INSTITUTIONAL INVESTOR EDUCATIONAL FOUNDATION

THE Hennick Centre FOR BUSINESS AND LAW

Shareholder Democracy: Good, Bad or Unimportant?

A discussion of the balance of power between shareholders, directors, and management

Moderator: Poonam Puri

Co-Director, Hennick Centre for Business and Law at Osgoode Hall Law School and Schulich School of Business at York University

The May IIEF Roundtable brought together a diverse mix of public and private fund managers, investor advocates, university professors, corporate lawyers, compensation consultants, board members and advisors, and shareholder activists. The roundtable participants were carefully selected to represent a range of perspectives and opinions on this topic. Most of the participants were Canadian, with the rest from the U.S. Participants represented organizations ranging in size from small private institutional investors and advisory firms to international consulting firms and large pension funds.

Setting the Stage

Moderator Poonam Puri invited the participants to explore a wide range of potential topics. She set the stage for the discussion with a brief overview of corporate governance and Say on Pay.

"Corporate governance can be defined in so many ways. One is the effort to align the interests of professional managers of public companies with the interests of shareholders and other stakeholders.

"After the recent economic crisis, the focus has been on risk management and executive compensation as well as other issues. Corporate governance issues can be addressed through a variety of mechanisms: legal rules and regulatory action, and voluntary or market-based mechanisms.

"The legal rules we're familiar with include the fiduciary duties of boards, shareholder rights to elect boards & appoint auditors, shareholder remedies such as the oppression remedy and derivative actions, regulatory enforcement, and private enforcement by shareholders and stakeholders through the courts.

"At the other end of the spectrum, there are market-based incentives such as the desire to maintain a good reputation and activism by institutional investors. The debate is over where on this spectrum we want to be.

"We'll begin our discussion with a focus on Say on Pay, then move to Majority Voting and the Proxy Voting system. "

(Following Chatham House rules, only the Moderator's comments are attributed by name.)

"Do we want a mandatory rule on Say on Pay in Canada?

Do we want a mandatory rule that shareholders be allowed a vote on executive pay?"
- Moderator Puri

In the U.S., Dodd-Frank requires nonbinding advisory votes on executive compensation

Moderator Puri: "Historically the Say on Pay discussion has focused on the absolute numbers of executive compensation, concerns about pay tied to performance, and concerns about how compensation schemes can encourage undue risk-taking. In the U.S., Dodd-Frank legislation requires public companies to provide non-binding advisory votes on executive compensation every one, two or three years based on the outcome of a shareholder vote every six years. It also requires shareholder votes on golden parachutes in the context of M&A transactions and it requires that compensation committees be fully independent.

"We want to hear your view on these issues, Moderator Puri continued. "In Canada, the CSA has proposed some provisions similar to Dodd-Frank in terms of directors hedging against their stock options, and disclosure of the compensation paid to advisors retained by the company. Do we want a mandatory rule on Say on Pay in Canada? Do we want a mandatory rule that shareholders be allowed a vote on executive pay?"

"Yes – it should be mandatory"

The **director of a leading shareholder advocacy organization** explained, "Say on Pay in Canada came about in an unusual way. We were plunged into a credit crisis shortly after banks had just announced their compensation packages for the previous year. There was a huge disconnect between what investors were experiencing and how bankers were being rewarded, which led to a conversation around Say on Pay. We saw that Say on Pay votes would focus boards on the issue – and help shed light on how boards were thinking. Historically, it's been very hard to understand from proxy circulars what boards are trying to achieve, because they're written in such esoteric language."

"When we asked boards how they were using compensation to incent management and manage risk, we found that almost every board had a very coherent process but did an awful job of explaining it to shareholders. We think Say on Pay should be required of all public companies. We're afraid that if we just let this play out in the nice Canadian way, that the regulators will still be talking about this in 10 or 15 years. 'Now' could mean 4-5 years. We're hopeful the OSC will act right away."

"No – It's too blunt an instrument"

"Our initial tendency was to assume that Canada would follow the U.S. and the U.K.," said the **representative from a board advisory organization,** "but we decided that this was a good issue to look at from a grass roots perspective. We understand the rationale for Say on Pay; it likely does provide a vehicle for engagement. But we think that Canadian issuers 'get it' – without Say on Pay.

"The best engagements are broader than just Say on Pay, and we think that's healthy. The problem with Say on Pay is that it creates an illusory vehicle for shareholder voice, and we think it's the wrong mousetrap for several reasons: 1) it requires a lot of information not available to shareholders; 2) the vote is yes or no and you don't get the contour of the decisions; and 3) we don't think retail investors will do the research necessary to make an informed decision. The alternative is to rely on proxy advisors and it's not clear whether that's a good thing. It's critical that corporate consultants take a holistic approach to advising on compensation. We have companies in Canada prepared to talk to shareholders. We don't need to follow other countries and adopt this blunt vehicle."

