July 12, 2013

BY E-MAIL AND COURIER

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Nunavut

c/o

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Dear Sirs/Mesdames:

Proposed Amendments to the Canadian Early Warning Reporting ("EWR") System

We are writing to you in response to the request of the Canadian Securities Administrators (the "**CSA**") for comments (the "**Request for Comments**") in respect of the proposed amendments (the "**Proposed Amendments**") to Multilateral Instrument 62-104 – *Take-Over Bids and Issuer Bids*, National Policy 62-203 – *Take-Over Bids and Issuer Bids* and National Instrument 62 –

103 – *Early Warning System and Related Take-Over Bid and Insider Reporting Issues*, all as published on March 13, 2013. We appreciate the opportunity provided by the CSA to provide comments on these initiatives.[1]

Capitalized terms used but not otherwise defined herein have the respective meanings given to such terms in the Request for Comments.

About Managed Funds Association and the Alternative Investment Management Association

Managed Funds Association ("**MFA**") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. Based in Washington, D.C., MFA is a global advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns.[2]

The Alternative Investment Management Association Limited ("**AIMA**"), headquartered in London, United Kingdom ("**U.K.**"), is a trade body for the hedge fund industry globally. AIMA's membership represents all constituencies within the sector, with over 1,300 corporate members worldwide, based in over 50 countries, including Canada. Members of AIMA include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting services and fund administrators. The objectives of AIMA are to provide an interactive and professional forum for its membership and act as a catalyst for the industry's future development; to provide leadership to the industry and be its pre-eminent voice; and to develop sound practices, enhance industry transparency and education, and to liaise with the wider financial community, institutional investors, the media, regulators, governments and other policy makers. Members benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals and its excellent reputation with regulators worldwide. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialized educational standard for alternative investment specialists.[3]

MFA and AIMA (together, the "**Associations**", "**we**", "**us**" or "**our**") members seek to generate returns for their investors through their investment strategies. Through shareholder engagement, certain of our members also seek to improve the performance and value of companies in their portfolios by catalyzing governance or structural changes. Our Associations' members have extensive experience investing in numerous jurisdictions, including investments in Canadian reporting issuers. Through these investments, the Associations and our members have come to appreciate a number of differences between Canadian securities laws applicable to shareholders,

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1 This submission was prepared with the assistance of Davies Ward Phillips & Vineberg LLP.

2 For further information about MFA and our member directory, see MFA's website at https://www.managedfunds.org/.

3 For further information about AIMA and our members, see AIMA's website at www.aima.org.

including those that relate to engaging in active investment strategies, and comparable rules in other jurisdictions. As such, we have acquired an understanding of the merits of the current Canadian rules, as well as some of their short-comings.

Executive Summary and the Current Debate

Recently, incumbents of public companies and pro-management commentators have been vocal in demanding a tightening of the EWR system in Canada. However, to date, the debate in Canada and other jurisdictions with blockholder reporting regimes has been largely one-sided, with many proponents of changing the EWR system citing alleged benefits that are neither supported by empirical evidence nor take into account the adverse effects such changes are likely to have. In our view, several aspects of the Proposed Amendments threaten to stifle shareholder engagement and democracy and will unduly restrict the ability of shareholders to have a positive impact on the corporate governance and performance of Canadian issuers. In short, and as discussed in greater detail throughout this letter, the Proposed Amendments will adversely affect reporting issuers, shareholders, Canadian capital markets and the economy in general.

Despite its origins as a response to take-over bids, the objectives of the EWR system have been considerably broadened and the system has come to set limits on incentives for engaged investors to make significant investments in Canadian companies with a view to seeking corporate governance and operational improvements. While such engaged investing is more often than not unwelcome by incumbent management and boards of directors, the evidence shows that it has broad positive effects on shareholder value, both for the short- and long-terms. Because of the beneficial influence on corporate governance and shareholder value that engaged investing has, it is important when considering any changes to the EWR system to carefully evaluate what impact the proposed changes are likely to have on incentives for this type of investment. As discussed in this letter, a number of the Proposed Amendments, including lowering the reporting threshold from 10% to 5%, requiring increased disclosure, and expanding the triggers for disqualification under the Alternative Monthly Reporting ("**AMR**") system to capture intentions to solicit proxies, will considerably reduce the market-based incentives for active shareholder engagement, thereby chilling the market for engaged investing and making it less likely that such activity will occur at an efficient level of frequency and intensity. Without that appropriate level of activity, stakeholders will no longer benefit from the value creation that results from engaged investing and corporate democracy will be weakened.[4]

Our members are particularly concerned that the Proposed Amendments reflect a piecemeal adoption of the most stringent aspects of other foreign reporting regimes that, if adopted, would result in one of the most onerous block reporting regimes of any jurisdiction. It appears to us that, despite the significant nature of the Proposed Amendments, they are being proposed without the benefit of any empirical assessment, including a careful cost-benefit analysis of the intended and unintended impact on relevant stakeholders and Canadian capital markets. They are also inconsistent with the legislative objectives in Canada since the 1980s to promote shareholder democracy and facilitate shareholder communication. Equally important, the

[4] Andrew Vollmer and Paul Wolfson (Wilmer Cutler Pickering Hale and Dorr LLP), "The Williams Act: A Truly 'Modern' Assessment" (5 August 2011), available online: <http://blogs.law.harvard.edu/corpgov/files/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf> [*Modern Assessment*] at 3.

Proposed Amendments fail to account for the changes in capital markets since the advent of the EWR system, which have witnessed a rise in institutional shareholders and the number of companies with significant shareholders, as well as improved access to information for all market participants. These changes suggest the current EWR system is more than adequate for its purposes, and, if anything, support a loosening of the EWR system. The Proposed Amendments are also poorly matched to the distinctive characteristics and needs of Canadian capital markets. In comparison to other jurisdictions, Canadian capital markets are smaller and less liquid, and comprised of a high prevalence of issuers that tend to be under-valued, smaller and more likely to have a controlling shareholder. These characteristics make the current EWR system more suitable for the Canadian marketplace, the competitiveness and growth of which is likely to be undermined by the Proposed Amendments.

The Request for Comments suggests that the changes will benefit shareholders. However, no analysis or empirical evidence is provided that would substantiate this claim. Indeed, no evidence has been presented that these changes are being called for by shareholder constituencies. In our estimation, the only beneficiaries of the Proposed Amendments will be incumbent management who will benefit from the tighter restrictions on the ability of shareholders to make significant investments in Canadian companies and to become actively engaged investors. Shareholders of these companies, on the other hand, will be the losers. As a result of the Proposed Amendments, the frequency of shareholder engagement as a check on poor corporate governance and performance will decline.

The costs to Canadian capital markets from the reduced frequency of shareholder engagement will far outweigh any potential benefits that may be perceived to accrue to a small subset of market participants. By stifling shareholder engagement, the Proposed Amendments will serve only to insulate incumbents from the owners of the companies they manage. As a result, underperforming incumbents – not shareholders – will be the true beneficiaries of these changes.

The principal aspects of the Proposed Amendments with which we are most concerned, are summarized in Table 1.

Table 1: Summary of our comments on the Proposed Amendments.

	Proposed Changes	**Summary of Comments**
Initial Reporting Threshold	Reduce initial threshold from 10% to 5%.	The lower threshold will make share acquisitions by engaged investors more expensive and, in many circumstances, too costly to justify the resources, time and effort for such activity. This, in turn, will chill the market for engaged investing, and erode the benefits of the value creation that results from having shareholder engagement.
Subsequent Reporting Threshold	In addition to acquisitions, decreases in ownership of 2% will be reported.	We agree that decreases in beneficial ownership can be material to the market and support this amendment.

	Proposed Changes	Summary of Comments
Reporting Deadlines	As before, shareholders will be required to issue and file a press release promptly and file a report within two business days.	If a 5% reporting threshold is adopted to match the U.S. regime, a corresponding longer filing period (*i.e.*, longer than 2 business days) should be adopted to minimize the chilling effect on engaged investing. The extended filing deadline should be determined only after careful review, empirical analysis and consultation, having regard to the costs and burdens of more immediate reporting relative to the chilling effect this will have on engaged investing, as discussed further in Part 6.
Exit Reporting	Shareholders will be expected to report when their ownership level falls below 5%.	We support a requirement that shareholders report their exit from the EWR system.
Increased Disclosure	Increased disclosure by all 5%+ shareholders, including more detailed disclosure of the intentions and plans of the acquiror and purpose of the acquisition.	This change is unnecessary and will result in the disclosure of more extensive boilerplate language or speculative comments and increased legal fees without increased benefits. Increased U.S.-style disclosure will also be impossible to provide given the immediate reporting obligation that applies under the current EWR system (in contrast to the 10 days under the comparable U.S. regime). We propose that: • if the EWR reporting threshold remains at 10%, shareholders should be required to issue and file a pared-down press release immediately (and in any event by the next business day) and file a report within a lengthier deadline than is prescribed under the existing EWR regime that includes all required disclosure; or • if the EWR reporting threshold is reduced to 5%, the requirement to issue a press release should be eliminated and shareholders should be required to file a report within an extended filing deadline.
Derivatives and Related Financial Instruments	Equity equivalent derivatives substantially equivalent in economic terms to conventional equity holdings will now be included for the purposes of the reporting threshold (including Total Return Swaps ("**TRSs**"), Contracts for Difference ("**CFDs**") and other derivatives that provide parties with a notional "long" economic interest).	Derivative instruments should not be captured in the reporting threshold unless there is an entitlement or option of the holder to acquire the underlying equity security or the instruments confer on the holder voting or investment control over the underlying equity security. Cash-settled TRSs and CFDs, for instance, should not be included for the purposes of the reporting threshold unless the holder has a right to require the counterparty to acquire or vote the underlying equity securities or has contractual rights over the counterparty's hedging (if any) of the underlying equity securities. We are supportive of requiring disclosure of (1) physically-settled derivatives and (2) cash-settled derivatives in circumstances where the shareholder would otherwise be required to file an EWR or AMR report.

	Proposed Changes	Summary of Comments
Securities Lending Arrangements	Borrowers and lenders of securities will have to account for the underlying securities for the purposes of the reporting threshold. Lenders under Specified Securities Lending Arrangements (i.e. those that include an unrestricted ability to recall the securities before a meeting of securityholders) will, however, be exempt from the reporting requirement.	We support this amendment in view of the exemption available to lenders for "specified securities lending arrangements".
Availability of AMR System	The AMR system will no longer be available to Eligible Institutional Investors ("**EIIs**") who solicit, or intend to solicit, proxies from securityholders of a reporting issuer on matters relating to the election of directors of the reporting issuer or a reorganization, amalgamation, merger, arrangement or similar corporate action involving the securities of the reporting issuer.	The CSA has taken the right approach by not adopting a U.S.-style "passive intent" condition for eligibility to use the AMR system. We do not believe any changes to the AMR system are warranted. However, if a tightening of the AMR system is pursued by the CSA, EIIs soliciting or intending to solicit proxies should not be disqualified from the AMR system. The exercise of a shareholder's right to solicit the support of other shareholders regarding the election of directors or to effect other changes should not disqualify that shareholder from AMR filing unless a dissident proxy circular is filed with a view to (1) proposing or opposing a control transaction[5] or (2) replacing a *majority* of the board of directors.
Moratorium Period	As before, filers may not acquire further securities until the expiry of the first business day after filing the report.	Because of the chilling effect on shareholder engagement, a moratorium should not apply in respect of further acquisitions. Alternatively, the moratorium should only apply if the shareholder has an intention to acquire control of the issuer. In addition, the existing 10-day moratorium that is applicable when an AMR filer loses AMR eligibility would be particularly troubling if eligibility for the AMR system could be lost as a result of solicitation or formation of an intention to solicit.

5 A control transaction includes, for example, take-over bids, corporate reorganizations, amalgamations, mergers, plans of arrangement and similar business combinations resulting in a change in effective control, as contemplated by section 4.2(b) of National Instrument 62-103 – *Early Warning System and Related Take-Over Bid and Insider Reporting Issues*.

This letter is structured in six parts:

1. *Benefits of Shareholder Engagement.* We outline the benefits of shareholder engagement that accrue to all shareholders, as well as to the issuer and the economy generally. We also discuss the significant costs that risk being imposed on engaged shareholders as a result of the Proposed Amendments and the resultant chilling effect.

2. *Regulatory History and Objectives of the EWR System.* We review the regulatory history of the EWR system and, in particular, its underlying purpose and note that the system has been the object of "mandate creep" without the benefit of empirical evidence or fresh consideration of the proper policy basis and objectives of the regime.

3. *Evolution of the Canadian Regulatory Regime and Capital Markets since the Adoption of the EWR System.* We discuss the evolution of Canada's regulatory regime and capital markets since the implementation of the EWR system. No longer is the marketplace comprised of atomized and ill-informed shareholders at risk of being taken advantage of by corporate raiders. Rather, today most shares are owned by sophisticated institutional investors who have the resources and incentives to be engaged and to respond to the initiatives of other engaged investors. In addition, regulatory and technological changes have fostered shareholder engagement by encouraging shareholder communication and improving the availability of information.

4. *Shareholder Reporting Regimes in Other Jurisdictions.* We compare the Proposed Amendments to the block shareholder reporting regimes in place in other jurisdictions and show that, although certain regimes have reporting thresholds lower than 10%, there are many important differences. In aggregate, the Proposed Amendments would impose the most onerous shareholder reporting regime anywhere.

5. *Distinctive Characteristics of Canada's Capital Markets.* We review the distinctive characteristics of Canada's capital markets, showing that Canada's markets tend to be smaller and Canadian issuers tend to be smaller, less liquid and more frequently controlled by significant shareholders than issuers in other markets. To that end, the Canadian marketplace is ill-suited for many of the aspects of equivalent foreign reporting regimes and justifies a unique Canadian system.

6. *The Substance and Effect of the Proposed Amendments.* We discuss our concerns with respect to specific elements of the Proposed Amendments and offer our recommendations.

1. Shareholder Engagement

Engaged shareholders perform the important function in the capital markets of engaging with and monitoring corporate management to foster good corporate governance and decision-making and to cultivate positive change. In doing so, engaged shareholders act as a private check on the inherent agency problem attributable to the separation of ownership and management in corporations; namely, that at some companies directors and managers are motivated by factors, such as self-preservation and enrichment, that are frequently unaligned with shareholder goals. While the trend towards greater institutional share ownership relative to retail share ownership is a positive development in terms of providing greater oversight of corporate managers, most institutional shareholders, such as mutual funds, index funds and pension funds, have business models that limit their incentives and capacity to efficiently monitor the management of their portfolio companies, despite the fact that the beneficial owners they represent have such an interest.[6] In effect, this gives rise to a new agency problem at the shareholder level between typically passive institutional shareholders and their own investors. Shareholders who specialize in engagement thus perform an important capital market role of addressing contemporary agency problems.

While shareholder engagement is typically initiated by just one shareholder (or a small group), with the costs borne solely by that shareholder, the benefits to the issuer are enjoyed by all shareholders equally and the issuer. Measures, like the Proposed Amendments, that create disincentives to shareholder engagement are inherently problematic.

Objectives of Engaged Shareholders

As value investors, engaged shareholders seek to identify and invest in under-valued companies. However, contrary to value investors who are willing to wait for the market to self-correct, activist investors are willing take the initiative and accelerate matters by engaging with investee companies, pressing for changes calculated to boost enterprise value.[7]

Engagement can take one of two forms: proactive and reactive. Reactive shareholder engagement occurs when one or more shareholders who already own a sizeable stake in a company become dissatisfied with the status quo and, instead of selling its investment, reacts by lobbying for change.[8] To the extent institutional investors, such as pension funds, mutual funds and life insurance companies, engage in activism, it will typically be reactive or rationally reticent.[9] In contrast, proactive shareholder engagement occurs when an investor acquires a sufficient holding in a company that it believes is delivering suboptimal shareholder returns with the intention to press for change if management does not take steps to correct matters.[10]

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6 Ronald J. Gilson and Jeffrey N. Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights", (May 2013) 113 Colum L Rev 863 at 865.

