Remarks to the Canadian Coalition of Good Governance

"The Role of Shareholders in Addressing the Governance Challenges of Today's Capital Markets"

June 10, 2015

(Check against delivery)

Good afternoon.

I want to thank Steve and CCGG for inviting me today to share my thoughts about the role of shareholders in addressing the governance challenges of today's capital markets.

Importance of CCGG

I want to start by recognizing the important role of CCGG in improving the governance of our public companies.

You have always been a strong advocate for regulatory change to improve corporate governance and have provided a very useful perspective on regulatory proposals.

I understand there is now also academic research confirming the positive impact that CCGG has had on governance.

Focus of remarks

The focus of my remarks today is on shareholder engagement in the governance of our public companies.

I will discuss the importance of good corporate governance in our capital markets, the structural changes that are impacting corporate governance, the regulatory context for shareholder engagement and the importance of institutional investor engagement in addressing today's corporate governance challenges.

Importance of corporate governance

In my view, an important goal of corporate governance in public companies should be to generate long-term wealth for shareholders and other stakeholders.

Corporate governance supports our securities regulatory mandate to protect investors and foster efficient capital markets.

Good corporate governance contributes to investor confidence in our markets, lowers the cost of capital to our firms and encourages efficient allocation of resources.

A public company that accesses capital from investors in our capital markets has a responsibility for its conduct and its governance. This is a responsibility it owes to its investors, other stakeholders and society as a whole.

As long-term investors in our capital markets, institutional investors can proactively engage with companies to impact the governance agenda for the benefit of the companies they invest in.

Structural shifts impacting governance in today's capital markets

The corporate governance landscape is being impacted significantly as a result of structural changes in the ownership of public companies and the increase in shareholder activism.

The most significant change – which should come as no surprise to those in this audience – is the increase in institutional ownership as more individual investors choose to save through intermediaries rather than invest directly in the capital markets.

Today institutional ownership represents just over 50% of Canada's stock market capitalization.

In 2013, the 50 largest institutional investors in Canada held in aggregate $900 billion in equity assets, which is the third largest after the US and the UK – 55% of those assets were in Canadian equities.

And, as was noted in the study on CCGG's impact, CCGG members collectively held an average stake of approximately 14% of the S&P/TSX Index issuers.

This increase in institutional ownership has created a class of investors with the sophistication and economic incentive to use its influence to improve governance practices.

In addition to increased institutional activism, we have also seen the emergence of hedge funds that practice a more "pressured" brand of shareholder activism by acquiring stakes in companies and proposing changes to increase shareholder returns.

Shareholder engagement in our capital markets

The capital markets rely on shareholders to price and allocate capital among different business opportunities. Shareholders have a direct interest in the performance of the companies they invest in. They are motivated to obtain information about the companies they invest in and monitor how company boards and management are performing. They are also motivated to take steps to make necessary changes if the board and management are not responding to the concerns raised by investors.

I recognize that not all investors have the incentives to inform themselves or monitor corporate performance. Some will limit their role to providing capital and exiting when they are not satisfied with corporate performance.

However, institutional investors do play a greater role in allocating resources and monitoring corporate performance in our capital markets. And you often do so by engaging with boards and management of issuers to address concerns before they become public and contentious and are willing to push for change when the board and management are unresponsive.

We are now in what has been called the era of “agency capitalism” - in which investment intermediaries have become the dominant shareholder force.

This is the promise of shareholder democracy.

In my view, shareholder democracy is about creating a regulatory framework that supports constructive engagement by shareholders in the governance of public companies.

We all recognize that the level and intensity of shareholder engagement will depend not only on the changing ownership structure of our public companies but also the regulatory framework that determines the legal rights shareholders have and their ability to exercise them through a fair, transparent and predictable process.

We often hear that Canadian corporate and securities law is more shareholder friendly than in the United States – it's more often than not meant as a criticism rather than a compliment. I think we should take it as a compliment.

We have recently reviewed a number of important regulatory requirements that influence the relationship between the board and shareholders.

First, we had a debate about the appropriate framework for regulating take-over bids and board responses to take-over bids; in particular the use of the poison pill defense to delay or defeat hostile bids.

There were those who believed that boards should be granted greater flexibility in implementing defensive measures to delay or defeat hostile bids, subject to court oversight of board compliance with fiduciary duties.