A **compensation consultant** agreed that Say on Pay "is a blunt instrument, and I'm not sure it provides management with meaningful information. It does help keep boards on track, but I don't think we need to mandate it. We need to let boards make their own decisions."

"Say on Pay votes help establish minimum standards of fairness"

Counsel for an SRI fund believes, "Say on Pay votes are useful in getting boards to pay attention. In our experience, boards started engaging far more when votes started coming through the pipeline."

"Shareholders are the only ones with the correct perspective on compensation"

"I agree that shareholders are not equipped to understand all the details," believes a **private fund manager**, "but shareholders *are* able to assess the overall direction and size of the compensation. We do have a problem in corporate Canada with the size of executive pay.

"I personally don't believe it's as difficult to get top executive talent as a lot of boards and compensation consultants would have us believe," he continued. "I think the only people in the position to step back and say the overall direction of compensation is correct are the shareholders."

A **global asset manager** spoke from the perspective of an employer as well as an institutional investor. "We compensate hundreds of people a year in our own business. We understand how difficult it is to get compensation right and we really don't care what anybody else thinks. We also respect the privacy of executives being compensated.

"As the debate has evolved, I have become increasingly more comfortable as to what is required to satisfy the need of Say on Pay. It's not at all restrictive; it doesn't remove the role of the compensation committee. In Canada, it was about setting minimum shareholder expectations for fairness – and requirements for disclosure. It's a blunt instrument. It really asks the 'yes' or 'no' question, 'Did you satisfy the minimum expectation for fairness?' If the answer is 'no,' the company at the very least has a communication problem with shareholders."

"Following the U.S. model is creating a cottage industry around Say on Pay lawsuits"

A **corporate lawyer** believes, "We need to pay attention to what's happening in the U.S.. The companies that are getting 'no' votes are having to put out additional proxy material to fight against the ISS recommendation if they feel the analysis or the facts are wrong. It can be very difficult to get corrections made. I'm very concerned that a cottage industry has sprung up around Say on Pay lawsuits. That's not something any of us had envisioned when we talked about the value of a Say on Pay advisory vote. Canada may not have to follow what the U.S. has done."

A **compensation consultant** indicated that there are 12 lawsuits outstanding in the U.S. already. **Moderator Puri** commented that "It's very interesting that something intended as just an advisory vote is leading to litigation already."

A **private investment manager** admitted, "We tend to be very silent, but we've found that Say on Pay has led to much better disclosure on a financial statement level, which is very useful to small investors. We're getting much more explanation regarding the keys to compensation, which gives tremendous insight into corporate strategy - and links the compensation to results. Doing the research on our own is very time-consuming and outside the realm of most investors."

A **private institutional investor** with a long history of leadership in corporate governance said, "I go back to basics. I look at our corporate system and the role of shareholders, whose basic role is to elect a competent board of directors. Only boards act in the best interest of the corporation. Shareholders do not; they act in their own interest. Shareholder engagement is like motherhood; of course I'm in favor of it. The question is how should they participate?"

"Say on Pay violates fundamental governance principles."

"Say on Pay has worked as a corrective measure, but let's not confuse it with something that needs to be entrenched in some sort of regulation as a standard." – Corporate Governance Consultant

"Shareholder representatives are engaging boards of directors on a variety of issues," believes the institutional investor, and I think that's a far more effective way to influence issues, including compensation. If you're a shareholder, should you be able to pick and choose your issues? For a board member, what's more important than recruiting and compensating management? If I as a board member am not getting compensation right, I should be turfed off the board."

"The problem is not big enough to warrant legislation"

A **corporate governance consultant** believes, "The board has the ultimate responsibility; if they're not doing a good job, replace them. We shouldn't be entrenching regulation that essentially condones bad governance and puts in fixes and patches to keep plugging the holes. It's a slippery slope….it's Say on Pay today, but could be 'Say on Something Else' tomorrow. That's not good governance. A report just came out on Harvard's blog about Say on Pay votes in the U.S. Out of 807 companies that had votes, only 15-20 have been negative. ISS has recommended voting "against" just 60 times, and only 11 have actually been voted "against" in a Say on Pay vote. The problem may not be big enough to warrant legislation. Most importantly, is there any empirical evidence that Say on Pay will improve corporate performance? Sometimes these things are passed for political reasons."

