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March 23, 2011

Mr. John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

Dear Mr. Stevenson:

OSC Staff Notice 54-701
Regulatory Developments Regarding Shareholder Democracy Issues

Thank you for the opportunity to comment on the shareholder democracy issues that were identified in OSC Staff Notice 54-701 Regulatory Developments Regarding Shareholder Democracy Issues (the "Notice"). My comments are restricted to the two first issues listed in the Notice, and do not include comments on the "Effectiveness of Proxy Voting System".

The views expressed in this letter are, of course, mine alone, and do not reflect the comments of nor are they to be attributed to any other person, firm or corporation with which I may have an association.

Mandatory Shareholder Votes on Executive Compensation - (Say on Pay)

The recent 'Great Recession' has re-emphasized, among other things, the importance of the compensation policies and arrangements for senior executives as incentives which are powerful instruments that significantly influence firm behaviour, positively and negatively. Compensation and incentive packages for management can be direct and important components in encouraging the durable creation of long-term corporate wealth and social value through fundamentally sound economic activity and in discouraging unduly risky short-term behaviour.

It is important to observe that there is a basic underlying public interest relating to the purpose of the creation of wealth and social value through private business enterprises. Value creating, for-profit, successful corporations and business ventures, large and small, are essential for economic growth and development, job creation and the ability of our society, through democratically elected governments, to be able to provide needed public services including health, education and social security.

Compensation, however, if not managed properly by the board of directors, can be a substantial contributor to the loss of shareholder value and damage to the interests of other important stakeholders in the company, including their related communities. The "*Summary of Findings and of Recommended Remedial Measures of the Independent Review Submitted to the Audit Committee of the Boards of Directors of Nortel Networks Corporation and Nortel Networks Limited*" reported that former corporate and finance management carried out accounting practices that were not in compliance with U.S. GAAP relating to the recording and release of provisions in 2002 and 2003. In three of the four financial quarters in question – when Nortel was at or close to break even - , "these practices were undertaken to meet internally imposed pro-forma earnings before taxes ("EBT") targets." This conduct caused Nortel to achieve and maintain profitability in certain quarters which in turn "caused it to pay bonuses to all Nortel employees and significant bonuses to senior management under bonus plans tied to a pro forma profitability metric".

The recognition of the important influence of management compensation and incentives on achieving the objective of generating long-term wealth for shareholders and corporate stakeholders, as well as increasing social value, places executive remuneration on the corporate governance priority agenda. In Canada, it is accepted and now settled by the Supreme Court of Canada that the "directors are responsible for the governance of the corporation", and are "required to act in the best interests of the corporation viewed as a good corporate citizen". The Supreme Court of Canada pronounced that, under current corporate legislation, this mandatory fiduciary duty "is not confined to short-term profit or share value" and, "[W]here the corporation is a going concern, it looks to the long-term interests of the corporation".

Under our division of authorities and obligation between directors and shareholders, the corporation's board of directors and its compensation committee have, and properly so, the duty and responsibility to approve the company's compensation policies, its system design and operations and to monitor and review the compensation system's effectiveness to ensure that the outcomes from the system are as intended. It is the board of directors that has the responsibility and accountability for the governance of the corporation, of which compensation of its senior executives and management is a critical component.

It would not be appropriate to interfere with, or for the shareholders to second-guess, the authority and business judgment of the board of directors over the conduct of the affairs of the corporation, including its management compensation policies and plans. The acceptance of the board's final decision-making authority over compensation does not mean, however, that current corporate governance policies and procedures within this system have been perfected beyond improvement, or that there is no room or flexibility within the current framework for the introduction of new policies to respond to and address changing and evolving circumstances. It may not be in the long-term best interests of the corporation, its shareholders and stakeholders, that the only blunt principal remedies for shareholders to deal effectively with allegations of underperformance in the execution of a board's duty are either to sell their shares and head for the exit or to initiate non-binding shareholder proposals, requisition shareholder meetings or engage in costly proxy contests to remove and replace directors.

A non-binding broad advisory Say on Pay vote provides a useful and less costly communication channel for shareholders to express general dissatisfaction with the board's handling of executive pay, separately and outside the context of the election of directors. "Vote-no" campaigns organized by shareholders are generally more effective to communicate shareholder concerns than shareholder proposals on the same issue, and at a lower cost to all concerned.

