ACTING LIKE OWNERS: PROXY VOTING, CORPORATE ENGAGEMENT AND THE FIDUCIARY ROLE OF PENSION TRUSTEES

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WORKING PAPER

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1. INTRODUCTION

Pension trustees have the primary responsibility for establishing a prudent investment policy for a pension plan and overseeing its implementation. Historically, this process has been focused on a limited number of elements, such as identifying authorized asset classes and setting the portfolio's asset mix. Few have considered the rights and responsibilities of the pension plan as shareowner in the companies in which the plan is invested as a means of mitigating firm risk and enhancing the long-term performance of the plan's investment portfolio.

This issue merits consideration for several reasons. First, pension plans have acquired a significant stake in Canadian equity markets.[1] Statistics Canada data from the fourth quarter 2003 indicate that trusteed pension plans own approximately 15% of the domestic market capitalization of theToronto Stock Exchange with the average plan portfolio containing anywhere between 30% and 60% equities.[2] Pension plan holdings in equities doubled in the decade between 1992 and 2002 from $72.4 billion to $148.5 billion.[3] For the most part, pension plans are invested broadly across the entire market. Consequently, trusteed pension plans have a very significant stake in capital markets and the performance of companies in which they are invested.

Second, high profile and persistent corporate scandals and malfeasance have focused shareowner attention on corporate policy and practice. Many agree that the misdeeds and poor governance practices among Canadian firms such as Nortel Networks, Hollinger Inc., and more recently Bennett Environmental Inc.[4], and the consequential devastating impact on the market and investor portfolios could have been mitigated by more diligent investor oversight. These lessons have spurred regulators, businesses, investors and civil society to implement various regulatory, voluntary and market mechanisms to hold corporations, their officers and directors more accountable. Indeed, corporate accountability has become the main preoccupation of capital markets as they attempt to shore up investor confidence.

Studies continue to explore the relationship between proxy voting, corporate engagement, and firm financial performance and risk mitigation.[5] While findings remain inconclusive, the potential for shareholders to influence corporate performance and to minimize risk to the market and individual firms through corporate engagement and proxy voting is recognized.

Accordingly, some pension plans have begun taking their role as owners more seriously, calling for higher standards and greater managerial accountability through corporate engagement and proxy voting. Fairvest Corporation recently reported that five management resolutions proposing stock option plan

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[1] Gil Yaron, "Canadian Institutional Shareholder Activism in and Era of Global Deregulation" in Janis Sarra, ed., *Corporate Governance in Global Capital Markets* (Vancouver: UBC Press, 2003).

[2] Statistics Canada, *Trusteed pension funds, market and book value of assets, by foreign and domestic holdings, quarterly* (CANSIM Table 280-0003)(Fourth quarter 2003); TSX, *TSX Statistics – December 2003* (January 2, 2004)(Media release).

[3] OECD, *Institutional Investors Statistical Yearbook 1992-2001* (Paris, France: 2004) 32 at 50.

[4] Eric Reguly, "Possible clues to implosion of Bennett were largely ignored" (August 5, 2004) *Globe & Mail* B2.

[5] Johathan M. Karpoff, Paul H. Malatesta & Ralph A. Walking, "Corporate Governance and Shareholder Initiatives: Empirical Evidence" (1996) *J. of Fin. Econ.* 365; Sunil Wahal, "Pension Fund Activism and Firm Performance" (March 1996) 31(1) *J. of Fin. & Quan. Analysis* 1; Mark Anson, Ted White and Ho Ho, "The Shareholder Wealth Effects of CalPERS' Focus List" (Winter 2003) 15(3) *J. of Applied Corp. Fin.* 8; Claire E. Crutchley, Carl D. Hudson & Marlin R.H. Jensen, *The Shareholder Wealth Effects of CalPERS' Activism* (1998) 7(1) *Financial Services Rev.* 1; Tim C. Opler & Jonathan Sokobin, "Does Coordinated Institutional Shareholder Activism Work? An Analysis of the Council of Institutional Investors" (May 1998) (unpublished); Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting* (New York: TIAA-CREF Institute, 2002) (Working Paper 1-100100); Jonathan M. Karpoff, "The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings" (September 8, 1998) (draft on file with author). *See* additional studies in Stapledon, *infra* note 12 at fn21 and fn22.

amendments in 2003 were defeated at annual general meetings of shareholders.[6] In another instance, GSI Lumonics Inc. cancelled a vote on changing its jurisdiction of incorporation to Delaware after it had received advanced proxies representing more than half of the eligible votes.[7] And in 2003 and 2004, shareholder proposals submitted to Canadian companies on various corporate governance and environmental issues also received majority support, sometimes including management.[8]

Yet, the vast majority of pension plans do not articulate a shareholder activism strategy of voting proxies and corporate engagement as part of their overall investment policy.[9] Proxy voting numbers continue to be low. Fairvest Corporation estimates that the average voter turnout for companies listed on the S&P/TSX Composite Index was 63.5% in 2003, a figure that has remained relatively consistent over the past seven years.[10] Data from the United States indicate a similar response amongst investors in American companies. ADP Investor Communications Services reports only 68% of all proxy ballots were returned in 2003; small shareholders (i.e. less than 1,000 shares) returned 40% of their shares while large shareholders (i.e. more than 300,000 shares) had a 70% response rate.[11]

Where proxies are voted, pension plans continue to delegate without any instruction the entire responsibility to voting intermediaries. According to the *2003 Key Proxy Vote Survey* conducted by the Shareholder Association for Research and Education (SHARE), 26 of the 38 investment managers surveyed exercised discretion over 85% or more of Canadian proxies voted on behalf of client pension plans. And of these, eighteen of these were given discretion to vote 98% of the time.[12]

Others speculate that the failure of Canadian shareowners to exercise their voting rights will create a vacuum where foreign investors ultimately come to exert control.[13] A 1999 report from a UK government committee (Newbold Committee) raised concerns about the potential influence of American investors on UK firms stating that "unless UK-held shares are voted, effective control may be overly influenced by US owners."[14] While companies in Canada are more closely-held, the concern may be mirrored to some

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[6] Michelle Tan, "At Long Last, Mandatory Disclosure. How Canada's Proxies Were Voted in 2003" (January 2004) 16(1) *Corporate Governance Review* 1 at 4.

[7] *Ibid.* at 3.