7 Brian R. Cheffins, "Hedge Fund Activism Canadian Style" (European Corporate Governance Institute, March 2013) available online: <http://ssrn.com/abstract_id=2204294> at 9; Gilson and Gordon, *supra* note 6 at 896-897; Marcel Kahan and Edward B. Rock, "Hedge Funds in Corporate Governance and Corporate Control" (May 2007), 155:5 Univ Penns L Rev 1021, available online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=919881> at 1028.

8 Cheffins, *ibid* at 6-7.

9 Gilson and Gordon, *supra* note 6 at 889-895.

10 Cheffins, *supra* note 7 at 1-2; Gilson and Gordon, *ibid* at 897-899; Kahan and Rock, *supra* note 7 at 1069.

Although the term "proactive" could be seen to connote an aggressive posture towards management, this is not necessarily the case.[11] Proactive shareholder activists, including many of our members, may be prepared to use the tools available to shareholders, such as proxy contests, to achieve desired outcomes. However, the preferred path is usually to do so by engaging in constructive talks with management and boards of directors that, more often than not, initially occur in private.

Critically, engaged investors – whether proactive or reactive – are not interested in acquiring a majority or defacto control position in the companies in which they invest.[12] They are even less inclined to launch a take-over bid.[13] Instead, activist investors prefer to assume minority positions in underperforming companies to avoid tying up capital in the form of majority or sole ownership of their investments.[14] A recent international study of 400 instances of hedge fund engagement occurring between 2000 and 2010 revealed that the proportion of shares owned by hedge funds averaged 11.6%.[15] Limited to Canada, this figure was 13.1%.[16] At this level of involvement, it is nearly impossible for an engaged shareholder on its own to gain or influence legal or defacto control of an issuer, particularly since Canada's capital markets are no longer dominated by dispersed, uninformed shareholders (see Part 3). Engaged shareholders also have a tendency to target companies with high levels of institutional ownership, making the possibility of an engaged shareholder influencing control even more remote.[17]

After acquiring a minority position in a company, engaged investors will typically seek to engage with management in a constructive dialogue about potential avenues for improvement. If management is uncooperative or non-responsive, engaged investors may seek the support of other shareholders in order to prompt management to effect change. However, even where a proxy contest is commenced, the preference of engaged investors is to avoid hands-on involvement in the operation and management of the companies in which they invest. Even when engaged investors escalate to a proxy contest, they tend to seek a short slate of board

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[11] Cheffins, *ibid* at 8. See also Gilson and Gordon, *ibid* at 896 and Kahan and Rock, *ibid* at 1029-1042.

[12] Cheffins, *ibid* at 11-13; Gilson and Gordon, *ibid* at 897-899; Kahan and Rock, *ibid* at 1088.

[13] Cheffins, *ibid* at 12.

[14] Cheffins, *ibid* at 11; Gilson and Gordon, *supra* note 6 at 899; Kahan and Rock, *supra* note 7 at 1088; Lucian Bebchuk *et al*., "Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy" (Fall 2013) J Corp L (Forthcoming), available online: <http://ssrn.com/abstract=2258083> at 12, 16.

[15] Cheffins, *ibid* at 12-13, citing Dionysia Katelouzou, "Hedge Fund Activism, Corporate Governance and Corporate Law: An Empirical Analysis Across 25 Countries" (Ph.D. Thesis, 2012) at 137. See also Nickolay Gantchev, "The Costs of Shareholder Activism: Evidence from a Sequential Decision Model", (2013) 107 J Fin Econ 610 at 622 (the average activist block is roughly 8%) and Alon Brav *et al*., "Hedge Fund Activism, Corporate Governance, and Firm Performance" (2008) 63 J Fin 1729 at 1747 (median initial ownership is 6.30%).

[16] Cheffins, *ibid* at 13.

[17] Nickolay Gantchev and Chotibhak Jotikasthira, "Activist hedge funds significantly improve company performance" (Hedge Funds Review, 25 February 2013): "The rationale for this is twofold. First, institutional investors are able to better evaluate the success of an activist intervention, facilitating a faster convergence of the target's share price to its improved fundamental value. Second, institutional voting directly impacts a campaign's success in its more confrontational stages." See also Gantchev, *supra* note 15 at 623.

representation with rare exceptions, preferring not to assume direct managerial or operational control of the target company.[18]

Proxy contests are highly public, highly regulated and lengthy, and therefore do not raise the secrecy concerns historically raised by take-over bids, which precipitated the introduction of the EWR system. Further, proxy contests are both difficult and expensive. The Canadian Coalition for Good Governance (the "**CCGG**"), for instance, has stated that:

> [a]ny shareholder that does incur the expense of preparing a dissident circular is also at a considerable economic disadvantage vis-à-vis management and an incumbent board which are able to use the company's resources to prepare the management information circular urging the election of their preferred directors.[19]

Proxy contests should not be discouraged as they serve as a disciplinary mechanism for holding boards accountable for corporate performance and constraining agency costs.[20] Engaged shareholders seek to influence, not control. They add value to companies for the benefit of all shareholders rather than extract value solely for themselves as corporate raiders launching take-over bids have been accused of doing.[21] Instead of operating through secretive tender offers, engaged shareholders use accepted and typically well-publicized channels of shareholder democracy to influence and persuade other shareholders and management to adopt their ideas for change. In fact, given the minority stakes acquired by engaged investors, evidence shows that the relative success or failure of an engaged shareholder's proposal is subject to evaluation and judgement by the remaining majority shareholders, rendering activists and their success critically dependent on garnering broad support for their value proposition.[22] An engaged shareholder who is perceived by other shareholders to be seeking purely short-term gains or a personal advantage through a proxy fight is unlikely to gain the necessary support for victory. To be sure, many activist investors fail in their endeavours because of their inability to generate the support needed of other shareholders to effect change. This proves that a "tyranny of the minority" is simply untrue.

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18 Alon Brav *et al*., "The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Product Market Competition" (The National Bureau of Economic Research, March 2013) NBER Working Paper No. 17517, available online: <http://www.nber.org/papers/w17517> at 14. See also Kahan and Rock, *supra* note 7 at 1088 and Soumyadri Chattopadhyaya, "The Effectiveness of Being Invisible: Hedge Funds, Hidden Ownership and Corporate Governance", 8:3 Eur Comp and Fin L Rev 305, available online: <http://ssrn.com/abstract=1733188> at 312-313.

19 David Denison, Letter re: OSC Staff Notice 54-701: Regulatory Developments regarding Shareholder Democracy Issues (Canadian Coalition for Good Governance, 31 March 2011) at 5. Jean-Nicolas Caprasse, Letter re: Response from ISS to the European Commission Consultation on the EU Corporate Governance Framework (Brussels: ISS, 22 July 2011) at 10: as a result, it may be more effective for investors to engage with companies on a collective basis.

20 Lucian Bebchuk and Robert Jackson, "The Law and Economics of Blockholder Disclosure" (2012) 2 Harv Bus L Rev 39 at 49, 51.

21 *Modern Assessment*, *supra* note 4 at 8.

22 Gilson and Gordon, *supra* note 6 at 897. See also Chattopadhyaya, *supra* note 18 at 322.

Benefits of Shareholder Engagement

The advantages of having an active community of engaged shareholders are many and supported by extensive empirical evidence. The purpose of this letter is not to enumerate all of them. It is, however, important to appreciate certain of the key benefits, including the following:

> *Check on Management.* The previously discussed traditional agency problem arising from the separation of ownership and management imposes significant costs on corporations.[23] Numerous corporate and securities law regulations (such as rules on conflicts, audit committees, disclosure obligations, insider trading and executive compensation, among others) are aimed at mitigating these costs and misalignments between ownership and management. However, most of these laws focus on simple disclosure or internal procedures. Ultimately, none of these rules can be as effective as the private check on management that an engaged body of shareholders provides.
>
> Retail investors and smaller institutional investors, as well as certain types of large institutional investors, like pension funds and mutual funds, typically have neither the experience or means nor the incentives to be active, informed shareholders. Specialized investors that are not constrained by business models (such as diversification requirements) or political or regulatory considerations from being more actively engaged in monitoring corporate managers thus fill an important gap, in effect ensuring a properly functioning governance market.[24] Larger specialized investors, including hedge funds and other proactive shareholders, with the necessary resources and experience can serve as a crucial check on management and governance for the benefit of all shareholders by holding management accountable for performance and using their skills and knowledge to perform monitoring and engagement on behalf of other more passive investors.
>
> Recent empirical studies have associated shareholder activism with significant improvements in a number of measures related to shareholder value, including improvements in stock prices, optimization of equity capitalization and capital allocation, increases in dividend payouts and CEO turnover.[25] These studies support the view that active investment mitigates agency costs related to free cash flow and entrenchment.[26]
>
> It is important to note that the role that engaged shareholders play in holding boards of directors accountable would otherwise go unfilled. More often than not, regulation of board *conduct* and remedial litigation are entirely ineffective, as the laws merely set minimum standards of conduct, whereas shareholders can hold incumbent boards and management accountable for suboptimal *performance*, even where the directors have acted in good faith and with due care and professional advice. In this way, engaged

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23 Sylvie Berthelot and Vanessa Serret, "The Evolution of Shareholder Activism in Canada" (International Conference of the French Finance Association, 11-13 May 2011), available online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1836875> at 4-5.

24 Kahan and Rock, *supra* note 7 at 864-869. See also Chattopadhyaya, *supra* note 18 at 318.

25 Brav, *supra* note 18 at 14.

26 Brav, *ibid*. Firms that generate cash flow beyond that required to finance all positive net present value projects are prone to agency problems because the excess cash (or free cash flow) is available to company managers to use at their discretion.

shareholders fill a crucial void in proposing and demanding optimal performance from incumbents.

Improved Corporate Governance. Shareholder engagement prompts the adoption of good corporate governance practices, ultimately improving board oversight of management. Boards challenged by engaged shareholders are more inclined to hold management accountable for company performance and reign in inappropriate or excessive compensation schemes. For instance, studies have associated the presence of blockholders with a reduced incidence of option backdating, stronger ties between CEO pay and performance, and generally lower levels of CEO pay.[27]

The positive impact on corporate governance practices is not limited to those issuers that are targeted by engaged shareholders. Anticipating the risk of being targeted, management of all issuers become more proactive and vigilant. Consider that following on the heels of several successful activist campaigns in Canada, in 2012 alone the CEOs of the following Canadian companies have been replaced: Canadian Pacific Railway Limited, Barrick Gold Corporation, Kinross Gold Corporation, Centerra Gold Inc., Rona Inc., Imperial Oil Limited, Encana Corporation, Enbridge Inc., Talisman Energy Inc., Suncor Energy Inc., Nexen Inc. and SNC-Lavalin Group Inc., among many others. Since 2012, eight of the top 30 TSX companies by market capitalization have replaced their CEOs.[28]

Superior Returns on Investment. Reflecting an expectation and borne out by experience, the market prices a 5% – 10% abnormal return into a target company's share price upon disclosure of an activist's investment.[29] A comprehensive study of 1,000 shareholder interventions between 2001 and 2006 found that the announcement of engagement produced an abnormal return of 7% – 8% during the 40-day announcement window, which did not reverse in the subsequent two years.[30] This market reaction is due to the history of demonstrated improved operating performance, share price and return on investment at companies subject to shareholder engagement.[31] These above-market returns are rarely temporary; this is not short-term focused behaviour. For example, studies have shown average (median) raw (*i.e.,* not market adjusted) shareholder returns of approximately 39% (33%) over an average 19-month activist campaign period and

27 Bebchuk and Jackson, *supra* note 20 at 48.

28 S&P Capital IQ (as of 21 May 2013).

29 Brav, *supra* note 18 at 2. See also Bebchuk and Jackson, *supra* note 20 at 47-48. J.P. Morgan, "Hedge fund activists 2.0: They are back! Creating value through pro-active strategies in response to hedge fund activism", (April 2010) available online: <https://www.jpmorgan.com/cm/BlobServer?blobkey=id&blobwhere=1158616132009&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> at 6: based on the stock price performance of 85 targeted firms from 2005 to 2009, J.P. Morgan focused on three time windows: (1) the first from a week before the first activism announcement and ending a day before announcement, showing targeted firms outperformed the market by 2.0%; (2) the second around the announcement day, showing targeted firms outperformed the market by 3.3%; and (3) the third starting the day after announcement and ending a week after announcement, showing targeted firms continued to outperform the market by 0.7%. Overall, J.P. Morgan found that the targets outperformed the market by 6.1%.

30 Lucian Bebchuk, "The Myth that Insulating Boards Serves Long-Term Value" (2013) 113 Colum L Rev (Forthcoming) at 30, citing Brav *et al.*, *supra* note 15.

31 Brav, *supra* note 18 at 2.

average (median) annualized market-adjusted returns of approximately 4% (4%).[32] Other empirical studies report average (median) raw target shareholder returns of 42% (18%) over the campaign period and annualized average (median) market adjusted returns of 21% (4%).[33] Consistent with the objective of long-term value creation, on average activist hedge funds hold their investments for a period of two years.[34]

A recent empirical study shows long-term effects of activism on shareholder wealth beyond one-to-two year periods. After studying the universe of approximately 2,000 interventions by activist hedge funds during the period from 1994 to 2007, the study found *no* evidence of a reversal of stock returns during a five-year period following the U.S Schedule 13D announcement by an activist shareholder, nor did the targets of activism exhibit abnormal negative returns during that same period.[35] The same study also found no evidence that long-term shareholders of target companies experience negative abnormal returns during the three-year period even after an activist reduces its stake in the target below 5%.[36]

Improved Productivity. The benefits of shareholder engagement are not confined to improved corporate governance and shareholder returns alone. Rather, target companies profit from demonstrably improved production efficiency from the year of targeting to three years after the activist intervention, on the order of 7.7% – 10.8%.[37] Equally important, studies have shown that the performance improvements among target companies would not have occurred had the hedge funds been mere passive investors.[38] These benefits are not short-lived, with the fundamentals of most target companies showing long-term improvements.[39] A study of 2,000 interventions by hedge funds during the 1994 – 2007 period has shown that the targets of shareholder engagement do not exhibit abnormal negative returns during the five-year period following intervention.[40] Studies have found that during the two years following the filing of a U.S. Schedule 13D, the targets of activist interventions experienced significant improvements in operating performance, relative to similar firms not targeted.[41] In addition, targets of

32 Gilson and Gordon, *supra* note 6 at 901; Gantchev, *supra* note 15 at 625. See also Benjamin Solarz, "Stock Picking in Disguise? New Evidence that Hedge Fund Activism Adds Value" (2010) 3:1 Mich J Bus 101 at 102 and Nicole Boyson and Robert Mooradian, "Experienced Hedge Fund Activists" (Working Paper delivered at the American Finance Association 2012 Chicago Meeting, 3 April 2012), available online: <http://ssrn.com/abstract=1787649> at 1, 4.

33 Gilson and Gordon, *ibid* at 901. Brav, *supra* note 15 at 1760-1761. See also April Klein and Emanuel Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors", (2009) 64 J Fin 187 at 187, 188, 219, 226: the authors report average target shareholder market-adjusted returns of approximately 22% over a one-year post-initiation period.

34 Brav, *supra* note 18 at 21.

35 Bebchuk, *supra* note 30 at 32, citing Lucian Bebchuk, Alon Brav and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism" (2013) working paper.

36 Bebchuk, *ibid* at 33.

37 Brav, *supra* note 18 at 1, 8 and 11: based on performance metric of "total factor productivity", which is defined as the difference between the actual and predicted output, given inputs.

