to offer up nominee names for consideration on those lists.
2. **Consider in advance what sort of "exceptional circumstances" might justify keeping an undersupported director on the board.** Boards should discuss, before faced with an undersupported director, what sort of exceptional circumstances might warrant allowing that director to stay on the board. For example, are there contractual provisions in place that would be breached if the director were removed? Would the loss of just one independent director render the company unable to comply with independence and audit committee requirements? Does a particular director have a key relationship, the loss of which would be materially adverse to the business? Having a sense of what those circumstances might be, and communicating those circumstances to shareholders in the proxy circular or within a majority voting policy itself, may better position the board to make a decision and fulfill its duties if one or more directors fail to achieve majority shareholder support for their election.
3. **Engage with shareholders.** Ideally, consistent with trends we discuss elsewhere in this report, issuers should designate one or more independent directors to engage with shareholders and obtain their views on the board's composition and each director's effectiveness. Identify whether there are investor concerns and, if so, develop a plan to respond to them. Engagement will become particularly important, if not essential, if a director does not obtain majority approval for his or her election.
4. **Conduct robust board assessments.** Ensure your organization has an appropriate board and director assessment process in place. This typically includes, at minimum, annual director questionnaires, peer reviews and one-on-one meetings between the chair and each director. When assessments reveal problems, boards should be prepared to take action to rectify the situation. In some cases, external "board doctors" or consultants can help identify where problems may lie and assist with developing solutions

08

Forum Selection Bylaws: Making Their Way Into Canada

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Despite much criticism for the practice, forum selection bylaws are starting to make their way into Canada, as a tool to restrict investors' ability to bring certain types of shareholder claims in jurisdictions not favoured by the issuer. Boards considering adopting a forum selection (or exclusive venue) bylaw should carefully weigh their pros and cons, including the likelihood that ISS and Glass Lewis and their investors may not support or approve the practice.

What are forum selection bylaws?

"Forum selection" or "exclusive venue/forum" bylaws are a mechanism for companies to limit shareholders' choice of legal venue by specifying the jurisdiction in which certain types of shareholder claims must be litigated. Historically more common in the United States, forum selection bylaws are now making their way into Canada, albeit slowly.

Canadian issuers are successfully adopting forum selection bylaws

Following in the footsteps of Yamana Gold Inc., which was the first Canadian company to adopt and obtain shareholder approval for a forum selection bylaw, three more Canadian issuers put this practice forward for a vote and had them approved by their shareholders in 2016.

Dundee Corp. had its proposed forum selection bylaw approved by show of hands at its AGM in June 2016, despite a negative recommendation from ISS. ISS cited the absence of a compelling rationale for limiting shareholders' litigation rights to the province of Ontario as the basis for its recommendation. ISS acknowledged that there is merit to the notion that Ontario judges are best suited to apply Ontario law to companies headquartered in Ontario, incorporated under the *Business Corporations Act* (Ontario) and holding significant assets in Ontario, and that an exclusive forum bylaw would likely help reduce the potentially high legal costs that would otherwise be incurred in litigation outside of the province. Nevertheless, ISS concluded that the bylaw would curtail shareholders' right to select any proper forum of their choosing, a restriction that was not supported by evidence of a "compelling company-specific history" or of "unusually substantial harm" from litigation brought by shareholders in non-Ontario courts.

Three more Canadian issuers had forum selection bylaws approved by shareholders in 2016, despite negative ISS recommendations.

ISS also recommended that shareholders vote against forum selection bylaws proposed by Avivagen Inc. and Enerplus Corporation. In both cases, the bylaws were approved by the companies' shareholders despite the negative ISS recommendation (with a 54.72% "For" vote in the case of Enerplus, and an undisclosed vote in the case of Avivagen).

ISS and Glass Lewis remain unsupportive of exclusive venue bylaws

ISS's negative recommendations in these and past Canadian cases have been based on its U.S. proxy voting guidelines (discussed in more detail in our *Davies Governance Insights 2015* report),[39] since the proxy adviser has yet to adopt Canada-specific guidelines on the topic.

Glass Lewis, on the other hand, addresses forum selection in its 2016 Canada *Proxy Paper Guidelines*. In those guidelines, Glass Lewis recognizes that companies may be subject to frivolous and opportunistic lawsuits, particularly in connection with a merger or acquisition, that are expensive and distracting, but it takes the view that provisions limiting a shareholder's choice of legal venue are nevertheless not in the best interests of shareholders as they may effectively discourage shareholder claims by increasing their associated costs and making them more difficult to pursue. Based on this, Glass Lewis will generally recommend that shareholders vote "Against" any bylaw or charter amendment containing an exclusive forum provision. In certain cases, it may support the practice if the company (1) provides a compelling argument for why the provisions would directly benefit shareholders, (2) provides evidence of abuse of legal process in other, non-favoured jurisdictions and (3) otherwise maintains a strong record of good corporate governance practices.[40]

In light of these guidelines, Canadian issuers should expect investor resistance, and likely negative recommendations by ISS and Glass Lewis, if they propose to implement a forum selection bylaw. Absent compelling evidence of the specific and substantial harms caused to the issuer by multijurisdictional litigation, which most issuers are reluctant to provide given the sensitivities of that information, bylaws such as these that seek to limit shareholders' rights remain unusual and controversial.