[8] A proposal submitted by Real Assets Investment Management Inc. and Ethical Funds Inc. in 2004 calling on the Bank of Montreal to report its environmental liabilities received a record 90.90% of votes cast with the support of management. A proposal submitted in 2003 to the Royal Bank of Canada by the Protection of Quebec Savers and Investors, Inc. (APEIQ) calling on the company Chair and Board Committees to report orally to the AGM garnered 83.80% of total votes cast. The Shareholder Association for Research and Education provides a complete list of all shareholder proposals submitted to Canadian corporations at www.share.ca. Lists of shareholder proposals filed by investors with U.S. companies are available at www.SocialFunds.com, Council of Institutional Investors (www.cii.org), and www.ishareowner.com..

[9] For the purposes of this paper, reference to "shareholder activism" or "active investing" includes the practices of voting proxies and corporate engagement only. While voting proxies are generally considered to be part of corporate engagement, these practices are treated separately in this paper for the purposes of legal analysis. "Active investing" is defined as "…comprised of investment strategies in which the investor takes actions involving the target corporation, other than simply buying or selling securities, that are designed to increase the returns generated by this investment. Such actions typically involve exerting significant influence over corporate policy or control over the corporate entity in the hope of elevating the value of the firm. An active investing strategy is thus one in which the returns derived from a given investment are endogenous – subject to influence by the individual investor after the investment is made.": Lilli Gordon & John Pound, *Active Investing in the U.S. Equity Market: Past Performance and Future Prospects* (Jan. 11, 1993) at 9 cited by Koppes and Reilly, *infra* note 68.

[10] Tan, *supra* note 6 at 3.

[11] Figures from ADP Investor Communications Services website at http://ics.adp.com/release10/public_site/about/stats.html#three cited in Rockefeller Philanthropy Advisors and As You Sow Foundation, *Unlocking the Power of the Proxy* (2004) at 9. Available at http://www.asyousow.org/powerproxy.pdf.

[12] Shareholder Association for Research and Education, *SHARE 2003 Key Proxy Vote Survey* (Vancouver: SHARE, 2003).

[13] Geoffrey P. Stapledon, "Are UK institutional investors obliged to vote their shares? If not, should this be mandated?" (Unpublished draft) at 5. On file with author.

[14] Committee of Inquiry into UK Vote Execution (Yve Newbold, Chair), *Report* (National Association of Pension Funds: London, 1999) at para 4.6, cited in Stapledon, *ibid.* at 7.

extent in this country, where US investors have more than CDN$66 billion invested in Canadian stock amounting to approximately 6% of the total domestic market capitalization of the TSX.[15] Failure of Canadian shareholders to exercise their voting rights may therefore result in the abdication of control of Canadian firms to foreign investors, or at least give disproportionate power to the more active foreign owners.

The picture is similar with regards to shareholder activism. Despite the introduction of new rules at the federal level easing restrictions on filing shareholder proposals and allowing for greater shareholder coordination and communication, only a small number of pension plans have incorporated corporate engagement strategies into their investment policies.[16] In 2004, while more than 100 shareholder proposals were submitted to Canadian corporations, only five Canadian pension plans filed proposals.[17] Admittedly, institutional investors often state that they prefer to take a quiet approach to engagement focused on dialogue with corporate directors and management.[18] This attitude makes it exceedingly difficult to assess the degree to which pension plans are engaging corporations; however, the observable instances of pension plan shareholder activism do generally reflect their low involvement to date.[19]

In light of these observations, this paper considers to what extent pension trustees have a fiduciary obligation to vote proxies and to engage companies that they own, what processes, if any, trustees must follow to fulfill that obligation, and what legal barriers hinder compliance. Does the failure of a plan to employ an activist investing strategy whose aim is to contribute to protecting the long-term interests of plan members leave trustees open to claims of breach of fiduciary duty? If such an obligation exists, does it extend to all issues including social, environmental and ethical (SEE) aspects of a company's operations? Does it apply to agents to whom responsibility is delegated? In the next section, I detail relevant aspects of the current framework governing proxy voting and corporate engagement by pension plans in Canada. Section three identifies the relevant fiduciary principles of pension trustees and applies a reviews law and policy in various common law jurisdictions to address the questions raised above. Reflecting on the previous two sections, section four explores some possible reasons for the observed failure of pension plans as a group to exercise their franchise in keeping with fiduciary standards. Section five concludes with suggested approaches that trustees can follow to prudently and responsibly vote proxies and engage corporations.

2. THE PROCESS OF PROXY VOTING AND CORPORATE ENGAGEMENT

2.1. The Proxy Voting Process

Proxy voting is the more technically obscure and poorly understood aspect of shareholder activism. While the assumption of "one share, one vote" is easily comprehended, this principle is rarely, if ever, realized due to a highly complex framework in which control is vested through various means in the hands of the

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[15] Statistics Canada, *Canada's International Investment Position* (Statistics Canada: Ottawa, Fourth quarter 2003) Catalogue no. 67-202-XIE at 30.

[16] No reported survey of pension plan investment policies has been conducted in Canada. However, the UK government recently found that a mere 9% of pension plans had either established their own policy or been influenced in their choice of investment manager based on the policies they offered in this area. *See* Sarah Horack, John Leston & Margaret Watmough, *The Myners Principles and Occupational Pension Schemes* (vol. 2) (London: Department of Work and Pensions, 2004) at 106.

[17] These pension funds included the United Brotherhood of Carpenters and Joiners Local 27 Pension Trust, Hotel and Restaurant Employees Union Local 362, Fonds Elisabeth Bergeron, Soeurs de Saint-Joseph-de-Saint-Hyacinthe, and the Congregation des Soeurs de Sainte-Anne.

[18] Globe & Mail article interview with Michael Wilson of the Canadian Coalition for Good Governance.

[19] For a discussion of the role and history of pension fund shareholder activism, *see* Moira Hutchinson, *The Promotion of Active Shareholdership for Corporate Social Responsibility in Canada* (Toronto: Michael Jantzi Research Associates, 1996); Marleen O'Connor, *Union Pension Power and the Shareholder Revolution* (1999) prepared for the Second National Heartland Labor-Capital Conference (unpublished).

companies and their agents. This section attempts to lay out the relevant aspects of the process from the perspective of pension trustees and the relationship of proxy voting to a pension plan's investment policy.