38 Brav, *ibid* at 5.

39 Brav, *ibid* at 1, 3.

40 Bebchuk, *supra* note 30 at 32.

41 Bebchuk, *ibid* at 34, citing Brav, *supra* note 15 at 1741-1745 and Alon Brav, Wei Jiang and Hyunseob Kim, "Hedge Fund Activism: A Review" (2009) Foundations and Trends in Finance 4.

intense activism benefited from an increase in return on assets ("**ROA**") in the first year after the initial activism and from an even higher increase in the subsequent two years.[42] Based on a different sample of activist situations, another study found that targets of activists benefited from improved performance (reflected in higher ROA) in each of the three years following the activist event.[43] Recently, it was shown that during the five-year period following activist intervention, the operating performance of targets was better in most years, and not worse in any year, than during the pre-intervention period.[44] Together, these extensive empirical results evidence the significant benefits to target's productivity and operating performance, and the long-term nature of those benefits.

More Efficient Allocation of Assets. In much the same way that shareholder engagement has been shown to enhance productivity, the involvement of an engaged shareholder frequently facilitates the efficient reallocation of corporate assets.[45] Despite being outsiders who may not have inside knowledge about a firm's operations, hedge funds can bring to businesses their capital allocation experience, capital markets expertise and absence of complicating social ties to enhance business decision making.[46] Armed with this skillset, hedge funds may encourage companies to divest underperforming or non-core assets in order to strengthen and refocus on their core line of business.[47] In effect, hedge funds help companies match assets with experts who can properly make use of them. This, in turn, allows companies to improve their cash flow and, as a result, their overall value.[48] By way of example, a recent "plant-level" study revealed that plants sold by companies after hedge fund intervention exhibited lower than average productivity prior to sale and experienced greater than average improvement in the hands of new owners.[49] This suggests that hedge funds play an important role in matching underperforming plants with new owners who can more efficiently and capably operate them.[50]

From a higher level, the effect of shareholder-prompted asset reallocation manifests itself in two ways. First, firms become smaller.[51] Simply put, engaged shareholders add value by "counteracting management's harmful tendency to build empires" and selling off assets yielding sub-optimal returns.[52] A study of hedge fund activism occurring in the United States between 2000 and 2008 revealed that targets of activist hedge funds tend to

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42 Bebchuk, *ibid* at 34, citing Boyson Mooradian, *supra* note32.

43 Bebchuk, *ibid* at 34, citing Christopher P. Clifford, "Value Creation or Destruction? Hedge Funds as Shareholder Activists" (2008) 14 J Corp Fin.

44 Bebchuk, *ibid* at 35.

45 Brav, *supra* note 18 at 2-4.

46 See e.g. Brav, *ibid* at 12.

47 Brav, *ibid* at 15.

48 Solarz, *supra* note 32 at 121.

49 Brav, *supra* note 18 at 3.

50 Brav, *ibid* at 3.

51 Solarz, *supra* note 32 at 124-125. See also Solarz, *ibid* at 108: companies targeted by activist hedge funds hoard assets, having an average of 1.9% more cash per dollar in assets than companies targeted by passive investors.

52 Solarz, *ibid* at 124-125: management may be incentivized to purchase underperforming assets to build a larger firm in order to secure greater compensation and job security.

reduce their assets by 6.6% over the two years following engagement.[53] Second, firms benefit from an improved ROA. A recent 2012 study demonstrated that companies partnered with experienced hedge funds generate median improvements in ROA of 1.7% and 1.2% over the one and two year periods following engagement.[54]

Engaged investors tend to target mature firms with relatively strong business fundamentals, but which may be experiencing deterioration due to bad governance or mismanagement such as poor adaptation to market changes.[55] It is also in these large companies where the potential for significant agency costs is the greatest. Given the importance of large enterprises in the Canadian economy as employers, innovators and providers of infrastructure crucial to the functioning of the economy, there is much more at stake should agency costs go unchecked.

The fruits of these positive changes are shared by the target company, its shareholders, the markets and the economy, more generally. In fact, the CCGG has stated that companies should welcome "[e]nhanced monitoring and engagement by shareholders … as it will assist them in improving their governance practices, lowering their risk and attracting institutional investors".[56] This stands in stark contrast to the situation of a take-over bid, the alternative capital market mechanism for achieving asset reallocation, where the bounty is captured by the acquiror alone.

Costs of Shareholder Engagement

Engaged investors who elect to engage with management of a company typically must bear all of the costs associated with that engagement.[57] However, as minority shareholders, they can only expect to receive a fraction of the improvements in shareholder returns, while the remaining shareholders who bear none of the cost also reap the benefits.[58] Costs of engagement include, among many others, reputational risk, transaction costs, brokerage costs, legal fees, communication and printing costs, and the costs of soliciting the support of fellow shareholders.[59] Engaged investors also incur significant costs in connection with researching companies, discovering inefficiencies and designing plans to fix these inefficiencies.[60]

The costs of engagement can be very significant, particularly if the engaged shareholder must conduct a proxy contest. Depending on the scope of an engaged shareholder's campaign, a recent 2013 study indicates that, based on 1,164 campaigns tracked in the 2000 to 2007 period, campaigns culminating in proxy contests cost nearly $11 million on average.[61] These costs also appear to be rising. The direct experiences of some of the Associations' members suggest that dispersion is high and, in some cases, costs can amount to nearly $15 – $20 million (excluding the internal costs and resources incurred by the activist in researching and developing its

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53 Solarz, *ibid* at 125.

54 Boyson and Mooradian, *supra* note 32 at 20.

55 Brav, *supra* note 18 at 12.

56 "2010 Principles for Governance, Monitoring, Voting and Shareholder Engagement" (Canadian Coalition for Good Governance, December 2010) at 1.

57 Cheffins, *supra* note 7 at 29; Bebchuk and Jackson, *supra* note 20 at 47; Gilson and Gordon, *supra* note 6 at 898.

58 Cheffins, *ibid* at 29.

59 See e.g. Cheffins, *ibid* at 30.

60 *Modern Assessment*, *supra* note 4 at 21.

61 Gantchev, *supra* note 15 at 623.

proposal before initiating engagement). These costs must be offset by the potential profit that an engaged investor expects to realize from the improvements that it aims to effect through the engagement. For this reason, the ability of an investor engaged in activism to acquire a stake at an undisturbed price is central to its strategy. However, as discussed above, the disclosure of the acquisition of a stake by an engaged shareholder has the demonstrated effect of boosting share prices and thus the cost of further acquisitions of shares by the engaged shareholder. As a result, particularly in cases involving the most effective and respected "activist" investors, the disclosure point under the EWR system demarcates the end point for the opportunity to purchase an initial stake at a price that does not reflect the anticipated benefits that the engaged shareholder will bring to shareholder value. Knowing the historical returns characteristic of companies with an engaged shareholder, existing shareholders tend not to sell and new investors tend to quickly flock to such companies in order to partake (and free-ride) in the anticipated gains, thereby causing an immediate rise in share price.[62] This, in turn, makes it more costly for engaged shareholders to add to their ownership positions at prices that can justify the costs of engagement.[63]

In this way, the disclosure point under the EWR system is directly related to the potential profit that an engaged shareholder can realize from a proactive strategy and thus the incentives for beneficial shareholder engagement in the market. By narrowing the window of opportunity for an engaged investor to build a stake in a company prior to disclosure, we believe that the Proposed Amendments will greatly reduce the opportunity for shareholders to recover the necessary benefits from their discoveries to justify their efforts.[64] This will, in turn, subvert the many important benefits that accrue to issuers, all shareholders and the capital markets.

Balancing the Interests of Management and Shareholders

Many calls for reform by pro-management commentators have been based on the belief that later disclosure prefers the interests of engaged shareholders over the interests of shareholders who sell their shares without knowledge of pending intervention. Fundamental to this position is a belief that the costs imposed on engagement are justified by "protecting" short-term selling shareholders. However, these advocates offer no legitimate policy justification as to why shareholders who have made the short-term decision to sell should be afforded priority over the overwhelming majority of shareholders who retain their interests and the engaged shareholders who propose changes intended to benefit all shareholders.[65] Conversely, engaged shareholders accumulating positions provide liquidity to these short-term sellers at higher prices, in effect affording them an opportunity to exit their investments on an uncoerced basis, at a time of their

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62 Websites like stockpickr.com track activist purchases specifically to facilitate piggybacking on activist situations.

63 Bebchuk and Jackson, *supra* note 20 at 47. See also Chattopadhyaya, *supra* note 18 at 313.

64 *Modern Assessment*, *supra* note 4 at 3, 23-25.

65 *Modern Assessment*, *supra* note 4 at 3. See also Gilson and Gordon, *supra* note 6 at 907: "A shareholder's decision to sell results either from liquidity needs or the shareholder's reservation price for the security in question. Any asymmetry of information involved in the transaction arises from the activist's private information about its own intentions, which may include a forecast as to the likely target firm response. *Why does the selling shareholder have an entitlement to share in the value of information created by the analysis of other investors? The thin logic of an argument whose goal is to facilitate a free riding strategy becomes even clearer when the question is examined from the ex ante shareholder perspective…*" [emphasis added].

choosing and at a price they deem attractive.[66] The rise in share price resulting from shareholder engagement is not an unjust transfer of wealth from selling shareholders to engaged investors; rather, it is directly attributable to the engaged investor's hard work.[67] In any event, empirical evidence in the U.S. has demonstrated that share prices rise *prior* to ownership disclosure because of the engaged shareholder's acquisition activity, which benefits short-term sellers.[68] If shareholder engagement is undermined by virtue of the Proposed Amendments, no shareholders (including short-term sellers) will reap any benefits.

Naturally, management also favours early disclosure. Rendering stake-building more difficult, early disclosure insulates incumbent management by preventing engaged shareholders from acquiring a position sufficient to persuade and influence issuers and other shareholders and justify the costs of engagement. However, management already enjoys considerable advantages *vis-à-vis* an engaged shareholder, including, most notably, access to the corporate treasury and unilateral control of the proxy machinery. Management also has an informational advantage through their real-time access to shareholder lists, including non-objecting beneficial owner lists and CDS and DTC participation lists.

In view of the many collective benefits reaped from shareholder engagement, and the existing obstacles that restrain it, we believe that regulators must be extremely careful not to add to the costs of shareholder engagement or create new obstacles.

2. Regulatory History and Objectives of the EWR System

The EWR system arose in the context of the Canadian take-over bid regime. Simply put, the EWR system was crafted to alert investors and target companies to impending take-over bids. Use of the EWR system to warn issuers about the intended exercise by shareholders of their shareholder franchise rights was not part of the original policy objective behind its adoption. Despite this, without any empirical basis for its statements, the CSA seems to suggest that the Proposed Amendments are necessary because the objective of warning issuers of potential shareholder engagement is not being achieved by the current rules. We believe that this attributes objectives to the EWR system that were in fact never intended and is inappropriate, particularly absent fresh consideration of its policy basis, costs and benefits.

Adoption of the EWR System

In 1983, the Securities Industry Committee on Take-Over Bids (the "**Committee**") proposed the adoption of a rule that purchasers not be permitted to acquire 10% or more of the voting rights of a company until such purchaser has given notice of their intentions and a reasonable period has passed for dissemination of the information.[69] In the Committee's view, a moratorium of five business days was reasonable. Notably, the Committee was not seeking to deter take-over bids. In its view, take-over bids played a useful role in the Canadian economy and facilitated the

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66 *Modern Assessment*, *ibid*.

67 *Modern Assessment*, *ibid*.

68 *Modern Assessment*, *ibid*.

69 Securities Industry Committee, "Report on the Securities Industry Committee on Take-Over Bids" (Toronto: Queen's Printer, 16 November 1983) at vii and 46-47 [*SIC Report*].

efficient reallocation of capital and other resources.[70] The purpose of disclosure was in the interest of fairness to public investors, who it was believed should be alerted to the risk of a possible take-over bid, lest investors be unwittingly dispossessed of the control premium.

In December, 1984, the Ontario Securities Commission (the "**OSC**") proposed amendments to take-over bid legislation, including the adoption of an EWR system.[71] The stated purpose of the system was to alert participants in the marketplace "to the assembly of substantial holdings that might lead to a take-over bid".[72] The EWR system was proclaimed into force on June 30, 1987 in a form materially the same as the system in place today, without the AMR system.[73] The take-over bid regime itself arose from a need to ensure the fair and equal treatment of shareholders in control transactions. The 1965 Kimber Report, for instance, called for a system that would permit informed decisions by what was then a highly disaggregated shareholder base.[74] At no point was the regime intended to restrain shareholders from joining together to effect changes in corporate governance or to limit shareholder engagement.

The EWR system's 10% reporting threshold was subject to fresh consideration in 1990, three years after its introduction.[75] It was proposed that the EWR threshold be reduced to 5% and that the take-over bid threshold be reduced from 20% to 10%. Ultimately, both lower thresholds were rejected because the costs of the proposed changes outweighed any perceived benefits. No further published response or particulars were released.

Historically, the EWR system has always been reviewed as part of a broader review of the take-over and issuer bid regime in connection with which it was initially implemented. We submit that this is the appropriate approach. The Request for Comments, however, is the first time the CSA has considered changes to the EWR system outside of such a broader review, and expressly notes that further changes to the take-over bid regime and AMR system will be considered as part of a future review. It is premature to amend the EWR system without due consideration of the consequential effects such amendments will have on the take-over bid regime and AMR system with which it is intimately linked.

Over-Expansion of the EWR System's Purpose

Since adoption, the EWR system has been the object of "mandate creep", with regulators attributing to the system objectives that are far broader than its originally intended purpose of providing early warning about a change of control. While it may be appropriate for the EWR

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70 *SIC Report*, *ibid* at ii-iii.

71 *Proposed Amendments to Take-Over Legislation*, OSC Notice, 7 OSCB 5329 (21 December 1984).

72 *Bill 68 / An Act to Amend the Securities Act*, OSC Notice, 9 OSCB 5167 (13 December 1985) at 5170. In 1993, the OSC reiterated the EWR system's narrow focus, affirming that its purpose was to ensure that the market be advised of "accumulations of significant blocks of securities that may: influence control of a reporting issuer because they can be voted or sold, or indicate that a control transaction in respect of that issuer is imminent": *Proposed Refinement of the Early Warning, Insider Reporting and Take-Over Bid Regimes*, Request for Comment, 16 OSCB 4539 (10 September 1993) at 6-184.

73 *Bill 156: Securities Amendment Act: Proclamation*, OSC Notice, 10 OSCB 3713 (26 June 1987) at 3713.

74 Report of the Attorney General's Committee on Securities Legislation in Ontario (Ontario, March 1965) at 22.

75 *Notice 90/06/80b – Proposed Changes to Provincial Securities Legislation – Take-Over Bids*, OSC Notice, 13 OSCB 2295 (8 June 1990).

system to serve a broader purpose, an expansion of these purposes should be accompanied by a thorough consideration of the evidence for a need to expand the EWR system's role.

In 1994, securities regulators first asserted the position that providing ownership information that might indicate an imminent take-over bid was not the EWR system's sole objective. Instead, the EWR system was expected to provide disclosure of information "of interest to the market place".[76] Expansion of regulatory purpose, in the absence of careful analysis and empiricism, is inappropriate in our view. Extending far beyond its conceived purpose, disclosure was expected to satisfy the public's interest in knowing the identity and purpose of shareholders capable of affecting a company's public float, liquidity, significant corporate events, the success of corporate transactions, the constitution of its board of directors or performance.[77] No study was conducted to explain or justify this expansion. In effect, the EWR system's mandate creep has blurred the distinction between engagement and control threats even though the nature of shareholder engagement and bids for *de facto* control are distinct phenomena and have different consequences for target issuers and shareholders.

