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Bad Company! The Assumptions Behind Proxy Advisors' Voting Recommendations

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The corporate governance challenge for Canada is to improve the quality of its corporate performance, which has been declining relative to its international peers for decades. This is quite different from the usual assumption that corporate governance is primarily a matter of controlling managerial self-dealing. While important, board monitoring of management is only one aspect of its role in a corporation; research suggests corporate governance arrangements have a significant impact on corporate outcomes, particularly in areas such as innovation where Canada lags.

Third-party proxy advisory firms, which provide advice to institutional investors in Canada on corporate governance matters, have grown in influence over the past decade. As securities regulators consider whether (and how) to treat them, an examination of the assumptions that underlie these advisors' voting recommendations, and the influence these assumptions have on corporate decision-making, suggest these assumptions create perverse governance incentives and are contradicted by empirical research on what produces the best corporate outcomes.

Pour le Canada, le défi que présente la gouvernance d'entreprise est d'améliorer la qualité du rendement, laquelle est en déclin constant depuis des décennies par rapport à ce qui se passe dans d'autres pays. Cette situation est fort différente de l'hypothèse habituelle voulant que la gouvernance d'entreprise vise d'abord à contrôler les opérations entre initiés des membres de la direction. La surveillance de la gestion par le conseil d'administration est certes importante, mais ce n'est que l'un des volets du rôle du conseil au sein d'une société par actions; la recherche suggère d'ailleurs que les arrangements concernant la gouvernance d'entreprise ont une incidence considérable sur les résultats des sociétés, en particulier dans des domaines comme l'innovation où le Canada tire de l'arrière.

Les sociétés d'expertise-conseil en matière de procurations donnent aux investisseurs institutionnels au Canada des conseils sur les questions de gouvernance d'entreprise; au cours de la dernière décennie, elles ont acquis une influence grandissante. Tandis que les instances réglementaires en matière de valeurs mobilières se demandent s'il y a lieu de s'intéresser à ces sociétés (et comment intervenir), un examen des postulats qui sous-tendent les recommandations de vote de ces conseillers et leur influence sur la prise de décision des entreprises suggère qu'ils créent des incitatifs pervers en matière de gouvernance et sont contredits par la recherche empirique sur les causes des meilleurs résultats des entreprises.

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Introduction

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- II. *Proxy advisory firm voting recommendations*
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Introduction

For more than three decades, the largely unexamined focus of corporate reformers has been to revitalize shareholder democracy.¹ It seemed a variety of issues arising from the modern separation of ownership and control could only be resolved if shareholders had better disclosure, better access to the proxy machinery, and more authority over decisions historically reserved for the board.² No reformer anticipated that a principal

1. The modern preoccupation with empowering the shareholders of widely-held corporations is usually dated to begin with the publication of Michael C Jensen & William H Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3:4 *Journal of Financial Economics* 305 [Jensen & Meckling, "Theory of the Firm"], although the fundamental issues arising from the separation of ownership and control have been known since Berle & Means's famous debate in the *Modern Corporation and Private Property* first published in 1932. See Adolf A Berle & Gardiner C Means, *The Modern Corporation and Private Property*, 10th printing (New Brunswick, NJ: Transaction Publishers, 2009) [Berle & Means, *The Modern Corporation*]. For another classic opinion on economic theory, see Frank H Easterbrook & Daniel R Fischel, "The Corporate Contract" (1989) 89:7 *Colum L Rev* 1416. For a more modern analysis of the shareholder primacy debate, see Henry Hansmann & Reinier Kraakman, "The End of History for Corporate Law" (2001) 89:2 *Georgetown LJ* 439 [Hansmann & Kraakman, "End of History"] (proclaiming the success of shareholder primacy law in corporate governance). See also Lynn A Stout, "On The Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (In the Closet)" (2013) 36:2 *Seattle UL Rev* 1169 [Stout, "In the Closet"] that discusses the history of corporate governance and the rise of shareholder primacy. For a discussion of shareholder/stakeholder primacy arguments, see notes 104-105.

2. See for example, Jeffrey G MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1996) 26 *CBLJ* 145; Roberta Romano, "Less is More: Making Investor Activism a Valuable Mechanism of Corporate Governance" (2001) 18:85 *Yale J on Reg* 175. After the enactment of the *Sarbanes-Oxley Act* of 2002, Pub L No 107-204, 116 Stat 745 [SOX], Canadian provincial regulators wanted to signal to capital market participants that the Canadian market was as "strong and protective of investors' interests as the American Market": see Christopher C Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative and Regulatory Response to *Sarbanes-Oxley*," Task Force to Modernize Securities Legislation in Canada (15 June 2006). Some reforms from Canadian regulators included: National Instrument 52-108 Auditor Oversight, Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings, Multilateral Instrument 52-110 Audit Committees, National Instrument 58-101 Disclosure of Corporate Governance Practices, National Policy 58-201 Corporate Governance

beneficiary of these reforms would be an oligopoly of third-party proxy advisory firms.³

While the magnitude of proxy advisors' direct impact on the shareholder vote is the subject of some academic debate,⁴ no one familiar with the modern boardroom seriously argues with Delaware's Chancellor Leo Strine's assessment that, "Powerful CEOs come on bended knees to Rockville, Maryland, where ISS [the dominant advisory firm] resides, to persuade the managers of ISS of the merits of their views...."⁵ Nor would any director in Canada dispute the assessment of a commission struck by the New York Stock Exchange that boards routinely ask, "What are the proxy advisory firms' policies on this action?"⁶

In Canada, proxy advisory firms have made the news in several of the most prominent corporate votes of the last two years. They assisted in Pershing Square Capital Management's acquisition of control over Canadian Pacific, and they gave life to Jana Partner's criticisms of the board of Agrium.⁷ They opposed Alimentation Couche Tard's offer for

Guidelines, National Instrument 51-102 Continuous Disclosure Obligations, National Instrument 52-107 Acceptable Accounting Principles, Auditing Standards, and Reporting Currency, National Instrument 71-102 Continuous Disclosure and Other Exemptions Relating to Foreign Issuers. For a detailed overview of these changes, see Tara Gray, "Canadian Response to the U.S. Sarbanes-Oxley Act of 2002: New Directions for Corporate Governance" (4 October 2005), online: Parliament of Canada <<http://www.parl.gc.ca/content/lop/researchpublications/prb0537-e.pdf>>; Stephen P Sibold, "Assessing Canada's Regulatory Response to the *Sarbanes-Oxley Act of 2002*: Lessons for Canadian Policy Makers" (2009) 46:3 *Alta L Review* 769 [Sibold, "Assessing Canada's Regulatory Response"]; Sukanya Pillay, "Forcing Canada's Hand? The Effect of the Sarbanes-Oxley Act on Canadian Corporate Governance Reform" (2004) 30 *Man LJ* 285. The Canadian government also enacted reforms to the *Criminal Code* dealing with insider trading and various issues involving financial fraud (Bill C-13, *An Act to Amend the Criminal Code*, 3rd Sess, 37th Parl, 2004, (Royal Assent 29 March 2004). Prior to the *Sarbanes-Oxley Act*, the Toronto Stock Exchange (TSX) changed its corporate governance guidelines (the "Best Practice Guidelines") as a result of the Dey Report in 1994 (see Peter Dey, *Where Were the Directors?—Guidelines for Improved Corporate Governance in Canada*, (December 1994), and the Saucier Committee Report, Joint Committee on Corporate Governance, "Beyond Compliance: Building a Governance Culture" (21 November 2001), online: <http://www.ecgi.org/codes/documents/beyond_compliance.pdf> ["Saucier Committee Report"]. The guidelines were further updated 26 April 2002. For an overview of changes prior to and after *Sarbanes-Oxley Act*, see Jonathan Lampe & Mark Spiro, "Corporate Governance Developments in Canada" at 45, online: Goodmans LLP <<http://www.goodmans.ca/docs/Corporate%20Governance%20Developments%20in%20Canada.pdf>>. The US also enacted "say-on-pay" legislation under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 111-203, §951, 124 Stat 1376 (2010), granting shareholders a vote on executive compensation.

3. See the discussion at notes 37-40 on proxy advisory firms.

4. See discussion at notes 41-42.

5. Leo E Strine, "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face" (2005) 30:3 *Del J Corp L* 673 at 688.

6. *Report of the New York Stock Exchange Commission on Corporate Governance* (23 September 2010) at 15, online: New York Stock Exchange <www.nyse.com/pdfs/CCGReport.pdf>.

7. Scott Deveau, "Corporate culture shift underway in Canada after CP Rail proxy fight," *Financial Post* (14 May 2012), online: Financial Post <<http://business.financialpost.com/2012/05/11/shift>>.

Casey's and Kinross's proposal to acquire Red Black, but supported Equinox Mineral's hostile bid for Lundin Mining.⁸ In all these disputes the opinion of the proxy advisors, particularly ISS, constituted a separate—and new—arena for conflict among the various interested parties.

It was just a matter of time before regulators became interested in the only powerful constituency in corporate governance entirely free of both regulation and legal duties to other parties.⁹ This paper reviews the positions taken by the proxy advisory firms in Canada, both in their annual proxy planning guides and in specific high-profile vote recommendations, to determine what fundamental assumptions about corporate governance lie behind them. A companion paper reviews the issues that arise in the practical day-to-day advisory business of generating tens of thousands of voting recommendations in Canada.¹⁰

We often assume that the central issue of corporate governance in Canada is to prevent managerial self-dealing, as this is generally how the problem has been characterized in the United States.¹¹ But this is not true. The most important public policy challenge faced by Canada in the area of corporate governance is that our corporations are, as a group, underperforming. The OECD has observed that Canada's productivity performance has, in recent decades, been the worst of all the G7 countries

underway-for-canadas-clubby-corporate-culture-after-cp-rail-proxy-fight/"; Peter Koven, "Jana predicts two dissident candidates will join Agrium board," *Financial Post* (8 April 2013), online: <http://business.financialpost.com/2013/04/08/jana-predicts-two-dissident-candidates-will-join-agrium-board/> [Koven, "Jana Predicts"].

8. Yvan Allaire, "The Troubling Case of Proxy Advisors: Some Policy Recommendations" (January 2013) Policy Paper No. 7 at 21, online: Institute for Governance of Private and Public Organizations (IGOPP) <http://www.igopp.org/IMG/pdf/pp_troublingcaseproxyadvisors-pp7_short_3_.pdf>.

9. See Securities and Exchange Commission, Concept Release on the US Proxy System (2010) File no. S7-14-10, online: Securities and Exchange Commission <<http://www.sec.gov/rules/concept/2010/34-62495.pdf>>; Autorite des Marchés Financiers (AMF), AMF Recommendation 2011-06 on Proxy Voting Advisory Firms (18 March 2011), translation available online: <http://www.amf-france.org/en_US/Reglementation/Doctrine/Doctrine-list/Doctrine.html?category=I+-+Issuers+and+financial+disclosure&docId=workspace%3A%2F%2FSpacesStore%2F12e1aead-0ff9-4f26-8fd0-d0ebe29d0efe>; Canadian Securities Administrators Consultation Paper 25-401: Potential Regulation of Proxy Advisory firms, OSC CSA Notice, (2012) 35 OSCB 5681 ["CSA Consultation Paper"].

10. Bryce C Tingle, "The Case for Regulating Proxy Advisory Firms," (forthcoming) ["Proxy Advisory Firms"].

11. Daniel JH Greenwood, "Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited" (1996) 69:3 *Southern Calif Law Rev* 1021 at 1023: "Virtually all major groups of corporate law scholars today agree on the centrality of the shareholder to corporate law; all but the communitarians agree that virtually the sole task of corporate law is to ensure that managers act as agents for the shareholder owners." See also: Hansmann & Kraakman, "End of History," *supra* note 1; Edward B Rock, "Saints and Sinners: How Does Delaware Corporate Law Work?" (1997) 44:4 *UCLA L Rev* 1009; and Bernard S Black, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39:4 *UCLA Law Rev* 811.

and identifies it as Canada's "key" long-term challenge.¹² The Bank of Canada recently pointed out that since 2005 labour productivity in Canada has grown by just 0.5 per cent annually, compared with 2.1 per cent in the U.S.¹³ Canada's productivity levels now rank in the bottom quartile of the OECD.¹⁴ The failures of Canada's corporations to compete effectively mean that Canada has lost considerable ground to other OECD countries in terms of living standards.¹⁵ The World Economic Forum dropped Canada's ranking in world competitiveness from seventh in 2000 to tenth in 2010.¹⁶ When it comes to research and development, and other measures of innovation we rank much further down the pack.¹⁷

As well, Canada's public markets have declined in their attractiveness to new businesses, with all the implications that has for the country's competitiveness, cost of capital and ability to nurture large-scale globally competitive companies.¹⁸ I have argued elsewhere the significant decline in the IPO market in this country is due to the disadvantages experienced by corporate managers in being public.¹⁹ Most of these disadvantages are connected to our relatively new corporate governance regime.

It would be wrong, therefore, to see the question of corporate governance in Canada as somehow ancillary to our shared life. Every Canadian should care a great deal about how we can improve the governance of our corporations. Research has repeatedly connected corporate governance regimes with corporate performance, particularly innovation and R&D.²⁰

12. OECD, *OECD Economic Surveys: Canada*, Economic Surveys, vol 2012, No 12, (2012) at 28, online: <http://www.oecd-ilibrary.org/economics/oecd-economic-surveys-canada-2012_eco_surveys-can-2012-en>.

13. Tiff Macklem, "Canada's Competitive Imperative: Investing in Productivity Gains" (Speech delivered at Productivity Alberta's Luncheon Series, 2 February 2011), online: <<http://www.bankofcanada.ca/2011/02/publications/speeches/canada-competitive-imperative-investing-2/>>. See also Report of the Expert Panel on Business Innovation, *Innovation & Business Strategy: Why Canada Falls Short* (June 2009), online: Council of Canadian Academies <<http://www.scienceadvice.ca/uploads/eng/assessments%20and%20publications%20and%20news%20releases/inno/%282009-06-11%29%20innovation%20report.pdf>>.