There are two legal interests in a share – a registered and beneficial interest. The registered shareholder is the individual whose name appears on the share or on the company's register[20]. The registered shareholder deals with the share on behalf of the beneficial owner of the share who maintains the beneficial interest in the share, including the attendant voting rights. The registered shareholder is not permitted to exercise any of the attendant rights without instruction from the beneficial owner.[21]

A pension plan may hold a registered, beneficial in shares in its portfolio, or alternatively no ownership interest at all. If pension plans purchase shares in their own name, they are both the registered and beneficial shareholder. More typically, pension plans hold a beneficial interest in the shares with the shares registered in the name of an intermediary, such as the plan's investment manager or custodian. This allows the plan's agent to deal with the securities on a day-to-day basis. However, the beneficial interest remains with the pension plan. In such instances, the pension plan as beneficial owner retains the authority to direct how proxies are voted and the registered shareholder is obligated to act on the directions of the beneficial owner.[22] In practice, pension plans commonly delegate many of the rights and powers associated with their shares to their investment manager or voting agent.[23] Finally, where pension plans are invested in equities through pooled funds, the pension plan has no legal interest in the shares. The legal interests in that instance are vested in the various intermediaries associated with the pooled fund.

In advance of a shareholder meeting, management is required to provide each registered shareholder entitled to vote at the meeting with notice of the meeting, a proxy circular spelling out the matters to be considered by shareholders at the meeting, and a form of proxy with which to vote.[24] The registered shareholder is then obligated to forward the documents to the beneficial shareholder for consideration and instruction, unless this responsibility has been delegated in writing.[25] As a result of the common practice of delegating authority, pension plans and pension trustees rarely see documentation sent by companies to shareholders, let alone provide instruction on how to vote.[26]

Where documentation is received by the plan, it must review the ballot and proxy circular before voting either electronically, by mailing the ballot to the custodian, or voting in-person at the shareholder

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[20] In most instances, the registered name appearing is the Canadian Depository of Securities (CDS). The Canadian Depository of Securities (CDS) is Canada's national securities depository, clearing and settlement hub. CDS supports Canada's equity, fixed income and money markets, holding over $2 trillion on deposit and handling over 50 million securities trades annually. CDS is accountable for the safe custody and movement of securities, accurate record-keeping, the processing of post-trade transactions, and the collection and distribution of entitlements relating to the securities that have been deposited by customers.

[21] In practice, many of these rights are delegated to the registered shareholder by the pension fund through contract.

[22] *Canada Business Corporations Act*, R.S. 1985, c. C-44, s.153(2) [hereinafter CBCA]: "An intermediary, or a proxyholder appointed by an intermediary, may not vote shares that the intermediary does not beneficially own and that are registered in the name of the intermediary or in the name of a nominee of the intermediary unless the intermediary or proxyholder, as the case may be, receives written voting instructions from the beneficial owner."

[23] *See 2003 Key Proxy Vote Survey*, *supra* note 12.

[24] BCCA, s.151(2); ABCA, ss.143(2-4); SBCA, 142(2-4); MCA, s.143(3); OBCA, s.258(1)(c).) Management who fails to comply with this requirement (as well as directors and officers who knowingly authorize, permit or acquiesce to it) without reasonable cause is guilty of an offence. Most institutional investors now receive a voter information form, not a legal proxy, and voting is done online.

[25] *See e.g.* CBCA, *supra* note 22, s. 153.

[26] New securities rules in force as of September 2004 permit a company to receive information about the identify of a beneficial owner from the registered owner unless the beneficial owner objects. If the beneficial owner objects, it must pay to receive corporate documents. Those opposed to this new policy argue that it is prejudicial to beneficial shareholders and exacerbates divide that already exists between beneficial owners and firms. *See* National Instrument 54-101 (Communication with Beneficial Owners of Securities of a Reporting Issuer) and Companion Policy 54-101CP.

meeting.[27] The time taken to transmit the documentation to the plan reduces the amount of time it has to consider the issue and cast its vote prior to the meeting. Plans report that on average they receive documentation for Canadian equities two weeks prior to a vote.[28] It is not unheard of for proxies of foreign equities to be received after the vote.[29] The time limitations often make it difficult for beneficial shareholders to properly consider matters raised, obtain the necessary authorizations and vote the proxies. This is one of the reasons why pension plans have historically delegated the responsibility for voting proxies to their investment managers or a proxy voting service.

Shareholders in Canada may appoint a proxyholder to vote on their behalf.[30] This practice recognizes the expertise of voting intermediaries and the nature of equity markets where the beneficial owner may own many companies in their portfolio making it difficult for them to vote every share directly and even more onerous to attend all shareholder meetings.[31] In practice, pension plans typically appoint their voting agent as proxyholder and most proxies are now voted electronically in advance of the meeting.[32]

In Canada, the voting options available to shareholders depend on the issue in question. On “routine” business (i.e. the election of the board of directors, appointment of the auditor), shareholders only have the option of voting for the proposal, withholding their vote or abstaining.[33] They do not have the ability to vote against such proposals. The inability to vote against means that these proposals always pass. Shareholders consequently have no control over the election of the directors or appointment of auditors through the voting process.[34] This is particularly troubling given the importance of issues such as director and auditor independence in the wake of recent corporate scandals.

Respecting all other proposals, shareholders may vote for, against, withhold, or abstain from voting.[35] Where a shareholder elects to abstain and names management as its proxy holder, corporate regulations permit management to exercise the proxies on behalf of the shareholder.[36] In practice, corporate proxy

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[27] *Canada Business Corporations Regulations 2001*, P.C. 2001-2139 (November 22, 2001), s.65 [hereinafter “CBCA Regs.”]: “A proxy circular shall be dated as of a date not more than 30 days before the date on which it is first sent to a shareholder of the corporation and the information, other than financial statements, required to be contained in it shall be given as of the date of the circular.”

[28] Interviews conducted in July 2004 by the author with various pension plan staff responsible for directing or voting proxies.

[29] Interview with Catherine Smith, Shareholder Association for Research and Education (May 4, 2004). Apparently, the delay with respect to foreign proxies may be due in part to technical limitations of US custodians.

[30] CBCA, *supra* note 22, s.148(1): A shareholder entitled to vote at a meeting of shareholders may by means of a proxy appoint a proxyholder or one or more alternate proxyholders who are not required to be shareholders, to attend and act at the meeting in the manner and to the extent authorized by the proxy and with the authority conferred by the proxy.