There are several institutional and other shareholders who express the view that they are not in a position to have sufficient detailed information of the specific circumstances of any particular company to be in a position to be able to make informed judgments whether the

executive compensation policies and practices of that company are appropriate in its circumstances and that compensation decisions should be made by the board of directors and not the shareholders. This issue of information asymmetries on complex matters between the board on the one hand and shareholders on the other is a very realistic and practical perspective. One of the merits of a broad advisory Say on Pay vote is that it recognizes this disparity and that shareholders cannot (and should not) micromanage compensation issues, that the proper forum for executive pay decision-making is the board of directors, and that such Say on Pay votes do not detract from the role and responsibilities of the board.

As requested by the Notice, the focus of this comment is on the narrow governance issue whether advisory (non-binding) shareholder votes on executive compensation (Say on Pay) should be made mandatory. The various and widely divergent opinions on the appropriateness and effectiveness of, and, with respect to the UK experience since 2002, the lessons from, mandatory Say on Pay shareholder votes are contained in the various articles and analyses referred to in the References set out at the end this comment in Addendum A. The opposing arguments 'For' and 'Against' introducing mandatory Say on Pay, which are now fairly well canvassed and known, are set out in such References and need not be repeated or summarized in the body of this comment.

On a voluntary basis, as at the beginning of February 2011, approximately 46 Canadian reporting issuers have agreed to hold advisory Say on Pay shareholder votes, up from 28 in 2010. The Canadian companies that have voluntarily adopted a Say on Pay are amongst the largest and most respected financial and business organizations in the country. One may argue that the marketplace is dealing with this matter and there is no need to make such advisory votes mandatory by regulation. I am not convinced of the winning merits of that argument. If Say on Pay advisory votes are considered to be 'in the public interest', then, just as Audit Committees are required by regulation to be composed only of 'independent' directors for public policy reasons (even if several issuers had agreed to so constitute their Audit Committees voluntarily under 'best practice' guidelines), then it is appropriate to move forward to achieve and assure public policy objectives through appropriately focussed regulation. Similarly, the voluntary 'comply or explain' approach is an ineffective policy instrument to implement a 'best practice'

uniformly for the benefit of investors. Issuers may explain, within a range of reasonable business judgment, why it is not appropriate for them to adopt or comply with a particular 'best practice' guideline, and the negative results from disparity of implementation in the capital markets of a desired public policy can only be avoided by a mandated requirement for governance improvements.

The adoption of mandated Say on Pay advisory votes in the U.K. and other jurisdictions, and recently in the U.S., for large public companies, as well as the lessons learned from the U.K. experience since 2002, are relevant factors, perhaps benchmarks of sort. It is doubtful that the Canadian capital markets are immune from the essentially similar issues that led to such regulatory developments in those jurisdictions or that investors in Canada do not now seek to advance 'shareholder engagement' with increasing awareness, though perhaps less actively than institutions in the large global markets.

On balance, subject to the comments noted below, I would recommend that Say on Pay be made mandatory, on an annual basis, for the larger reporting issuers listed and posted for trading in Ontario which are incorporated in Canada or a province or territory thereof.

Some further observations related to this recommendation are summarized below:

- As outlined above, executive and compensation policies and practices have an important influence on firm behaviour, and can have a causal relationship with the creation or destruction of company value. Say on Pay will not be the solution by itself to ameliorate, eliminate or even destabilize excessive executive remuneration practices where it may exist. But, advisory Say on Pay votes are not ineffective, and may operate over time to influence more companies to (i) increase the disclosure and transparency of the board's compensation decisions and practices, (ii) elevate the board's accountability for remuneration policy and its application, and, perhaps, strengthen the board's independence from management in setting remuneration policies and rewards, (iii) increase the sensitivity of linking pay to the achievement of appropriate business performance metrics of the company, (iv) reduce severance

packages, (v) highlight any 'rewards for failure' and 'pay without performance', (vi) promote more communication and awareness between the board and the company's shareholders, (vii) increase shareholder interest and involvement, and (viii) operate to align the interests of the board, management and the shareholders to incentivize long-term performance.

- It is clear that shareholders have an appropriate and continuing interest in the board's decisions concerning executive pay and that such decisions affect value. Under corporate law, the directors cannot change the name of the corporation, which has little relationship to the firm's performance, without prior shareholder approval given at a meeting of shareholders. It does not appear extreme or inappropriate to provide shareholders with an *ex-post facto* annual non-binding advisory vote on the board's decisions in the prior year on such a critical matter as executive pay.
- A properly drafted resolution for an annual, advisory (non-binding) Say on Pay shareholder vote on the Compensation Discussion and Analysis report (Form 51-102F6 *Statement of Executive Compensation*) (the "CD&A") from the board to its shareholders does not detract from, qualify or limit the authority of the board, in its business judgment, to design, adopt and amend its own compensation plans and policies, to make final determinations and award remuneration and incentives for its executives and management that the board considers in the best interests of the company in order to accomplish its strategic objectives within its risk management policies, and to monitor the effectiveness of its compensation plans.
- Where applicable, the holders of dual class non-voting, restricted voting and subordinate voting shares, in addition to fully voting common shares, should be granted the right to vote on the Say on Pay resolution, irrespective of any prohibitions, restrictions or limitations on the exercise of voting rights attaching to such shares in the company's articles, charter, by-laws or other constating documents.
- The board of directors, not just the company's Compensation Committee, should be required formally to approve and adopt the CD&A and the approved CD&A should be required to be sent to all shareholders entitled to vote on the Say on Pay resolution. Just as the board approves the annual audited financial statements, after review and on the recommendation of the Audit Committee, the board should also approve the