14. Aggregate Income and Productivity Trends: Canada vs United States, 1961–2011 (18 June 2012), online: <<http://www.csls.ca/data/ipt1.asp>>.

15. Conference Board of Canada, *How Canada Performs: Detail and Analysis* (current as of March, 2013), online: <<http://www.csls.ca/data/ipt1.asp>>.

16. Klaus Schwab et al, "The Global Competitiveness Report 2010–2011" (2010), online: World Economic Forum <http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf>.

17. In 2010, Canada ranked 20th on R&D spending and 19th in innovation: Soumitra Dutta & Irene Mia, eds, "The Global Information Technology Report 2010–2011" (2011), online: World Economic Forum <http://www3.weforum.org/docs/WEF_GITR_Report_2011.pdf>.

18. Bryce C Tingle et al, (2013) "The IPO Market in Canada: What a Comparison with the United States Tells Us About a Global Problem" 54 *Can Bus LJ* 321.

19. *Ibid.*

20. See, for example, Jie He et al, "The Dark Side of Analyst Coverage: The Case of Innovation"

Commentators from Warren Buffett²¹ to the global managing director of McKinsey & Company,²² to the current U.K. government²³ have called for changes to the current corporate governance regime, which they see as interfering with long-term growth rates. This paper asks whether proxy advisory firms, the most influential of the new participants in Canada's new corporate governance regime, are part of the problem.

I. *The rise of proxy advisory firms and their influence*

Like much of the developed world, Canada witnessed a transformation of its capital markets in the past half-century.²⁴ Previously, nearly all shares in Canada were owned and voted directly by individual investors; now large blocks of these shares, particularly in the largest TSX-listed companies, are owned and voted by intermediary institutions such as pension and mutual funds. While individuals remain, in some sense, "owners" of the securities held by these institutional investors, their "ownership" is

(2013) 109:3 *Journal of Financial Economics* 856; Andrew Prevost et al, "Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?" (2000) 73:2 *The Journal of Business* 177; William Johnson et al, "The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms" (29 April 2013), online: SSRN <<http://papers.ssrn.com/abstract=1923667>>; Natalie Mizik, "The Theory and Practice of Myopic Management" (2010) 47:4 *Journal of Marketing Research* 594; Aleksandra Kacperczyk, "With Greater Power Comes Greater Responsibility" (2009) 30:3 *Strategic Management Journal* 261; Brian Bushee, "Do Institutional Investors Prefer Near-Term Earnings Over Long-run Value?" (2001) 18:2 *Contemporary Accounting Research* 207; Brian Bushee, "The Influence of Institutional Investors on Myopic R&D Investment Behaviour" (1998) 73:3 *The Accounting Review* 305; William Pugh et al, "Antitakeover Charter Amendments: Effects on Corporate Decisions" (1992) 15:1 *Journal of Financial Research* 57; Campbell Harvey et al, "Value Destruction and Financial Reporting Decisions" (2006) 62:6 *Financial Analysts Journal* 27; and Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-termism Contribute to the Decline of the Western Economies* (Eleven International Publishing, 2013).

21. Warren Buffett, "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management" (2009), online: The Aspen Institute <<http://www.aspeninstitute.org/sites/default/files/content/images/BSPPOnlineBroch.pdf>>.

22. Dominic Barton, "Capitalism for the Long-Term, McKinsey on Cooperatives" (2012), online: McKinsey & Company <http://www.mckinsey.com/client_service/strategy/latest_thinking/mckinsey_on_cooperatives>.

23. John Kay, "The Kay Review of UK Equity Markets and Long-Term Decision Making" (July 2012), online: The United Kingdom Department for Business Innovation and Skills <<http://bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-or-equity-markets-final-report.pdf>> [Kay, "The Kay Review"]; and Vince Cable (Secretary of State, Department of Business, Innovation and Skills), "Ensuring Equity Markets Support Long-Term Growth: The Government Response to the Kay Review" (November 2012), online: United Kingdom Department for Business Innovation and Skills <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf>.

24. Jeffrey G MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1996) 26:2 *Can Bus LJ* 145 at 146 [MacIntosh, "Institutional Shareholders"]: "the total assets of banks, life insurance companies, trustee pension plans, trust and loan corporations, mutual funds, local credit unions and Caisses Populaires (measured in constant 1986 dollars) has grown from \$267 billion in 1969 to \$1.2 trillion in 1990."

essentially a shared undivided interest in a portfolio of securities selected, managed and voted by professional fund managers.

In Canada, 32% of the shares of TSX-listed issuers are held by institutions,²⁵ which are estimated to be responsible for two-thirds of the trades on the TSX by dollar volume.²⁶ A similar trend can be seen in the United States, where institutional share ownership has gone from 6.1% in 1950 to 50.6% in 2009.²⁷ Indeed, institutional investors held 73% of the thousand largest U.S. corporations that year.²⁸

John Coffee points out the consequences of this concentration of share ownership in the hands of intermediaries: money managers show “limited interest in corporate governance issues...because the expected gains from most such governance issues are small, deferred, and received by investors, while the costs are potentially large, immediate, and borne by money managers.”²⁹ This should be immediately familiar as a new instantiation of the principal-agent problem central to any discussion of the governance of widely-held companies.

Fund managers are rewarded according to their performance relative to other fund managers and certain benchmarks, such as the TSX Composite Index.³⁰ Clever and conscientious voting of the shares in their portfolios affects the relative performance of those portfolios far less than the selection of investee companies in the first place and the timing of trades in those companies.³¹ As well, efforts undertaken to improve the governance of portfolio companies benefit other fund managers and the

25. CSA Consultation Paper, *supra* note 9 at 5684.

26. Shamsud D Chowdhury & Eric Z Wang, “Institutional Activism Types and CEO Compensation: A Time-Series Analysis of Large Canadian Corporations” (2009) 35:1 *Journal of Management* 5 at 7 [Chowdhury & Wang, “Institutional Activism Types”].

27. Matteo Tonello & Stephen Rabimov, “The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition” (2010) Research Report R-1468-10-RR at 22, table 10, online: The Conference Board of Canada Inc <<http://www.conferenceboard.ca/e-library/abstract.aspx?did=3890>>; Jeffrey N Gordon, “The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices” (2007) 59:6 *Stan L Rev* 1465 at 1568, table 4 and figure 6.

28. Gordon, *supra* note 27. In its recent petition to the SEC on proxy advisors, NASDAQ advises that institutional share ownership now exceeds 75%: NASDAQ OMX Group, Inc Petition to SEC (8 October 2013) at 2, online: SEC <<https://www.sec.gov/rules/petitions/2013/petn4-666.pdf>>.

29. John C Coffee, “Liquidity Versus Control: The Institutional Investor as Corporate Monitor” (1991) 91:6 *Colum L Rev* 1277 at 1317-1328. See also, Jill E Fisch, “Securities Intermediaries and the Separation of Ownership and Control” (2010) 33:4 *Seattle UL Rev* 877 at 879; and Stephen M Bainbridge, *Corporate Governance After the Financial Crisis* (New York: Oxford University Press, 2012) at 247-248 [Bainbridge, “After the Financial Crisis”].

30. Michael K Berkowitz & Yehuda Kotowitz, “Incentives and Efficiency in the Market for Management Services: A Study of Canadian Mutual Funds” (1993) 26:4 *Canadian Journal of Economics* 850.

31. Bernard S Black & John C Coffee Jr, “Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation” (1994) 92:7 *Mich L Rev* 1997 at 2063-2064.

benchmark indices that include those companies, eliminating any relative performance advantage that would accrue to the money manager.

Thus, we would expect the men and women who control significant percentages of Canada's share capital to pay little attention to corporate voting—and that is more or less what we see.³² Many institutional investors in Canada simply do not vote their shares except in high-stakes contested votes. (Canadian fund managers have a “duty” but not a legal obligation to vote.³³) Other institutional investors vote their shares, but like Fidelity Investments, conduct their proxy voting through a separate internal group, without providing for input or recommendations from portfolio managers or research analysts.³⁴ Even if there were incentives for money managers to carefully scrutinize the proxy materials of the companies they own in their portfolios, the sheer number of these companies would probably defeat such efforts. As proxy advisor Glass Lewis & Co., notes, “Most institutions do not have adequate in-house resources to ensure that the right decisions are being made on the hundreds or thousands of proxies they vote each year.”³⁵

Various attempts to measure the involvement of institutional investors in the proxy process have tended to support this picture of disengagement.³⁶ For example, a survey of shareholder proposals in the United States found that mutual funds were the architects of only 4.5% of all shareholder proposals, and 80% of these concerned social and environmental issues unconnected with the basic business and financial performance of the

32. This is a well-known phenomenon that first achieved prominence in Berle & Means, *The Modern Corporation*, *supra* note 1. See as well, Lynn A Stout, “The Mythical Benefits of Shareholder Control,” *Regulation* (Spring 2007) 42, online: <<http://www.cato.org/regulation/spring-2007>> [Stout, “Mythical Benefits”]; MacIntosh, “Institutional Shareholders,” *supra* note 24 at 153-154; Edward B Rock, “The Logic and (Uncertain) Significance of Institutional Shareholder Activism” (1991) 79:3 *Geo LJ* 445 at 460-463; Simon CY Wong, “Why Stewardship is Proving Elusive for Institutional Investors” [2010] *Butterworths Journal of International Banking and Financial Law* at 406.

33. See Discussion Paper, “The Quality of the Shareholder Vote in Canada” (22 October 2010) at 169, online: Davies Ward Phillips & Vineberg LLP <<http://www.dwpv.com/Sites/shareholdervoting/media/The-Quality-of-the-Shareholder-Vote-in-Canada.pdf>>: “That duty will typically (but may not always) require the institutional investor to vote its shares, whether to protect the long-term value of the investment or to approve or disapprove an action or even that may affect the investment in the short term.”

34. Fidelity Funds' Proxy Voting Guidelines (November 2011), online: Fidelity Investments <http://www.fidelity.ca/cs/Satellite/en/public/products/regulatory_documents/proxy_voting/guidelines>.

35. Glass, Lewis & Co Products and Services (31 August 2013), online: LinkedIn <<http://www.linkedin.com/company/glass-lewis-&-co./products>>.

36. See, e.g., Robert C Pozen, “Institutional Investors: The Reluctant Activists” *Harvard Business Review* (1994) at 140, 144, online: *Harvard Business Review* <<http://hbr.org/1994/01/institutional-investors-the-reluctant-activists/ar/1>>; Bernard S Black, “Shareholder Activism and Corporate Governance in the United States” (1998) 3 *The New Palgrave Dictionary of Economics and the Law* 459 at 460 [Black, “Shareholder Activism”].

company.³⁷ Extensive empirical evidence from the IPO market suggests that institutional investors do not prefer companies that give them stronger governance rights.³⁸ Rather they cheerfully pay premiums for companies with poison pills, staggered boards and two-tier voting structures in a process that Professor Lynn Stout analogizes to Ulysses seeing the advantage of tying his own hands.³⁹

Proxy advisory firms are intended to solve the problems surrounding institutional voting. They specialize in reviewing the proxy materials that accompany shareholder meetings, and issuing recommendations on how shareholders should vote. The cost of these services is shared by their many clients, all of whom are institutional investors. On the face of it, proxy advisory firms have a business model that incentivizes them to provide accurate voting guidance to their clients, the professional money managers. Bad advice should, over time, lead to a decline in proxy firms' market share.⁴⁰ Advisory firms can bring the dedicated resources needed to review and evaluate the tens of thousands of specific matters that come up for vote each year in Canada's public markets. If investment funds organize themselves around research, selecting stock and trading, proxy advisory firms can focus on reviewing information circulars and evaluating corporate governance.

There is some controversy about the actual influence of proxy advisory firms on the shareholder vote. The Investment Company Institute undertook a massive study of proxy votes by funds and found that while, "funds vote proxies in accordance with their board-approved guidelines... fund voting patterns are often broadly consistent with vote recommendations of proxy advisory firms."⁴¹ The position of investment funds, as well as the proxy

37. Ronald J Gilson & Jeffrey N Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights" (2013) 113:4 Colum L Rev 863 at 887. See also, Roberta Romano, "Less is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance" (2001) 18 Yale J on Reg 174 at 181 [Romano, "Less is More"].

38. Stout, "In the Closet," *supra* note 1 at 1182-1183; Brandon S Gold, "Agents Unchained: The Determinants of Takeover Defenses in IPO Firms" (2013), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2262095>.

39. Stout, "Mythical Benefits," *supra* note 32 at 45.

40. There are, however, scholars who argue that the value of proxy advisors to institutional investors is not actually a function of the accuracy of their voting recommendations, but rather acts as a source of "criticism insurance" (Larry Ribstein, "Larry Ribstein on *The Corporate Governance Industry*" (12 June 2006), online: The Conglomerate Blog <http://www.theconglomerate.org/2006/06/the_corporate_g.html>) or as a source of useful noise: "low-quality ratings make it harder to hold them [investors] accountable for poor decision making or poor outcomes associated with those investment decisions." Charles W Calomiris & Joseph R Mason, "Conflicts of Interest, Low Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings" (19 April 2010), online: e21 Economic Policies for the 21st Century <http://economics21.org/files/pdfs/commentary/04_19_2010_calomiris_mason_governance.pdf> .

41. Sean Collins, "Proxy Voting by Registered Investment Companies: Promoting the Interests of

advisors themselves, is that this is a case of correlation, not causation.⁴² Poor corporate governance will be just as visible to investment funds acting independently as it will to a proxy advisor. Professional money managers claim they find the proxy advisors' recommendations useful, but say they are just one factor taken into consideration when choosing how to vote.⁴³ The corporate subjects of proxy advisors' recommendations have a very different perspective. It is almost uniformly believed by issuers that proxy advisors swing between 10% and 25% of the votes cast at shareholder meetings. The responses filed in connection with the CSA request for comment concerning proxy advisors turned up similar estimates of their influence.⁴⁴

Scholars disagree about proxy advisors' direct impact on shareholder voting. One study found that a negative recommendation from ISS with respect to a director reduced the votes cast in his or her favour by over 20% in circumstances where there are no obvious firm performance or governance

Fund Shareholders" (10 July 2008) 14 Research Perspective 1, online: Investment Company Institute <<http://www.ici.org/pdf/per14-01.pdf>>.