Recognizing the compliance burden of the EWR system on larger investors not seeking corporate control, the non-control investor reporting regime (NI 62-103) was adopted in 1999 after several years of consultation and refinement. The primary purpose of the rule was to provide exemptions from the EWR requirements to institutional investors who lacked control intent with respect to their ownership or control of securities. This was introduced in the form of the AMR system currently in effect.

By providing an exemption for institutional shareholders not seeking to acquire control, the adoption of the AMR system was in effect a confirmation that the purpose of the EWR system was to regulate take-over bids and other control transactions. Shareholders not seeking to acquire control would be afforded a much more lenient reporting timeline and abbreviated disclosure and would not be precluded from continuing to make purchases either before or after disclosure was made. In crafting and refining the rule over several years, regulators sought to ensure that the regime did not affect legitimate activities of shareholder engagement by using overly narrow notions of passivity. In 1994, for instance, the OSC stated in a request for comments:

> the implementation of relief from the existing [EWR] regime based on 'passivity' could act as an impediment to the otherwise legitimate exercise of the institutional investor's shareholder franchise activity, to the extent the institution is constrained from engaging in certain market activity in order to preserve its 'passive' status.[78]

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76 *Speech by Leslie Milrod at the Insight Conference Held on January 31, 1994*, 17 OSCB 493 (4 February 1994); *Proposed Refinement of the Early Warning Regime and the Rules Regarding Insider Reporting, Take-over Bids and Control Block Distributions*, OSC Notice, 17 OSCB 4419 (16 September 1994).

77 *The "Early Warning" System – Some Thoughts*, OSC Notice, 18 OSCB 890 (3 March 1995); *Early Warning System and Related Take-over Bid, Insider Trading and Control Block Distribution Issues*, Request for Comments, 18 OSCB 4887 (20 October 1995).

78 *Proposed Refinement of the Early Warning Regime and the Rules Regarding Insider Reporting, Take-over Bids and Control Block Distributions*, *supra* note 76.

In 2003, the British Columbia Securities Commission (the "**BCSC**") considered reducing disclosure under the EWR system.[79] The BCSC was sensitive to the growing complexity and unwieldiness of securities regulation in Canada. Among the problems it identified with the EWR system were that it: (1) applies to all securityholders and not just those with take-over bid intentions; (2) requires duplicate disclosure in the report and press release; and (3) duplicates much of the insider reporting system. In fact, in a survey conducted by the BCSC, only half of respondents indicated that they use early warning reports to get the information they need, preferring to use insider reports.

In view of the above, and following an 18-month investigation, the BCSC concluded that the EWR system "should be limited to the context for which it was intended – the take-over bid arena."[80] We agree. The initial goals of the EWR system were properly conceived to protect shareholders in transactions affecting corporate control. They are ill-suited to regulating "active" shareholders seeking to engage with issuers. In expanding the objectives of the EWR system, at no point has there been an evidence-based assessment of the need for the proposed changes nor the relative costs and benefits of imposing greater burdens on shareholders. Absent empiricism, we believe that such changes would constitute bad policy-making.

No Cost Benefit Analysis has been Performed on the Proposed Amendments

Securities regulators have repeatedly and consistently re-affirmed that the costs of regulation should not outweigh the expected benefits. Section 2.1 of the *Securities Act* (Ontario) specifically directs the OSC to have regard to the principle that "[b]usiness and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized".[81] In considering the proposed changes to the EWR system in 1994, OSC Special Counsel confirmed the importance of this statutory requirement in making changes to the EWR system, noting that "[t]hese are not idle words…".[82]

The importance of undertaking a careful cost-benefit analysis of rule proposals was recently emphasized by the OSC in its Statement of Priorities released on April 4, 2013, in which it included the following priority to address in the current year:

> Demonstrate the OSC's effective use of research, data and analysis through:
> (a) Improved cost-benefit analysis in rule proposals
> (b) Clear examples of use of data and analytical approaches
> …[83]

Despite this fresh reaffirmation of the importance of cost-benefit analysis in rule making, we note that the Request for Comments contains no such analysis at all, and certainly not with

[79] *The BC Model, Draft Legislation, Commentary and Guides for a New Way to Regulate*, BCSC Notice, BCN 2003/12 (WL).

[80] *The BC Model, Draft Legislation, Commentary and Guides for a New Way to Regulate, ibid* at 175.

[81] *Securities Act*, RSO 1995, c S5, s 2.1(6) [*OSA*].

[82] *Speech by Simon Romano (OSC Special Counsel) re: the "Early Warning" System*, OSC Notice, 18 OSCB 890 (3 March 1995) at 9 (WL).

[83] *Statement of Priorities – Request for Comments Regarding Statement of Priorities for Financial Year to End March 31, 2014*, OSC Notice, (2013) 36 OSCB 3423 (4 April 2013) at 5.

respect to the impact of the Proposed Amendments on shareholder engagement. The Request for Comments cites no empirical data or analytical approaches to justify the Proposed Amendments or to identify the perceived mischiefs they are designed to address. We also do not believe that the market's posited desire for increased and earlier disclosure on the basis that the information *may* be relevant to investment decisions or material to some sufficiently outweighs the considerable costs of the Proposed Amendments; namely, the adverse impact the proposed amendments will have on shareholder engagement and democracy. Indeed, traditionally passive retail and institutional investors may want to encourage engaged investor behaviour and should not want to dispossess them of their economic incentives and resulting benefits of such behaviour.[84]

The impetus for the proposed changes originates from pro-management advocates and commentators who seek to enhance the advantages incumbents already enjoy by making it more difficult for shareholders to engage with and monitor the issuers in which they invest. In trying to make their case, these advocates espouse terminology concerning the "control" and "influence" engaged shareholders allegedly enjoy without accurately reflecting the activities or benefits they undertake, and inaccurately ascribe short-term objectives to activist shareholders that stand in stark contrast to the significant long-term benefits empirical evidence shows stems from engagement. In addition, pro-management commentators frequently rely upon rare anecdotal cases of hidden ownership or alleged empty voting in the proxy contest context as the apparent evidence of the need to expand the objectives and burdens of the EWR system. However, as discussed below in Part 6, such perceived abuses are indeed rare and, to the extent present, are better regulated by the crafting of discrete rules targeted at abusive behaviour (if any), rather than omnibus changes to the EWR system impacting the entire Canadian economy.

3. Evolution of the Canadian Regulatory Regime and Capital Markets since the Adoption of the EWR System

The trend of Canadian corporate and securities regulation over the past two decades has been to foster shareholder democracy and to encourage greater shareholder involvement. The Proposed Amendments would amount to an unfortunate slide backwards from the progress that has been made to date on this front. To that end, this section considers (1) the changes in Canada's corporate and securities laws since 1987, which demonstrate a clear legislative policy of fostering shareholder engagement, (2) the changes in Canada's capital markets since 1987, which demonstrate that many of the original drivers behind the EWR system no longer exist, and (3) the improved access to and availability of information to issuers and shareholders, which reduce the scope for secretive stakebuilding and the need to protect shareholders therefrom. These changes do not support a need for a tightening of the EWR and AMR systems of the nature and scope contemplated by the Proposed Amendments.

Changes to the Canadian Regulatory Regime since 1987

Since 1987, various regulatory initiatives have reflected a clear legislative policy of fostering shareholder communication and engagement. In addition to improvements in corporate governance rules and guidelines, enhancements to disclosure under corporate and securities laws,

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[84] Gilson and Gordon, *supra* note 6 at 916-917.

and mandating minority shareholder approval rights for related party and other special transactions, the policy of fostering shareholder engagement and communication is evidenced by the liberalization of proxy solicitation rules and the adoption of National Instrument 54-101 – *Communication with Beneficial Owners of Securities of a Reporting Issuer* ("**NI 54-101**").

Liberalization of the Proxy Solicitation Rules

In 2001, amendments to the *Canada Business Corporations Act* significantly relaxed corporate proxy solicitation requirements. The amendments eliminated the need to file a dissident proxy circular when soliciting 15 or fewer shareholders or when the solicitation is conveyed by public broadcast, speech or publication.[85] The legislative intent underpinning this change was to encourage shareholder engagement by "facilitating wider communication and encouraging more participation in corporate decisions through the shareholder approval process."[86] The Canadian Senate Banking Committee supported liberalization of the proxy system on the grounds that it would "promote open and meaningful communication among shareholders".[87] The Ontario legislature expressed the same intent when it followed suit in 2007.[88]

In 2007, the CSA adopted corresponding changes to provincial securities laws, noting that the relaxed rules would:

> allow securityholders and their representatives a greater level of participation in decision-making at annual and special meetings of securityholders. The proposed amendments will allow securityholders to engage in these activities without incurring substantial financial costs by having to mail formal proxy requests and information circulars to all securityholders.[89]

Adoption of NI 54-101

In 2002, the CSA implemented NI 54-101 to replace National Policy Statement No. 41 – *Shareholder Communication*. Much like the liberalization of the proxy solicitation rules, NI 54-101 was aimed at improving shareholder communication and reducing complexity and compliance burdens.[90] The amendments broadened the use of electronic communication in the proxy solicitation process by, for example, permitting the dissemination of materials by e-mail, internet or other electronic means. NI 54-101 also reinforced a shareholder's right to

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85 Wayne Gray, *The Annotated Business Corporations Act*, loose-leaf (consulted on 16 April 2013) 2d ed (Toronto: Thomson Canada Limited, 2004) at 1-328; *Canada Business Corporations Act*, RSC 1985, c C-44, s 150.

86 *House of Commons Debates*, 37th Parl, 1st Sess, No 76 (11 June 2001) at 1205 (John Cannis). See also *Debates of the Senate*, 37th Parl, 1st Sess, 139:6 (8 February 2001); *Debates of the Senate*, 37th Parl, 1st Sess, 139:8 (21 February 2001); *House of Commons Debates*, 37th Parl, 1st Sess, No 59 (10 May 2001).

87 Margaret Smith, "Canada Business Corporations Act: Shareholder Communications" (Parliament Research Branch, Law and Governance Division, 18 January 2000) at 7 citing *Corporate Governance* (Standing Senate Committee on Banking, Trade and Commerce, August 1996) at 67.

88 *An Act to modernize various Acts administered by or affecting the Ministry of Government Services*, SO 2006, c 34, Sched B, s 18.

89 *Notice of Amendments and Notice and Request for Comment – Amendments to NI 51-102 Continuous Disclosure Obligations, Related Forms and Companion Policy, and Consequential and Other Amendments*, Notice and Request for Comments, 30 OSCB 8570 (12 October 2007) at 8574.

90 Stuart B. Morrow, "Proxy Contests and Shareholder Meetings" (2003) 36 UBC L Rev 483 at paras 26-30.

confidentiality of identity that existed under the predecessor rule by drawing a distinction between Non-Objecting Beneficial Owners ("**NOBOs**") and Objecting Beneficial Owners ("**OBOs**"). As of 2010, 51% of Canadian investors were OBOs, preferring to remain silent and anonymous.[91] This right to anonymity is especially important to institutional investors, including our members, whose investment portfolio and trading decisions are proprietary and the value of which could be diminished by disclosure. Since its implementation, NI 54-101 has been the subject of ongoing review and several amendments. The CSA has repeatedly recognized the need for rules that foster communication and reduce compliance burdens and costs and that preserve shareholders' rights to confidentiality.

Taken together, the foregoing amendments reflect a concerted, thoughtful legislative intent to promote shareholder democracy and engagement. As has been and will be further discussed, the Proposed Amendments run counter to the trend in both corporate and securities law by erecting obstacles to shareholder engagement that will serve to buffer incumbent management against challenge.

Changes in the Composition of Canadian Capital Markets since 1987

In addition to Canada's evolving regulatory regime, its capital markets have changed considerably over the past several decades since the advent of the EWR system. Of particular relevance has been the rise of institutional shareholders and the largely consequential surge in companies with significant shareholders. Together, these trends diminish the influence that a minority shareholder with an interest of 10% or more in a company (a "**Significant Shareholder**") might have on control. By lowering the reporting threshold, the Proposed Amendments would require more shareholders with smaller ownership positions and less ability to influence or engage with issuers to report despite the fact that the importance of being a 10% shareholder has diminished with increased institutional ownership.

Between 1990 and 2006, Canadian household share ownership of public companies fell from 44.9% to 28.9%.[92] Over the same period, share ownership by pension funds, investment funds and insurance companies rose from 32.2% to 43%.[93] These investors have vastly greater knowledge and resources than average retail investors and actively monitor their investments and have the capacity and incentive to be vigilant against opportunistic tactics employed by other shareholders. Unlike today's institutional investor, the individual investors who comprised a greater proportion of the shareholder base in days past typically owned a tiny fraction of a

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91 Davies Ward Phillips & Vineberg LLP, "The Quality of the Shareholder Vote in Canada" (Discussion Paper, 22 October 2010), available online: <www.dwpv.com> at 64: in 2002, only 20% of shareholders were OBOs.

92 Rydqvist *et al*, "The Evolution of Aggregate Stock Ownership", CFS Working Paper No. 2011/18 (Frankfurt: Center for Financial Studies, December 2010) at 8. See also *Modern Assessment, supra* note 4 at 15 and "Statistical Bulletin – Ownership of UK Quoted Shares" (Office for National Statistics, 28 February 2012) at 7. We are not aware of more recent Canadian data. However, U.S. data indicates the percentage of institutional ownership has continued to increase and was over 60% in the U.S. as of 2010. Individual shareholders in the U.S. currently account for only one-third of equity holdings, compared to over 80% in 1968. In the U.K., individual share ownership has fallen from 29.3% in 1990 to 11.5% in 2010.

93 Rydqvist, *ibid*. See also *Modern Assessment*, *supra* note 4 at 13.

company's stock, and thus could not justify the costs of playing an active role in corporate governance and were ill-equipped to respond to opportunistic tactics.[94]

With shareholdings of institutional investors having overtaken those of individual investors, the concerns animating the EWR system – that an investor could acquire control by pressuring unsophisticated shareholders or by secretly acquiring shares – are no longer valid.[95] First, institutional shareholders have greater incentives to monitor corporate management than individual shareholders, and are active participants in shareholder democracy.[96] Second, institutional shareholders have virtually instant access to research and resources, including research from brokerage firms, investment banks, research firms, rating agencies and shareholder advisory firms.[97] Third, the prevalence of institutional investors makes it nearly impossible for a minority activist investor to exercise control over a corporation.[98] Since most companies have several institutional, large-block shareholders, no one minority shareholder can affect control.

Not unexpectedly, the number of reporting issuers with Significant Shareholders has increased, as well. By our measure, the percentage of companies listed on the TSX or TSX Venture Exchange (the "**TSX-V**") with 10%-plus holders has climbed to an average of 42.3% over the past five years from 15.8% in 2000 (see Figure 1).[99]

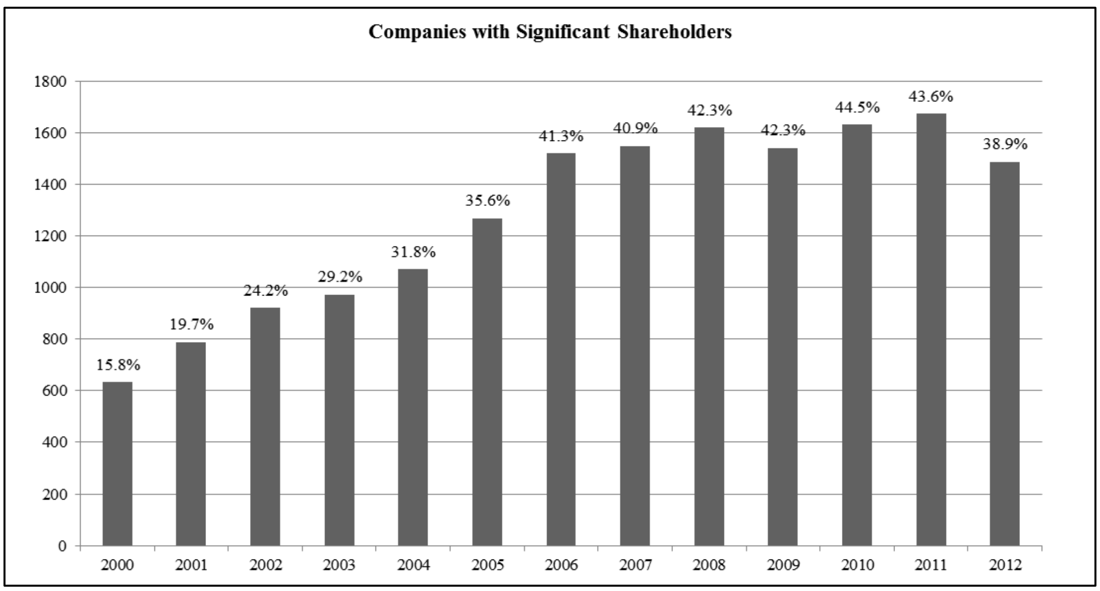

Figure 1: Number of companies listed on the TSX / TSX-V with Significant Shareholders.