Adopting exclusive venue provisions should be done cautiously, and with the benefit of legal advice.

OUR TAKE: FORUM SELECTION BYLAWS REQUIRE CAREFUL CONSIDERATION AND ARE NOT THE NORM

While slowly starting to make their way into Canada, forum selection bylaws remain quite uncommon and, for many, controversial. Boards of Canadian issuers considering adopting exclusive venue provisions should do so cautiously, only after careful deliberation of their relative pros and cons, and with the benefit of legal advice. Boards should also expect that ISS and Glass Lewis will

likely recommend that shareholders vote against these provisions, unless the board can provide compelling arguments of their benefit to shareholders and can identify specific and substantial evidence of past harms suffered as a result of litigation emanating from multiple jurisdictions or outside of the jurisdiction(s) in which the issuer has the closest connection. For most issuers, providing this level of information is not likely to be desirable.

Furthermore, in contrast to developments in the United States, where courts have recognized the validity and enforceability of forum selection provisions, the practice remains untested in Canada. It is therefore unclear whether forum selection bylaws would be upheld as enforceable if challenged before a Canadian court.

If your board is considering adopting a forum selection bylaw, think about discussing the proposal with the company's significant shareholders. As with many other governance and transaction-related issues discussed elsewhere in this report, understanding investors' views on these issues, particularly those that directly impact their shareholder rights, can provide insight into whether your investor base is likely to approve the practice, even in the wake of negative recommendations from the leading proxy advisory firms.

09

Mitigating Corruption Risk: Understand How Corruption Risks Apply to You and Establish a Compliance Program

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Risk management, and the numerous issues it engages, remains an important priority for Canadian securities regulators, institutional investors and proxy advisory firms. Within risk management, establishing and enforcing policies to protect against bribery and foreign corrupt practices, particularly for larger organizations operating in emerging markets, remains an important responsibility for boards, requiring ongoing oversight. Failure to do so can result in serious adverse consequences to companies and their leadership.

Corruption investigations and their penalties likely on the rise

With increased globalization, ever-changing legal, political and regulatory regimes, increased activity by many issuers in emerging markets and the continued rise in companies' reliance on technology, risk management is an important and complex area for which boards retain principal responsibility. Within this area, managing bribery and corruption risks, particularly for larger organizations carrying on activities in emerging markets or environments known for corrupt behaviour or through various subsidiaries and/or agents, can be particularly challenging. In the face of stepped-up anti-corruption laws and investigations in Canada, the United States and the United Kingdom, boards and risk management committees of companies should be proactively managing their corruption risk. Failure to do so can have devastating consequences. Consider, for example, the following high-profile cases.

This past March, Canadian health sciences firm Nordion Inc. settled charges under the U.S. *Foreign Corrupt Practices Act* (FCPA) for lacking sufficient internal controls to detect and prevent bribes paid by a former employee to Russian government officials. Nordion settled with the SEC and agreed to pay US$375,000 in fines.

Nordion appears to have gotten off easy. Penalties under the FCPA have been as high as US$800 million (Siemens AG) and US$579 million (KBR Inc./Halliburton). The SEC took Nordion's self-reporting into account, along with its extensive cooperation with the SEC's investigation and the immediate steps taken to remedy the situation. While self-reporting can be viewed as a mitigating factor for companies faced with charges of foreign corrupt practices, it will not eliminate responsibility for the activities, and companies can still face stiff penalties.

Canadian prosecutors reportedly declined to lay charges under the Canadian *Corruption of Foreign Public Officials Act* (CFPOA) in the Nordion case. While fewer than a dozen cases have been prosecuted since the CFPOA came into effect in 1999, CFPOA prosecutions are likely on the rise, given increased pressure on Canada to demonstrate compliance with treaty obligations under the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. For more details about past CFPOA and foreign corruption cases, see our *Davies Governance Insights 2015*[41] and *Davies Governance Insights 2014*[42] reports.

In the face of stepped up anti-corruption laws in Canada, the U.S. and the U.K., boards and company executives should be proactively managing corruption risk.

Consequences of corrupt practices can be devastating to a business and its principals

Allegations of bribery and corruption can be very harmful to a company's reputation. Investigations divert the attention of management and the board, significantly drain company funds and can also derail M&A transactions. Consequences for involved individuals can be devastating and include fines and/or imprisonment.

In addition to potential criminal and regulatory actions, violating anti-bribery and anti-corruption laws can have significant collateral consequences. The $1-billion class action filed against SNC-Lavalin Inc. (TSX:SNC) on behalf of shareholders is a prime example, commenced years after investigations and charges were first laid against the company as a result of its alleged corrupt practices. Plaintiffs claim that SNC-Lavalin and its officers should be liable for damages (investment losses due to share price collapse) resulting from corrupt payments made in contravention of SNC-Lavalin's policies. They point to public statements made by SNC-Lavalin indicating it had sufficient operating controls that ensured compliance with anti-bribery and anti-corruption standards. They further allege that SNC-Lavalin's financial statements were materially false and/or misleading, exposing the company to material risks of criminal and regulatory actions and severe reputational damages that have compromised SNC-Lavalin's ability to procure new business, particularly in developing countries.