42. Comment letter from Katherine H Rabin & Robert McCormick for Glass Lewis & Co on CSA Consultation Paper 25-401 Potential Regulation of Proxy Advisory Firms (20 September 2012), online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120920_25-401_rabink_mccormickr.pdf>; Comment letter from Debra L Sisti & Martha Carter for ISS on CSA Consultation Paper 25-401 Potential Regulation of Proxy Advisory Firms (10 August 2012), online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120810_25-401_sistid_carterm.pdf>.

43. See for example, Portfolio Management Association of Canada, Letter to CSA, 21 September 2012 at 2: "Such recommendations are exactly that—recommendations only—and most investors, if not all, will evaluate matters independently, thoroughly and in their own unique decision making process..."; Ontario Teachers' Pension Plan, Letter to CSA, 21 September 2012 at 6: "At Teachers', proxy advisory firms provide us with just one of the many inputs in our proxy voting decision making process"; RBC Global Asset Management Inc, Letter to CSA, 20 September 2012 at 2: "ISS and Glass, Lewis, through their guidelines, research reports and voting recommendations, are only two sources of information on which our guidelines and voting decisions are based"; and TIAA-CREF, Letter to CSA, 21 September 2012 at 2: "we prepare and follow our own internal proxy voting guidelines, using proxy advisory firm research solely as an informational tool to supplement our internally produced research. Moreover, we formulate our own voting decisions in-house. . . . In sum, these [proxy advisory] services inform and facilitate, but do not substitute for TIAA-CREF's exercise of independent judgment in arriving at our own decisions on how to direct the voting of portfolio company shares. . . ." All letters to CSA available online: OSC <<http://www.osc.gov.on.ca/en/36504.htm>>.

44. See, e.g., CI Financial, Letter to CSA, 21 September 2012 at 4 discussing a director who attracted a withhold vote one year from ISS: "That other director had almost 16% of the shares withheld from his election. Prior to this, and again at the [next] annual meeting in 2011, his election was supported by over 99% of the shares voted." Bennett Jones, CSA Letter, at 2: referring to "large swings" in the vote attributable to proxy advisors. Astral Media Inc, Letter to CSA, 21 September 2012 at 2: "ISS recommendations will always influence the outcome of a vote and, depending on the percentage of votes held by institutions that vote in accordance with ISS recommendations, may *determine* the outcome of a vote" [emphasis in the original]. Letters to CSA available online: OSC <<http://www.osc.gov.on.ca/en/36504.htm>>.

anomalies.⁴⁵ Another study concluded that ISS swayed between 13.6% and 20.6% of the vote.⁴⁶ However, a more recent study attempting a different research methodology found that “the impact of an ISS recommendation ranges from 6% to 13% for the median company.”⁴⁷ In contested elections there is evidence to show proxy advisors' recommendations serve to “certify” dissident campaigns and have a larger effect than usual.⁴⁸

It should be observed that even the low end of the range for proxy firm influence—nearer 10% than 20% for example—represents a great deal of power in a widely held firm. IBM submitted data to the SEC which it claimed, “is evidence for *de facto* control” of IBM by proxy advisors.⁴⁹ Over the previous two years, 11.9% (2010) and 13.5% (2009) of IBM's shares were voted in conformity with ISS's recommendations within one day after ISS published those recommendations.

“By comparison, for the previous five business days, no more than 0.20% and 0.27% of the total IBM votes were cast in any one day in 2009 and 2010, respectively. To put that into proper perspective, the IBM voting block essentially controlled by ISS has more influence on the voting results than IBM's largest shareholder... [a] voting block... controlled by a proxy advisory firm that has no economic stake in the company....”⁵⁰

The Agrium proxy battle this year provides insight into the situation in Canada. An activist investor, Jana Partners, had engaged in an escalating war of words with the board and management of Agrium over a variety of strategic, governance and financial issues.⁵¹ Underpinning many of

45. Jie Cai, Jacqueline L Garner & Ralph A Walking, “Electing Directors” (2009) 64:5 *Journal of Finance* 2389 at 2401. See also Angela Morgan, Annette B Poulsen & Jack G Wolf, “The Evolution of Shareholder Voting for Executive Compensation Schemes” (2006) 12:4 *Journal of Corporate Finance* 715 at 715-737 (finding the impact of ISS recommendations is greater than 20% on compensation-related issues).

46. Jennifer E Bethel & Stuart L Gillan, “The Impact of the Institutional and Regulatory Environment on Shareholder Voting” (2002) 31:4 *Financial Management* 29 at 46.

47. Stephen Choi, Jill Fisch & Marcel Kahan, “Director Elections and the Role of Proxy Advisors” (2009) 82:4 *S Cal L Rev* 649 at 906.

48. Cindy R Alexander et al, “The Role of Advisory Services in Proxy Voting” [2009] National Bureau of Economic Research Working Paper No. 15143 at 28 and 34, online: National Bureau of Economic Research <http://www.nber.org/papers/w15143.pdf?new_window=1>.

49. Comment letter from Andrew Bonzani for International Business Machines Corporation, on the US Securities and Exchange Commission “Concept Release of the US Proxy System” Release No. 34-62495 File No. S7-14-10 (15 October 2010) at 2, online: US SEC <<http://www.sec.gov/comments/s7-14-10/s71410-84.pdf>>.

50. *Ibid* at 3.

51. See Institutional Shareholder Services Inc, Proxy Paper: Agrium Inc (26 March 2013) at 17 for a list of key events in the contested proxy battle [“ISS Proxy Paper”]; see also Amanda Stephenson, “Agrium Wins Proxy Fight; all Five Jana Nominees Rejected,” *Calgary Herald* (9 April 2013), online: <<http://www.calgaryherald.com/business/Agrium+wins+proxy+fight+five+Jana+nominees+reject+ed/8218133/story.html>>.

Jana's complaints about strategy was a valuation metric (measuring total shareholder return) that was quite different from the metric used by even the third-party analysts following the company.⁵² Unusually for these scenarios, nearly all of the largest shareholders of Agrium ended up supporting the board.⁵³ (Quite often the activist shareholder succeeds in convincing long term shareholders a change is required, or the run up in share price occasioned by an activist campaign induces long-term shareholders to take profits, and voting control moves towards shorter-term speculators with an investment thesis that depends on the proposed changes.⁵⁴) As well, Glass Lewis, Egan-Jones and a small European advisory firm came out in favour of Agrium.⁵⁵

Into this apparent consensus came the recommendation of Institutional Shareholder Services (ISS) late in the process: three of the Agrium directors should be replaced by two members of the slate proposed by Jana Partners, including founder Barry Rosenstein.⁵⁶ This would create a nine-person board that included both sides of a fight that had been conducted publicly and was repeatedly characterized as "vicious" and "dirty" in the press.⁵⁷ A foretaste of possible future board meetings was Barry Rosenstein's "jaw dropping rant" (the phrase used by newspaper reporters) at the shareholder meeting after the voting results were announced.⁵⁸

52. *Ibid* at 21-25. Glass Lewis & Co Proxy Paper: Agrium Inc (26 March 2013) at 14 ["Glass Lewis Proxy Paper"]: "After considering the presented arguments, we ultimately find the Dissident's position, which relies, in part, on less common quantitative methodologies, offers insufficient cause to support the election of its nominees...."

53. Peter Koven, "Jana's Agrium proxy battle had little chance of succeeding," *Financial Post* (12 April 2013), online: Financial Post <<http://business.financialpost.com/2013/04/12/agrium-story/>>.

54. See the study by April Klein & Emanuel Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors" (2009) 64:1 *The Journal of Finance* 184 at 225: "Activists are extremely successful in getting existing management to acquiesce to their demands as articulated in the initial 13D filing, with hedge funds enjoying a success rate of 60% and nonhedge fund activists accomplishing their objectives 65% of the time. Both groups are particularly successful at gaining board representation on the target firm within one year of the initial finding."

55. "Glass Lewis Proxy Paper," *supra* note 52; Egan-Jones Ratings Company, "Proxy Report #210497" (Agrium Inc) (21 March 2013); Pension & Investment Research Consultants Limited, *Proxy Paper: Agrium Inc* (21 March, 2013).

56. "ISS Proxy Paper," *supra* note 51 at 31.

57. Scott Hagggett, "Agrium Sweeps Proxy Vote, Jana Cries Foul," *Reuters* (9 April 2013), online: Reuters <<http://www.reuters.com/article/2013/04/09/agrium-jana-idUSL2N0CW1PM20130409>>; and Peter Koven, "Jana Predicts Two Dissident Candidates Will Join Agrium Board," *Financial Post* (8 April 2013), online: Financial Post <<http://business.financialpost.com/2013/04/08/jana-predicts-two-dissident-candidates-will-join-agrium-board/>>.

58. *Ibid*. A reporter from The Wall Street Journal simply referred to it, as "not exactly gracious" and "remarkable": Ronald Barusch, "Dealpolitik: Agrium Lesson for Activists: Don't underestimate the Adversary" (12 April 2013), *The Wall Street Journal* (blog), online: Deal Journal <<http://blogs.wsj.com/deals/2013/04/12/dealpolitik-agrium-lesson-for-activists-dont-underestimate-the-adversary/>>.

The strange suggestion by ISS that a board be made up of two groups with fundamental differences of opinion on strategy and even how to value the business, along with a history of bad blood and publicly-aired criticisms of one another, provides an interesting test of proxy advisors' power in Canada. How many institutional investors went along with this counter-intuitive recommendation? According to Agrium, roughly 12% of its shares were voted in favour of ISS's proposed slate in the days after its recommendations were published.⁵⁹

In many ways the debate over the percentage of votes effectively "directed" by advisory firm recommendations is misleading. What actually matters is the general impact of proxy advisory firms on the governance of Canadian public companies. Decisions undertaken by directors for the sole purpose of satisfying ISS's proxy planning guidelines are as much a measure of influence as calculating vote tallies. In this respect, the widely held *belief* among businesspeople that proxy advisory firms influence "a third or more" of the vote is the key statistic.⁶⁰

A recent survey conducted by the Conference Board, NASDAQ and the Stanford Rock Center found that over 70 per cent of directors and executive officers reported that their compensation decisions were influenced by the published guidelines of proxy advisory firms.⁶¹ An earlier study asking a slightly different question had found that 54 per cent of companies had actually changed their compensation scheme within the previous three years primarily to meet the standards of a proxy advisory firm.⁶²

No similar survey appears to have been performed in Canada, but when the SEC review of proxy advisory firms began in 2010, a consulting firm that works closely with Canadian boards opined: "Canadian proxy voting outcomes are affected by the voting recommendations of U.S. based proxy advisors in the same way and largely to the same extent as those in the U.S."⁶³

59. Notes on file with author, based on discussions with Agrium executives on 29 April 2013.

60. Paul Rose, "The Corporate Governance Industry" (2007) 32:4 J Corp L 887 at 889.

61. David F Larcker et al, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions" (March 2012), online: Stanford Business Center for Leadership Development and Research <<http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html>>.

62. Center on Executive Compensation, "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight" (January 2011) at 4, online: <<http://www.executivecompensation.org/docs/c11-07b%20Proxy%20Advisory%20White%20Paper.pdf>>.

63. Hugessen Consulting Inc, "SEC Takes a Look at Proxy Advisory Firms," (August 2010) *Briefing*, online: Hugessen Consulting Inc <http://www.hugessen.com/pdf_docs/Briefings_Proxy_Advisors_SEC_Release_august_17.pdf>.

To anyone familiar with the modern Canadian boardroom, there is little doubt that proxy advisory firms cast a long shadow across the table. Even if the board is confident that it can win a vote over the negative recommendation of ISS, having a significant number of shareholders vote against a management proposal is considered an embarrassment to be avoided if at all possible, and significant institutional opposition to a resolution interferes with building strong relationships with the major shareholders.

ISS states in its proxy planning guides that board decisions it disapproves of (such as approving a non-conforming compensation scheme) may result in negative recommendations made against specific directors in future annual general meetings.⁶⁴ In a similar vein, part of the rationale ISS offered for supporting Jana's dissident directors was that Agrium corporate governance was deficient.⁶⁵ Thus, even if the directors feel they can achieve victory on the matter at hand, they will worry about the impact of their choices on future proxy recommendations. Few boards are willing to alienate ISS, because few boards are confident that they will never need ISS's help in the future.⁶⁶

II. *Proxy advisory firm voting recommendations*

If proxy advisory firms have significant influence over the governance of Canadian corporations, how do they use it? Late each year ISS publishes its "Canadian Proxy Voting Guidelines" for TSX and TSX Venture

64. Institutional Shareholder Services Inc., "2013 Canadian Proxy Voting Guidelines, TSX Listed Companies" (19 December 2012) at 10-11, online: ISS <<http://www.issgovernance.com/files/2013ISSCanadianTSXGuidelines.pdf>> ["ISS Guidelines TSX"].

65. "ISS Proxy Paper," *supra* note 51 at 23 (questioning the board's capital allocation and its commitment to total shareholder value: "[t]hat the board now points to Agrium's dividend yield as highly competitive among—though not outpacing—peers also suggests a lack of urgency..."), 25 (questioning the board's management of its retail business), 25-6 (arguing deficiencies in the competencies of the existing board members), 26 (questioning board strategy), 27 (referring to the board as having "a burgeoning credibility problem" and wondering whether the shareholders can trust the board going forward), 30 ("the board has taken some questionable actions, which raise questions about its credibility" and suggesting the existing board is incapable of taking an "unbiased" look at Agrium's business).