"70 Canadian organizations have already adopted Say on Pay, so it's hard to retract that," believes a **corporate governance/compensation consultant**. "We're seeing a trend toward adopting performance based vesting. How are we incorporating the company's value drivers in the actual compensation plan? We're also seeing a positive focus on compensation risk reviews. Our concern as compensation consultants is that there is a lack of appreciation for the complexity of the compensation issues."

"Transparency leads to good decision making"

"Say on Pay votes now require disclosure of who the advisors were and what they were paid," the consultant continued, "but there is no requirement for the compensation committee to disclose what they did with the consultant's recommendations. As consultants we run a reputation risk."

An **investor advocate** believes, "Having the right to vote is an important part of the value of the share. The flip side is the obligation for investors to do their research and engage with boards."

An American shareholder activist said, "In the U.S., we're big believers in process. We believe that if you have processes that force transparency you get appropriate decision making. That's how we got environmental regulation in the 70's - by mandating transparency, not conduct or outcome. Also, in our experience, litigation has surfaced a lot of important information for shareholders and is an important part of the process. Given where we've been, we need a process that drives transparency."

"To say that Say on Pay has led to better disclosure is an overstatement," voiced a **corporate attorney.** "A lot of factors have resulted in better disclosure, including individual voting for directors and the work of advocacy organizations like the CCGG. The economy tanking forced companies to defend their compensation schemes."

Director Elections: Slate or Majority Voting; where should we be heading in Canada?

"From an institutional investor point of view," insisted a **public pension fund representative**, "majority voting is the single most important thing we can have and it would solve a lot of issues. It boils down to, 'is the board doing a competent job?' We'd much prefer majority voting over slate voting, which puts shareholders in a bind at times."

"Shareholders have the fundamental right to vote for each individual director"

The **representative of a shareholder advocacy organization** believes, "We need to get back to the basics of the corporate law structure as it was originally created, where shareholders had a vote."

A shareholder advocate thinks, "It's outrageous that a board can stonewall and ignore the legitimate votes of shareholders. We have plurality voting, slate voting is permitted and there's no mandate in most cases for boards to disclose the results of shareholder votes. We believe that this is the core problem of corporate governance in Canada and it's astounding that regulators don't get that concept of shareholder democracy. Our hope is that the OSC will see the light and mandate majority voting. To say we've solved the problem voluntarily is not true."

"Shareholders cannot vote 'no'; they can only vote 'withhold'," said a **corporate attorney**. "I think a 'withhold' vote should be considered a 'no' vote. If a director receives a majority of 'withhold' votes, why should the board second guess that? That director should resign; it's clear that the shareholders want that board member out."

"Majority voting should be considered a best practice"

The representative of a **corporate directors group** concurs, "There's a lot of alignment on this issue. However, we think majority voting should be considered a best practice. The slight difference of opinion is about whether the board should simply take the outcome of the ballot box or have some residual discretion. We think there should be some discretion to allow the board to deal with exceptional issues. Take for example a highly valuable director with a serious family issue causing him to miss a lot of meetings – a personal issue you don't want to disclose in your proxy circular. He'd get a negative advisory for his attendance record even though he's of high value to the company.

"There's also an issue with the fact that voter participation is very low in most widely held companies. If only 10% of shareholders vote, a small group with ulterior motives could take over the company."

When challenged by a **shareholder activist** to explain why a director who's missed 8 of 9 meetings shouldn't be disclosed, the **board advisor** insisted, "It's a fundamental principle in Canada to retain confidentiality if it's in the company's best interest." His remark was countered by others who believe that shareholders should have the information to make an informed decision.

"Shareholder Democracy ≠ Political Democracy"

"There seems to be a guttural reaction in Canada to equate democracy in corporate governance with democracy in general political elections," the **board advisor** continued. "That's a fallacy. In corporate Canada, there are no choices; you don't know who the alternatives might be. I don't have a disagreement with the principle – but with the mechanics. It's not a simplistic issue and boards should have some discretion. We think voluntary adoption is preferable to mandating majority voting."

A **shareholder activist** suggested, "Some objectivity has to come into play; there's a natural tendency to become emotionally attached to fellow board members, and that's where process can be valuable."

A former **securities regulator** believes, "If we have majority voting, we'll simply be at the level of elections in Communist China – with the power to vote 'yes' or 'no.' Why don't we look at facilitating shareholders to nominate candidates – and then have true elections with more candidates to choose from? The candidates with the greatest plurality of 'yes' votes would get the slots. Wouldn't that be true shareholder democracy?"

Counsel for a public pension fund is concerned about "leaving too much discretion for the board to retain egregious offenders. Having too much discretion guts the policy."