Although the SNC-Lavalin class action has not yet proceeded to trial, it has been certified and represents a novel foray of private litigation into Canada on the basis of foreign corrupt practices. The prospect of potential securities law liability for bribery and corruption risk disclosure, in addition to the many other significant penalties triggered by breaches of corruption laws, should serve to caution officers and directors of Canadian public companies to proactively manage corruption risk.

Understand how corruption risk applies to you and establish a compliance program

The ongoing developments and investigations, both domestic and foreign, in bribery and foreign corruption cases illustrate the far-reaching implications of

allegations and convictions under these laws. So how should companies protect themselves? We recommend boards adopt and implement these eight strategies.

1. **Know what bribery of foreign public officials entails.** Payments made to foreign public officials to gain favourable or expedited treatment in contractual, procurement, licensing, tax and other regulatory processes are prohibited. A bribe does not have to be paid for an offence to be committed; even an agreement to give or offer such a benefit could be fatal. The benefit also does not have to go directly to the public official; it could be an indirect advantage to family members. Boards and their risk management committees should ensure they understand the law.

2. **Maintain accurate financial records.** Bribes are often camouflaged by various means, including commissions, marketing expenses, travel and entertainment expenses, discounts, petty-cash withdrawals, supplier payments or write-offs. Sometimes, they are simply not recorded at all. Under the FCPA and the CFPOA, companies are required to maintain accurate financial books and records, and companies can be more easily charged when it cannot be proven that a bribe was actually made or paid.

3. **Prevent "facilitation payments".** Facilitation payments are relatively small payments made to expedite or secure performance of routine government matters within a foreign official's duties. Payments to facilitate granting licences and permits, processing visas and work orders or providing police protection could qualify as legitimate. But facilitation payments are not permitted under the stringent U.K. *Bribery Act*, and this defence is in the process of being repealed in the Canadian act. The U.S. Department of Justice and the SEC take a very narrow view of this defence — the official's actions must be routine and non-discretionary.

4. **Know the jurisdictional reach of legislation.** The jurisdictional reach of the FCPA (which appears to be broader and deeper than its Canadian and U.K. counterparts) should be a focus for most companies. It applies not only to U.S.-incorporated companies but also to cross-listed Canadian companies. The FCPA also applies to foreign companies engaging in activities that facilitate corrupt payments on U.S. soil. Sending or receiving a wire transfer to or from a U.S. bank, sending an email through the U.S. or providing instructions from a U.S. phone could be sufficient to establish jurisdiction.

5. **Be aware of parent company liability for actions of foreign subsidiaries.** A parent company benefiting indirectly from a bribe made by a foreign subsidiary or joint venture is unlikely, on its own, to be enough to attach liability to the parent. But a parent company may be held liable if the parent directly participated in the bribe or controlled the subsidiary in a way that made the subsidiary the parent's "agent" at law. Regulators evaluate control by examining the parent's knowledge and direction of the subsidiary's

actions, including reporting requirements and approvals. If your foreign subsidiary is not wholly owned or if you do not have majority ownership, be aware that the FCPA dictates that parent companies owning 50% or less of the subsidiary are required only to use good faith efforts to cause the subsidiary to devise and maintain a system of internal accounting controls consistent with the issuer's own obligations under the legislation. Minority shareholders should request periodic confirmation or certification from the majority shareholder that activities of the subsidiary and majority shareholder are in compliance with applicable anti-bribery and anti-corruption laws.

6. **Avoid the "head in the sand" defence.** Anti-bribery and anti-corruption legislation imposes liability not only on those with knowledge of bribery but also on those who purposefully avoid actual knowledge by being "deliberately ignorant" or "wilfully blind". Boards cannot insulate themselves by simply not understanding or monitoring the issues.
7. **Undertake a risk assessment program.** Create a program by identifying (1) key risks associated with the company's industry, business activities, suppliers, customers and countries of operation; (2) government entities and representatives the company or its business partners deal with, as well as employees, agents and consultants who oversee or conduct dealings with public officials; and (3) sales or payments to government entities, including state-owned or financed organizations. Pay extra attention to operations or sales in environments known for corrupt behaviour. The board, together with senior management, should also engage in continuous analysis of internal reporting and control structures and critically analyze the company's reliance on intermediaries for doing business abroad.
8. **Implement a comprehensive compliance process.** Establishing adequate procedures, reasonable internal controls and a strong compliance program, and maintaining ongoing board oversight for that process, will go a long way in demonstrating good faith efforts for managing corruption risk. The process should include, at minimum, four elements: (1) a strong code of conduct (this is absolutely critical); (2) procedures for dealing with agents; (3) internal controls; and (4) a system to identify red flags. (For details, see "Our take" below.)

For information about other important areas of risk management that boards and senior management should be aware of, see "Other Current Issues and Trends Relevant for Boards" below.