annual CD&A to be submitted to shareholders, after review and on the recommendation of the Compensation Committee.

- "Small" reporting issuers should be exempted from the mandatory annual advisory (non-binding) Say on Pay shareholder vote on the CD&A. The Ontario Securities Commission should be granted the authority, on its own motion or on an application, to exempt reporting issuers and classes of reporting issuers on terms and conditions it deems in the public interest.
- The mandated requirements for an advisory (non-binding) shareholder Say on Pay vote should apply only to an annual vote on the CD&A and should not be extended to voting on specific compensation issues, such as 'golden parachutes', CEO or senior executive employment contracts, retention awards, severance agreements or pension or post-retirement benefits as a condition to or at the time such compensation arrangements are approved by the board or the Compensation Committee. Such matters fall within the board's role and responsibilities and its business judgment, which will be reported to shareholders in the annual CD&A.
- There should be no mandated requirement for the board to take into account, respond or comment publicly on the results of the Say on Pay vote in any particular manner, other than be required to disclose publicly in a timely fashion the results of the vote and to file such disclosure on SEDAR. The board should have the flexibility to take into account, respond or comment on the vote as it considers appropriate in light of the relationship and engagement that it has with its shareholders and investors and its corporate governance practices in relation to a mandated Say on Pay vote.

Notwithstanding the more influential role that institutional investors have in the UK and the historic and deeper cultural background and relationship between large British companies and their shareholders, I can relate to the following comments of Sir Adrian Cadbury, author of the 1992 Cadbury Report on UK Corporate Governance:

> "Say on pay promotes dialogue between investors and boards and encourages investors to engage with boards on a readily understandable issue, where interests may conflict. It is also a litmus test of how far boards are in touch with the expectations of their investors."

The Case Study summarized in Addendum B is an example of the litmus test of a relationship between a board and the expectations of its shareholders concerning executive pay in the circumstances of that situation and the board's public reversal of its position on Say on Pay at the same time.

Slate Voting and Majority Voting for Uncontested Director Elections

The right of the shareholders to elect the directors of the company is arguably the most fundamental right that shareholders have. In Ontario, the *Business Corporations Act* does not specify the manner by which shareholders shall elect directors, other than where the articles provide for cumulative voting. Applicable law in Ontario provides, however, by regulation and a national securities law instrument, that the form of proxy for the election of directors cannot provide the shareholders the right to vote 'for' or 'against' the election of directors, whether the election is to be a vote on a slate of director nominees or on nominees individually, and requires that the form of proxy can only provide the shareholders the right to vote 'for' or to 'withhold from voting' for the election of directors. The consequences of this legal restriction on the shareholders' right to vote for the election of directors is that, because 'withheld' votes are not counted, directors who receive the most 'for' votes are elected – this is referred to as the "plurality system". Directors can therefore be elected even though shareholders 'withhold' a majority of the votes cast (namely, the aggregate of the 'for' votes and the 'withheld' votes) for the election of a slate of directors or individual directors. Where a majority of the shareholder votes cast for the election of directors are 'withheld' votes, there is a credible basis to conclude that such a vote is a judgment by the holders of the voting majority that those less-than-majority director candidates are no longer suitable to serve (or continue to serve) as directors of the company.

Plurality voting should be used for contested elections for directors, whether or not such a contested election involves a formal proxy contest. In a contested election, a director is elected to the board by virtue of having received the most 'for' votes. A contested election for directors is one where the number of candidates nominated for election exceeds the number of positions

on the board to be filled. Where there is a contested election for directors, it should be specified that a separate vote of shareholders by ballot shall be taken with respect to each candidate nominated for election as a director.

In Canada, over 50 percent of companies in the S&P/TSX Composite Index have a Majority Voting policy (106 out of 199 companies) for uncontested director elections, according to the Clarkson Centre for Board Effectiveness. In the United States, approximately 80 percent of the S&P 500 companies and 60 percent of the Russell 1000 have adopted some form of majority voting policies or bylaw provisions, according to the California Public Employees' Retirement System (Calpers). On each side of the border, it is predominantly the larger public companies that have adopted Majority Voting.