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94 *Modern Assessment*, *ibid* at 12, citing Bernard Black, *Shareholder Passivity Reexamined*, (1990) 89 Mich L Rev 520 at 522.

95 *Modern Assessment*, *ibid* at 14.

96 *Modern Assessment*, *ibid*.

97 *Modern Assessment*, *ibid* at 15.

98 *Modern Assessment*, *ibid* at 15-16.

99 System for Electronic Document Analysis and Retrieval, available online: SEDAR <www.sedar.com> [*SEDAR*]. Figures respecting the number of companies with significant shareholders are based on the number of unique reporting issuers for whom one or more EWR or AMR filings were made in a given year.

In addition to the increase in the number of reporting issuers with Significant Shareholders, the pattern of ownership by institutional shareholders has also changed. Today, most companies in Canada and the U.S. have several concentrated shareholders, further making it nearly impossible for a minority shareholder to gain a *de facto* controlling stake.[100] Gaining enough shares to "control" any of these companies and overcome opposition from other institutional shareholders would be very difficult, if not practically impossible.

In light of the foregoing, many of the premises upon which the EWR system is based should now be questioned. Shareholders are neither disaggregated and dispersed, nor lacking in information as they were in the past. All shareholders have better access to information, making it highly unlikely that a 5% – 10% (or higher) shareholder could take advantage of an issuer or its shareholders. In addition, the rise in the incidence of Significant Shareholders makes it virtually impossible for any single shareholder with a 5% – 10% interest to influence or control an issuer. We believe that in reducing the reporting threshold and requiring increased disclosure the Proposed Amendments fail to take these developments into account.

Improved Access to Information since 1987

The past two decades have also witnessed a transformation in the availability and communication of information. Both new technologies and the emergence of proxy advisory firms and other shareholder resources have facilitated the dissemination and sharing of information among shareholders and issuers.

In 1997, the CSA launched the System for Electronic Document Analysis and Retrieval ("**SEDAR**"), the statutory objective of which was to make filed information more readily available in order to enhance investor awareness of the business and affairs of public companies and investment funds and to promote confidence in the transparent operation of capital markets in Canada.[101] Similarly, in 2001, National Instrument 55-102 – *System for Insider Data on Insiders (SEDI)* ("**NI 55-102**") came into force with a view to providing "faster and more efficient dissemination" of insider information through the SEDI system.[102] NI 55-102 mandates that reporting insiders file insider reports under provincial securities laws in electronic format using www.sedi.ca. Notably, this reporting regime deems shareholders to be insiders at the 10% beneficial ownership level.[103] Together, SEDAR and SEDI have enhanced "information liquidity", making it easier for engaged shareholders to identify and analyze underperforming companies and for issuers and their shareholders to identify and analyze a company's shareholder base.[104]

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[100] See e.g. *Modern Assessment*, *supra* note 4 at 15-16.

[101] SEDAR, *supra* note 99.

[102] *NI 55-102 – System for Insider Data on Insiders (SEDI)*, Request for Comments, 23 OSCB 4227 (16 June 2000) at 4229.

[103] See e.g. *OSA*, *supra* note 81, s 1(1). Note that the existing definition of "beneficial ownership" is preserved intact for purposes of determining whether the 10% ownership threshold is triggered for purposes of reporting on SEDI under NI 55-102.

[104] Cheffins, *supra* note 7 at 50.

In the same vein, since 1987, proxy advisory firms such as Institutional Shareholder Services, Glass Lewis and Egan Jones have emerged, providing institutional shareholders with governance and proxy voting research and analysis.

The scope of resources available to issuers, shareholders and other market participants is not limited to formal databanks of real-time information such as those provided by SEDAR and its U.S. counterpart EDGAR. Market participants need only look to the Internet today to obtain extensive data and analyses concerning public companies, their governance, performance and results and shareholder bases. For example, websites such as Bloomberg, Yahoo!Finance, Stockhouse, Seeking Alpha, Reuters, StockCharts, Google Finance and Morningstar, just to name a few, offer extensive online investment and portfolio management tools, governance and financial data, stock and fund analyses, video commentary, and more.

Simply put, shareholders now have access to a wealth of real-time information resources which were not available when the EWR System was adopted. There is no longer the same need to protect shareholders from secretive stake-building.

4. Shareholder Reporting Regimes in Other Jurisdictions

In the Request for Comments, the CSA refers the reader to the shareholder reporting regimes of several major foreign jurisdictions in order to justify the reduction in reporting threshold to 5%, the requirement for increased disclosure and the broad inclusion of derivative instruments. The desire for change appears to be motivated, in part, by a desire to mirror the regimes in effect in these jurisdictions. However, by proposing to adopt piecemeal aspects of each of these regimes, the CSA has failed to consider each of these regimes in their entirety or the unique characteristics of the Canadian marketplace. As a result, the Proposed Amendments would unwittingly implement one of the more onerous block reporting regimes of any jurisdiction.

Below, we consider the shareholder reporting regimes of the U.S., the U.K. and Australia.

United States

Shareholders of U.S. corporations are subject to the beneficial ownership reporting rules in section 13 of the *Securities and Exchange Act of 1934* (the "**1934 Act**") and the regulations thereunder. Although the 1934 Act imposes a 5% reporting threshold and comprehensive disclosure of the acquiror's purpose, plans and proposals in respect of acquisitions, importantly, the U.S. rules also afford shareholders 10 days to file the applicable Schedule 13D report and do not impose any moratorium on trading during that period.[105] This is materially less onerous than the Proposed Amendments, which not only impose the obligation to immediately file a press release followed by an EWR report within two days, but also prohibit additional acquisitions of subject securities until one full business day after disclosure. Unlike the Proposed Amendments, the U.S. system therefore affords engaged shareholders a 10-day window within which to (1) build a stake sufficient to justify the costs of engagement and (2) comply with the requirement for extensive disclosure. The *de facto* reporting threshold in the U.S. is, therefore,

[105] Note, however, that a moratorium applies when a reporter shifts from the Schedule 13G reporting regime to Schedule 13D.

not 5%, but rather 5% plus whatever additional interest can be acquired during the 10-day window.

In addition, unlike the Proposed Amendments, the U.S. rules limit the universe of derivative instruments captured for the purposes of calculating the reporting threshold. However, such instruments must be disclosed once the beneficial ownership reporting threshold has been triggered. Specifically, shareholders must report only instruments granting them the right to acquire beneficial ownership of the underlying security within 60 days by, for instance, the exercise of an option, warrant or right, or the conversion of a security.

In much the same way as Canada offers the AMR system, the U.S. affords certain classes of shareholders acquiring securities without the purpose or effect of changing or influencing control of the issuer an opportunity to file a less frequent abbreviated Schedule 13G report. Unlike under the AMR system, Schedule 13G filers need disclose only (1) the identity of the purchaser and (2) the number and description of the shares in which such person has an interest and the nature of such interest. The AMR system, on the other hand, requires highly particular disclosure of, among other things, the purpose, plans or future intentions of the purchaser, along with much of the disclosure required of EWR filers. A summary chart comparing these passive investment regimes, including the proposed changes to the AMR system, is included below on page 32 as Table 3.

As in Canada, the U.S. shareholder reporting regime is the subject of a vigorous, ongoing debate. Some pro-management commentators advocate in favour of reducing the filing deadline from 10 days to one business day and incorporating cash-settled derivatives for the purposes of calculating the reporting threshold.[106] Opponents, including distinguished academics, have emphasized the adverse effect such changes would have on American issuers and shareholders.[107] Specifically, tightening the rules would be expected to reduce returns to "blockholders" – namely, holders of a significant number of shares – and thereby reduce the incidence and size of outside blocks. Accordingly, blockholders would be less inclined to invest in monitoring and engagement, which would, in turn, result in increased agency costs and managerial slack. As described above in the Canadian context, "an important source of incentives to become an outside blockholder is the blockholder's ability to purchase shares at prices that do not yet fully reflect the expected value of the blockholder's future monitoring and engagement activities."[108] To eliminate this incentive would rob shareholders of the benefits of shareholder engagement, including the concomitant reduction in agency costs.

The U.S. debate has been under consideration by the Securities and Exchange Commission since 2011, without any rule changes having been proposed by the regulator. This cautious and patient approach to the issue is in contrast to the CSA's hurried approach in publishing the Proposed Amendments without performing any prior public consultation or scintilla of cost-benefit analysis.

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[106] Wachtell, Lipton, Rosen & Katz, "Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934" (7 March 2011).

[107] See e.g. Lucian Bebchuk and Robert Jackson, "Commission Examination of Section 13(d) Rules and Rulemaking Petition Submitted by Wachtell, Lipton, Rosen & Katz" (11 July 2011); Bebchuk, *supra* note 14.

[108] Bebchuk and Jackson, *ibid*.

United Kingdom

Shareholders of U.K. issuers are subject to the Disclosure and Transparency Rules (the "**DTRs**"), which were recently updated after a review of some of the same issues currently under consideration by the CSA. The DTRs impose a 3% reporting threshold on U.K. issuers and a 5% reporting threshold on non-U.K. issuers, along with an obligation on holders of U.K.-issuer securities to disclose to the issuer when their ownership interest reaches, exceeds or falls below any 1% interval between 3% and 100%.[109] This obligation, however, applies in respect of an issuer's shares that (1) carry the right to vote in all circumstances at general meetings of the issuer, (2) are admitted to trading on a regulated or prescribed market and (3) are held or deemed to be held through the direct or indirect holding of certain financial instruments. The U.K. threshold is in respect of *all of an issuer's voting shares*, not each class of voting or *equity securities* as in Canada.

Disclosure under the DTRs must be made by shareholders to issuers and, if the disclosure relates to shares traded on a regulated market, filed by the shareholder with the Financial Conduct Authority ("**FCA**"), within four trading days for non-U.K. issuers and within two trading days in all other cases, the first of which shall be the day after the date on which the shareholder (1) learns of the acquisition or disposal or the possibility of exercising voting rights, or on which, having regard to the circumstances, the shareholder should have learned of it, regardless of the date on which the acquisition, disposal or possibility of exercising the voting rights takes effect, or (2) is informed of the event. A person is deemed to have knowledge of the acquisition, disposal or other event no later than two trading days after the transaction. As a result, the latest disclosure point may, in certain cases, not occur until up to four or six trading days, depending on whether or not the issuer in question is a U.K. issuer, from the time of the initial transaction. Unlike the Proposed Amendments, disclosure amounts to little more than a statement as to the number of voting rights held, the name of the shareholder and any person entitled to exercise the voting rights on behalf of that shareholder (and any chain of controlled undertakings through which the voting rights are effectively held) and the date on which the threshold was crossed. There is no need to disclose the purpose of the transaction or the intentions or plans of the acquiror. Upon receipt of notification from the shareholder, the issuer must disclose to the market the information via a regulated information service as soon as possible and not later than the end of the next trading day (for U.K. issuers) or the end of the third trading day (for non-U.K. issuers).

As in the U.S., the DTRs do not provide for any moratorium on further acquisitions. Therefore, similar to the U.S. regime, the absence of any moratorium, combined with a longer filing deadline, means that the *de facto* reporting threshold in the U.K. is, not 3% for U.K. issuers and 5% for non-U.K. issuers, but rather 3% and 5% plus whatever additional interest can be acquired prior to being required to disclose the transaction.

Akin to the AMR regime, the DTRs exempt market makers from disclosing until they reach a 10% threshold, provided the market maker does not intervene in the management of the issuer concerned and does not exert any influence on the issuer to buy such shares or back the share

[109] Note, however, that non-U.K. issuers are subject to a 5% reporting threshold and must only disclose when they reach, exceed or fall below 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75%.

price. The DTRs also exempt from disclosure shares and certain derivatives (like CFDs) (1) held by a collateral taker under a collateral transaction that involves the outright transfer of securities provided the collateral taker does not declare any intention of exercising (and does not exercise) any voting rights, (2) held by a custodian (or nominee) in its custodian (or nominee) capacity provided it only exercises voting rights under instructions given in writing or by electronic means, (3) acquired for the sole purpose of clearing and settlement within a settlement cycle not exceeding three trading days following the transaction, or (4) acquired by a borrower under a stock lending agreement provided the shares are on-lent (or otherwise disposed of) no later than the next trading day and the borrower does not declare any intention of exercising (and does not exercise) any voting rights. Also exempt from disclosure by a person, except at the thresholds of 5%, 10% and above, are shares (1) forming part of property belonging to another which that person manages under a written agreement, (2) which may be exercisable by a person in his or her capacity as the operator of an authorized unit trust scheme, a recognized scheme or a collective investment in transferrable securities scheme, (3) exercisable by an investment company with variable capital, or (4) exercised by a category of investment entity prescribed by the FCA.

Under the DTRs, certain "qualifying financial instruments", such as transferable securities, options, futures, swaps, forward rate agreements and other derivative contracts, are relevant to the reporting threshold if the holder enjoys under formal agreement, on maturity, either the unconditional right to acquire on the holder's own initiative the underlying voting shares or the discretion as to the right to acquire the voting shares. In addition, subsequent to their initial adoption, the application of the DTRs to derivatives relating to U.K. issuers whose shares are listed on a regulated market (like the London Stock Exchange's main market) or a prescribed market (like AIM) was broadened for purposes of calculating the reporting threshold and disclosure, to require the inclusion of financial instruments having a "similar economic effect" to qualifying financial instruments. An instrument is considered to have a "similar economic effect" if its terms are referenced, in whole or in part, to an issuer's shares and the holder of the financial instrument has a long position on the economic performance in the shares, whether or not the instrument is settled in shares or in cash. This language captures, *inter alia*, long positions held through CFDs, swaps (including TRSs), and options or forward sale contracts, even if cash-settled and regardless of whether the holder has the ability to exercise voting rights or obtain physical delivery of the underlying shares. More importantly, however, the DTRs exempt from the reporting threshold calculation and disclosure several cash-settled derivative transactions executed by recognized client-serving intermediaries acting in a client-serving capacity (*i.e.*, CFD or TRS writers like financial institutions, banks and investment firms acting as intermediaries and fulfilling orders from clients otherwise than on a proprietary basis or hedging positions arising out of such deals) and CFDs held within the trading book to the extent the holdings do not exceed 5%, in each case, provided the firm does not intervene in or influence management of the issuer concerned or exercise the voting rights.

This baseline approach to including derivatives rests on the premises that derivative transactions are hedged through holding the referenced securities and that the instrument holders either have control over the voting rights in the underlying equity shares or can exert influence over the voting rights in the shares held by the counterparty, or are given an advantage in acquiring or gaining access to the shares. However, as discussed further in Part 6 below, and based on our members' experiences, we believe these premises are faulty and do not justify an all-inclusive treatment of derivatives in block disclosure regimes. Rather, we submit discrete, carefully crafted solutions are more appropriate for regulating the disclosure of derivative instruments within the context of the EWR regime.