OUR TAKE: BOARDS SHOULD DEVELOP AND OVERSEE A COMPREHENSIVE ANTI-CORRUPTION COMPLIANCE PROCESS

Even in companies with risk management committees, the board ultimately retains principal responsibility for all risk management activities. As a starting point, it is critical to ensure that the board, in coordination with senior management, understands the local and foreign anti-corruption laws that apply to their organization and the bribery and corruption risks that arise in the business. It is also important for boards to establish and maintain oversight of a comprehensive anti-corruption procedure, including clear policies, internal controls and a strong compliance program. Doing so will help prevent corruption and is one of a company's best defences if faced with allegations of corruption.

A comprehensive compliance programs should, at minimum, including the following features.

A. Code of conduct

A strong code of conduct requiring compliance with all applicable anti-bribery and anti-corruption laws should be clear and concise. Disseminate it to all employees and agents and require them to be bound by it.

B. Procedures for dealing with agents

- Perform thorough background checks on your company's agents. Investigate their qualifications, business reputation and relationships, if any, with foreign officials.
- Understand agents' roles within your business and how they are compensated.
- Ensure agent contracts include a "right to audit" clause.
- Regularly exercise audit rights to ensure agents' compliance, based on an individual risk analysis.
- Require annual/periodic certifications of compliance from agents.

C. Internal controls

- Establish controls for petty cash, employee reimbursements and cheque authorizations while maintaining accurate financial record-keeping processes that include independent audits.
- Conduct compliance-based assessments of annual employee performance reviews.
- Ensure clear reporting channels and confidential helplines are available.
- Maintain an up-to-date response plan for all investigations.
- Regularly evaluate and revise the compliance program.

D. Red flag identification

Be on the lookout for unreasonably high commissions to third-party agents or consultants, excessive gifts, cash payments, consulting agreements that are vague regarding services performed, and transactions with third parties tied to foreign public officials or their relatives.

10

Takeover Bid Code and Early Warning Reporting Amendments

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Takeover Bid Code and Early Warning Reporting Amendments

On May 9, 2016, the Canadian Securities Administrators' (CSA's) previously proposed amendments to Canada's takeover bid regime came into force, as did the CSA's amendments to the early warning reporting rules, under National Instrument 62-103 — *The Early Warning System and Related Take-Over Bid and Insider Reporting Issues*. As a result, the relative leverage of targets and bidders in takeover bids has shifted, and 10%-plus investors now face increased reporting obligations under the early warning regime.

Amended takeover bid code

The new takeover bid rules are designed to shift the balance of power between target boards and shareholders by extending the minimum bid period to 105 days and mandating a minimum 50% tender condition.

The three main features of the new rules are as follows:

- **50% mandatory "minimum tender" condition.** Bids must be subject to a mandatory tender condition requiring more than 50% of target securities held by persons other than the bidder to be tendered before the bidder can take up any securities under the bid.
- **10-day extension.** Even once the minimum tender condition and other bid conditions have been met, bids must be extended for an additional 10 days to permit undecided shareholders to accept the bid.
- **105-day bid period.** Bids must now remain open for a minimum of 105 days unless either (1) the target board announces that it is reducing the bid period to a shorter period of at least 35 days, in which case the shorter period applies to all contemporaneous bids; or (2) the target announces a friendly transaction, in which case the minimum deposit period for all contemporaneous bids is automatically reduced to 35 days.

More time and leverage for target boards

The new 105-day period gives target boards a significantly longer period of time to evaluate a bid, seek alternatives or make the case for rejection of a bid. This period also provides a greater degree of predictability for a target board and its advisers to establish a strategic process, providing a fixed period of time, as opposed to the variable and shorter durations that securities commissions have historically allowed for poison pills.

By giving target boards control over the ability to shorten the 105-day bid period, the new rules incentivize interested bidders to negotiate with target boards, rather than taking their offers directly to shareholders. A short bid period is typically key to limiting interloper risk. Under the new rules, bidders will have to bargain with the target to get that benefit, giving target boards the opportunity to negotiate for a better price and other concessions in return.

10

Takeover Bid Code and Early Warning Reporting Amendments

Minimum 50% tender condition prevents minority blocking positions and makes partial bids more difficult

The new takeover bid rules facilitate a form of collective shareholder decision-making in response to a bid, a marked departure from the previous regulatory policy of protecting the rights of shareholders to make individual decisions to tender.

The requirement for a 50% minimum tender condition prevents shareholders from selling to a bidder if the bid is not supported by a majority of the target shareholders. In the past, hostile bidders would typically reserve the right to waive their own self-imposed minimum tender condition. This meant that even if a bidder was unsuccessful in achieving a targeted majority of shares, it might seize the opportunity to become a significant minority shareholder (e.g., 40% owner) by waiving its minimum tender condition and thus achieving a blocking position.

The rule changes also make partial bids more difficult. Even if a bidder is not seeking to acquire majority ownership of the target, the 50% minimum tender condition will apply – meaning that a majority of shareholders will have to be willing to sell a portion of their shares to the bidder.