[31] Historically, Canadian law required shareholders to vote in person at annual general meetings. Some countries continue to require shareholders to vote in person. *See* Theodor Baums, “Shareholder Representation and Proxy Voting in the European Union: A Comparative Study” (Paper presented at the Conference on Comparative Corporate Governance: Hamburg, May 15-17, 1997).

[32] SHARE, *supra* note 12.

[33] CBCA Regs, *supra* note 27, s.54(7): “A form of proxy shall provide a means for the shareholder to specify that the shares registered in their name are to be voted or withheld from voting in respect of the appointment of an auditor or the election of directors.”

[34] In its report of the 2004 proxy season, Fairvest reported that two Canadian companies (Manulife and TSX Group) presented a slate of nominees that exceeded the total number of available directorships. *See* Michelle Tan, “Moving Off the Beaten Path: A Review of the 2004 Proxy Season” (June/July 2004) 16(4) *Corporate Governance Review* 1 at 3. In the United States, the SEC has proposed new rules that would allow shareholders to nominate directors. See Securities and Exchange Commission (October 17, 2003) Release No. 34-48626 (“Security Holder Director Nominations”).

[35] CBCA Regs., *supra* note 27, s.54(5): “A form of proxy shall provide a means for the shareholder to specify that the shares registered in their name are to be voted for or against each matter or group of related matters identified in the notice of meeting or in a management proxy circular, dissident's proxy circular or proposal under section 137 of the Act, other than the appointment of an auditor and the election of directors.”

[36] CBCA Regs, *ibid.,* s.54(6): “A form of proxy may confer authority with respect to matters for which a choice is not provided in accordance with subsection (5) if the form of proxy, the management proxy circular or the dissident's proxy circular states, in bold-

circulars often indicate that management will be appointed as proxy holder in the event that the shareholder fails to make an election, in which case the vote will be treated as a vote "for" management's recommendation.[37] As a result, a decision not to vote often equals a vote for management by default.

A custodian is generally hired by the company to manage the voting of proxies. In the absence of a confidential voting policy, votes received in advance of a shareholder meeting are often scrutinized by the company. It is common practice by companies to contact dissident shareholders in order to discuss and to attempt to influence their decision. Until recently, companies only had lists of registered shareholders (i.e. those whose names appear on the share).[38] In order to communicate with beneficial shareholders, companies hire firms specializing in shareholder communication, who effectively pierce the veil to ascertain the identity of the beneficial owner directing the vote. To date, many Canadian firms have not adopted confidential proxy voting policies, remaining free to review votes cast prior to the Annual General Meeting of shareholders.

At the annual general meeting, voting is conducted by a show of hands or a secret poll if requested by a shareholder or where the anticipated support for the proposal exceeds a prescribed percentage.[39] Where there is a show of hands, the outcome of the vote may or may not take into consideration votes cast electronically prior to the meeting. Furthermore, until 2004 with the introduction of rules requiring the disclosure of vote totals, companies could chose not to publish vote results and most elected not to do so, and the rules still allow circumvention of the disclosure requirement. The rules do not specify exactly what information must be disclosed, and an early compliance report by the Canadian Coalition for Good Governance indicates that most companies are not providing meaningful disclosure in a timely manner.[40]

This framework for voting proxies presents certain challenges for pension plans and pension trustees. The delegation of voting authority to intermediaries, lack of reporting by intermediaries, corporate access to proxies in advance of the meeting, difficulties in obtaining proxy information, time constraints on directing and exercising proxies, and the inability to oppose routine business proposals or obtain vote results are some of the barriers which shareholders face. These barriers are discussed in more detail in section 4 of this paper.

2.2. The Corporate Engagement Process

Corporate engagement is a process through which shareholders as owners communicate their interests and concerns to companies. Engagement mechanisms run the gamut from private acts such as letter writing and corporate-shareholder dialogue, to more public strategies including filing shareholder proposals, media campaigns and, in extreme situations, litigation. While there is often an incremental approach taken to engagement, the order of the mechanisms used may vary. For example, investors may wish to approach a company quietly to avoid public scrutiny and allow more freedom in negotiations.

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face type, how the proxyholder will vote the shares in respect of each matter or group of related matters." France has a similar default regime. In contrast, Italy's Civil Code forbids delegating voting power to employees or members of the company's board, its subsidiaries, outside auditors, or to representatives of the bank. Spain's law prohibits giving a proxy to anyone other than another company shareholder. See Baums, *supra* note 31 at 10,14,18.

[37] *See e.g.* 2004 proxy circular of Precision Drilling: "The persons named in the enclosed form of proxy will vote the shares in respect of which they are appointed in accordance with the direction of the Shareholders appointing them. In the absence of such direction, such shares will be voted, for the approval of the election of the nominees hereinafter set forth as directors of the Corporation, for the re-appointment of KPMG LLP Chartered Accountants as Auditors of the Corporation and for the approval of the 2004 Stock Option Plan."

[38] NI 54-101, *supra* note 26.

[39] CBCA, *supra* note 22, s. 141(1): "Unless the by-laws otherwise provide, voting at a meeting of shareholders shall be by show of hands except where a ballot is demanded by a shareholder or proxyholder entitled to vote at the meeting. (2) A shareholder or proxyholder may demand a ballot either before or after any vote by show of hands."

[40] Canadian Coalition for Good Governance, *Report on Compliance with Section 11.3 of National Instrument 51-102* (CCGG: Toronto, August 2004) (unpublished draft).

Alternatively, a proposal may be filed first in order to capture a company's attention and encourage dialogue.

The process of private negotiation can be relatively short or be protracted over several years depending on the parties and nature of the issues under consideration. Filing a shareholder proposal is often appealing because of its immediate publicity; however, it also has disadvantages including the need to comply with a regulatory framework. Rules governing the submission of proposals are provided in corporate law. Therefore, the applicable law is determined by the jurisdiction in which the company is incorporated. Once the jurisdiction is determined, the rules dictate which shareholders are eligible to file a proposal, what must be included in the proposal, the permissible issues that can be raised, timelines for filing and circulating the proposal, the grounds on which a proposal may be excluded by the company, and the mechanisms for resolving disputes.