The *City Code on Takeovers and Mergers* (the "**Code**") also supplements the DTR disclosure regime by providing for certain additional disclosure obligations and dealing restrictions on persons during an offer period of a takeover offer subject to the Code.

Australia

Shareholders of Australian issuers are subject to the substantial holder rules of the *Corporations Act 2001* (the "**Australia Act**"), itself the product of significant debate and evaluation. The Australian Act mandates disclosure by shareholders acquiring or ceasing to have a "substantial holding" in a company.[110] A person has a substantial holding if the total votes attached to voting shares in the company in which they or their associates have "relevant interests" is 5% or more of the total number of votes. A relevant interest refers to whether a person (1) is the holder of the securities, (2) has the power to exercise, or control the exercise of, a right to vote attached to the securities, or (3) has the power to dispose of, or control the exercise of a power to dispose of, the securities. Accordingly, just as in the U.K. regime, the threshold is determined on the basis of all outstanding voting shares, not those of a particular class of voting or equity securities.

Further, the Australian notion of relevant interests creates explicit exemptions for most derivative instruments as well as proxies received by reporting persons in respect of the exercise of voting rights. This is far less burdensome than the all-encompassing inclusion of derivatives under the Proposed Amendments.

Disclosure under the Australian Act must be made by shareholders within two business days of becoming aware of the triggering information.[111] Although shareholders must disclose any 1% change in relevant interests, no moratorium applies and, as in the U.K., reporting obligations are minimal. Specifically, shareholders must only report the details of their relevant interests in voting shares, certain details of agreements pursuant to which they have relevant interests in the company and the size and date of their change in holdings. There is no need to disclose the purpose of the transaction or their intentions with respect to the issuer.

Included below is a high-level comparison of the current Canadian rules and the Proposed Amendments against the principal features of the shareholder reporting regimes outlined above, with the most restrictive provisions amongst these regimes highlighted. Table 2 summarizes the

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110 Separately from the substantial holder rules, the Australian Act also affords the Australian Securities and Investments Commission (the "**ASIC**") or a listed company the right to direct that a member of the company disclose in a report, among other things, (a) full details of such member's relevant interests in the company and the circumstances that gave rise to that interest and (b) the name and address of each person who has given such member instructions about the acquisition or disposal of the shares or interests or the exercise of any voting or other rights attached to the shares or interests. Unless the recipient of the direction proves the direction to be vexatious or is granted a discretionary exemption by the ASIC, such disclosure must be made within two business days.

111 Disclosure must be made by 9:30 a.m. on the next trading day of the relevant financial market if a take-over bid is made for voting shares in the company and the shareholder becomes aware of the triggering information during the bid period.

general rules applicable to shareholders in each jurisdiction and Table 3 summarizes the exemptions available for passively-held investments under the Canadian AMR system (current and proposed) and the corresponding U.S. Schedule 13G regime.

As is evident in the Tables below, the Proposed Amendments will create a regime that is more rigid and burdensome on shareholders than other foreign reporting systems in many respects. The Proposed Amendments now reflect (1) nearly the lowest reporting threshold, (2) the shortest reporting deadline, (3) the most onerous disclosure, (4) the only example of a trading moratorium and (5) one of the most inclusive treatments of derivative instruments in the absence of several important exemptions and exceptions. Each of these elements, viewed in the context of its entire host framework, may be appropriate to suit the needs of its respective jurisdiction. However, the piecemeal combination of these elements, by way of contrast, is inappropriate and ill-suited for the Canadian market. Certainly, the Request for Comments does not make an evidence-based case for the proposition that the Canadian markets demand the adoption of the most burdensome elements of other regimes.

Table 2: Summary comparison of shareholder reporting regimes in Canada, the U.S., the U.K. and Australia (active investments).

	Canada (Current)	Canada (Proposed)	U.S.	U.K. (U.K. issuers)	U.K. (non-U.K. issuers)	Australia
Initial threshold	10%	5%	5%	3%	5%	5%
Filing period	Immediately	Immediately	10 days	2 + 1 trading days	4 + 3 trading days	2 trading days
Moratorium	Yes	Yes	No	No	No	No
Subsequent threshold(s)	2%	2%	1%	1%	10%, 15%, 20%, 25%, 30%, 50% and 75%	1%
Are derivatives captured?	No	Yes	Limited Cases*	Yes, with exemptions*	Yes, with exemptions*	No
Is securities lending captured?	No	Yes	Yes	Yes	Yes	Yes
Press release	Yes	Yes	No	No	No	No
Disclosure of Purpose / Intentions	No	Yes (AMR & EWR)	Yes	No	No	No

* See discussion above for further details.

Table 3: Summary comparison of shareholder reporting regimes in Canada and the U.S. (passive investments).

	Canada (Current AMR System)	**Canada** (Proposed AMR System)	**U.S.** (Schedule 13G: Qualified Investors below 10%)[112]	**U.S.** (Schedule 13G: Qualified Investors above 10%)
Initial threshold	10%	5%	5%	10%
Initial filing period	10 days after end of month	10 days after end of month	45 days after end of calendar year	10 days after end of month
Moratorium	No	No	No[113]	No[113]
Subsequent threshold(s)	2.5%	2.5%	Any changes	5%[114]
Subsequent filing period	10 days after end of month	10 days after end of month	45 days after end of calendar year	10 days after end of month
Are derivatives captured?	No	Yes	Limited Cases*	Limited Cases*
Is securities lending captured?	No	Yes	Yes	Yes
Press release	No[115]	No[115]	No	No
Disclosure of Purpose / Intentions	Yes	Yes	No	No

* See discussion above for further details.

Canadian securities regulators have been cautioned against blindly adopting the regulations of foreign securities regulators. In 2006, Professor Christopher Nicholls stated: "even if foreign initiatives appear to be based on coherent principles and to reflect reasoned and proportionate responses to serious problems, a second level of analysis is called for."[116] Canadian regulators have generally been careful in rule-making to follow this advice and consider the particular needs of the Canadian market: Canada's unique approach to take-over bid regulation and defensive tactics is a good example. Canada's decision to deviate from the U.S. in allowing banks to operate nationally, grow to economically efficient sizes and hold broad-based investment portfolios, ultimately allowing them to enjoy significantly high levels of stability, is another.[117] We submit the same is true of the EWR system.

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112 Qualified Investors include banks, brokers-dealers and investment companies or advisers who have acquired securities in the ordinary course of business without any purpose, or without the effect, of changing or influencing the control of the issuer.

113 A Schedule 13D report must be filed within 10 days of the date on which a Qualified Investor ceases to hold the securities without the purpose or effect of changing or influencing control of the issuer. A 10-day moratorium applies after such a Schedule 13D is filed.

114 Qualified Investors must file a report within 10 days of the end of any calendar month in which the percentage of securities beneficially owned increases or decreases by more than 5% of the class.

115 If an EII becomes disqualified from the AMR regime a press release must be immediately issued and filed and an EWR report must be filed within two business days of filing such press release.

116 Christopher Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to *Sarbanes-Oxley*" (Task Force to Modernize Securities Legislation in Canada, 15 June 2006) at 145.

117 Nicholls, *ibid* at 147.

5. Distinctive Characteristics of Canada's Capital Markets

The distinctiveness of Canada's capital markets further warrants rejecting an uncritical adoption of discrete aspects of foreign shareholder reporting regimes. In adopting piecemeal features of foreign regimes, the Proposed Amendments fail to have regard to the unique characteristics of the Canadian markets, including the nature, size and number of its reporting issuers. As discussed below, the Canadian market is both smaller and less liquid than U.K. and U.S. markets, and consists of a disproportionately large number of companies that are either under-valued, small or controlled. We believe the CSA has not given due regard to the risk of deterring investment in crafting the Proposed Amendments. We also believe that the current EWR system is a more suitable regime for the Canadian marketplace.

Undervalued Companies

Proponents of tightening the EWR system have asserted that shareholder activism has exploded in Canada due to accommodating laws that facilitate blockholder accumulations. In reality, the rise in shareholder engagement in Canada has been a product of the prevalence of underperforming and undervalued companies, in part because there has historically been a low incidence of block accumulation by engaged shareholders to hold management accountable. In 2003, a Bank of Canada study concluded that, as compared to U.S. companies, Canadian companies had a "lower relative valuation even after controlling for company size, industry, the cost of equity, profitability, dividend policy, accounting policy and the risk-adjusted return of the stock market where a company was listed".[118] Similarly, boards were perceived to be underperforming. In 2004, the president of Fairvest, a corporate advisory service, maintained "[t]here is a good opportunity out there for [investors] to come in and shake up boards that just aren't getting it".[119]

A subsequent study, conducted in 2006, matched a sample of Canadian firms listed exclusively in the Canadian market with U.S. firms of the same size and industry over a 16-year period.[120] The study confirmed that Canadian firms have lower valuation multiples than their American counterparts and therefore trade at a discount.[121] Further, the discount was found to be increasing, not decreasing, with time.[122]

Contrary to popular opinion, the recent experience of large Canadian companies becoming the targets of block accumulation by engaged shareholders is not indicative of Canadian companies

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118 Cheffins, *supra* note 7 at 35-36, citing Michael King and Dan Segal, "Valuation of Canadian- vs. U.S.-Listed Equity: Is There a Discount", (Bank of Canada, 2003) at 2, 7.

119 Cheffins, *ibid* at 35, citing Keith Kalawsky, "Hedge Funds Take Off the Gloves" (Financial Post, 22 October 2004) at 1.

120 Michael King and Dan Segal, "Market Segmentation and Equity Valuation: Comparing Canada and the United States", (July 2008) 18:3 J Int'l Fin Market Institutions & Money 245 at 246, 257.

121 King and Segal, *ibid* at 246, 257: four valuation measures were used: (1) the market value of equity to book value of equity, (2) the ratio of the stock price to the last 12 months earnings per share, (3) the ratio of the market value of a firm's assets to its replacement cost, and (4) the ratio of a firm's enterprise value to EBITDA.

122 King and Segal, *ibid* at 257.

being easy targets of U.S. hedge funds. In fact, the frequency of proxy contests in Canada still lags far behind what is experienced in the U.S.[123]

Distribution of Companies by Market Capitalization

More so than the U.S., the U.K. and Australia, Canada is comprised of a small number of large issuers and a far larger number of small issuers, including a significant number of micro-cap issuers.[124] As shown in Table 4, the smallest 10 percentile of issuers on the TSX and TSX-V account for only 0.01% of the market capitalization of the exchanges, whereas the top 10 percentile account for 93.1% of the exchange. By way of comparison, the smallest 10 percentile companies on the New York Stock Exchange ("**NYSE**"), London Stock Exchange ("**LSE**") and Australian Stock Exchange ("**ASX**") account for 0.13%, 0.05% and 0.02% of their respective exchange's aggregate market capitalization.

Table 4: Distribution of companies on major exchanges[125]

Exchange	No. of Issuers	Market Capitalization		
		Top 10 Percentile	Bottom 10 Percentile	Bottom 20 Percentile
TSX and TSX-V	3,879	93.1%	0.01%	0.04%
NYSE	2,638	71.2%	0.13%	0.44%
ASX	1,866	93.7%	0.02%	0.05%
LSE	2,304	74.6%	0.05%	0.22%

An emphasis on complex regulatory rules may prove disproportionately burdensome for investors investing in smaller companies.[126] As a result, smaller companies may face additional challenges in attracting investors, increasing the cost of capital for these companies and reducing overall foreign direct investment in the Canadian economy. For shareholders looking to invest in Canada, the relatively high prevalence of smaller issuers means that the gross dollars that engaged shareholders may deploy before tripping over the disclosure threshold under the EWR system and hitting the moratorium is already lower, and would be halved if the reporting threshold is reduced from 10% to 5%. Given that smaller issuers tend to be more reliant on raising equity capital and are shown to benefit to a greater extent from activism than larger issuers, the adverse impact of the Proposed Amendments on the competitiveness and efficiency of Canada's markets is likely to be particularly pronounced.

Securities laws should seek to facilitate, as oppose to burden, the capital raising process of smaller companies characteristic of the Canadian markets if Canadian capital markets are to remain efficient and competitive despite their small size. The Proposed Amendments, however, will achieve precisely the opposite result by erecting obstacles to shareholder investment.

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[123] See Aaron Atkinson *et al.*, "2013 Canadian Proxy Contest Study" (Fasken Martineau DuMoulin, 2013); Warren de Wied, "Proxy Contests"(Practical Law The Journal, November 2010) at 33.

[124] Nicholls, *supra* note 116 at 133.

[125] S&P Capital IQ (as of 3 May 2013).

[126] Nicholls, *supra* note 116 at 135.

Relative Size of Companies

Canadian companies are also smaller than their U.S. counterparts in absolute terms. The average market capitalization of companies listed on the TSX and TSX-V is $1.4 billion and $22.7 million, respectively.[127] Companies listed on the NYSE average $9.38 billion, and there are only 52 TSX-listed companies out of 1,568 TSX companies with market capitalizations in excess of the NYSE average.[128] In order to compensate for the costs of shareholder engagement (which are not proportionate to firm size), engaged shareholders must acquire proportionately larger stakes of Canadian companies than of U.S. companies. With a 5% reporting threshold, the Proposed Amendments will make this both more difficult and costly.

Prevalence of Controlled Companies

Further, unlike in other markets, a significant percentage of Canada's largest non-financial public companies have controlling shareholders, or shareholders with voting interests in excess of 10%.[129] As of 1996 (the latest date to which data are available to us), 70% of Canadian reporting issuers were under legal or *de facto* control of a single or small group of shareholders.[130] As already noted, since that time, there has been a rising incidence of Significant Shareholders in Canada (see Figure 1 above). In the U.S., by way of comparison, only 35% of companies listed on the NYSE have a Significant Shareholder and only 2.9% have a 50% shareholder.[131] Accordingly, in order to exert influence on Canadian companies, engaged shareholders must acquire proportionately larger ownership blocks than in the U.S. and than they had to in the days prior to the rise in the incidence of Significant Shareholders. This suggests that the ability of a 5% shareholder to influence control is less, not more, significant than it was in 1997 and significantly less than in the U.S.

Liquidity of the Canadian Marketplace

The liquidity of Canadian equity exchanges is lower than that of the major global exchanges.[132] A close proxy for a market's liquidity is the number of trades executed per year. By this measure, with 216 million trades (or approximately 55,000 per issuer), the TMX falls well behind the NYSE Euronext (1,374 million trades or 521,000 per issuer) and LSE (222 million trades or 90,000 per issuer).[133] The consequences of reduced liquidity are twofold. First, it makes it considerably more difficult for investors to "vote with their feet" in response to underperformance or unwelcome governance practices. In many cases, engagement with management is the only viable option for shareholders. Second, reduced liquidity negatively impacts the ability of an engaged shareholder to build an investment position. Arguably, even if a U.S.-style 10-day reporting window were adopted under the Proposed Amendments, engaged

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127 S&P Capital IQ (as of 3 May 2013).

128 S&P Capital IQ (as of 3 May 2013).

129 Nicholls, *supra* note 116 at 134.

130 Janis Sarra, "Shareholders as Winners and Losers Under the Amended Canada Business Corporations Act", (2003) 39 Can Bus LJ 52 at 55.

131 S&P Capital IQ (as of May 7, 2013).

132 Sheryl Kennedy, "Canada's Capital Markets: How Do They Measure Up?" (Bank of Canada Review, Summer 2004) at 37.

133 "2012 WFE Market Highlights" (World Federation of Exchanges, 22 January 2013) [*WFE*] at 12; S&P Capital IQ (as of 3 May 2013); "List of All Companies" (London Stock Exchange, 29 March 2013).

shareholders might nonetheless face challenges in acquiring their initial stake before public disclosure because of liquidity constraints.