Rights plans continue to play a role – in the 2016 proxy season, a total of 81 reporting issuers in Canada put rights plans to their shareholders, and the rights plans were approved.

The future of poison pills?

The new rules do not address the continued use of poison pills (shareholder rights plans). In its release accompanying the new rules, the CSA confirms that it has decided not to amend the existing policy on defensive tactics (National Policy 62-202). However, the CSA warns that it is prepared to examine the actions of target boards in light of the amended bid regime to determine whether they are abusive of securityholder rights. Given the significant extension of the minimum bid period, we expect that rights plans will not be allowed to further postpone take-up by hostile bidders.

On the other hand, we expect issuers will continue to adopt rights plans in order to have some protection against creeping bids – that is, the practice of assembling positions over time in excess of 20% of a company's outstanding shares through acquisitions exempt from the takeover bid rules, particularly private agreements and normal course purchases. This view appears to be borne out by recent practice. In the 2016 proxy season, a total of 81 reporting issuers in Canada (24 issuers in the Composite Index, compared with 17 issuers in the same

index in 2015) put rights plans to their shareholders and the rights plans were approved. Given that rights plans are continuing to be adopted and approved by shareholders, the CSA may yet be required to hold hearings on the use of such plans, particularly in the context of proxy contests.

Securities commissions' focus to turn to other defensive tactics

Although routine pill hearings in the context of hostile bids are likely a thing of the past, the new 50% minimum tender condition will result in greater scrutiny of other defensive tactics, particularly private placements of equity securities. The minimum tender requirement will give shareholders holding significant blocks of shares great influence over the success of a bid. In many cases, a single minority shareholder or a control-block holder could effectively block another bid from proceeding. The potential for large blocks of shares to frustrate the minimum tender condition, or to block a bid from proceeding altogether, is likely to result in continued securities commission involvement in hostile bids.

Hecla Mining Co.'s hostile takeover bid for Dolly Varden Silver Corp. in early July 2016 was the first contested transaction since the new regime came into force on May 9, 2016. Three days before the takeover bid was launched, Dolly Varden announced that it would complete an equity private placement. Hecla sought cease-trade orders from both the OSC and the British Columbia Securities Commission (BCSC). On July 25, following a joint hearing, the OSC and the BCSC released separate orders dismissing the application for a cease trade. Reasons have not yet been released. Although the transaction is a small one, the decision in *Dolly Varden* suggests that regulators are unlikely to treat private placements much differently than they have in the past and their review and assessment of such placements will be highly specific to the facts. For example, the BCSC's *Re Red Eagle* decision in 2015[43] and the Alberta Securities Commission's 2009 decision in *Re ARC Equity Management*,[44] which allowed private placements to proceed in the context of contested bids, stand in contrast to the 2012 rulings in *Re Fibrek* from Québec and *Re Inmet Mining Corp.* from British Columbia, where the private placements were cease-traded.[45]

Amended early warning reporting (EWR) rules

At the same time as the new takeover rules were enacted, the CSA also adopted amendments to the early warning reporting system. Generally, while the initial 10% reporting threshold remains unchanged, other changes are likely to require more frequent reporting by investors that fall within the regime once they cross

the 10% ownership threshold and will require more detailed disclosure about their investment plans, as well as their intentions to influence control of the subject issuer in which they hold securities.

Key changes to EWR and alternative monthly reporting (AMR) regimes

Key elements of the new EWR and AMR rules are as follows:

- **10% threshold remains.** The threshold for shareholders to report their ownership of shares remains at 10% of the outstanding shares. The CSA had originally proposed lowering the threshold to 5%, consistent with the Rule 13d reporting threshold applicable under U.S. rules. However, the CSA was persuaded through the comment process that a 5% threshold would not be appropriate for the Canadian market.
- **Filers must report ownership changes.** Shareholders that fall within the EWR regime will be required to report both increases and decreases of 2% or more. They will also be required to report when they have fallen below the 10% threshold. Under the prior rules, there was no clear obligation to file reports disclosing decreases in shareholdings.
- **AMR eligibility tightened up.** Eligible institutional investors that rely on the AMR regime will now lose their eligibility to rely on the AMR system if they engage in proxy solicitation in opposition to management in connection with director elections or corporate transactions.
- **Derivatives not included in threshold calculation.** Contrary to the original proposal, shares underlying cash-settled derivatives, such as total return swaps, are not included in determining whether a shareholder has crossed the 10% threshold. However, the CSA has published guidance reminding investors that they could be deemed to have beneficial ownership of securities held by a derivative counterparty if investors are able, formally or informally, to obtain those securities from the counterparty or to direct that counterparty with respect to the voting of those securities.
- **Reporting of securities borrowing arrangements.** The rules have clarified investors' reporting obligations with respect to borrowed securities. The purpose of these changes is to provide greater transparency for borrowing arrangements and the potential use of borrowed securities to engage in "empty voting" – that is, the voting of shares by a holder that has no economic interest in the shares. The rules allow for exclusion of borrowed securities for the purpose of determining the EWR threshold trigger for securities lending arrangements that meet certain criteria.