On the other hand, others – like the CCGG – believed that the ability of shareholders to tender into the bid of their choice was an important shareholder right that should not be discarded.

We, together with our CSA colleagues, concluded that the ability of shareholders to tender into a bid of their choice was an important ownership right and also an important governance mechanism as it would motivate boards to act in the best interests of shareholders even when there was no bid.

However, we felt that some changes to the bid regime were necessary to ensure investors were making a voluntary and informed decision to sell control of the company and that boards had sufficient time and leverage to fulfill their fiduciary obligations to the company and its shareholders.

While not everyone will agree with where the CSA has landed, I think we have achieved the right balance. Target boards will not be able to “just say no” to a hostile bid but those bids will have to have a majority tender condition and they will be open for up to 120 days if the target board needs the time to respond to the bid.

Second, we consulted widely on whether to amend our early warning regime for disclosure of significant shareholder ownership from the current 10% trigger to a lower 5% trigger.

Based on the feedback we received, including from CCGG and its members, we concluded that it was appropriate for us to leave the trigger at the current 10%. One of the concerns was the potentially detrimental impact on activism of reducing the trigger to 5%.

Third, we actively supported amendments to the TSX Manual that mandates majority voting for its listed issuers as we believe that directors should only be elected at uncontested meetings if they have the confidence of a majority of shareholders.

The ability of Canadian shareholders to sell their shares in a take-over bid, requisition meetings under corporate law and reject directors in uncontested director elections provides the regulatory context for shareholder engagement in Canada.

Today's governance challenges

As I indicated, I believe institutional investors need to be actively engaged in addressing the governance challenges that our public companies face today.

In my opinion, institutional investors should proactively engage with issuers on governance issues. This will allow issuers and investors to determine the appropriate governance practices for specific issuers or sectors. It will also allow regulators to focus on areas where voluntary progress is not occurring or feasible.

In my view, there are at least three important challenges that we face today:

(i) the debate over shareholder activism and its long-term impact on our public companies;

(ii) the concern about executive compensation practices; and

(iii) increasing gender diversity on the boards of public companies.

Shareholder activism and the debate about short-termism

The increase in shareholder activism, especially by hedge funds, has become the subject of intense debate as to its effect on the long-term value of our public companies.

I am not sure if there will ever be agreement on this issue but there is no doubt that increased shareholder activism has made boards more sensitive to the concerns of their shareholders and has increased the need for boards to engage with their shareholders.

As Mary Jo-White has noted, “Increasingly, companies are talking to their shareholders, including so-called activist ones. That, in my view, is generally a very good thing. Increased engagement is important and a growing necessity for many companies today.”

There is no doubt that shareholder activism is here to stay and so the question for boards and institutional investors is how to address the concerns raised by activists in a way that supports public companies that generate long-term sustainable value.

Many institutional investors have a significant long-term stake in our public companies. This gives them the opportunity to engage with both boards and activist shareholders to determine whether a proposal is in the best interest of shareholders and the company.

Institutional investors can and should engage with public company boards to address governance, strategic and operational concerns before they result in a public activism campaign.

Institutional investors also need to engage with hedge funds to determine whether their proposals are in the long-term interest of all shareholders and not just the short-term interests of specific shareholders. This is a responsibility that cannot be outsourced to proxy advisors.

Canadian pension funds have already demonstrated leadership in activism through private engagement with issuers and by exercising their voting power at shareholder meetings.

I have been very impressed by the intellectual leadership shown by CPPIB and McKinsey & Co. in bringing together senior corporate and investment leaders for their initiative on long-termism called “Focusing Capital on the Long Term”.

The initiative provides concrete proposals for action that directors and institutional investors can adopt so that our public companies can be run for the long-term benefit of shareholders and other stakeholders.

Even my friend Marty Lipton of Wachtell Lipton has referred to their report as providing practical steps to address short-termism.

It is important that we move the discussion of shareholder activism beyond the rhetoric of short-termism versus long-termism. This can only occur if institutional investors are engaged owners that challenge both boards and activists to act in the long term best interest of public companies and their shareholders.

Executive Compensation

The second governance challenge that I want to focus on is improving executive compensation practices.

Executive compensation provides visibility into the governance practices of a public company in a way that resonates with investors. No investor wants to see directors and executives being rewarded for failure or poor performance.