Size of the Canadian Marketplace

Canadian listed issuers represent a small fraction, on the order of 3.7%, of the total world market capitalization of public companies.[134] The TMX Group Limited (the "**TMX**"), consisting of the TSX and TSX-V, for instance, is the eighth largest exchange by market capitalization with $2,059 billion, far less than the NYSE Euronext ($14,086 billion) and the London Stock Exchange (the "**LSE**") ($3,397 billion) (see Figure 2).[135] The eighth largest market can ill afford to apply the most onerous, complex regulatory regime to its participants.

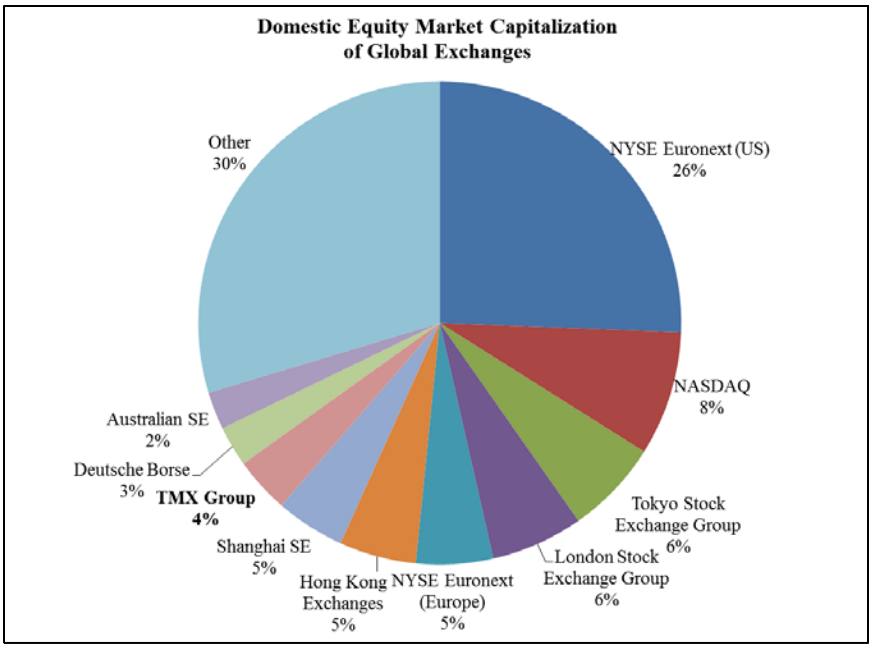

Figure 2: Relative size of TMX by market capitalization.

A small market, in particular, must take into account the impact of regulation on its ability to attract and retain capital to allow the market to remain competitive and grow. Imposing increased disclosure obligations in addition to the lower reporting threshold will have the effect of revealing the proprietary, confidential and valuable trading strategies of both engaged and institutional shareholders. This will act as a deterrent to investment and may serve to stifle one of the sources of capital available to Canadian issuers. Consider that institutional shareholders, Canada's principal source of domestic capital, already tend to invest overwhelmingly in non-Canadian public securities (see Table 5). The institutional investor base is also much smaller in Canada than in the U.S., both in absolute terms and as a percentage of GDP (see Figure 3).[136]

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134 *WFE*, *ibid* at 1, 6.

135 *WFE*, *ibid* at 6.

136 Eric Gonnard *et al*, "Recent Trends in Institutional Investors Statistics" (OECD, 2008) at 4-5: in 2007, Canadian institutional shareholders held $1.272 trillion in assets (146.4% of GDP) and U.S. institutional shareholders held $24.22 trillion in assets (211.2% of GDP).

There is therefore a more pressing need to promote, and not deter, both domestic and foreign investment.

Table 5: Public equity investments by Canadian institutional shareholders.

Institution	Total Public Equity Investments	Canadian Public Equity Investments	Canadian Percentage of Equity Investments
Canada Pension Plan Investment Board[137]	$49.3 billion	$4.8 billion	9.72%
Ontario Teachers' Pension Plan[138]	$59.5 billion	$11.4 billion	19.2%
OMERS Administration Corporation[139]	$13.6 billion	$1.82 billion	13.4%
British Columbia Investment Management Corporation[140]	$37.3 billion	$13.8 billion	37.0%
The Caisse de dépôt et placement du Québec[141]	$64.5 billion	$22.0 billion	34.1%
Alberta Investment Management Corp.[142]	$26.9 billion	$6.5 billion	24.2%
Total	*$251.1 billion*	*$60.3 billion*	*24.0%*

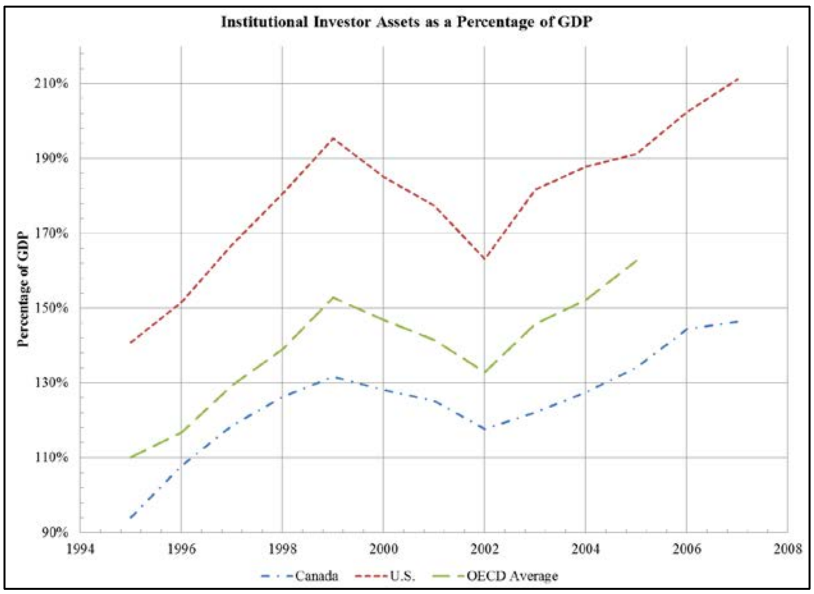

Figure 3: Comparison of relative size of institutional investors in Canada and the U.S.

137 2013 Annual Report, Canada Pension Plan Investment Board (current as of 31 March 2013).

138 "Public Equities", (Ontario Teachers' Pension Plan, current as of 31 December 2012), available online: <http://www.otpp.com/web/guest/investments/asset-groups/public-equities>.

139 2012 Annual Report, OMERS Administration Corporation (current as of 31 December 2012). Quoted data reflect OMERS' holdings in public equity investments. OMERS' exposure (*i.e.* accounting for derivative instruments) to public equities was $18.2 billion, of which $5.0 billion relates to Canadian public equity investments.

140 "Assets Under Administration", (British Columbia Investment Management Corporation, current as of 31 March 2012), available online: <http://www.bcimc.com/investments/assetmix.asp>.

141 "Equity", (Caisse de dépôt et placement du Québec, current as of 31 December 2012), available online: <http://www.lacaisse.com/en/investments/portfolio/equity>.

142 2012 Annual Report, Alberta Investment Management Corp. (current as of 31 December 2012).

6. The Substance and Effect of the Proposed Amendments

Under the following headings, we discuss the elements of the Proposed Amendments with which we have serious concern and provide our recommendations in respect thereto.

Reporting Threshold

As noted, the Proposed Amendments contemplate a reduction in the reporting threshold from 10% to 5% of a person's beneficial ownership of, or control or direction over, voting or equity securities of any class of a reporting issuer. For the reasons that follow, we believe that no reduction should be made to the reporting threshold until the CSA has been able to conduct a careful analysis of the potential impact the change would have on the Canadian economy and capital markets and their participants, and has the benefit of empirical data and further public consultations to assist in determining what, if any, change should be made.

1. *A 5% shareholder has limited influence on control.* A 5%, or even a 10%, shareholder cannot effect any changes or influence control without the support of other shareholders. Quorums at shareholders meetings are rarely so low that a holder of less than 10% of a class of shares can influence the outcome. In addition, the recent trend of issuers adopting advance notice by-laws or policies means that minority shareholders are highly unlikely to use the element of surprise to take advantage of a low quorum at a shareholder meeting.[143] To have influence, a shareholder with less than 10% would need to solicit the support of other shareholders, who continue to control the company. Control is not passed to the engaged shareholder. Thus, what is more relevant than a shareholder's ownership is the act of solicitation, which we believe is already adequately regulated by Canadian proxy solicitation rules.

   No longer atomized, uninformed and passive, Canadian shareholders are also increasingly sophisticated institutional investors capable of evaluating corporate management and weighing in critically on any initiatives pursued by an activist. The prevalence of institutional investors makes it nearly impossible for a minority investor to exercise control over a corporation.

2. *There is no logical connection between the reporting threshold and the requisition threshold.* The Request for Comments suggests that lowering the reporting threshold to 5% is appropriate because it is possible for a shareholder holding 5% to requisition a meeting of shareholders under corporate legislation. The logic of this proposition does not bear up under scrutiny. In fact, the two

[143] See Davies Ward Phillips & Vineberg LLP, "Davies Insights – Governance" (January 2013), available online: <www.dwpv.com>: Issuers have developed tools, such as advance notice by-laws, to prevent 5% or 10% shareholders from taking advantage of low voter turnout at meetings to "ambush management". Widely used in the U.S. and on the rise in Canada, advance notice by-laws or policies require any person proposing to nominate a director for election at a meeting of shareholders to provide the company with advance notice of, and prescribed details concerning, the proposed nominee. Failure to do so renders the individual ineligible for election.

regimes bear no relationship to each other, any more than the shareholder proposal remedy (available to a 1% shareholder) bears to the reporting threshold.

First, the purpose of the 5% requisition threshold is wholly unrelated to the ability of a shareholder to influence control of an issuer. In fact, the impetus for reducing the former 10% requisition threshold to 5% under corporate law was to ensure that minority shareholders are more easily able to put the business they wish to transact before a meeting of shareholders "notwithstanding their minority position and an actual or potentially unwilling board of directors".[144] To that end, the threshold serves as protection against the abuse of minority shareholders, and was not meant to suggest that 5% holders can affect control.

Second, despite much commentary around the potency of the requisition right, this remedy is in fact exercised very infrequently. Based on a review by Davies Ward Phillips & Vineberg LLP of every publicly-disclosed shareholders' meeting requisitioned between 2008 and 2012, there were only 62 meeting requisitions issued over that five-year period. Of these, in only 17 cases was the requisitioning shareholder's ownership not publicly disclosed. Of those 17, only two – representing 3% of the total – ultimately led to a proxy contest. Over the same period, we note that 15,473 EWR and AMR reports were filed on SEDAR. It is entirely incommensurate to revise a disclosure regime on the basis of the ability of shareholders to requisition meetings when only two proxy contests in a five-year period were commenced absent an EWR or AMR report under the current system. Clearly, whatever perceived harm may exist from undisclosed share ownership in those few cases could be more discretely targeted. For example, disclosure by dissident shareholders would be more appropriately dealt with under the proxy solicitation regime, the regulation of which is extensively governed by corporate statutes and National Instrument 51-102 – *Continuous Disclosure Obligations* ("**NI 51-102**"). For example, NI 51-102 could be amended to specifically require dissidents filing circulars to disclose any material ownership interest in the company, as is required under the *Business Corporations Act* (Ontario).[145] In addition, any company receiving requisitions could be required to disclose them.

Third, the requisition right is available to *any* shareholder, no matter how small the interest so long as that shareholder can get others to join in the requisition to meet the 5% requirement. There is no more logic to requiring a single 5% holder to file an early warning report than there is to requiring a group of shareholders with smaller individual ownership positions to do the same. We are strongly of the view that shareholders banding together to file a requisition should not be characterized as "joint actors" for purposes of Part XX of the *Securities Act*

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[144] *Airline Industry Revitalization Co. v. Air Canada*, 1999 Can LII 15075 (Ont. SC) at para 48; *Corporations, Canada Act* RSC 1970, c C-32, s 103(1) (10% threshold); *Canada Business Corporations Act*, SC 1974-75-76, c 33, s 137 (5% threshold); *Business Corporations Act*, RSO 1960, c 71, s 308 (10% threshold); *Business Corporations Act*, SO 1970, c 25, s 109 (5% threshold). See also *Paulson & Co. Inc. v. Algoma Steel Inc.*, 2006 Can LII 116 (Ont. SC) at para 40.

[145] *Ontario Business Corporation Act,* RRO 1990, Reg *62,* s 33, Item 6(i).

(Ontario) as that would have an unwarranted chilling effect on shareholder democracy.[146] There may be other reasons why such holders constitute a group, but the mere request for a shareholders meeting should not on its own be the reason.

Fourth, while the right to requisition a meeting belongs to the shareholder, the shareholder has no control over the process. A requisition initiates a long, public and regulated process, the control of which is in the hands of the issuer. All the requisition does is require the issuer to call a shareholders meeting to consider the matter put forward by the shareholder. It does not allow the shareholder to make its case in management's proxy circular; nor does it allow the shareholder to solicit proxies in support of its position. Instead of lowering the EWR reporting threshold, we recommend adopting a requirement that issuers issue and file a press release upon receipt of a requisition. This will ensure disclosure of material information without imposing onerous reporting requirements on the vast majority of 5% – 10% shareholders who have no intention of requisitioning a meeting.

3. *Shareholders have a right to confidentiality.* Corporate and securities laws recognize a shareholder's right to confidentiality of identity. Indeed, the principle of confidentiality forms the basis of the objecting beneficial owner regime provided under NI 54-101 and its predecessor, National Policy Statement No. 41. Forced disclosure of a shareholder's identity, in addition to detailed information about their strategies and intentions, requires a more compelling policy justification. The Request for Comments also provides no evidentiary support for the suggestion that disclosure would be beneficial to shareholders.

   By lowering the reporting threshold and therefore requiring earlier disclosure, the Proposed Amendments will strip shareholders holding between 5% and 10% of any right to confidentiality.

4. *On average, proxy contests are initiated by dissidents with more than a 10% interest.* The CSA's concern that proxy contests are being initiated by shareholders below the 10% level is misplaced. Based on a review of the 198 proxy contests that occurred between 2003 and 2012, only 43% of contests involved a dissident owning less than 10% and, on average dissidents held a 14% ownership interest in targets (median: 11%).[147] We note that over 3,700 companies are publicly listed in Canada on the TSX and TSX-V.

   If there are perceived gaps in proxy solicitation rules that permit abuses in activities undertaken by engaged shareholders, those abuses should be addressed through amendment of the proxy solicitation rules. Amendments, if any, should only be undertaken following a careful analysis and review of the prevalence and

[146] *OSA*, *supra* note 81.
[147] Data supplied by Kingsdale Shareholder Services Inc.

nature of those perceived abuses, as well as a public consultation concerning the appropriate regulatory response.

5. *Other jurisdictions have materially different reporting systems.* While certain other jurisdictions have reporting thresholds below the 10% level, a 5% threshold should not be adopted blindly without due consideration of such foreign reporting systems in their entirety. Compared to the Proposed Amendments, foreign regimes with lower reporting thresholds generally feature: (1) longer filing periods, (2) narrower or more nuanced definitions of derivative instruments combined with broad exemptions and exceptions resulting in the exclusion of many derivative arrangements for purposes of calculating the reporting thresholds and disclosure, (3) no moratorium, (4) no obligation to issue a press release, and (5) generally less onerous disclosure.

6. *The costs of a 5% reporting threshold outweigh the benefits.* The benefits of a 5% reporting threshold are few. Earlier disclosure, however, promises to raise block acquisition costs and curb the market for shareholder engagement, the benefits of which are many. As discussed, by serving as a private check on management, shareholder engagement promotes better corporate governance, yields higher long-term returns to all shareholders, demonstrably improves corporate productivity and leads to a more efficient allocation of assets by companies.