- **Enhanced disclosure required.** The rules now require more detailed disclosure in early warning reports by shareholders regarding their ownership of shares and their future intentions regarding the issuer. The new requirements are similar to the disclosure obligations applicable to filers of Schedule 13D under Rule 13d of the SEC, although there are important and nuanced differences.

Filers must now disclose more detail regarding plans and future intentions

Before the May 9 EWR amendments, the required disclosure regarding the purpose of the transaction giving rise to the early warning report was prescribed in National Instrument 62-104 as follows:

> *Purpose* of the offeror and any joint actors *in effecting the transaction* or occurrences that gave rise to the news release, including *any future intention to acquire* ownership or, or control over, *additional securities* of the reporting issuer. [emphasis added]

The new disclosure required for both EWR and AMR filers concerning the purpose of the transactions is significantly expanded:

> Item 5 – Purpose of the Transaction – State the purpose *or purposes* of the acquirer and any joint actors for the acquisition *or disposition* of securities of the reporting issuer. Describe *any plans or future intentions* which the acquirer and any joint actors *may have which relate to or would result in any of the following*: [emphasis added; the following is an abbreviated and summarized list]
>
> - additional share acquisitions or dispositions
> - a corporate transaction, such as merger, reorganization or liquidation, or a material asset sale
> - board of directors or management changes, including *any plans or intentions* to change the number or term of directors or to fill vacancies on the board
> - capitalization or dividend changes
> - material changes to business or corporate structure
> - changes to articles of incorporation, bylaws or change of control defences
> - delisting of securities
> - proxy solicitations

The greatest challenge filers will face is when, and to what degree they will disclose their plans and intentions.

The wording of the new disclosure requirements is very similar to the U.S. requirements in Rule 13d but, again, contains some important nuances; in many cases it is so similar that we anticipate Canadian regulators will expect, and many filers are likely to adopt, disclosures akin to the U.S. practice. However, EWR filers are expected to include in their reports significantly more detail about a wide range of possible transactions and more frequent updates as plans and intentions develop.

To date, many Canadian filers have failed to strictly comply with the new requirements, and we are seeing a range of practices develop. Perhaps the greatest challenge filers will face is when, and to what degree, they will disclose their plans and future intentions as they attempt to balance compliance with the new requirements with a general desire to not provide premature or overly detailed disclosure about potential future actions.

OUR TAKE: TACTICAL RIGHTS PLANS STILL SERVE AN IMPORTANT PURPOSE; INVESTORS SHOULD SEEK COUNSEL ON THEIR NEW EWR OBLIGATIONS

With the new takeover bid and early warning regimes now in place, many issuers and investors will need to revisit some of their tactics.

Issuers that have a rights plan in place and wish to retain it should consider whether it complies with the current rules and, if not, update it accordingly. For issuers that do not have a rights plan in place, the board should consider whether to adopt one if protection is desired against creeping bids or in the face of an anticipated bid. Potential acquirers will also need to revisit their takeover bid strategies, recognizing the increased leverage now held by target boards.

Investors that hold or intend to acquire 10% or more of the shares of a Canadian public company should ensure they understand their obligations under the EWR and AMR regimes (as applicable), particularly given the often very short time frame within which press releases and EWR reports must be filed once the 10% threshold is passed. Some activist AMR filers may find themselves unable to rely on the more lenient provisions of that system, depending on their intentions to influence the issuer. Importantly, EWR and AMR filers alike need to carefully consider and consult with legal counsel to ensure they are complying with the enhanced disclosure requirements, particularly those concerning their plans and future intentions.

11

Other Current Issues and Trends Relevant for Boards

11
Other Current Issues and Trends Relevant for Boards

Boards and their committees face a continued increase in the number and complexity of issues for which they are ultimately responsible, making performing director duties more time consuming and onerous than ever. From governance issues, to risk management, to long-term strategy, boards must ensure they maintain an appropriate diversity of skills and competencies to tackle the issues and maximize the effectiveness of their decision-making in today's markets.

In addition to the top governance issues already discussed in this report, 2016 has seen a number of other important developments that boards and senior management should stay abreast of. Boards now face a multitude of issues, requiring significantly increased time and attention from the directors in carrying out their duties, including CEO oversight and succession planning. Largely as a result of the rising number of issues that boards are responsible for, directors also face more stringent "overboarding" restrictions from ISS and Glass Lewis, reducing the number of public company boards that directors may sit on. We also discuss in this chapter another important risk management function of boards: protecting against cybersecurity risks, still a challenging area for many boards and now becoming a "hot button" for securities regulators. Finally, we provide a brief update on the ongoing initiatives to improve Canada's proxy voting infrastructure.

CEO succession planning: Boards should take a proactive, hands-on approach

Without a doubt, one of the most important responsibilities of the board is hiring and firing the CEO. This year, as in past years, we continue to see very different approaches to CEO succession planning. Some companies are proactive and have a succession plan in place before the loss of their CEO, thereby facilitating a smooth transition. In other cases, companies have found themselves with no plan in place, leaving the issuer without its top leader or any identified internal or external recruits who may be a suitable replacement when faced with the unexpected resignation or firing of the CEO.