After review of the issues relating to Slate Voting and Majority Voting for Uncontested Director Elections, subject to the comments below, I support the recommendations of the Canadian Coalition for Good Governance contained in its policy "*Majority Voting Policy*" (Revised, March 2011).

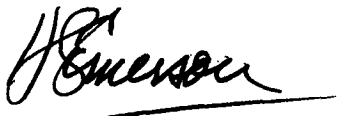
There a few additional comments:

- If the board of directors has an unlimited or overly broad discretion whether or not to accept the resignation of a director who fails to receive a majority of the votes cast in an uncontested election, the vote of the shareholders electing directors becomes advisory only. Compared to Say on Pay votes, which are appropriately advisory and non-binding in light of the subject matter of the vote, the election of directors is clearly and wholly within the proper jurisdiction of shareholders, and not the board of directors. As a matter of principle, shareholder votes on the election of directors should not be second-guessed by the board. A board decision not to accept the will of a majority shareholder vote under a Majority Voting policy by refusing to accept the resignation of a director who did not receive a majority of the votes cast is a contrary, overriding judgment by the board. At issue in such circumstances, is the integrity of the director election process and acceptance of the authority of determinations by a shareholder majority voting within its

legal jurisdiction. It may be appropriate to provide for a reasonable period of time for the board to accept the resignation of a director in order to allow for an orderly transition to fill the vacancy resulting from the forced resignation, or, in the event that a majority of the members of the board nominated for election fail to receive a majority of the votes cast, to call a special meeting of shareholders to vote on new nominees to replace the directors who were rejected by the shareholders.

I would be pleased to discuss any of the comments in the letter further at your convenience should you wish to do so.

Yours truly,



H. Garfield Emerson

ADDENDUM A

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ADDENDUM B

Case Study - Impact of Shareholders Reaction to Executive Pay - Manulife Financial Corporation

On February 12, 2009, Manulife Financial Corporation ("MFC") reported shareholders' net income of $517 million ($0.32 per share fully diluted) for 2008, compared to net income of $4.3 billion ($2.78 per share fully diluted) for 2007.

In its Proxy Circular dated March 17, 2009, for its Annual and Special Meeting of Shareholders held May 7, 2009, MFC disclosed that, earlier in August 2008, in recognition of his "extraordinary performance" as CEO over many years and his agreement to extend his retirement for a period of 5 months from the end of 2008 to May 2009, the Board awarded its retiring CEO compensation for the 5 month period of US$12.5 million (then approximately Cdn$15.1 million), which was equal to his 2007 total direct compensation. (2008 total compensation for the CEO was $13.25 million). The US$12.5 retirement award was composed of US$2.5 million cash and US$10 million in restricted share units which were to vest and be paid in December 2011.

In the same Proxy Circular, MFC disclosed a shareholder proposal that had been filed to be voted on at the meeting that the MFC Board adopt a governance rule stipulating that the executive compensation policy be subject to an advisory vote by the shareholders. The MFC Board recommended in the Proxy Circular that its shareholders vote against the Proposal. At that time, MFC was the only Canadian large financial services company not to offer its shareholders a say on pay. The MFC Chairwoman said that the MFC Board did not support the say on pay policy "because the company already aligns its compensation with performance".

On April 16, 2009, MFC issued a press release announcing that it had reversed its position on 'say on pay' and that it would provide its shareholders with a non-binding advisory 'say on pay' vote on its executive compensation policy. The press release stated:

> "The board's initial recommendation that shareholders vote against 'Say on Pay' this year was based on the lack of support for the proposal among Manulife shareholders in 2008, as well as the views of Canadian institutional shareholders, many of whom opposed an advisory vote until just recently," said Manulife Chair

> Gail Cook-Bennett. "Since the release of Manulife's proxy circular we have seen the Canadian Coalition for Good Governance come out in favour of 'Say on Pay', and have also heard from many shareholders who now support the measure, so the board decided to respond."

The next day, on April 17, 2009, Dominic D'Alessandro, the retiring CEO of MFC, said that, after discussions with a number of MFC's major shareholders, he was 'caught off guard' by the strongly adverse shareholder reaction to the US$12.5 million pay package for his 18 weeks of work in 2009. As a result, he said he will only accept the US$10 million in restricted share units if MFC's share price reaches Cdn$36 per share by the end of 2011, and if it reaches $30, he will take only half. If the share price does not reach $30, he will not take any of the restricted share units.