66. According to one report: "There were 42 cases of shareholder activism among Canadian firms last year [2012], almost double the 22 a year earlier, according to Kingsdale Shareholder Services Inc, the firm involved in 85% of the country's proxy battles" (see Katia Dmitrieva & Sean B Pasternak, "Ackman-Like Activism Spurs Agrium, SNC Rallies" *Bloomberg News* (13 February 2013), online: Bloomberg <<http://www.bloomberg.com/news/2013-02-13/ackman-like-activism-spurs-agrium-snc-rallies-corporate-canada.html>>); While the number of proxy contests declined in 2013, it was still 45% higher than the average for the five years ending in 2007. The report also notes that activists succeeded in two-thirds of board-related contests last year: Fasken Martineau LLP, Canadian Proxy Contest Study—2014 Update, at 2 and 5, online: Fasken Martineau <<http://www.fasken.com/en/canadian-proxy-contests-2013-in-review/>>.

companies for the following year.⁶⁷ These guidelines are designed to assist issuers to understand the basis on which ISS will be generating its voting recommendations over the coming year. A companion paper discusses exactly how these Voting Guidelines are developed and the practical issues arising from attempts to follow the recommendations.⁶⁸ Here we will examine what the Voting Guidelines assume constitutes good corporate governance.

The Voting Guidelines are generated by ISS based on an annual policy survey of institutional investors about corporate governance, combined with industry roundtables and feedback from market participants.⁶⁹ In general they reflect the conventional wisdom about corporate governance assumed by academics, regulators and activists—a conventional wisdom not necessarily supported by empirical research.⁷⁰ Without insisting that the guidelines are wrong, this distinction suggests the possibility that they might be. The lack of empirical research also highlights an important point: proxy advisory firms are concerned that their voting recommendations reflect the opinions and prejudices of their clients, the institutional investors; it matters less to proxy firms whether the governance regime reflected in their voting guidelines is correct.

1. *The monitoring board*

The Joint Committee on Corporate Governance struck by the TSX (the Saucier Committee) reflected on the ultimate goal of corporate governance in Canada:

The objective of corporate governance is to promote strong, viable and competitive corporations. Boards of directors are stewards of the corporation's assets and their behaviour should be focused on adding value to those assets by working with management to build a successful corporation and enhance shareholder value.⁷¹

This conception of the board's role aligns it with not just the long-term interests of corporate stakeholders, but with Canada's need for competitive, innovative and successful companies. However, very soon

67. "ISS Guidelines TSX," *supra* note 64 at 5; see also Institutional Shareholder Services Inc, "2013 Canadian Proxy Voting Guidelines, Venture Companies" (19 December 2012), online: ISS <<http://www.issgovernance.com/files/2013ISSCanadianVentureGuidelines.pdf>>.

68. Bryce C Tingle, "Proxy Advisory Firms," *supra* note 10.

69. David F Larcker, Allan L McCall & Brian Tayan, "And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?" Stanford Rock Center for Corporate Governance, Closer Look Series—CGRP31 (25 February 2013), online: <http://www.gsb.stanford.edu/cldr/research/closer_look.html> at 3 [Larcker, McCall & Tayan, "Then A Miracle Happens!"].

70. Bryce C Tingle, "Proxy Advisory Firms," *supra* note 10.

71. Saucier Committee Report, *supra* note 2 at 7.

after the Saucier Committee issued this report, the frauds of Enron came to light, the various scandals of that era achieved a cultural critical mass, and discussions about corporate governance came to be dominated by a very narrow subset of board responsibilities: monitoring management.

There is no question that providing an independent check on management is an essential aspect of protecting the company's interests, but it is only one facet of the board's overall responsibility. Boards must also work with management to develop strategy and make plans that will allow the company to succeed in its markets. They must provide a sounding board for the CEO, and assist him or her in solving the problems confronting the company. They must, in other words, contribute more than mere independence to the company.⁷²

Nevertheless, ISS's voting recommendations fundamentally assume that the board should function almost exclusively as a monitoring device. Section after section of ISS's 2013 Canadian Proxy Voting Guidelines for TSX-Listed Companies concerns itself exclusively with independence and the degree of control the board manifests over managerial behaviour in circumstances like compensation, where conflicts of interest exist. The Guidelines may state that "[i]ndependent oversight of management is a primary responsibility of the board," implying there are other responsibilities, but these other responsibilities never enter into the actual voting recommendations.⁷³ The Guidelines even discuss board "skills, experience and competencies," but these never generate voting outcomes.⁷⁴

What does generate voting outcomes? In nearly every case it is "independence." "Withhold" recommendations will be issued where the board lacks an independent majority, or when a board lacks separate compensation or nominating committees, or when insiders sit on those committees, or if the board fails to replace management when "appropriate."⁷⁵ Other voting recommendations require the separation of the Chair and CEO roles,⁷⁶ support shareholder proposals asking for independent super-majorities on the board,⁷⁷ criticize poison pills that put the decision to sell in the hands of the board,⁷⁸ censure directors that

72. See Jonathan R Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton, NJ: Princeton University Press, 2008) at 51-68 [Macey, *Corporate Governance*] for an overview of the various responsibilities of boards.

73. "ISS Guidelines TSX," *supra* note 64 at 5.

74. *Ibid* at 6.

75. *Ibid* at 8-9, 12.

76. *Ibid* at 13.

77. *Ibid* at 13.

78. *Ibid* at 17.

approve executive compensation schemes that are too generous and do not sufficiently reflect pay-for-performance,⁷⁹ among others.

ISS's curious recommendation of a hybrid board in the case of Agrium makes sense if the board is understood almost exclusively as a device to monitor management. The addition of two hostile directors to the ranks of the board would only improve the level of scrutiny—the passionate searching for managerial failure and self-dealing—which makes up the monitoring function. From a monitoring perspective it is irrelevant that management would begin censoring and managing the information provided to the board, that the trust necessary for any group of individuals to collaborate would evaporate, or that profound disagreements and rancor would paralyze a body that typically acts by consensus.

There is a great deal of empirical research on the performance of boards dominated by independent directors, and very little of it supports the overwhelming emphasis given to it by ISS.⁸⁰ Bhagat and Black conclude,

79. *Ibid* at 25.

80. For the first large-scale long-term study on whether board independence correlates with greater corporate performance, see Sanjai Bhagat & Bernard Black, "The Non-Correlation Between Board Independence and Long-Term Firm Performance" (2002) 27:2 J Corp L 231 at 233 [Bhagat & Black, "The Non-Correlation"] ("Firms with more independent boards do not perform better than other firms"); Benjamin E. Hermalin & Michael S. Weisbach, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature" (2003) 9:1 Economic Policy Review 7 at 20; (surveying economic literature and finding "board composition is not related to corporate performance"); Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114:7 Yale LJ 1521 [Romano, "Quack Corporate Governance"] (provides a summary of empirical studies showing that firm performance is not improved with independent directors); Usha Rodrigues, "Fetishization of Independence" (2008) 33:2 J Corp L 447. For examples of studies concerning the relationship between board composition and firm performance, see: Paul W. MacAvoy et al., "ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis" (1983) in Statement of The Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations" (performing an empirical evaluation of the American Law Institute's proposed mechanism to increase corporate fiduciary responsibility and concluding that there is no significant relationship between board composition and corporate performance); Anup Agrawal & Charles R. Knoeber, "Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders" (1996) 31:3 Journal of Financial and Quantitative Analysis 377 at 389-394 (finding director independence, along with more debt financing and activity in the market for corporate control, actually reduces company performance); Stephen M. Bainbridge, "A Critique of the NYSE's Director Independence Listing Standards" (2002) 30 Sec Reg LJ 370 at 372 (arguing that the NYSE Committee's proposals that would increase the number of independent directors are not supported by evidence on director performance); Barry D. Baysinger & Henry N. Butler, "Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition" (1985) 1:1 J L Econ & Org 101 at 118 (finding there is no linear relationship between performance and board independence, and firms who tried to increase independence did not improve); Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants" (2002) 55:3 Stan L Rev 885 at 888-899 (arguing that independent directors do not necessarily "do the right thing" for shareholders in a take-over context); Sanjai Bhagat & Bernard S. Black, "The Uncertain Relationship Between Board Composition and Firm Performance" (1999) 54:3 Bus Law 921 at 921-932 (explaining there is no evidence that greater board independence

on the basis of their research, that “there is no convincing evidence that

creates better performance or growth and no empirical evidence firms should have “super-majority independent board” with only one or two inside directors); Bernard S Black, “Does Corporate Governance Matter? A Crude Test Using Russian Data” (2001) 149:6 U Pa L Rev 2131 at 2133-2134 (describing the weak evidence a board’s independence has on market value and firm performance); Rajeswararao S Chaganti, Vijay Mahajan & Subhash Sharma, “Corporate Board Size, Composition and Corporate Failures in Retailing Industry” (1985) 22:4 Journal of Management Studies 400 at 414 (finding no relation between the number of outside directors compared with inside directors and corporate failure in the retail industry); John E Core, Robert W Holthausen & David F Larcker, “Corporate Governance, Chief Executive Officer Compensation, and Firm Performance” (1999) 51:3 Journal of Financial Economics 371 at 404 (finding no evidence independent directors create a more effective board and finding no evidence that greater equity ownership by outside directors creates a more effective board); James D Cox, “The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director’s Spine” (1993) 61:4 Geo Wash L Rev 1233 at 1239 (explaining that few studies have found a correlation between board composition and firm performance); Dan R Dalton et al, “Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance” (1998) 19:3 Strategic Management Journal 269 at 282 (reviewing 54 empirical studies and determining there is “virtually no evidence of a systematic relationship” between board composition and financial performance); Harold Demsetz & Belen Villalonga, “Ownership Structure and Corporate Performance” (2001) 7:3 Journal of Corporate Finance 209 at 209 (studying the relationship between ownership structure and firm performance, concluding: “We find no statistically relation between ownership structure and firm performance.”); Robert W Hamilton, “Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits” (2000) 25:2 J Corp L 349 at 371 (finding that recent changes in corporate governance structures to majority and super-majority independent boards have resulted in “no detectable increases in shareholder wealth”); Benjamin E Hermalin & Michael S Weisbach, “The Effects of Board Composition and Direct Incentives on Firm Performance” (1991) 20:4 Financial Management 101 at 111 (finding “no relation between board composition and performance” and “even if such a relation does exist, it is small, with little *economic* significance”); April Klein, “Firm Performance and Board Committee Structure” (1998) 41:1 JL & Econ 275 at 277 [Klein, “Firm Performance”] (finding little association between firm performance and overall board composition but finding a positive relation between insiders on finance and investment committees and stock market performance measures); Laura Lin, “The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence” (1996) 90:3 Nw UL Rev 898 at 961-967 (concluding that data does not support the notion independent directors can always be relied on as effective monitors of management, but also finding board independence make a difference in some monitoring functions); John A Wagner III, J L Stimpert & Edward I Fubara, “Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects” (1998) 35:5 Journal of Management Studies 655 at 655 (finding that the greater presence of outside directors improves firm performance, but so too does the increase of presence of inside directors); Sanjai Bhagat & Bernard S Black, “The Board Game,” *Chief Executive Magazine* (1 October 1997), online: Chief Executive.net <<http://chiefexecutive.net/the-board-game>> (“the proportion of independent directors on a board has no consistent effect on stock price or accounting based performance”). For more research literature, see Eric Fogel & Andrew M Geier, “Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors” (2007) 32:1 Del J Corp L 33 [Fogel & Geier, “Strangers in the House”] (confirming previous studies finding no correlation between independent directors and firm performance and arguing shareholder-owners should be in the majority and independent directors in the minority); Frederick Tung, “The Puzzle of Independent Directors: New Learning” (2011) 91:3 BUL Rev 1175 (examining firm information environments and the effects on independent directors efficiency and why previous literature has largely been unable to identify a correlation between independent directors and firm performance). But also see research indicating independent directors may add value: Ira M Millstein & Paul W MacAvoy, “The Active Board of Directors and Performance of the Largely Traded Corporation” (1998) 98:5 Colum L Rev 1283 at 1318 (finding a “substantial and statistically significant correlation between an active, independent board and superior corporate performance”).

increasing board independence, relative to the norms that currently prevail among large American firms, will improve firm performance."⁸¹ In fact, their evidence suggests companies with super-majorities of independent directors (ISS recommends a vote in favour of these) actually perform worse than those with fewer independent directors.⁸² This is not an idiosyncratic result. One meta-analysis of 54 empirical studies comprising 159 samples and 40,160 observations concluded there was no connection between board composition and corporate performance.⁸³

What is true of the board as a whole is true of every part of it as well. Studies examining the performance of audit committees have found no relation between committee independence and performance.⁸⁴ In fact, the literature does not even show conclusively that totally independent audit committees reduce the likelihood of financial statement misconduct.⁸⁵ As for independent compensation committees, it is worth noting that in Hollinger's case, the looting of the company by insiders was supervised by independent directors. Hollinger's corporate report (Form 14A) filed with the SEC in 2003 mentions three times in four pages that independent directors approved all transactions between Hollinger and insiders.⁸⁶

The problem, of course, is that independence is a purely negative quality—the absence of a relationship. It tells one nothing about what skills, experience, talent and effort a director brings to the task. Warren Buffett once wrote,

Over a span of 40 years, I have been on 19 public company boards (excluding Berkshire's) and have interacted with perhaps 250 directors. Most of them were "independent" as defined by today's rules. But the great majority of these directors lacked at least one of the three qualities I value (business savvy, interested, shareholder-oriented). As a result their contribution to shareholder well-being was minimal at best and, too often, negative. These people, decent and intelligent though they were, simply did not know enough about the business and/or care enough about shareholders to question foolish acquisitions or egregious

81. Bhagat & Black, "The Non-Correlation," *supra* note 80 at 233.

82. *Ibid.* See Fogel & Geier, "Strangers in the House," *supra* note 80 at 52: "Our findings show that the worst ROE [return on equity] performers in each of fifty industries have approximately the same percentage of independent directors as the best ROE performers in each industry. No pattern emerges to suggest that it makes any difference at all to shareholders' financial return whether a board has a higher or lower percentage of independent directors."