In the case of federally-registered companies (comprising more than one third of the S&P/TSX Composite Index), both registered and beneficial shareholders may submit proposals.[41] One or more shareholders must hold a minimum of $2,000 worth of shares or 1% of the total outstanding shares for a period of at least six months. In the case of nominations for director, a shareholder or shareholders must hold a minimum of 5% of outstanding shares or a class of shares entitled to vote. Proposals must include a set of prescribed information and be no more than 500 words in length. Proposals must be submitted to the company within 90 days of the date of the Notice of Meeting from the previous annual general meeting. The company may then exclude the proposal from inclusion in the company's proxy circular on a number grounds, including where the company deems the proposal to not relate in a significant way to the business and affairs of the corporation. In such instances, the shareholder's only recourse is to the court to obtain an order requiring the company to circulate the proposal.

Given the complex regulatory framework governing the handling of shareholder proposals and the barriers that shareholders continue to face in this regard, shareholders rarely rely exclusively on this approach. A review of studies comparing various approaches in relation to firm performance suggests that quiet negotiation may be a more profitable strategy than filing shareholder proposals, although this conclusion is recognized to be overly simplistic, ignoring the myriad of factors that potentially confound the findings.[42] For example, the difficulty of observing the frequency and evaluating the effectiveness of private negotiations has already been noted. Similarly, the use of shareholder proposals might result from the need for more aggressive strategies in response to challenging or intransigent management scenarios in addition to providing a focused context for private discussions.[43]

3. DOES THE EXISTING LEGAL FRAMEWORK IMPOSE A FIDUCIARY OBLIGATION ON PENSION TRUSTEES TO BE ACTIVE SHAREHOLDERS?

Canadian law remains ambiguous about whether corporate engagement and proxy voting are fiduciary responsibilities of plan trustees. The current legal framework governing the voting of proxies by pension plans in Canada is minimal and not well known or enforced. Similarly, there is no policy or jurisprudence that discusses the prudent approach of pension plans towards corporate engagement. The courts have traditionally discussed the fiduciary obligations of pension trustees to act prudently and loyally in general terms. Rarely do these general principles get interpreted in relation to specific governance responsibilities of trustees and other plan fiduciaries. Lack of clarity in the law and other systemic market barriers continue to leave trustees uncertain or unaware about their responsibilities with respect to the voting of plan proxies. For pension plans, the questions at issue are whether pension trustees have a

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[41] CBCA, *supra* note 22, s.137. For a summary of the rules governing the filing of shareholder proposals with federally incorporated companies, see Gil Yaron, *A Guide to Preparing and Submitting Shareholder Proposals with Federally-Incorporated Canadian Corporations* (Vancouver: SHARE, 2003) available at www.share.ca.

[42] Brian Pearce, Patrick Roche, and Nick Chater, *Sustainability Pays* (London: Cooperative Insurance Society, 2002) at 51-52.

[43] *Ibid.* at 52.

fiduciary obligation to vote plan proxies and engage companies with whom they are invested, to what extent pension trustees may delegate responsibility for these practices to agents, and the degree of responsibility agents incur upon delegation. These questions are considered in this section.

3.1. Do pension trustees have a fiduciary obligation to vote proxies?

Federal pension regulations require that a pension plan's investment policy account for the retention or delegation of the voting rights attached to investments.[44] Eight of thirteen jurisdictions require a plan administrator to provide instruction on "the retention or delegation of voting rights acquired through investments" in a plan's investment policy.[45] Accordingly, most jurisdictions require pension plans to have a policy addressing the voting of plan proxies[46], although none provide guidelines on what constitutes an appropriate policy or process for executing the policy.

Some direction is provided in investment guidelines established by Office of the Superintendent of Financial Institutions (OSFI) for federally-regulated pension plans.[47] As guidelines, they are not law, but are considered by the courts to have persuasive value. The guidelines state that proxies are valuable plan assets and must be voted in the best interests of plan members.

> "Plan administrators should not ignore the value of voting rights acquired through plan investments. Shareholder votes are often most valuable when used in alliance with others. *Failure to describe in the investment policy how these rights will be used leaves plan administrators open to charges of either negligence or arbitrary action, possibly in violation of the standard of care requirement.* Investment policies should describe and require the use of voting rights, whether directly or through proxy.
>
> If the power to vote proxies is delegated to investment managers, proxies should be bound by rules established in the investment policy. The administrator should receive a report showing how proxies were voted, and affirming compliance with the administrator's proxy voting policy."[48] (emphasis added)

From a process perspective, the OSFI guidelines clarify that where pension plans delegate authority to vote plan proxies to a voting agent pursuant to regulation (above), the plan's board of trustees must provide direction on how the proxies are to be voted and monitor compliance of their voting agents. According to OSFI, failure to detail how voting rights will be exercised in the plan's investment policy could constitute a breach of fiduciary duty.

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[44] *See e.g. Pension Benefits Standards Regulations 1985,* SOR/87-19, s.7.1(1)(f); *Pension Benefits Regulations,* R.R.0 1990, Reg. 909, amended to Reg. 680/00, s.78(2).

[45] *Employment Pension Plans Regulation,* Alta. Reg. 35/2000, s.51(1); *Pension Benefits Standards Regulation,* B.C. Reg. 433/93, s.38(3)(f); *Pension Benefits Standards Regulation*, SOR/87-109 amended SOR/90-363, s. 7.1(1); *Pension Benefits Regulation*, N.B. Reg. 91-19, s.44(3); Nfld. Reg. 114/96, s.39(6). Prince Edward Island's statutory regime for pensions is not yet in force, nor has it adopted the requirements of another jurisdiction.

[46] George P. Dzuro, Murray Gold, Arleen Huggins and Michael Mazzuca, "Pension Funds as Shareholders" in Raymond Koskie, Mark Zigler, Murray Gold, Roberto Tomassini, *Employee Benefits in Canada* (3rd ed. rev.) (Brookfield, Wisconsin: International Foundation of Employee Benefit Plans, Inc., 2004) at 287.

[47] Office of the Superintendent of Financial Institutions. *Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans* (OSFI: Ottawa, April 2000). Available at www.osfi-bsif.gc.ca/eng/pensions/guidelines/pdf/penivst.pdf.

[48] *Ibid.* at endnote 4, Appendix 1, section 1.6.6. Similar "Compliance Assistance Guidelines" adopted by the Pension Commission of Ontario in May 1990 (since rendered obsolete when Ontario adopted Schedule III of the federal *Pension Benefits Standards Act* ("investment rules")) provide that a policy "...should set out the plan's policy on voting of securities carrying voting rights – specifically, whether the administrator will retain voting rights acquired through the plan's investments, or, if they are to be delegated, to whom. If the pension plan has a policy or policies on voting, these should be stated. The [investment policy] should also describe the procedures to be followed to review proxy statements and solicitations and deciding how to vote securities." Cited in Dzuro et al., *supra* note 46 at 287.