Take, for example, the case of Canadian Pacific Railway (CP Rail), a TSX-listed company that presented an orderly and well thought-out succession plan for its CEO. In July 2016, the company issued a press release announcing that the company had reached an agreement with Keith Creel, the current president and COO, to take the reins as CEO in July 2017, and that Hunter Harrison would retire at that time, after serving five years as CEO.[46] The press release also noted that Harrison would continue on with a three-year, post-retirement consulting arrangement to provide continuity and support. The press release included quotes from Harrison, Creel and the chair of the board.

What can be learned from this example? CEO succession planning should be an ongoing item on the board's agenda. The board should assess the CEO's performance, *in camera*, at regular board meetings and, through the chair or lead independent director, provide feedback to the CEO. The board should know the answer to the question "If the CEO were suddenly unable to serve, who

Boards should know the answer to the question: "If the CEO were suddenly unable to serve, who would step up in the next 24 hours to fill his or her shoes?"

would step up in the next 24 hours to fill his or her shoes?" And there is no one better than the CEO to share his or her candid insights and frank advice in this regard. The board should also know which members of the senior management team are being groomed for the top job (and why and how). The current CEO (and senior HR executive) should be able to explain why those individuals have been chosen and what their development plans look like. The chair of the board and the CEO should structure opportunities for non-management board members to get to know these individuals, so that when the time comes to choose the next CEO, they have a high level of familiarity with internal candidates and can effectively evaluate them against external candidates in a formal process. Evergreen lists of potential external candidates should also be maintained.

In sum, strong CEO succession planning requires a proactive, hands-on approach by the board. It will help the board avoid reactive decisions and properly fulfill one of its most important responsibilities, while also ensuring an orderly transition when replacing a company's key leader.

ISS and Glass Lewis tighten up "overboarding" policies

In late 2015, proxy advisory firms ISS and Glass Lewis updated their proxy guidelines, reducing the number of public company boards that directors of TSX-listed issuers can sit on before being considered "overboarded". Under ISS's amended policy, starting February 1, 2017, ISS will generally issue a "Withhold" recommendation against a director nominee (1) if the nominee is a CEO of a public company and sits on more than one outside public company board (down from two) or (2) if the nominee is not a CEO and sits on more than four public company boards (down from six) *and* the nominee has attended less than 75% of board and committee meetings within the past year without a "valid reason" for the absences. ISS will include cautionary language in its reports if a director is overboarded, regardless of attendance.

More Canadian public company directors will now find themselves overboarded under ISS and Glass Lewis policies.

Glass Lewis also amended its policy for the 2017 proxy season: it will recommend shareholders vote against executive officers of TSX-listed companies who serve on more than two boards in total (down from three) and against non-executive directors who serve on more than five boards in total (down from six). Unlike ISS's, Glass Lewis's overboarding guidelines are not double-trigger – it will generally issue a negative vote recommendation for nominees if they are overboarded, regardless of their attendance records.

In light of these changes, more directors of Canadian public companies are likely to find themselves overboarded. Directors serving on multiple boards are

also finding it more difficult to devote the necessary time and attention to their duties in light of the increasing number of issues and responsibilities placed before them. Issuers that have not considered or addressed overboarding as part of their director selection and nomination processes or that have not established restrictions on the number of public company boards a director may sit on should consider doing so. Annual director evaluation processes should take into account directors' board and committee commitments (including additional time required of board and committee chairs) and their impact on board and committee effectiveness. Doing so can help ensure directors maintain the necessary time, energy and attention to carry out their duties and will avoid inadvertent breaches of ISS's and Glass Lewis's policies.[47]

Cybersecurity risk: Risk management continues to be a high priority

In our *Davies Governance Insights* 2014 and 2015 reports,[48] we discussed the important role that boards play in risk management oversight. Risk management is a broad area encapsulating many different issues for which directors are ultimately responsible. Boards must ensure they obtain reasonable assurance from senior management that they have identified the company's principal risks and put in place appropriate risk management policies and procedures consistent with the organization's risk appetite. Those risks will vary by company and industry and can include legal, operational, geopolitical, economic, market and disclosure risks. Consider, for example, the risk management issues engaged by companies facing the possibility of foreign corrupt practices, discussed above under "Mitigating Corruption Risk: Understand How Corruption Risks Apply to You and Establish a Compliance Program". Other top risk management priorities include managing a public company's disclosure risks as well as risks associated with parent company liability for subsidiary actions.

Managing cybersecurity risks and their potentially significant exposures continues to be a top priority and responsibility for many boards.