83. Dan R Dalton et al., "Number of Directors and Financial Performance: A Meta-Analysis" (1999) 42:6 *Academy of Management Journal* 674.

84. Romano, "Quack Corporate Governance," *supra* note 80 at 1530.

85. *Ibid.* at 1533.

86. See Hollinger International Inc, "Schedule 14A, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934" US Securities and Exchange Commission (2003), online: SEC <<http://www.sec.gov/Archives/edgar/data/868512/000095013703001865/c75509ddef14a.txt>>.

compensation.⁸⁷

Independent director-dominated boards fail to correlate in meaningful ways with positive financial outcomes because independent directors are poorly suited to provide a contributory role in the company.⁸⁸ They typically have very little knowledge of the company's business or markets. They have no independent sources of information about the company and so depend almost entirely on the perspective and advice of the CEO.⁸⁹ They are as likely to spot new opportunities or hidden challenges to the company as any other outsider—which is to say, they have very little chance.

A board dominated by its monitoring function actually discourages management from adopting the transparency and humility necessary for mentoring and collaborative effort. No one is absolutely candid with a group whose primary purpose is to criticize. The steps that executives take to manage the board, usually by controlling the flow of information, further diminish the ability of the board to make valuable contributions of advice and expertise to the business.⁹⁰

None of this means, of course, that independence is irrelevant. Monitoring is part of what directors are supposed to do, after all. But independence only goes to one thing, and that is addressing conflicts of interest, and boards do a great deal of work besides this.

87. Letter from Warren E Buffett (21 February 2003) to Shareholders in Berkshire Hathaway Annual Report 2002 at 17, online: <<http://www.berkshirehathaway.com/letters/2002pdf.pdf>>.

88. *Ibid* at 54 (addressing whether there is a conflict between the expectation for directors to perform both a monitoring and management function). See also note 80 for a list of empirical studies suggesting there is no correlation between independent directors improving firm performance. Also see Klein, "Firm Performance," *supra* note 80: ("Whereas several papers have demonstrated a link between effective monitoring and the presence of outsiders on the board for firms experiencing gross failures of strategy and performance, no paper to date has been able to find an association between board composition and firm performance on a day-to-day basis.")

89. Silvia Dominguez-Martinez, Otto H Swank & Bauke Visser, "In Defense of Boards" (2008) 17:3 *Journal of Economics & Management Strategy* 667; Renee B Adams & Daniel Ferreira, "A Theory of Friendly Boards" (2007) 62:1 *The Journal of Finance* 217 [Adams & Ferreira, "Friendly Boards"] (quality of information directors get from management can be limited because of the monitoring role independent directors play); Lawrence E Mitchell, "Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance" (2005) 70:4 *Brook L Rev* 1313 (examining how outside directors rely almost exclusively on information provided by inside directors and the consequences of such reliance). Another reason given for the failure of independent directors is lack of true independence: "Even if a director meets the bright-line test for independence, the enculturation of the recruitment process, plus social approbation that comes with board service, coupled with the board room interpersonal dynamics of loyalty and friendship, serve to shear the director of true independence very quickly." See Fogel & Geier, "Strangers in the House," *supra* note 80 at 50.

90. Adams & Ferreira, "Friendly Boards," *supra* note 89 at 218.

2. *Shareholder authority*

Traditionally, Canadian law has tended to favour directors among the various constituencies surrounding a corporation.⁹¹ Ed Waitzer refers to the traditional approach in Canada as “the director-centric model.”⁹² The Supreme Court of Canada’s decisions in *Peoples* and *BCE* are probably better understood in light of their impact on the scope of action and authority of the board of directors (greatly increasing both) than by focusing on their apparent rejection of the shareholder primacy model of the corporation.⁹³

91. Stéphane Rousseau, “Directors’ Duty of Care After *Peoples*: Would It Be Wise to Start Worrying About Liability?” (2004–2005) 41:1 Can Bus LJ 223 at 223 “Courts were highly deferential when called upon to review directors decisions.” One consequence of this deference is that there have only been “a handful of cases” in Canada where directors have been sued for breaching their duty of care (see Bernard S Black & Brian R Cheffins, “Outside Director Liability Across Countries” (2006) 84:6 Tex L Rev 1385 at 1443).

92. Sean Vanderpol & Edward J Waitzer, “Addressing the Tension Between Directors’ Duties and Shareholder Rights—A Tale of Two Regimes” (2012) 50:1 Osgoode Hall LJ 177 at 208.

93. *Peoples Department Stores Ltd (Trustee of) v Wise*, 2004 SCC 68, [2004] 3 SCR 461 [*Peoples*]; *BCE Inc v 1976 Debentureholders*, 2008 SCC 69, [2008] 3 SCR 560 [*BCE*]; the debate between shareholder/stakeholder primacy models is often cited as beginning with the Berle-Dodd debate: see Berle & Means, *The Modern Corporation*, *supra* note 1 at Chapter VII Corporate Powers as Powers in Trust (shareholder theory) and E Merrick Dodd Jr, “For Whom are Corporate Managers Trustees?” (1932) 45:7 Harv L Rev 1145 (stakeholder theory). Since then, Milton Friedman advocated for shareholder theory as the economic basis of all corporate decision making (see Milton Friedman, “The Social Responsibility of Business is to Increase its Profits,” *The New York Times Magazine* (13 September 1970): [T]he only “social responsibility of business is to maximize profits.” For more recent shareholder theory arguments, see Lucian A Bebchuk, “The Case for Increasing Shareholder Power” (2005) 118:3 Harv L Rev 833; Hansmann & Kraakman, “End of History,” *supra* note 1 (proclaiming the success of shareholder primacy law in corporate governance). See also the debate between Kent Greenfield & D Gordon Smith, “Debate: Saving the World with Corporate Law?” (2007) 57:4 Emory LJ 947 at 965-966 (discussing Professor Greenfield’s rejection of shareholder primacy). For articles evaluating shareholder/stakeholder primacy models, see: Andrew R Keay, “Stakeholder Theory in Corporate Law: Has It Got What It Takes?” (2010) 9:3 Rich J Global L & Bus 249 (for a history of stakeholder theory and analysis of its worth). For arguments advocating for stakeholder theories, see Lynn A Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (San Francisco, CA: Berrett-Koehler, 2012) [Stout, *Shareholder Value Myth*]; Margaret M Blair & Lynn A Stout, “A Team Production Theory of Corporate Law” (1999) 85:2 Va L Rev 248 (arguing for a variation of stakeholder primacy called team production theory); Lynn A Stout, “In the Closet,” *supra* note 1 (outlining the pitfalls of shareholder primacy). For stakeholder theories in the Canadian context, see Stephanie Ben-Ishai, “A Team Production Theory of Canadian Corporate Law” (2006) 44:2 Alta L Rev 299 (team production theory in the Canadian context); Poonam Puri & Tuvia Borok, “Employees as Corporate Stakeholders” (2002) 8 J Corporate Citizenship 49; Poonam Puri, “The Future of Stakeholder Interests” (2009) 48:3 Can Bus LJ 427 (for an analysis of stakeholder interests concerning social and environmental responsibility); Allan C Hutchinson, *The Companies We Keep: Corporate Governance for a Democratic Society* (Toronto: Irwin Law Inc, 2005) (arguing against shareholder primacy); Leonard I Rotman, “Debunking the ‘End of History’ Thesis for Corporate Law” (2010) 33:2 BC Int’l & Comp L Rev 219 (“Canadian corporate law jurisprudence and the structure of Canadian corporate law statutes reveal the complete lack of support for shareholder primacy”). See also Stephen Bainbridge for an analysis on director primacy models (Stephen M Bainbridge, “Director Primacy in Corporate Takeovers: Preliminary Reflections” (2002) 55:3 Stan L Rev 791 and Stephen M Bainbridge, “Director Primacy and Shareholder Disempowerment” (2006) 119:6 Harv L Rev 1735).

Corporations will continue to operate primarily for the benefit of the shareholders, who have many mechanisms available to them to ensure that their interests are respected.⁹⁴ *BCE* and *Peoples* gave boards a great deal more latitude for action, by refusing to require them to tie every decision to the shareholder interest (whether broadly or narrowly construed). Whatever innovation this introduced into legal doctrine, it was business as usual for Canadian courts.⁹⁵ It is also the traditional approach of American corporate law.⁹⁶

ISS is generally much less concerned with the authority of boards. One of the key assumptions found in their Proxy Voting Guidelines is that “boards of directors should be responsive to the wishes of shareholders as indicated by majority supported shareholder proposals or lack of majority support for management proposals including election of directors.”⁹⁷

94. These include the tremendous influence of share price on executives and directors (Macey, *Corporate Governance*, *supra* note 72 at 119); the market for corporate control (see Henry G Manne, “Mergers and the Market for Corporate Control” (1965) 73:2 *The Journal of Political Economy* 110; Eugene F Fama, “Efficient Capital Markets: II” (1991) 46:5 *The Journal of Finance* 1575 for a discussion of empirical tests of capital market efficiency); and of course voting rights. There is also significant literature on how the “stakeholder primacy” model conflicts with shareholder votes, proposals, and interests. See Edward Iacobucci, “Indeterminacy and the Canadian Supreme Court’s Approach to Corporate Fiduciary Duties” (2009) 48:2 *Can Bus LJ* 232 (the *BCE* decision is vague and devoid of any substantive content on director responsibility); J Anthony Vanduzer, “*BCE v 1976 Debentureholders*: The Supreme Court’s Hits and Misses in its Most Important Corporate Law Decision Since *Peoples*,” *Case Comment*, (2010) 43 *UBC L Rev* 205 at 59 (no direction on how directors are supposed to manage conflicts between shareholders and stakeholders; Peer Zumbansen & SB Archer, “The BCE Decision: Reflections on the Firm as a Contractual Organization” (2008) [unpublished, archived as CLPE Research Paper No.17/2008], online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160094> (considering a relational contract theory in analyzing the conflict between shareholders and stakeholders and arguing for greater contextual analysis); Edward J Waitzer & Johnny Jaswal, “*Peoples, BCE* and the Good Corporate ‘Citizen’” (2009) 47 *Osgoode Hall LJ* 439 (for the debate on how directors should discharge their responsibilities); Also see the debate between stakeholder and shareholder primacy models at note 93.

95. *Teck Corporation Limited v Millar*, [1973] 2 *WWR* 385, 33 *DLR* (3d) 288 (BCSC) [*Teck*] is often cited for expanding the interests directors can consider in making decisions. In *Peoples*, the court cited *Teck* and although stating that the directors’ duty of care is to the corporation, the court also said in acting in the “best interests” of the corporation, directors may consider other stakeholders, including creditors. The court also upheld the business judgment rule, where courts will not second-guess business decisions that were reasonable at the time, even if they prove to be ultimately unsuccessful. *BCE* reaffirmed that directors duty is the corporation itself, but directors may take into account interests of stakeholders: “In considering what is in the best interests of the corporation, directors may look to the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions” at 40. The court also commented on the business judgment rule: “Courts should give appropriate deference to the business judgment of directors who take into account these ancillary interests, as reflected by the business judgment rule. The ‘business judgment rule’ accords deference to a business decision, so long as it lies within a range of reasonable alternatives” at 40.

96. See for example, Bainbridge, “After the Financial Crisis,” *supra* note 29 at 203-233.

97. ISS Guidelines TSX, *supra* note 64 at 5.

This translates into concrete voting outcomes in the Proxy Guidelines in several places. For example, one factor determining whether a “withhold” recommendation will be issued in connection with a director is whether he or she has been responsive to shareholder proposals.⁹⁸ Poison pills that reserve the decision to sell the company in the hands of directors are to be rejected.⁹⁹ Also to be rejected are provisions in by-laws or articles that either deviate from board processes ISS believes are best or would diminish the number of things that require shareholder approval.¹⁰⁰ Private placements are to be approved only if they meet certain ISS (shareholder) requirements regardless of board support for the financing.¹⁰¹ Director-suggested changes to various pre-existing arrangements are to be rejected out of hand.¹⁰²

Above all, ISS advocates placing executive compensation in the hands of the shareholders. In addition to having complex and detailed rules setting out the boundaries of acceptable executive compensation schemes,¹⁰³ ISS will recommend negative votes in circumstances where “the board exhibits poor communication and responsiveness to shareholders.”¹⁰⁴ This includes failing to respond to concerns raised in say-on-pay votes, whether or not the measure passed.¹⁰⁵ Mere “significant opposition” can trigger a board obligation.

ISS generally will support shareholder proposals setting out specific requirements for compensation schemes, such as requiring options to vest on performance hurdles.¹⁰⁶ Failures by a board to adhere to ISS's compensation guidelines, even with respect to items that don't normally go to the shareholders, will attract negative recommendations against directors that approve them. Thus, the terms of employment agreements,

98. *Ibid* at 8.

99. *Ibid* at 17.

100. *Ibid* at 16, 22-23, where the ISS Guidelines recommend to vote against proposals to approve unlimited capital authorization; generally vote against proposals to create unlimited blank cheque preferred shares or increase blank cheque preferred shares where the shares carry unspecified rights, restrictions, and terms or the company does not specify a purpose for the increase; and generally vote against proposals to create a new class of common stock that will create a class of common shareholders with diminished voting rights.

101. *Ibid* at 22.

102. *Ibid* at 24.

103. *Ibid* at 25-36. See also Institutional Shareholder Services Inc, “2013 Canadian Pay for Performance Methodology: Frequently Asked Questions” (23 January 2013), online: ISS <<http://www.issgovernance.com/files/2013CanadianP4PMMethodologyFAQ20130123.pdf>>.

104. ISS Guidelines TSX, *supra* note 64 at 25.

105. *Ibid* at 29.