The professional organization representing a majority of investment managers in Canada has acknowledged the material importance of responsible proxy voting. The CFA Institute's (previously the Association for Investment Management and Research) Standards of Practice Handbook states:

> "Actively exercising [voting] rights through corporate governance may be an effective way of enhancing portfolio value. Not exercising these rights ignores a valuable ownership right that could be managed for the benefit of the portfolio and, in certain accounts, may constitute a dereliction of legal and fiduciary responsibilities to clients."[49]

In the United Kingdom, many investor organizations, such as the Pension Investment Research Council, view the voting of proxies as a fiduciary obligation of pension trustees.[50] The Newbold Committee asserted in its report that "regular, considered voting should be regarded as a fiduciary responsibility."[51] While the Canadian and British pronouncements are not law, they do have persuasive value in the eyes of the court.

The legal position in the United States is much clearer. Interpretative bulletins issued under the *Employee Retirement Income Security Act of 1974* (ERISA), legislation governing private pension plans in the United States, emphasize the importance and fiduciary nature of voting proxies:

> "The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock."[52]

This has been interpreted to require that a pension plan vote all of its proxies; "...failure to vote a proxy is a breach of a plan administrator's fiduciary obligations."[53] This interpretation of the fiduciary duty of pension trustees was pointedly reinforced more than two decades ago by the former Assistant Secretary of Labor, David George Ball, who affirmed that a trustee's fiduciary obligation is breached if he/she "fails to vote, or casts a vote without considering the impact of the question or votes blindly with management."[54] At least one academic has argued that the US position reflects the obligations of Canadian pension trustees as well:

> "Given the strength of fiduciary law in Canada, it is undoubtedly the case that Canadian regulators and courts would find, as have their U.S. counterparts, that plan administrators must exercise proxy votes as an aspect of their fiduciary obligations."[55]

France also recently amended its law to require that investment managers vote all shares that they hold or explain why if they don't.[56]

Canadian law is less certain on whether a pension trustee owes a fiduciary obligation to ensure that all proxies are voted. The Ontario Teachers' Pension Plan takes the view that abstaining is not in the best interests of plan members, thereby implying that abstaining constitutes a breach of trustee's duty of loyalty to plan members. A September 11, 2002, press release of the Canadian Coalition on Good

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[49] Association of Investment Management and Research, *Standards of Practice Handbook: The Code of Ethics and the Standards of Professional Conduct* (8th ed.) available at http://www.cfainstitute.org/publications/catalog/standards_cat.html.

[50] Submission made to the National Association of Pension Funds Committee of Inquiry into Vote Execution, "PIRC presents challenge on reform of the company AGM and the shareholder process" (11 December 1998). Available at www.pirc.co.uk/proxnapf.htm.

[51] Newbold Committee at 7 cited in Stapledon, *supra* note 13 at 18-19.

[52] 29 CFR 2509.94-2 (Interpretive bulletin relating to written statements of investment policy, including proxy voting policy or guidelines.)

[53] Dzuro et al., *supra* note 46 at 287.

[54] "Ball Signals Continued Commitment to Proxy Voting Issues at Department" (January 29, 1980) 17 *Pension and Benefits Reporter* 207 cited in *Unlocking the Power of the Proxy,* supra note 10 at 13.

[55] Dzuro et al., *supra* note 46 at 287.

[56] Stephen Davis, "Votes Rule" (June 27, 2003) 7(26) *Global Proxy Watch* 1.

Governance quotes Claude Lamoureux, President and CEO of the $75.7 billion dollar plan[57], as stating that "Our top priority is creating and preserving shareholder value for our plan members. That begins with taking share ownership seriously and *voting on every proposal in a company's proxy circular*...." (emphasis added) However, at least one academic argues that instances may arise where it is prudent to not vote on an issue, provided that the trustees and their voting agents have considered the issues and options and believe abstaining to be in the best interests of plan members.[58] Geofrey Stapledon, Deputy Director with the Centre for Corporate Law and Securities Regulation at the University of Melbourne's Faculty of Law, argues against a compulsory voting requirement. He concludes that "a failure to vote an equity investment will not normally involve a breach of duty so long as active and genuine consideration has been given to the issue of whether to vote."[59]

Based on this review of Canadian pension regulation and statements made by regulators along with policy from other common law jurisdictions[60], the better view would appear to be that pension trustees have a fiduciary obligation to ensure that both policy and process exist governing the voting of proxies. Consideration should be given to all matters subject to a vote and guidelines and monitoring mechanisms implemented where responsibility is delegated, with no clear requirement that all proxies must be voted. However, the evidence indicates this approach is not being followed in practice by most pension plans. Surveys cited earlier demonstrate low vote turnout, low numbers of pension plans with strong policies on proxy voting, high levels of unsupervised delegation and general lack of attention to this responsibility by pension trustees and service providers in the absence of enforcement by regulators.[61]

3.2. Do pension trustees have a fiduciary obligation to engage the corporations in which the pension plan holds stock?

Canadian law imposes no specific obligation on pension trustees to include corporate engagement as part of the pension plan's investment policy. While there has been little consideration in Canada of the prudential value of corporate engagement by regulators or academics, I submit that the common law principles of prudence and loyalty impose an obligation on trustees to establish an engagement policy as part of a strategy to protect the long-term best interests of plan members. It is often asserted that pension plans invested in Canadian capital markets may not have the option to sell stock. In such instances, prudence dictates the need for policy that permits trustees and their agents to engage management to bring about improvements in performance.[62] Furthermore, as long-term investors, prudent management of plan assets arguably requires taking measures to ensure good governance practices prevail that support a healthy economy, stable capital markets and investor confidence.[63] These views were reflected in submissions made to the Senate Standing Committee on Banking, Trade and Commerce in 1998 chaired by the Honourable Michael Kirby (Kirby Commission) as well as the Commission's statements supporting institutional investor activism.[64]

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[57] Ontario Teachers' Pension Plan, *2003 Annual Report* at 1. Available at http://www.otpp.com/web/website.nsf/ar03_index.html.

[58] Stapledon, *supra* note 13 at 21.

[59] *Ibid.* at 5.

[60] The OECD's *Principles on Corporate Governance* (2004) (Part I, section F) state in part: "...Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights..."

[61] Tan, *supra* note 6.