"Boards – not shareholders - understand best what constitutes an effective board"

"The only body that is legally bound to act in the best interests of the company is the board; chipping away the board's responsibility is a negative direction to take." – Institutional Investor

"Almost all the time, nominating committees do a pretty good job," believes the **director of a shareholder advocacy organization.** "Most shareholders rely on them to do the right thing. That said, you do need discipline. Shareholders need tools to do something when things don't go well: the ability to terminate a director and proxy access. Major shareholders should have the right to propose a director and have access to the management circular."

"I support the adoption of majority voting and the elimination of slate voting," said an **institutional investor**. "However, with regard to proxy access, the board understands what is needed to constitute an effective board – the skill sets, constituents to be represented, the right chemistry. You want independent minds, courageous, committed people - and outsiders don't really understand what's in the best interest of the corporation. "

A **representative from a financial analysts organization** believes, "If the shareholder advocacy and board advisory organizations would announce that they support majority voting, assuming 90% of issuers would adopt it, it would be the 10% that do not which need the regulatory encouragement."

"Director elections are a different ball game"

"Independent voting for directors, majority voting and vote results reporting are all good things," believes a **compensation consultant**. "However, when you get to director elections, it's a different ball game. 'Withhold' votes should not necessarily be counted as 'no' votes. I also think it's worth exploring the ability of shareholders to propose nominees in the management proxy circular. The issue of board composition could be addressed in the circular by explaining the board's recommendations." A **private fund manager** noted, "The cultures in the governance systems in Canada and the U.S. are different. "We should develop our own governance systems."

"Unregulated proxy advisory firms are a growing problem"

A **mutual fund executive** believes, "Before we rush into mandatory voting, we should ask why, in the ordinary course of business, do shareholders withhold votes? I think it comes back to proxy advisory firms. It's the obligation of shareholders to do their own due diligence and not simply follow the proxy advisors. On our board, some of the most effective board members get 'no' recommendations from the advisory firms. The concern is that the advisory firms are unregulated – even though they can get things strikingly wrong. Mandating majority voting will only increase the importance and influence of these unregulated firms."

A **corporate attorney** sees more evidence of ISS control of the market. "The effect of an ISS recommendation is powerful; a recent study shows that it affects 20% of voting."

"The role of the proxy advisory system needs to be examined," agreed a public **pension plan representative.** "The proxy advisors are unregulated and not transparent."

The **general counsel for an investor advocacy organization** countered, "The Council of Institutional Investors took issue with the methodology of the study about the power of proxy advisors. They did *not* believe the study showed blind allegiance to ISS recommendations."

The **legal counsel for a public pension fund** believes, "We're sophisticated enough in Canada to go through what the proxy advisors say and make our own decisions. It's not in our best interest to follow them blindly."

What should be done to reform the proxy voting system?

"A lot of questions have been raised about the proxy system's integrity, reliability and transparency."
- Poonam Puri

A global perspective

"The CSA got it wrong by saying that equity controlled corporation nominees are by definition not independent," insists a representative from an **investor rights group**. "I'm influenced by my many years in Hong Kong. The vast majority of companies in Hong Kong are equity controlled, and generally there is no Say on Pay or compensation problems. Shareholders are not upset with executive compensation; their interests are aligned with the other shareholders."

"Boards should retain some discretion in 'no' vote situations"

A **corporate lawyer** commented, "As to whether the board should have an overriding discretion over the removal of a director who receives a 'no' vote, I believe they should have control over the timing of that removal. What if the director in question is the CEO or the Chair of the Audit Committee? I don't think they should be forced to say goodbye to a valuable board member without the opportunity to address the transition."

With just a few minutes left, Moderator Puri shifted the discussion to the proxy voting system.

Professor Puri referenced a 2010 discussion paper by a major Canadian law firm that pointed out failures such as:

- Proxy materials not delivered in time
- The absence of clear and accessible rules
- Properly cast votes that are not given full weight, go uncounted or are over-counted
- Limited transparency and accountability in terms of the unregulated outsourcing of significant aspects of the proxy voting system

"It's shocking that there's no assurance that votes will be counted," voiced **an investor advocate**. "It's a global problem. I believe the fundamental problem is that no one in the system is responsible for making it work, for ensuring that votes are counted. Regulators should take a simplistic approach and insist that votes be counted properly."

The representative of a **corporate directors group** notes, "Historically, nearly 99% of votes are in favor of management – with just a few highly contested proxy fights. It's imperative that we have integrity in the vote counting process. This is a huge issue and not just corporate Canada's responsibility. It's a capital markets issue."

A **representative from a financial analysts organization** believes that corporations can't wait for the system to be reformed before taking responsibility. "They have the obligation to ask the hard questions: How are you reconciling the votes; do you have ISO quality checks; do you have the Section 5970 done? If we wait for everything to be done, it will take a long time."