106. *Ibid* at 36.

severance agreements and pensions are brought into the ambit of shareholder authority.¹⁰⁷

The rise of activist shareholders, which, like Jana Partners in Agrium's case or Pershing Square in CP's case, put corporate strategy and personnel decisions at the centre of their proxy campaigns also has the effect of increasing shareholder influence over companies. In 2003 there were six activist campaigns in Canada; by 2012 it had risen to 42 campaigns.¹⁰⁸ In the U.S. there were 27 campaigns in 2000 and more than 200 in 2013.¹⁰⁹ This means that proxy advisory firms are increasingly called upon to evaluate the merits or lack thereof of competing corporate strategies and personnel decisions. ISS has created a division, based out of New York, that evaluates the merits of contested elections. As Paul Rose states,

In recent years, the corporate governance rating industry has eroded directorial and managerial power and enhanced shareholder power. ...It is no coincidence that aggressive, activist investors are affecting corporate decisions with increasing success in recent years—the rise of the corporate governance industry has made such activity inevitable.¹¹⁰

There are two possible rationales for assuming shareholder primacy in directing the affairs of the corporation. Perhaps shareholders know more than the directors, or maybe shareholders' interests and incentives are better aligned with the welfare of the corporation than the directors'. Each of these will be taken up in turn.

The ISS Guidelines appear to assume that the shareholders (and ISS) are more likely than the directors to hold correct views on matters of executive compensation, the approval of new equity issuances, certain organizational matters and various other topics. Undoubtedly, boards of directors do occasionally lose their way. But this alone is not sufficient to justify shareholder primacy. Are shareholders generally better than

107. *Ibid* at 29.

108. David Pett, "How you can profit from shareholder activism," *Financial Post* (27 September 2012), online: <http://business.financialpost.com/2012/09/27/how-you-can-profit-from-shareholder-activism/>; Katia Dmitrieva & Sean B Pasternack, "Ackman-Like Activism Spurs Agrium, SNC Rallies," *Bloomberg* (13 February 2013), online: <http://www.bloomberg.com/news/2013-02-13/ackman-like-activism-spurs-agrium-snc-rallies-corporate-canada.html>.

109. Martin Lipton, "Some Thoughts for Boards of Directors in 2014" (29 November 2013) (blog), online: <https://blogs.law.harvard.edu/corpgov/2013/11/29/some-thoughts-for-boards-of-directors-in-2014/>. Lipton points out that in the last seven years *one-sixth* of S&P 1500 companies have faced activist campaigns and that 56% of the activist campaigns in 2013, targeted companies whose stock prices outperformed the market prior to the campaign beginning.

110. Paul Rose, "On The Role and Regulation of Proxy Advisors" (2011) 109 *Michigan L Rev* First Impressions 62 at 64-65.

the directors at identifying what is best for the corporation, at least in the specific areas covered by the ISS Guidelines (and by any successful shareholder proposal)?

In considering this question, we must recall that the proxy advisory industry would not exist if shareholders were generally able and willing to make informed, intelligent decisions themselves. Collective action problems, free-riding issues and significant disincentives discourage shareholders from expending the time and effort needed to thoroughly inform themselves about the affairs of the firm.¹¹¹ This is why corporate law reposes authority in a much smaller group: the directors. As the court in the famous U.S. case *Smith v. Van Gorkom* argued, "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."¹¹²

A proxy advisory firm is doubtless an improvement on the shareholders in the sense that it has the incentives to devote resources to investigate companies more thoroughly than some shareholders are capable of, and others are prepared to, but this often only means a modest increase in time and resources. Outside of contested elections, there is little evidence from proxy voting recommendations that there is any understanding of a company's business, strategy or markets beyond that revealed in a share price or quick ratio. In the case of contested elections (for instance, as part of an activist campaign) the advisory firms devote more resources to investigate the business; the activist and the company will be invited to make submissions to the proxy advisory firm and an analyst will examine the question (but not to the extent of even visiting a company's headquarters).

Compared with the directors, the proxy advisor firm will only ever have a very superficial understanding of the company. Even after meetings and correspondence with both sides of the Agrium dispute, for example, ISS acknowledged that "[t]he most compelling fact about this proxy contest is not that the distribution business [a central issue was whether this should

111. See discussion at notes 33-34. Also, see Robert C Clark, *Corporate Law* (Little, Brown Book Group Limited, 1986) at 389-400 and Frank H Easterbrook & Daniel R Fischel, "Voting in Corporate Law" (1983) 26:2 JL & Econ 395 (discussing collective action problems); Evaristus Oshionebo, "Shareholder Proposals and the Passivity of Shareholders in Canada: Electronic Forums to the Rescue?" (2012) 37:2 Queen's LJ 623 (for an analysis on shareholder passivity related to the difficulties in submitting proposals); Bernard S Black, "Shareholder Passivity Reexamined" (1990) 89 Mich L Rev 520 at 567; Black, "Shareholder Activism," *supra* note 36; Andrei Shleifer & Robert W Vishny, "A Survey of Corporate Governance" (1997) 52:2 The Journal of Finance 737; Sanford J Grossman & Oliver D Hart, "Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation" (1980) 11:1 The Bell Journal of Economics 42 (free-riding makes it cost ineffective for small shareholders to monitor management).

112. *Smith v Van Gorkom*, 488 A.2d 858, 3 EXC 112 (Del. 1985) at para 69.

be sold or kept] is well run or poorly run, but that shareholders still cannot answer this question for themselves.”¹¹³ In fact, ISS could not answer the question themselves—that’s why they punted and recommended a hybrid board.¹¹⁴

The board of directors of a corporation usually has a long, deep association with the business. They have a sense of corporate history and culture, the strengths and weaknesses of the executives, and the nature of the company’s markets, that shareholders and proxy advisory firms cannot replicate. We see this in areas where shareholder managerial competence can be measured. Examinations of hedge fund activism, for example, have found gains only in the subset of companies that are subsequently acquired; no gains appear where only the management of the company is affected.¹¹⁵ Another empirical study of the same phenomena concluded, “only a minority of the targets’ stock prices beat market indices over the period of engagement, with financial underperformance being particularly notable in cases where the hedge fund entered the target boardroom.”¹¹⁶

When it comes to shareholder proposals, a recent study in the U.S. found no evidence these proposals resulted in either long-term or short-term improvements in corporate value.¹¹⁷ Of the 1,164 activist campaigns between 2000 and 2007 examined in one U.S. study, over 70% were rejected by the shareholders as presumably not in the interests of the company.¹¹⁸ Indeed, Romano points out that

“[i]t is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. The disparity in identity of sponsors—the predominance of public and union funds [making proposals], which, in contrast to private sector funds, are not in competition for investor dollars—is strongly suggestive of their presence.”¹¹⁹

113. “ISS Proxy Paper,” *supra* note 51 at 30.

114. *Ibid.*

115. Robin Greenwood, “The Hedge Fund as Activist” (22 August 2007) (newsletter), online: Harvard Business School Working Knowledge <<http://hbswk.hbs.edu/item/5743.html>>.

116. William R Bratton, “Hedge Funds and Governance Targets: Long-Term Results,” University of Pennsylvania Institute for Law and Economics Research Paper No. 10-17, September 2010, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1677517>.

117. Joao Dos Santos & Chen Song, “Analysis of the Wealth Effects of Shareholder Proposals” (22 July 2008) U.S. Chamber of Commerce Research Paper, online: Center For Capital Markets <http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/080722wfi_shareholder.pdf>.

118. Nickolay M Gantchev, “The Costs of Shareholder Activism: Evidence from a Sequential Decision Model” (2013) 107:3 *Journal of Financial Economics* 610.

119. Romano, “Less is More,” *supra* note 37 at 231. See also Bainbridge, “After the Financial Crisis,” *supra* note 29 at 247 for a series of high-profile examples of attempts by the manager of an institutional shareholder to use the proposal process for private purposes.

The prevalence of private benefits being sought by shareholders in these cases explains why these shareholders deviate from the “rational apathy” that generally characterizes the shareholder engagement with corporate governance.¹²⁰

In relation to its policy that shareholder proposals passed at a meeting should be enacted, or the board removed, ISS received submissions from many of the largest corporations in the U.S., as well as the Business Roundtable and the National Association of Corporate Directors, all making the argument that “[b]oards would be coerced to abdicate their fiduciary duties, which do not disappear or become less significant when a majority of votes cast at a meeting support a particular proposal. Boards should not feel compelled to act where they believe such action is not in the best interests of the company.”¹²¹ ISS nevertheless adopted the rule—a decision that can only be explained by their abiding belief that shareholders (and ISS) are, in some sense, perfectly qualified to manage wide aspects of a company’s business.

The second assumption accounting for the privileging of shareholders over directors is ISS’s apparent belief that the interests of the shareholders are better aligned with those of the company. While corporate law has attempted to address agency costs (in the form of conflicts and shirking) by imposing legal duties on the directors, shareholders have no such duties. Indeed, shareholders are deliberately left free to transact in the corporation’s shares with a view only to their own profit. Canada has never gone so far as the United States and imposed fiduciary duties even on majority shareholders.¹²²

120. See discussion at notes 29-39.

121. Letter from Matthew Lepore, Vice President and Corporate Secretary, Chief Counsel, Pfizer Inc. (7 November 2012), online: ISS <<http://www.issgovernance.com/files/PfizerInc..pdf>>; See Larcker, McCall & Tayan, “And Then A Miracle Happens!,” *supra* note 69.

122. The strongly majoritarian focus of English and early Canadian corporation law is described in Jeffrey G MacIntosh, “Minority Shareholder Rights in Canada and England: 1860–1987” (1989) 27:3 *Osgoode Hall LJ* 561. This majoritarian attitude is aptly evidenced by *Foss v Harbottle* (1843), 2 *Hare* 461, 67 *ER* 189 (VC Ct), where the court held that it was the decision of the majority shareholders on whether to take action for a wrong done to the company, indicating the decisions of majority shareholders are absolute. Despite early decisions, there were a few judicial holdings indicating there was some sort of fiduciary duty owed by majority shareholders, at least in terms of anti-discrimination against a minority shareholder (see *Allen v Gold Reefs of West Africa Ltd*, [1900] 1 *Ch* 656 (CA)). The closest Canada’s courts came to imposing this sort of duty was *Goldex Mines Ltd v Revill* (1974), 7 *OR* (2d) 216 at 223-224, 54 *DLR* (3d) 672 (Ont CA) where the court held the “majority must act fairly and honestly,” but did not actually decide that majority shareholders owed a duty to minority shareholders. These attempts were firmly rejected in the Ontario Court of Appeal decision in *Brant Investments Ltd v KeepRight Inc* (1991), 3 *OR* (3d) 289, 80 *DLR* (4th) 161 (CA) where the court held that Canadian law has never actually imposed a fiduciary duty on majority shareholders. Nonetheless, shareholders do have an action under the oppression remedy, which some commentators are referring to as a “quasi-fiduciary duty.” See Poonam Puri et al, *Cases, Materials and Notes on Partnerships and Canadian*

The ways in which the interests of short-term shareholders vary from those of most other corporate constituencies is obvious. Earnings manipulation, misleading public disclosure, short-term and high-risk business strategies, can all help short-term holders of shares make profits.¹²³ If, for example, the market is not giving value to a company's R&D investment, then it should be ended, regardless of the long-term consequences to the company's business.¹²⁴ The money would be better spent in a stock buy-back programme.¹²⁵

Long-term shareholders, on the other hand, are often held up as the group whose interests are reliably aligned with those of the company.¹²⁶ However, as Jesse Fried points out, long-term shareholders' interests are only aligned with the long-term growth of the company when that company neither issues nor repurchases its shares.¹²⁷ In the case of repurchases, long-term shareholders will benefit if management diverts funds from valuable projects to buy back shares at a moment that they are undervalued, or if management engages in price-manipulation around repurchases. In each of these cases, while the economic interests of the corporation are harmed,

Business Corporations, 5th ed (Toronto: Carswell, 2011), Chapter 7 "Regulating the Exercise of Power by Controlling Shareholders." See also Jeffrey G MacIntosh, Janet Holmes & Steven Thompson, "The Puzzle of Shareholder Fiduciary Duties" (1991) 19:1 Can Bus LJ 86 where the authors suggest reasons why Canada has never imposed a fiduciary duty on controlling shareholders, unlike the US.

123. Natasha Burns, Simi Kedia & Marc Lipson, "Institutional Ownership and Monitoring: Evidence From Financial Misreporting" (2010) 16:4 Journal of Corporate Finance 443 at 444 (finding short-term investors are positively correlated with increases in the likelihood and severity of accounting restatements). See also "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management" (9 September 2009) at 2, online: The Aspen Institute <<http://www.aspeninstitute.org/publications/overcoming-short-termism-call-more-responsible-approach-investment-business-management>>; see also Martin Lipton & Steven A Rosenblum, "Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come" (2003) 59:1 Bus Law 67 (deriding the influence of short-term shareholders) and Lynne Dallas, "Short-Termism, the Financial Crisis, and Corporate Governance" (2011) 37:1 J Corp L 264 (the impacts of short-termism on the recent financial crisis). Lynn Stout also write on the problems of short-termism (see Stout, *Shareholder Value Myth*, *supra* note 93 at chapter 5. See also Kay, "The Kay Review," *supra* note 23.

124. Brian J Bushee, "The Influence of Institutional Investors on Myopic R&D Investment Behaviour" (1998) 73:3 The Accounting Review 305 at 307. (Companies with more short-term shareholders are more likely to cut R&D expenses to make short-term targets.)

125. Justin Fox & Jay W Lorsch, "What Good Are Shareholders?" (2012) 90:7-8 Harv Business Rev 49, at 50: "Corporations do need capital to invest in growth, but they don't get it in aggregate from shareholders. Net issuance of corporate equity in the U.S. over the past decade has been negative \$287 billion, according to the Federal Reserve. That negative number would be much bigger if we left out financial institutions and their desperate fundraising in 2008 and 2009. Factor in dividend payments, and we find a multi-trillion dollar transfer of cash from U.S. corporations to their shareholders over the past 10 years."

126. Jesse M Fried, "The Uneasy Case For Favoring Long-Term Shareholders" (18 March 2013) European Corporate Governance Institute, ECGI-Law Working Paper No. 200, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2227080#%23> [Fried, "Uneasy"].

127. *Ibid.*

the long-term shareholders prosper at the expense of those short-term shareholders selling into the company's repurchasing programme.