An important mechanism for giving shareholders a voice on executive compensation is the adoption of say-on-pay votes. A number of public companies have adopted say-on-pay voluntarily or as a result of shareholder pressure.

The question I have is can say-on-pay benefit public companies by improving shareholder engagement, putting pressure on compensation committees to better align pay with performance and giving shareholders a voice on compensation practices distinct from their views on the directors?

While a significant number of say-on-pay votes have been supportive of the compensation practices disclosed, I am observing that there are boards of some public companies that do not appear to be listening to their shareholders' concerns about pay practices.

In my view, it is very important that boards that receive less than overwhelming support for their pay practices seek to engage pro-actively with their shareholders to address the reasons for such lukewarm support. If they fail to do so, they should then not be surprised if shareholders withhold votes in director elections or exercise other shareholder rights to make sure their concerns are heard.

We know there are similar concerns being raised in the US, where say-on-pay is mandatory, about the responsiveness of boards to negative say-on-pay votes. We would hope for a different response in Canada considering the ability of Canadian shareholders to challenge directors.

We appreciate that institutional investors have taken a leadership role in proposing say-on-pay and voting against compensation practices that do not align with the company's performance.

At the OSC, we are examining whether boards are adjusting compensation practices in response to say-on-pay results. We are also considering whether mandatory say-on-pay would result in improved executive compensation practices for our public companies.

Gender diversity

The third governance challenge where we encourage the institutional investor community to get more engaged is in the area of gender diversity.

In 2014, we implemented a rule that requires all TSX-listed issuers to provide:

(i) a report on the number of women on their board and in senior management;

(ii) disclose the adoption of policies regarding women on boards;

(iii) disclose the company's consideration of the representation of women on boards and in executive positions; and

(iv) disclose any targets they had for women on boards and in executive officer positions.

We did this for one reason - to increase gender diversity on boards and in executive officer positions. It is my belief that diversity speaks directly to the core principles of fairness and equal opportunity. Talent is not gender specific; talented people must have the opportunity to succeed regardless of background and gender.

To have 21st century boards, I believe that Canada's boards and companies must better reflect the diversity within today's society. Diversity of opinion is a catalyst for constructive dialogue, better decision-making and stronger, more competitive companies. Gender diversity is just good corporate governance.

Our rule is about disclosure, but it's not about disclosure for disclosure's sake. It is intended to create meaningful dialogue at the highest level – right at the heart of corporate leadership in this country.

We now have close to 1000 issuers disclosing information on their approach to gender diversity. Upon early review, we've seen some good examples, companies that not only provide comprehensive information, but that have significant representation of women in key roles and who are willing to push further in setting targets and achieving continual improvement.

But we’ve also seen others where, even if it may qualify as “compliant” disclosure, it is at best “technical” compliance and certainly does not reflect our overall objective or desired outcome. This type of disclosure leads us to believe that the boards of these companies are not taking the issue as seriously as we had intended.

Where board engagement is lacking, shareholder engagement must help drive the agenda forward. The disclosure we have mandated is intended to help shareholders like you make more informed decisions. If it's not meeting this goal, or if you feel that boards can and should be doing better, it is your opportunity to have your voices heard.

You can challenge boards on how they are addressing gender diversity and whether the quality of disclosure they are providing indicates sufficient commitment.

At the OSC, we will continue to play our part. In the fall, we will publish a report of our findings from our disclosure review. And we intend to hold a roundtable, to bring together leaders in this area to continue to push for new ideas in finding experienced candidates and stronger momentum in getting the job done. We often hear from companies that there are no qualified women candidates, but we know that the talent is there.

And, for the first time, we will make data from our disclosure review publicly accessible to all interested stakeholders. This is part of an ongoing effort to encourage everyone to support this initiative.

In the longer term, we will evaluate whether the comply-or-explain approach is having our intended effect of meaningfully increasing representation of women on boards and senior management.

Conclusion

I want to conclude my remarks by reiterating that the increase in institutional ownership of our capital markets is an opportunity for institutional investors to engage on addressing some of the key governance challenges of our time – generating long-term value for all investors, improving executive compensation practices and increasing gender diversity in our public companies.

I am confident that you will rise to the occasion.

Thank you again for the opportunity to share my thoughts.