Increased Disclosure

The Proposed Amendments contemplate an overhaul of the EWR system's disclosure obligations. Shareholders will be required to include comprehensive disclosure about their purpose, future plans and intentions and derivative holdings. For the reasons that follow, we believe that the existing disclosure regime more than adequately serves the EWR system's purpose. We do, however, support the additional disclosure required in respect of securities lending transactions (provided the investor is otherwise required to file), as well as the proposed requirement to report dispositions at increments of 2% and make exit filings.

1. *The filing deadline should be extended.* We believe the requirement to immediately (any in any event by the next business day) issue and file a press release followed by the two-day report filing deadline is incompatible with the proposed increased disclosure. The contents of the proposed reports is equivalent to that required in U.S. Schedule 13D reports. However, filers of Schedule 13D reports are afforded 10 days to file.

   To the extent that the requirement for increased disclosure is adopted, we believe filing obligations should be revised as follows:

   - If the reporting threshold remains at 10%, shareholders should be required to issue and file a pared-down press release immediately (and in any event by the next business) and file a more detailed report with a longer deadline than the two business days currently prescribed under the existing EWR system. The pared-down press release should contain (1) the name and address of the shareholder, (2) the designation and number or principal amount of securities and the securityholding percentage acquired, (3) the designation and number or principal amount of securities and the securityholding percentage after the transaction and (4) the value of any consideration paid per security.

- If the reporting threshold is reduced to 5%, the requirement to issue a press release should be eliminated and shareholders should be afforded an extended filing deadline after the crossing of the threshold to file a report.

In any case, we believe the CSA should undertake further public consultation and a careful review and empirical analysis as to the appropriate deadline to be adopted in respect of EWR filings, having regard to the costs and burdens of more frequent and immediate reporting relative to the chilling effect that this will have on engaged investing and its resulting benefits. We submit that irrespective of the reporting threshold ultimately adopted under the EWR system, the current two-business day reporting deadline should be extended to balance the relative costs and burdens of EWR filings, including the increased disclosure required, against the posited benefits.

2. *Shareholders should not be required to disclose their future plans/intentions.* The proposed requirement that holders disclose their future intentions, plans and purpose with specific reference to an enumerated list is inappropriate. At the time the 5% reporting threshold is reached, many of the items on the list may be outside the scope of a shareholder's knowledge. 5% shareholders, for instance, may not have turned their minds to the issuer's present capitalization or dividend policy, corporate structure, charter or by-laws. As a consequence, this sets up the potential for a disclosure foot-fault by requiring investors to anticipate and disclose future intentions and plans which, with subsequent hindsight, might be challenged as inadequate by an issuer or regulator.

3. *Increased disclosure will not eliminate the use of boilerplate language.* We do not share the CSA's view that these changes will eliminate the extensive use of boilerplate language in EWR and AMR reports. Instead, we believe lengthier reports with more extensive boilerplate language will emerge. Accordingly, we believe the EWR and AMR reports should be streamlined to:

   - reduce duplication between press releases and reports; and
   - remove the requirement for investors to speculate about "future" intentions, plans or proposals outside of the more traditional control context and other information or events not within their knowledge or control.

4. *The scope of derivative disclosure should be narrowed.* While we are generally supportive of disclosure of trades in certain types of equity derivative instruments (*e.g.* non-cash settled products), we submit that such instruments should be captured for purposes of calculating the reporting threshold only if there is an option to acquire the underlying voting security or the holder has investment control over (*i.e.,* the power to force the acquisition or disposition), or the ability

to exercise the voting rights attached, to the underlying security. Cash-settled TRSs and CFDs, for instance, should not be captured for the purposes of the reporting threshold, as they do not typically convey a right to acquire or exercise voting rights in respect of the underlying voting shares, unless the holder has a right to require the counterparty to acquire or vote the underlying voting shares or has contractual rights over the counterparty's hedging (if any) of the underlying voting shares. Otherwise, cash-settled and physically-settled derivatives should only be relevant for the purposes of disclosure if the shareholder is otherwise required to file under the EWR system, and should not be captured by the reporting threshold. As discussed, the regimes of several other developed markets have adopted such an approach and have resisted imposing an all-encompassing inclusion of derivatives for the purposes of calculating the reporting threshold and disclosure. No justification has been demonstrated for an all-inclusive approach to derivatives in Canada and no instances of abuse have been cited (see also "Hidden Ownership" below).

5. *Eliminate the need to disclose counterparties.* The Proposed Amendments will require reporting shareholders to disclose the names of counterparties (including those who are not joint actors) to contracts, agreements and understandings with respect to any securities of an issuer. Many shareholders are already reticent to engage in discussions with other shareholders at the risk of being publicly characterized as a joint actor or unwittingly tainted with material non-public information. This overly broad provision will have the effect of chilling communication among shareholders, further undermining shareholder democracy. Given the need to maintain appropriate incentives for shareholder engagement and democracy, disclosure of counterparties should not be required unless such parties are joint actors, which is already adequately captured under the current EWR system.

Alternative Monthly Reporting

The Proposed Amendments will significantly increase disclosure required by AMR filers. Detailed information respecting the intention and purpose of acquisitions, more extensive than that currently required under the EWR system, will be required. In addition, the AMR system would be unavailable to an EII who solicits, or intends to solicit, proxies from securityholders of a reporting issuer on matters relating to the <u>election of directors</u> of the reporting issuer or a reorganization, amalgamation, merger, arrangement or similar corporate action involving the securities of the reporting issuer. The consequence of this change will be to make the AMR system, with its longer reporting deadline, less accessible to all shareholders including engaged shareholders, thereby chilling shareholder engagement. For the following reasons, we do not believe the AMR system should be amended, other than to perhaps make it available to all passive investors and not only EIIs:

1. *Increased disclosure is unnecessary under the AMR system.* For reasons similar to those discussed above with respect to the proposed increased disclosure for the EWR system, we do not believe there is a need for increased disclosure regarding the investment intent of EIIs relying on the AMR system. Indeed, the U.S.'s

similarly-intended Schedule 13G regime mandates disclosure of only the purchaser's identity, as well as the number of shares in which the purchaser has an interest and the nature of such interest. By requiring that shareholders disclose their research and investment strategies for the benefit of free-riding investors, the Proposed Amendments will stifle shareholder engagement. The CSA has advanced no justifiable policy basis for doing so.

2. *AMR filers should not be disqualified for soliciting or intending to solicit proxies.* We do not believe that the proposed expansion of the trigger for disqualifying EIIs from eligibility to use the AMR system is warranted. "Solicitation" has an extremely broad definition and encompasses much more than the act of mailing a proxy circular. Solicitation could include conversations between shareholders about an upcoming vote, or the encouragement by one shareholder of another to withhold its vote from a particular nominee or proposal. If the consequences to a shareholder from engaging in such conversations would include the loss of eligibility from the AMR system, shareholders will be less inclined to have such conversations. This would be particularly so if the loss of AMR system eligibility would entail, as currently proposed, a 10-day moratorium on the acquisition of further securities following the issuance of the required news release. There are already significant impediments to such communications, to the detriment of shareholder democracy, and this would only serve to exacerbate the problem.

The chilling effect that this change would have on shareholders is inconsistent with and would frustrate the legislative and regulatory initiatives that have been designed to facilitate greater shareholder engagement.[148]

In our view, the exercise of a shareholder's right to solicit the support of other shareholders to effect change should not result in disqualification unless control of the company is sought. While we submit the AMR system is already adequate for its purposes and does not require changes, if a tightening of the AMR system is pursued by the CSA, we would support disqualification from the AMR system only if a shareholder files a dissident circular that either (1) proposes or opposes a control transaction or (2) seeks to replace a *majority* of the board of directors. It is unnecessary and inappropriate to disqualify an EII based on the mere intention to solicit, as informal communications with other shareholders could be construed as solicitation. It is also inappropriate to disqualify an EII based on an intention to seek a change in the minority composition of an issuer's board or other governance proposals, neither of which actions are indicative of any level of "control" and, in fact, are examples of the legitimate exercise of the fundamental shareholder franchise that should not be undermined. We note that under the final "proxy access" Rule 14a-11 adopted by the SEC in 2010, it was contemplated that the shorter U.S. Schedule 13G reporting regime would be available to shareholders availing themselves of Rule 14a-11 in order to nominate a minority

[148] See e.g. Smith, *supra* note 87: the aim of the proxy solicitation regime is to promote open and meaningful communication among shareholders.

of directors.[149] We submit that a similar approach remains appropriate for the AMR regime in Canada if any tightening of that regime is pursued, whereby eligible investors would remain entitled to rely on the AMR system, with its longer filing deadlines and abbreviated disclosure, provided the investor does not intend to seek to nominate or replace a majority of the board of directors of the issuer or otherwise seek to propose or oppose a more traditional control transaction.

3. *AMR disqualification should not impact the SEDI exemption.* One consequence of changing the trigger for AMR disqualification is that shareholders who no longer qualify for the AMR system will also lose their SEDI exemption. We believe the SEDI exemption should be made available to all shareholders without access to confidential information.

TELUS Corporation ("**TELUS**") has recently criticized Canada's AMR system as being too lenient in response to the recent opposition of Mason Capital to the elimination by TELUS of its non-voting shares. However, even in that case, the nature of Mason's economic interest in TELUS and its control of voting shares in numbers significantly disproportionate to its economic interest was apparent from Mason's AMR filings. To the extent that there were aspects of Mason's disclosure that are perceived to be inadequate, we cannot see how this one exceptional case would justify the sweeping changes in the Proposed Amendments. Indeed, the principal issue in the Mason/TELUS case was the disproportionate voting interest of Mason relative to its economic interest. The Proposed Amendments do not address this issue at all beyond requiring more disclosure.

The most significant point to recognize about the Mason/TELUS case is how isolated it was. While the case raises serious issues that should be considered by regulators and legislatures, it seems to have permeated and informed numerous aspects of the Request for Comments to a much greater extent than is warranted given its uniqueness. Furthermore, the Proposed Amendments would not affect an empty voter that does not intend to solicit proxies. For example, an empty voter with a voting interest sufficient to block a two-thirds vote would still qualify to use the AMR system provided it did not intend to solicit support from other shareholders.

Hidden Ownership

The Proposed Amendments broaden the scope of interests captured within the early warning calculation to include equity derivative positions that are substantially equivalent in economic terms to conventional equity holdings. In particular, the CSA is concerned with cash-settled TRSs and similar derivative instruments involving a counterparty that would "make the securities available" to the shareholder upon request. This concern is premised on the faulty perceptions that such derivative transactions are hedged through holding the referenced securities (which is often not the case and is only one of many ways to hedge a transaction) and that the derivative holder either has a string on the underlying equity shares or holds some influence or

[149] While approved and adopted by the SEC, Rule 14a-11 was vacated in its entirety. It was determined by a U.S. court of appeal that, among other things, the SEC had not undertaken an adequate assessment of the economic effects of the new rule or adequately framed the costs and benefits of the rule.

advantage in acquiring the underlying voting shares solely by virtue of entering into the derivative, irrespective of whether it can be settled by the holder for cash or physical shares. We can confirm, from our experience representing active market participants throughout the world, that this is not the case and is a gross oversimplification of derivative products available in today's markets. In fact, particularly with respect to engaged shareholders, it is ubiquitous market practice to have *no* agreements with respect to the acquisition or disposition of the underlying voting securities or with respect to the counterparty's hedging (if any) or the exercise of any votes attached to the underlying voting securities.

We submit that derivatives should be captured in the reporting threshold only if the holder has an option to vote, acquire or force a disposition of the underlying equity shares or has contractual rights over the counterparty's hedging (if any) of the underlying equity shares. More specifically, we believe a U.S.-style regime would be more appropriate, requiring shareholders to account for voting securities if they have the right to acquire beneficial ownership of such securities within 60 days.

We note that concerns of rare anecdotal cases of empty voting and hidden ownership appear to be the motivating factors behind the proposed inclusion of equity derivatives into the reporting threshold calculation and increased disclosure. However, instances of empty voting and hidden ownership have been extremely rare. The CSA has advanced no empirical evidence to support their concern or justify the proposed solution. Discrete, not omnibus, solutions should be crafted to protect against these perceived abuses. For example, regulators could address the issue more narrowly and directly by crafting discrete solutions that would sterilize cash-settled arrangements that might otherwise give the holder some rights or influence in respect of the underlying shares, and similarly over time develop discrete rules to capture other, ever-evolving derivatives that may present concerns of hidden ownership or empty voting to the detriment of the proxy voting system or market participants, if evidence indicates such a problem exists. For example, rules could be crafted to provide that TRSs, CFDs and similar cash-settled instruments would not need to be included for purposes of calculating the reporting threshold or disclosure if the binding features of the arrangement prevented the holder from acquiring any underlying shares from the counterparty or exercising any influence over the counterparty's acquisition, voting or hedging (if any) of such underlying shares. Similarly, reporting and disclosure of such instruments could be excluded from the EWR regime provided the investor has no intention to exert influence over management of the issuer in question. Such solutions, while requiring more careful analysis and crafting, are more appropriate than the wholesale expansion of the notion of beneficial ownership, which we believe is inappropriate and will have far-reaching consequences that are not likely to address the real concerns created by these arrangements. In addition, such an approach will create a disconnect between the EWR system and other securities laws, such as the take-over bid regime.

In the Request for Comments, it is not apparent that the CSA has considered the challenges the broad inclusion of equity derivatives would create for the derivatives market. It would require any holder of an equity derivative who reaches the 5% threshold to disclose its holdings, even if the holder has no intention of influencing corporate policies.[150] Given that the Canadian equity

[150] *Modern Assessment*, *supra* note 4 at 27.

derivatives market is worth approximately CDN$37 trillion,[151] the reforms would be a dramatic and unnecessary regulatory shift likely to unsettle and chill the markets, all with no demonstrable benefits.

On the basis of the foregoing, we submit the proper approach is to first examine and understand precisely what sorts of derivative instruments are being utilized and then, only on the basis of careful analysis and empiricism, craft narrow and discrete solutions in response.

Moratorium

We note that, as part of the Proposed Amendments, the CSA proposes to retain the moratorium on acquisitions until the end of the business day following filing of an EWR or AMR report. We believe it is entirely inappropriate to impose a moratorium at the 5% level and do not believe there is a justifiable policy basis for doing so. None of the U.S., the U.K. or Australia has imposed a moratorium respecting similar or longer filing periods. In fact, most blockholder reporting regimes in today's developed capital markets do not feature any moratorium on subsequent trading in these circumstances. The effect of the moratorium is to prevent engaged shareholders from accumulating sufficient positions to justify the cost of engaging with management and directors.

Conclusion

While the CSA has couched the Proposed Amendments in the language of market transparency, investor confidence and market efficiency, their actual effect will be to stifle shareholder engagement and democracy and insulate incumbents from their owners. As a result, all shareholders will be deprived of the value derived from shareholder engagement. The only winners will be underperforming managers who will face less frequent challenges to the status quo.

Through its actions, the CSA has shown that it is serious about supporting shareholder democracy and maintaining a balance between the costs and benefits of regulation. To be faithful to this policy, the CSA should undertake a comprehensive review of the role of the EWR system as a whole before adopting piecemeal aspects of other reporting jurisdictions without due regard for the distinctiveness of the Canadian market.

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151 "Canadian, U.S. Clearing Firms Agree to Explore Swap Clearing Link" (TMX News Release, 5 April 2011).

Once again, thank you for the opportunity to comment on the Proposed Amendments. If you wish to discuss any of our comments, please do not hesitate to contact the undersigned.

Yours very truly,

/s/ Stuart J. Kaswell

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