[62] *See e.g.* Stephen Foerster, "Institutional Activism by Public Pension Funds: The CalPERS Model in Canada?" in Ronald J. Daniels & Randall Morck, *Corporate Decision-Making in Canada* (Calgary: University of Calgary Press, 1995) 379 at 381.

[63] See Yaron, *supra* note 1; James P. Hawley & Andrew T. Williams, *The Rise of Fiduciary Capitalism*: *How Institutional Investors Can Make Corporate America More Democratic* (Philadelphia: University of Pennsylvania Press, 2000).

[64] Report of the Senate Standing Committee on Banking, Trade and Commerce on *The Governance Practices of Institutional Investors* (November 1998) chaired by the Honourable Michael Kirby.

In the U.S., no express obligation requires trustees and investment managers to exercise their rights as shareholders; however, ERISA makes clear that an investment policy that contemplates corporate engagement activities as part of a pension plan's investment strategy is consistent with a trustee's statutory fiduciary duties provided the trustees determine that such action is likely to influence the value of the company's stock on a cost-benefit basis:

> "Activities intended to monitor or influence the management of corporations in which the plan owns stock is [sic] consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved...such a reasonable expectation may exist in various circumstances; for example, where plan investments in corporate stock are held as long-term investments or where a plan may not be able to easily dispose such an investment..."[65]

ERISA is also clear that this position applies with respect to both actively and passively managed portfolios.[66]

A review of Institutional Investors in the UK, commissioned by the Chancellor of the Exchequer in 2000 (Myners Report), found a lack of active intervention by institutional investors in companies even where there was a reasonable expectation that such intervention would enhance the value of investments.[67] Principle 6 of the UK government's response to the Myners Review endorsed the view that pension plans should have a shareholder activism strategy:

> The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Trustees should also ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.[68]

In its response, the UK government signaled that it would introduce ERISA-like regulation if voluntary measures did not result in marked increases in pension shareholder activism. According to the Government's follow-up survey conducted in 2004, a mere 9% of occupational pension schemes were found to "have acted on activism and either established their own policy, or been influenced in their choice of Investment Manager by the policies they offered in this area."[69]

In October 2002, the Institutional Shareholders' Committee, which includes representation from the British National Association of Pension Funds, also issued a statement of principles on the responsibilities of institutional shareholders and their agents.[70] While the statement is not law, it requires that "both institutional shareholders and agents will have a clear statement of their policy on activism and on how

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[65] *Supra* note 52.

[66] 59 Fed. Reg. 38860,38862: "This standard would not be different for portfolios designed to match the performance of market indexes (sometimes referred to as 'index funds'). In such funds, the investments are often held on a long-term basis and the prudent exercise of proxy voting rights or other forms of corporate monitoring or communications may be the only method available for attempting to enhance the value of the portfolio." *See also* Richard H. Koppes and Maureen L. Reilly, "An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing" (Spring 1995) 20(3) *J. of Corp. L.* 413 citing *Donovan v. Cunningham,* 716 F.2d 1455, 1474 (5th Cir., 1983), *cert. denied,* 467 U.S. 1251 (1984); *Buccino v. Continental Assurance Co.,* 578 F.Supp. 1518, 1521 (S.D.N.Y. 1983); *Katsarow v. Cody,* 744 F.2d 270, 276 (2d Cir. 1984); *Public Service Co. of Colo. V. Chase Manhattan Bank,* 577 F. Supp. 92, 104 (S.D.N.Y. 1983); *Citizens and Southern Nat'l Bank v. Haskins,* 327 S.E. 2d 192, 197 (Ga. 1985): "the trustees of a modern pension plan have a clear and specific duty to monitor all equity holdings."

[67] Paul Myners, *Institutional Investment in the United Kingdom: A Review* (London: HM Treasury, 2001).

[68] HM Treasury and Department of Work and Pensions, *Myners Review: Institutional Investment in the UK – The Government's Response* (2001).

[69] Horack et al, *supra* note 16 at 106.

[70] Institutional Shareholders' Committee, *The Responsibilities of Institutional Shareholders and Agents – Statement of Principles* (2002). Available at http://www.abi.org.uk/Display/File/38/Statement_of_Principles.pdf.

they will discharge the responsibilities they assume." Specific responsibilities to be addressed are also enumerated. A recent survey of local authority pension funds and investment managers in the UK found that 13% of 55 funds regarded themselves to be in full compliance with the ISC Statement of Principles reflecting a similar level of activism as demonstrated in the UK government survey.[71] According to one author, the Statement of Principles was warmly received by the UK government and will likely figure into any new legislative requirements.[72]

In conclusion, while no definitive statement of law exists in Canada on point, the emerging view supported by American law and British pronouncements is that prudence dictates the need to establish and oversee a policy of engagement to be applied in instances where poor corporate practices have the potential of adversely impacting shareholder value.

3.3. Do these obligations extend to corporate social and environmental practices?

There have been no statements made by Canadian regulators regarding the application of general principles on corporate engagement and proxy voting with respect to social and environmental practices of companies. The better view would appear to be that where there is a reasonable expectation that social and/or environmental issues might or do present a material consideration for a company, intervention is appropriate. Certainly, where issues are brought to a vote, the obligation to evaluate the potential impact of the issue on corporate performance would apply to social and environmental issues to the same extent as it does to other governance issues.

This view would seem to be in accord with statements by the US Department of Labor (DOL), the body responsible for regulating pension plans in the United States. According to the DOL, the responsibility to vote proxies extends to *all* matters subject to a vote, including issues pertaining to corporate governance, and corporate social and environmental practices:

> "Active monitoring and communication activities would generally concern such issues as the independence and expertise of candidates for the corporation's board of directors and assuring that the board has sufficient information to carry out its responsibility to monitor management. Other issues may include such matters as consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans, *the corporation's investment in training to develop its work force, other workplace practices and financial and non-financial measures of corporate performance*."[73] (emphasis added)

3.4. To what extent may pension trustees delegate these responsibilities?

As stated, pension regulation specifically provides that a pension plan's investment policy must indicate whether responsibility for voting proxies is to be delegated.[74] However, the regulations do not specify a prudent process of delegation or require a plan to articulate a process. Similarly, the law makes no specific reference to the delegation of responsibility for corporate engagement.

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[71] Stuart Imeson, *Delegating Shareholder Engagement – Local Authority Pension Funds and Fund Managers: A survey of policy and practice* (West Yorkshire: Local Authority Pension Fund Forum, July 2004)(Interim Report) at 3.