Fried goes on to point out that in the case of a company issuing shares, anything that inflates the value of the shares being sold to new investors benefits the long-term shareholders by reducing their dilution. Indeed, for a company about to conduct a financing or acquisition, the long-term shareholder is in much the same position as a short-term shareholder. Earnings manipulation or high-risk and short-term business strategies all reduce their dilution and can leave them better off at the expense of the new investors, even after the damage to the company is realized.¹²⁸ These are not abstract concerns. Fried cites research that, "over the last 40 years an aggregate of over \$2.2 trillion has been transferred to long-term investors through bargain repurchases and inflated-price equity issuances."¹²⁹

Both long- and short-term shareholders, if they are diversified, also have incentives to encourage undue risk-taking by a company. Some corporate failures in an investment portfolio will be offset by gains realized by companies whose gambles pay off.¹³⁰ Thus, what is best for a portfolio of companies may not be what is best for any one company in particular.¹³¹ Directors must steer a middle path between shareholders' appetite for risk and creditors' risk aversion.

Many long-term shareholders are funds managed by professional advisors, whose personal interests diverge markedly from those of the company and the funds' unitholders. Money managers are rewarded based on their relative performance, not their absolute returns.¹³² If a fund owns a risk-averse company that is being outperformed by its peers, the manager is incentivized to demand the company management replicate the risky strategy, even if it significantly increases the risk of corporate failure. If the risky strategy does fail, at least the decline in the money manager's portfolio will be in line with those of his or her peers. Lawrence Mitchell argues,

128. *Ibid* at 48: "One study found that firms with large blockholders (which are more likely to be long-term shareholders) are more likely to engage in earnings manipulation around equity offerings than firms without such blockholders."

129. *Ibid* at 7.

130. Equityholders are incentivized to seek risk as they receive all the upside of successful gambles but share the downside with corporate creditors (see Jensen & Meckling, "Theory of the Firm," *supra* note 1).

131. See, for example, Roger L Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL* (Boston, Mass: Harvard Business Review Press, 2011) at 1-42 [Martin, "Fixing the Game"].

132. See notes at 22-24 for a discussion on how money managers are compensated and rewarded.

Managers thrive by increasing their portfolio's value. That is a hard thing to do and it takes time. So for years fund managers have increased their pay by putting pressure on corporate managers to increase short-term stock prices at the expense of long-term business health... For example, managers responded to the pressure by using their retained earnings to engage in large stock buybacks. In the three years leading up to September 2007, companies in the S&P 500 used more money to buy back stock than invest in production. With retained earnings gone, all that was left to finance production was debt. When the credit markets collapsed, these corporations could not borrow, and thus could not produce.¹³³

Professional money managers are often subject to other incentives as well. In rejecting the SEC proxy access rules in 2011, the U.S. Court of Appeals for the District of Columbia observed,

there is good reason to believe institutional investors with special interests will be able to use the rule... Nonetheless, the [SEC] failed to respond to comments arguing that investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self-interested objectives rather than the goal of maximizing shareholder value, and will likely cause companies to incur costs even when their nominee is unlikely to be elected.¹³⁴

It is hard to see why, in principle, ISS assumes shareholders (and the professionals that manage many of them) are better stewards of the corporation than the directors. They may be in certain individual cases, just as the directors may be wrong about strategy or personnel in certain individual cases, but in general it is not true. Nevertheless, the assumed superiority of shareholders underlies many of ISS' proxy voting recommendations.

3. *Governance by formal rules*

Many provisions in the ISS Voting Guidelines indicate that a voting recommendation will be issued on a case-by-case basis. This might suggest that ISS conducts nuanced, contextual evaluations of the board's activities, but almost invariably, the reference to case-by-case voting is followed by specific criteria that will actually determine the vote. So, for example, a recommendation to support a director nominee of a majority shareholder will be made on a case-by-case basis, but only if each of

133. Lawrence Mitchell, "Protect Industry from Predatory Speculators," *Financial Times* (8 July 2009), online: Financial Times Comment Opinion subsection <<http://www.ft.com/cms/s/0/fac881b6-6be5-11de-9320-00144feabdc0.html> - axzz2te0eK3ZX>.

134. *Business Roundtable and Chamber of Commerce of the United States of America v Securities and Exchange Commission*, 647 F.3d 1144 (DC Cir 2011).

six conditions are met and satisfactory conclusions drawn from three additional requirements.¹³⁵

For this reason, most issuers believe that proxy advisory firms produce one-size-fits-all or “check the box” corporate governance rules.¹³⁶ This is particularly concerning in a country like Canada, where every level and type of regulator in the securities arena has consciously refrained from imposing strict governance rules. Looking at pre-Sarbanes-Oxley initiatives, the Saucier Committee observed, “some of the U.S. approaches appear to us to be excessively rules-based and not in keeping with the way in which governance practices have evolved in Canada over the recent past.”¹³⁷

Several years later, following the controversial adoption of a mandatory regime in the U.S. as part of the Sarbanes-Oxley reforms, there was significant debate in Canada about whether to follow suit.¹³⁸ Canadian regulators ultimately decided to avoid most of the rules-based approach of Sarbanes-Oxley. Indeed, the regulators even chose to avoid endorsing specific principles as recommended or superior forms of corporate governance. Instead, they require issuers “to disclose their corporate governance practices with reference to specified disclosure items, without suggesting or implying an ideal or preferred practice.”¹³⁹

While a board of directors can customize its governance practices to take into account a myriad of circumstances and personalities, this approach is not open to proxy advisory firms. In Canada, there are approximately 3,800 public companies and 84% of those companies on the TSX have

135. “ISS Guidelines TSX,” *supra* note 64 at 9.

136. See for example, Power Corporation of Canada, Letter to CSA, 19 September 2012 at 8: “[T]here are legitimate governance differences for controlled companies like Power Corporation and our controlled public company subsidiaries. A ‘one-size-fits-all’ approach is clearly inappropriate.”; Canadian Tire Corporation, Limited, Letter to CSA (20 August 2012) at 2: “We, like many other public companies in Canada and the United States, are concerned that the summary output of proxy advisory firms can be—and in the past has been—inaccurate or incomplete and often reflects a ‘one size fits all’ or doctrinaire approach.”; and Gildan Inc, Letter to CSA (21 September 2012) at 10: “A related issue is the ‘one size fits all’ approach of PA [proxy advisory] Firms, which results in cookie-cutter guidelines that do not address the nuances of certain types of issuers.”

137. “Saucier Committee Report,” *supra* note 2 at 27. See also Kerry Shannon Burke, “Regulating Corporate Governance Through the Market: Comparing the Approaches of the United States, Canada and the United Kingdom” (2001–2002) 27:3 J Corp L 341. Burke points out that the UK and Canada have reasons for refusing to follow United States-style corporate governance rules. In the case of the UK there are statutory preemptive rights that give the shareholders control over management; Canada has the oppression remedy. See also Sanjai Bhagat, Brian J Bolton & Roberta Romano, “The Promise and Peril of Corporate Governance Indices” (2008) 108:8 Colum L Rev 1803. Bhagat, Bolton & Romano point out that Sarbanes-Oxley style governance rules are alien even to the US tradition.

138. Sibold, “Assessing Canada’s Regulatory Response,” *supra* note 2 at 783-791.

139. *Ibid* at 791.

year-ends of December 31.¹⁴⁰ In nearly all cases this means their AGMs are scheduled to occur within a three-month period between mid-March and mid-June, known to securities professionals as “proxy season.” For 80% of TSX-listed companies there are less than 50 days between receipt of the proxy materials and the meeting.¹⁴¹ In other words, the proxy advisory firms must generate thousands of voting recommendations during a very short time period. It would simply be impossible for this to consist of more than a check-the-box exercise.¹⁴²

No one defends check-the-box corporate governance. Not even the proxy advisors have good things to say about what ISS deprecates as one-size-fits-all approaches.¹⁴³ For several reasons, flexibility has been a priority in Canada’s traditional approach to corporate governance. For one thing, there is little agreement about what actually constitutes the end of good corporate governance. ISS offers different proxy recommendations to union pension funds, public pension funds and socially responsible investors, because those investors are interested in different outcomes (including, for example, reducing income inequality or avoiding certain kinds of polluting activities) than other investors.¹⁴⁴ Even the touchstone of shareholder value obscures conflicts between the interests of short-term and long-term shareholders, and the conflicts between both types of shareholder and the corporation itself.¹⁴⁵

Box-checking approaches to corporate governance likely encourage boards to focus on mere mechanical compliance rather than on what the company actually needs.¹⁴⁶ The spirit of conscientious stewardship over the firm disappears in a process conducted with one eye on whether the outcome will conform to the proxy advisors’ rules.

140. Professor Yvan Allaire, “The Troubling Case of Proxy Advisors: Some Policy Recommendations” (January 2013) Policy Paper No. 7 at 15, online: Institute for Governance of Private and Public Organizations (IGOPP) <http://www.igopp.org/IMG/pdf/pp_troublingcaseproxyadvisors-pp7_short_3_.pdf>.

141. *Ibid.*

142. Issues that arise in connection with generating these recommendations in a very short period of time are discussed in x, “Proxy Advisory Firms,” *supra* note 10.

143. Debra L Sisti & Martha Carter, “Re: Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms” (10 August 2012), ISS letter to Canadian Securities Administrators consultation paper 25-401 at 15, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120810_25-401_sistid_carterm.pdf> [Sisti & Carter, “ISS letter”].

144. Stephen J Choi, Jill E Fisch & Marcel Kahan, “The Power of Proxy Advisors: Myth or Reality?” (2010) 59:4 Emory LJ 869 at 883 [Choi, Fisch & Kahan, “Power of Proxy Advisors”]. Sisti & Carter, “ISS letter,” *supra* note 143 at 6, indicates it manages over 400 custom policies for investors in Canada alone.

145. See discussion at notes 124, 131.

146. Sridhar Arcot, Valentina Bruno & Antoine Faure-Grimaud, “Corporate Governance in the UK: Is the Comply or Explain Approach Working?” (2010) 30 Int’l Rev L & Econ 193 at 193.

Even in circumstances where there is widespread agreement about the most desirable outcomes, multiple institutional arrangements can achieve them. One study of the influence of different governance arrangements on controlling excessive executive compensation found that shareholder activism, a CEO/Chair split, an independent board, and an independent compensation committee all tended to substitute for one another.¹⁴⁷ It is not necessarily the case that good corporate governance requires all of them simultaneously (although ISS's rules make this assumption). A strongly independent board can offset a compensation committee with a non-independent member, for example.

Finally, corporate governance ultimately concerns the management of people, particularly senior executives. There are significant differences between executives, not just in terms of temperament and career objectives, but in their risk tolerance, discount rates and wealth portfolio diversification.¹⁴⁸ These individual differences in turn produce unique dynamics within a management team and the board of directors. No one would argue that just one set of institutional arrangements is optimized for every one of the infinitely varied communities which make up a modern business corporation. But that is what the rules-based approach of the proxy advisory firms assumes.

A good example of the dysfunctional ways the proxy advisors' rules interact with a recalcitrant real world is afforded in the area of executive compensation. This is a particularly useful example as it is one area where there is near universal agreement about the ends of corporate governance: restraining excessive executive compensation. It is also very much a growth area for the proxy advisory firms as say-on-pay votes become more common.¹⁴⁹ Even before the current activism around executive pay began,¹⁵⁰ nearly 60% of US public companies referred to proxy advisors' policies when designing an executive compensation plan.¹⁵¹

147. Chowdhury & Wang, "Institutional Activism Types," *supra* note 26 at 30.

148. See for example the research cited *ibid* at 13.

149. For current Canadian practices, see Nicholas Van Praet, "Canada Out of Step on Say on Pay," *Financial Post* (15 April 2013), online: <<http://business.financialpost.com/2013/04/15/saypay/>>; Say on pay was made mandatory in the U.S. under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 111-203, § 951, 124 Stat 1375 and in the UK under the *Companies Act 2006* (UK), c 46, s 439.

150. "2013 Canadian Say on Pay Results," (3 July 2013) Issue 2013-5 at 1, online: Meridian Compensation Partners <http://www.meridiancp.com/images/uploads/TNU-2013-5_July_2013_Say_on_Pay_Outcomes.pdf>: "Three companies failed to receive majority support [in 2013 for Say on Pay]: Barrick Gold, Equal Energy and Golden Star Resource. [In 2012], only one company (QLT Inc) failed to receive majority support."

151. David F Larcker, Allan L McCall & Brian Tayan, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions, Director Notes, The Conference Board," (March 2012), online: Conference Board of Canada <<http://www.conference->

The rules found in ISS's Proxy Guidelines relating to executive pay are extremely complex and are supplemented by an additional 21-page FAQ to assist companies in understanding how ISS generates its recommendations in this area.¹⁵² The touchstone for ISS is the relationship executive compensation in a company bears to its Total Shareholder Return performance over the short (one-year) and medium (three-year) term.¹⁵³ This is, itself, a controversial choice, since it ties executive compensation in most companies to one factor: share price. (Dividends are included in total shareholder return, but they are either not paid or are swamped by share price fluctuations in most Canadian companies.¹⁵⁴)

Many corporate governance experts, however, believe there are significant problems with tying executive compensation to share price. Roger Martin argues that because stock prices factor in the market's expectations for the future, to constantly increase a company's share price means its management must continually improve not its growth, but its growth *rate*.¹⁵⁵ Obviously over time this becomes mathematically impossible. Focusing executives on managing the market's expectations about the company also transfers their attention from something they can affect (the actual financial performance of the company) to something they can barely influence (the fluctuations of the market). Martin argues that the repeated corporate frauds over the past fifteen years, along with the reckless over-leveraging that preceded the 2008 crisis, are the logical result of tying executives' compensation to the share price. When corporate officers cannot improve upon market expectations naturally, they are tempted to resort to earnings manipulation or higher-risk strategies to boost growth.