In light of companies' increased dependence on ever-evolving information technology, managing cybersecurity risks and their potentially significant exposures continues to be a top priority for many boards. And we believe it should remain so in 2016 and beyond, partly because Canadian securities regulators are paying more attention than ever to the disruptive implications of cybersecurity breaches. In June 2016, the OSC released its annual priorities for 2016–2017, in which it committed to undertake "initiatives to promote proper due diligence by market participants in relation to internal breaches and intrusions from external parties".[49] The OSC's action plan includes improving collaboration and communication with market participants on cybersecurity issues, assessing

cybersecurity resilience and providing guidance on expectations for market participants' cybersecurity preparedness.[50]

Meanwhile, the United States may be taking a different approach by mandating disclosure by public companies of whether any board member has expertise in cybersecurity. In December 2015, the *Cybersecurity Disclosure Act* to this effect was introduced in Congress.[51] If no member of the board has cybersecurity expertise, the company would be required to describe what other measures are in place to ensure cybersecurity risks are appropriately addressed and mitigated.

Directors have a duty to act in the best interests of the corporation and exercise the care and diligence that a reasonable person would under the circumstances. While directors are not (yet) required to be cybersecurity experts, they are required to exercise due care in ensuring that cybersecurity risks are properly identified and that reasonable processes are in place to appropriately mitigate them. We continue to recommend the best practices set out in *Davies Governance Insights 2015* to help directors bridge the so-called cyber confidence gap.

Update on flawed proxy voting infrastructure: Voluntary “meeting vote reconciliation” protocols proposed

Investors and issuers frequently cite instances of “over voting” or missing, rejected or prorated votes, as undermining market participants' confidence in the proxy voting system.

Flaws in the proxy voting infrastructure in Canada and the need to improve the accuracy, reliability and accountability of the system by which votes are counted at shareholders' meetings have been discussed for years, including in various Davies reports.[52] Investors and issuers frequently cite instances of "over-voting" or missing, rejected or pro-rated votes, undermining market participants' confidence in the proxy voting system. In response to the various deficiencies, over the past several years the CSA has conducted a series of consultations, round tables, shareholders' meeting reviews and working groups, through which it has identified significant information and communication gaps, as well as lack of consistency and transparency, in the processes by which shareholder voting is conducted in Canada – typically through proxies given by beneficial shareholders through multiple tiers of intermediaries up to a tabulator.

Continuing its efforts, earlier this year the CSA published for comment a set of four protocols (the Protocols)[53] that delineate the roles and responsibilities of the key entities involved in the meeting vote reconciliation process and provide guidance on the operational processes that those entities should implement to make the system more accurate, reliable and accountable. Among other

things, the Protocols contain guidance designed to improve the accuracy of vote entitlement information provided to tabulators by intermediaries seeking voting instructions from beneficial shareholders, improve consistency in how voting entitlements are recorded, create consistency in tabulating and recording proxy votes and, notably, provide for feedback from meeting tabulators to intermediaries and beneficial owners whose voting entitlements have been rejected or pro-rated (including the reasons why). Once finalized, the Protocols are expected to lay the foundations for moving to electronic vote transmission and developing an end-to-end vote confirmation capability.

Having sought and received comments on the Protocols, the CSA intends to publish the final Protocols at the end of 2016. Although compliance is not mandatory, the key entities involved are encouraged to voluntarily adopt the Protocols starting in the 2017 proxy season. The CSA will monitor the voluntary implementation and consider the need for additional rules and policy guidance. For more information, see ourDavies publication *Closing the Loop: Voluntary Meeting Vote Reconciliation Protocols Proposed for 2017 Proxy Season*.[54]

Database and Methodology

The quantitative analysis in this report is based on data provided by ISS Corporate Solutions, Inc. and drawn from the 2016 management information circulars of 367 issuers on the Toronto Stock Exchange (TSX) that are included in the Composite Index, the SmallCap Index or both as at May 31, 2016. There are a total of 2,284 issuers listed on the TSX. Although the 367 Composite Index and SmallCap Index issuers included in our study represent only 16% of all TSX-listed issuers, they represent 83% of the total market cap on the TSX.[55]

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

Composite Index: The S&P/TSX Composite Index (referred to in this report as the Composite Index) comprises 234 issuers. It is the "headline index" and the principal broad market measure for the Canadian equity markets. It includes common stock and income trust units. Six of the 234 Composite Index issuers did not issue a proxy circular for the relevant time period discussed; accordingly, our analysis is based on 228 Composite Index companies.

Two components of the Composite Index are also referred to in this report:

- **TSX 60:** The S&P/TSX 60 Index (referred to in this report as the TSX 60) is a subset of the Composite Index and represents Canada's 60 largest issuers by market capitalization.
- **Completion Index:** The S&P/TSX Completion Index (referred to in this report as the Completion Index) is the Composite Index excluding the TSX 60 issuers. It comprises 174 issuers. (Our analysis includes only 168 of the issuers on the Completion Index because, as noted above, six issuers did not issue proxy circulars.)

SmallCap Index: The S&P/TSX SmallCap Index (referred to in this report as the SmallCap Index) includes 212 issuers, 67 of which also meet the market capitalization eligibility criteria and are part of the Composite Index.[56] (Our analysis includes only 206 of the issuers on the SmallCap Index because six issuers did not have circulars.)

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

Notes

Notes

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57 We also acknowledge the invaluable contribution of Ivana Gotzeva, Director of Knowledge Management at Davies, in researching, drafting and providing feedback throughout the preparation of this report.

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