The Institute for Governance of Private and Public Organizations, located in Montreal, issued a policy paper in 2012, which recommended:

Compensation should be linked to quantitative and qualitative indicators which drive the economic performance of the company, which measure the long-term value of the company; every company is somewhat different in this respect and cookie-cutter programs will not do the job; quantitative indicators should not be stock-price related but of the sort

board.org/retrievefile.cfm?filename=TCB-DN-V4N5-12.pdf&type=subsite>.

152. ISS, 2013 Canadian Pay for Performance Methodology: Frequently Asked Questions (23 January 2013), online: <<http://www.issgovernance.com/files/2013CanadianP4PMethodologyFAQ20130123.pdf>>.

153. "ISS Guidelines TSX," *supra* note 64 at 26-27.

154. According to the Canadian DRIP & SPP List (online: <<http://www.driprimer.ca/canadiandriplist>>), which purports to include all Canadian companies that pay dividends, approximately 120 companies and 50 REITs paid dividends out of the 1,517 issuers listed on the TSX and 2,344 issuers listed on the TSX-V (see TMX Group, "Equity Financing Statistics—January 2015," online: <<http://www.tmx.com/resource/en/422>>).

155. Martin, "Fixing the Game," *supra* note 131.

that do measure the long-term health of the company, such as Return on Invested Capital (ROIC) and Economic Value Added (EVA); they should not be highly volatile and easily manipulated; qualitative performance should be linked to the more subtle character of an organization, its ethics, the sense of belonging and fairness felt by most members of the organization.¹⁵⁶

The point is not that ISS's focus on share price is necessarily wrong (although I suspect it is), it is that reasonable men and women, equally sophisticated about corporate governance matters, can disagree on this point. And yet this is the assumption that fundamentally generates ISS's voting recommendations.

The ISS recommendations also, of course, fail to capture the features of executive compensation that are the idiosyncratic outcomes of the personality of the executive (how risk adverse, how wealthy), the circumstances of the company (how dire), the alternatives available to the executive (a pleasant retirement, a more prestigious or higher paying job), the alternatives to the company (a less experienced, capable, popular replacement) or the priorities of the board (to sell the company, improve morale, innovate or build a new business). Anyone who has negotiated a compensation package with an incoming senior executive knows that these factors drive compensation decisions as much (and often more) than the company's recent performance relative to its peers. Obviously, however, proxy advisory firms have too little time and too little information to incorporate these sorts of nuanced considerations into their recommendations.

Empirical research performed on proxy advisory firms' executive pay policies holds few surprises. The most recent study looked at 2,008 firms in the Russell 3000 Index that held their shareholder meetings in 2011 and were required by the Dodd-Frank Act to have a shareholder say-on-pay vote on executive compensation, many of them for the first time.¹⁵⁷ A large number of these companies announced alterations to their executive compensation schemes in the eight months preceding their shareholder meeting and many of these changes sought to better align the firms' executive compensation with published proxy advisor guidelines.

156. Yvan Allaire, "Pay for Value: Cutting the Gordian Knot of Executive Compensation," (March 2012), online: Institute for Governance of Private and Public Organizations at 54 <http://igopp.org/IMG/pdf/pp_payforvalue_allaire_en_v4.pdf>.

157. David F Larcker, Allan L McCall & Gaizka Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms" (10 May 2013), Stanford University Graduate School of Business Research Paper No. 2105, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453>.

The researchers found that stock market reaction to these compensation changes was statistically negative. “[The] policies of proxy advisory firms...induce boards of directors to make compensation decisions that *decrease* shareholder value.”¹⁵⁸

Other research has found that proxy advisory voting recommendations for stock option exchanges and re-pricing also decreases shareholder value.¹⁵⁹ Indeed, “future operating performance is lower and executive turnover is higher when the exchange program is constrained in the manner recommended by ISS.”¹⁶⁰ A measure of the power of proxy advisors is that the patterns of insider trading activity during the months prior to the new plans’ adoption suggest that insiders expect the new plan to be value destroying.¹⁶¹ Yet the advisor-approved plans are adopted regardless. As another paper summarizes the situation: “there is no research evidence to support ISS criteria for equity compensation plans or the firm’s calculation of proprietary metrics... which are used to determine whether shareholder dilution is excessive.”¹⁶²

4. *Standard setting and penalties*

The Voting Guidelines published by proxy firms serve a dual purpose: to provide prior warning to issuers of the kinds of actions that will attract critical vote recommendations (this is a matter of fairness), and to guide the corporate governance practices of Canadian issuers (this is a matter of setting standards). As one supporter of the proxy advisors commented,

“to the extent that issuers are changing their practices to conform to the policies of proxy advisors and those policies reflect the principles of good governance supported by institutional investors, then it is a positive development that will lead to improved governance in Canadian public companies.”¹⁶³

158. *Ibid* at 45.

159. David F Larcker, Allan L McCall & Gaizka Ormazabal, “Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services” (15 April 2011), online: Stanford University Graduate School of Business <<https://gsbapps.stanford.edu/researchpapers/library/RP2077&100.pdf>> [Larcker, McCall & Ormazabal, “Proxy Advisory Firms and Stock Option Exchanges”].

160. David F Larcker & Brian Tayan, “Do ISS Voting Recommendations Create Shareholder Value?” (19 April 2011) Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-13 at 2, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1816543>.

161. Larcker, McCall & Ormazabal, “Proxy Advisory Firms and Stock Option Exchanges,” *supra* note 159 at 160.

162. Larcker, McCall & Tayan, “Then A Miracle Happens!,” *supra* note 69 at 4.

163. Daniel E Chornous, “Re: CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms” (19 September 2012) at 6, online: Canadian Coalition for Good Governance <http://www.ccg.ca/site/ccgg/assets/pdf/submission_re_csa_consultation_paper_25-401signed-1.pdf>.

The Voting Guidelines have the kind of mandatory language one would expect from a document intended to establish standards of behavior. A violation of one of these standards results in a penalty, in this case an adverse vote recommendation. Unfortunately advisory firms have only this one, crude, penalty at their disposal. The tool is made even blunter by the very limited number of matters voted on by shareholders, and by the inherent mismatch between the complex matters often put before the shareholders and the simplistic yes or no alternatives provided to the shareholders at the meeting.

This leads to strange results throughout the Voting Guidelines. For example, the Voting Guidelines provide that violations of recommended practices for executive compensation may result in recommendations against the re-election of members of the compensation committee.¹⁶⁴ But while the compensation committee investigates the details of compensation and negotiating with senior management, the board as a whole makes the ultimate decision on compensation. Indeed, under Canadian corporate law, the board cannot delegate equity-based compensation to a committee (very often this is the largest component of remuneration paid to executives by value).¹⁶⁵

One experienced Canadian director pointed out the operation of this rule is “intimidation bordering on extortion,” that it is “unfair” and “highly detrimental to recruiting appropriate members to compensation committees.”¹⁶⁶ Why have proxy firms decided to focus this penalty on the members of the compensation committee? First, there is no alternative penalty available to the advisors—only a “withhold” recommendation with its attendant reputational and professional consequences. This can be (and apparently is) experienced as extortion, but in fairness to the proxy firms, there is no other way for them to engage with the company. It might make more sense to be reorganize the compensation committee, commission a third party to study the issuer’s compensation practices, terminate an offending officer, or get rid of a particular unknown director who advocated for the offending practice. But proxy advisors don’t have these alternatives available to them. Secondly, outside of the most egregious violations of remuneration best practices, it does not make sense to replace the entire board. Many, maybe even most, violations of the remuneration rules in the Voting Guidelines are technical or otherwise non-material. Focusing the

164. “ISS Guidelines TSX,” *supra* note 64 at 25.

165. See *Canada Business Corporations Act*, RSC 1985, c C-44, s 115(3)(c).

166. Douglas Reeson, “Re: Comments on CSA Consultation Paper 25-401—Proxy Advisory Services” (7 January 2013) at 2, online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20130107_25-401_reesond.pdf>.

penalties on the members of the compensation committee actually reflects the most proportionate approach to the problem, given proxy advisors' limited tools. The policy's unfairness and logical inconsistencies are an unavoidable side effect.

The Voting Guidelines prescribe a number of rules for certain types of transactions. Failure to adhere to one of the rules results in a vote against the transaction regardless of its overall merits. For example, failure to adhere to any one of the eighteen requirements of a shareholder rights plan, including some remarkably general ones (e.g., the plan contains "unacceptable key definitions"¹⁶⁷), will result in a recommendation to vote against the plan as a whole, ignoring whether, in substance, the plan would effectively serve to maximize shareholder value by facilitating an auction.¹⁶⁸

Interviews with issuers and legal counsel turn up story after story of major, complex transactions imperiled by proxy advisors because of immaterial violations of the Voting Guidelines. A stock option plan needed by a company in financial distress and in the process of restructuring its senior management team was rejected because it did not contain a provision forbidding an action banned by the TSX in any event.¹⁶⁹ A trust conversion almost failed to occur by the deadline set by the government because the proposed corporate entity included a class of preferred shares issuable in series (a relatively common—and benign—feature of Alberta *Business Corporations Act*-incorporated companies).¹⁷⁰

The disproportionate response of the proxy advisory firms to minor deviations from their rules might seem like the work of an unreasonable analyst, but it is built into the Voting Guidelines. The only way a proxy advisor can enforce the house rules is by being willing to burn down the house. The crude penalties found in the Voting Guidelines (and there are no others available) thus generate perverse outcomes: the advisors as

167. "ISS Guidelines TSX," *supra* note 64 at 17.

168. See the evidence that even "dead hand" poison pills assist company shareholders get better valuations on take-overs: Katherine Gleason and Mark Klock, "Is There Power Behind the Dead Hand? An Empirical Investigation of Dead Hand Poison Pills" (23 May 2008) Penn State Legal Research Paper No. 02-2008; Corporate Control, Vol 6, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1136784>. See also, John Coates, "Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence," (2000) 79:2 Texas L Rev 271, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=263632>.

169. Personal experience of the author. See also Carol Hansell, "CSA Consultation Paper 25-401 at 5," (20 June 2012), online: Ontario Security Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120920_25-401_hansellc.pdf>. Davies, CSA Response Letter (20 September 2013) at 5.

170. "ISS Guidelines TSX," *supra* note 64 at 23. Interview of General Counsel, Canadian Oil Sands by Bryce C Tingle (17 May 2013).

tribune for the shareholders routinely recommend actions that run directly contrary to those shareholders' best interests.

Conclusion

There is no shortage of recommendations as to how to fix the market for third-party proxy advice. Securities law in Canada has traditionally used two principal regulatory approaches to problems in its public markets: banning a practice, or requiring additional disclosure. While variations of both approaches have been suggested in relation to proxy advisory firms, one difficulty with the former is that issuers, advisory firms and institutional shareholders are the most sophisticated actors in the capital markets, and banning a practice which affects only them (and which market success suggests is useful) runs contrary to the logic of securities regulation.

Blackrock Inc., one of the largest institutional investors in the world, wrote a letter to the CSA in response to its request for comment on proxy advisors.¹⁷¹ In general, Blackrock supported the industry. It pointed out that it submits votes at approximately 15,000 shareholder meetings in over 90 countries each year. It employs only 20 corporate governance professionals.

The bulk of these votes occur in the second quarter of the year. The increasingly global focus of investors adds additional demands on the resources allocated to proxy voting analysis. Meeting materials are often available only in the company's local language.... Cross-border voting introduces a further layer of complexity in the form of market-specific restrictions, burdensome administrative requirements, and narrow disclosure windows, to name a few.¹⁷²

There is no real alternative to third-party proxy advisors—not if we expect institutional shareholders to vote at all. We might encourage optimal governance outcomes by permitting each institutional shareholder to decide whether it will vote on a particular matter, rather than requiring them all to vote, regardless of the inclination, expertise and effort they put into a particular voting decision.¹⁷³ Indeed, while it is outside the scope of this paper, the very existence of the proxy industry suggests a generation of corporate governance activists has been wrong: more institutional

171. Robert E Zivnaska, "Re: Canadian Securities Administrators Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" (20 September 2012), Blackrock Inc comment letter to Canadian Securities Administrators consultation paper, online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120920_25-401_zivnuskar.pdf>.

172. *Ibid* at 1-2.

173. See note 32.

involvement is probably not the solution to improving the management of Canada's businesses.¹⁷⁴

But even if we accept the current norms and legal duties around institutional shareholder voting, there is at least one regulatory intervention that would reduce the problems discussed in this paper: let companies directly address the recommendations made by proxy advisors. Give them advance notice of proxy firm recommendations. Permit them to make their case to the proxy firm analysts, or at least to the fund manager clients of the proxy firms. Such changes should improve the quality of disclosure and by doing so improve the quality of the proxy advice. This familiar formula has underlain many changes to the shareholder voting regime in this country over the past thirty years. It is not radical to think it might work in the case at hand.

The directors of every Canadian issuer should have an opportunity to review and comment on any voting advice widely disseminated by third parties. (Currently ISS only allows companies that form part of the TSX/S&P Composite Index to review proxy recommendations for factual accuracy only. Glass Lewis does not show its work to anyone prior to its publication.)

If an issuer disagrees with a recommendation, the directors should be permitted to outline the reasons for the board's disagreement in the voting recommendation document circulated by the proxy advisory firm to investors. This would permit the issuer to explain why the recommendations of the proxy advisor are not in the best interest of the company. Simply requiring the two perspectives to be published side-by-side would improve the quality of the work done by the advisor (which has no interest in being caught in absurdities) and better educate investors deciding how to cast their votes. The board has the greatest incentive, and is in the best position, to point out the ways in which the assumptions underlying the Voting Guidelines may sometimes fail to generate good corporate governance.

174. This issue is discussed in Bryce C Tingle, "Proxy Advisory Firms," *supra* note 10; see also Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton, NJ: Princeton University Press, 2007), surveying the empirical data that demonstrates the failures of democratic voting as a governance alternative to markets—an argument directly relevant to corporate governance, and Lynn Stout, *The Shareholder Value Myth*, 1st ed (San Francisco, CA: Berrett-Koehler Publishers, Inc, 2012), discussing the limitations of shareholder-centric corporate governance generally.