[72] Presentation by Mario Conti entitled "Shareholder Activism and Regulation" given to the Association of Pension Lawyers Annual Conference (London: 15 November 2002).

[73] *Supra* note 52.

[74] *Supra* note 44.

Pension trustees have a duty at common law not to delegate their responsibilities (*delegates non potest delgare*).[75] This prohibition arose from concerns that fiduciaries might attempt to escape liability by delegating responsibility to a third party, thereby frustrating the purpose of the trust.[76] The interpretation of this principle has relaxed somewhat in recognition of the complexities involved in administering a large, institutional trust, such as a pension plan. Pension statutes in several jurisdictions expressly permit delegation by the plan administrator to an agent, while requiring that the fiduciary personally select the agent, be satisfied of the agent's suitability to perform the requisite tasks, and carry out prudent and reasonable supervision of the agent.[77] In jurisdictions whose statutes are silent on the issue of delegation, the question remains to what extent pension trustees may delegate responsibility for these practices and, where such authority is delegated, what requirements are imposed on trustees.

Trust law requires trustees to retain control over policy decisions while permitting delegation of responsibility for implementing decisions. According to the eminent trust scholar, Donovan Waters,

> "The rule which emerges from the authorities seems to be this: whenever the power, discretion or duty assigned to the trustee requires that a policy decision be made, the trustee must make it himself. A policy decision is one which, if dispositive, determines how much and at what time a beneficiary takes; if administrative, it directly affects the likelihood of the trust's object or purpose being achieved."[78]

In *Wagner v. Van Cleeff,* the court held that trustees have a duty to supervise their agents. In that case, the plaintiff appointed respondent V as trustee of her deceased sister's estate at the recommendation of respondent W, a lawyer that V had recommended to the plaintiff. W later absconded with the estate's funds. On appeal reversing the trial judge, the court found that V had breached his duty by delegating entire responsibility for the administration of the estate to W and failing to supervise W's actions. In the court's words, "an administrator who puts the assets of an estate in the hands of an agent and takes no steps to ensure that the assets are properly dealt with has breached the duty to supervise."[79]

Similarly, the case of *R. v. Blair* focused on a breach of the 10% concentration rule, limiting a pension plan from investing more than 10% of plan assets in one particular investment. Enfield Corporation (E) owned a number of subsidiaries, including Federal Pioneer (FP). FP had a pension plan for its employees that was overseen by a pension committee appointed by E. The committee comprised the President and CEO of E, a vice-president from FP, and the president of another of E's subsidiaries who was also an external director of E. The committee appointed an investment manager for the plan who purchased two million common shares of E for the plan in violation of the 10% concentration rule.

The trial judge held that the committee was the plan administrator for the purposes of the *Pension Benefits Act* and was criminally liable for failing to supervise the investment manager. This decision was reversed on appeal on the basis that the committee was not deemed to be the plan administrator for the purpose of the Act and therefore could not be liable under the provision. However, the court did clarify that the trustee may not delegate "the control process because this represents the ultimate responsibility it has assumed to ensure that the plan is properly managed. Control responsibilities consist of regular

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[75] *Boe* v. *Alexander*, *ibid.*; *Re Floyd* [1961] O.R. 50, 26 D.L.R. (2d) 66 (Ont. H.C.); *Re Blow* (1977), 18 O.R. (2d) 516, 89 D.L.R. (3d) 721 (Ont. H.C.).

[76] For a history of the duty not to delegate, *see* Koppes and Reilly, *supra* note 66 at 427-429.

[77] *Pension Benefits Standards Act,* R.S.B.C. 196, C.352, s.8(7-8); *Pension Benefits Act,* C.C.S.M., c.P32, s.28.1(6-8); *Pension Benefits Act,* S.N.B. 1987, c. P-5.1, s.8(1-3); *Pension Benefits Act,* N.S.R.S. 1989, c.340, s.29(4-6) as amended 2000, c.29; *Pension Benefits Act*, R.S.O. 1998, c.P.8, s.23(5-7).

[78] Donavan Waters, *Law of Trusts in Canada* (2nd ed.) (Toronto: Carswell, 1984) at 707.

[79] *Wagner v. Van Cleeff* (1991), 5 O.R. (3d) 477 at 484 (Div. Ct.).

policy reviews by the pension committee. Such reviews should be conducted at least once a year."[80] Operational responsibilities, the court noted, can and should be delegated.

According to one legal counsel, *R. v. Blair* stands for the proposition that the duty to supervise is a nondelegable responsibility of pension trustees. Trustees must "select and supervise the agent or employee personally and employ him or her only so far as the matter lies within his or her professional competence."[81] Pursuant to the case law, supervision includes:

- Establishing standards against which performance is judged (in the context of proxy voting, this means setting guidelines);
- Selecting the agent;
- Monitoring performance on a regular basis; and
- Questioning the agent regarding any issues of concern.

While no Canadian case has considered the application of the delegation rule in the context of proxy voting or corporate engagement, the better view is that it extends to all aspects of investment oversight. This is the case in the United States where trustees are obligated to "periodically monitor decisions made and actions taken by the investment manager with regard to proxy voting decisions."[82] According to one senior DOL executive, "*'monitoring and other active investment strategies', in addition to voting,* may be an aspect of the fiduciary duties of the trustees and investment managers of U.S. non-public pension funds."[83] Therefore, where trustees delegate authority for these practices, the pension plan should:

- Establish guidelines as a matter of policy;
- Ensure that the agent has the requisite expertise and capacity to fulfill the tasks responsibly; and
- Monitor compliance with the plan's policies and guidelines.

In practice, Canadian pension plans generally delegate authority in the plan's investment policy to their investment manager or service provider and grant them full discretion on how to vote in all instances.[84] A UK survey of 55 local authority pension funds found that 64% of the funds currently delegate all shareholder engagement activities on UK equities to an external investment manager and receive reports from their managers on a quarterly basis.[85] Observations suggest that practice in Canada is poorer with most pension plans not having proxy voting guidelines and delegating responsibility to their investment manager to be voted at the manager's discretion without any reporting or compliance requirements.[86]

The case is more problematic with respect to corporate engagement. Few pension plans in Canada address corporate engagement in their investment policy and their intermediaries consequently often act without delegated authority.[87] In contrast, 42% of 55 local authority pension plans surveyed in the UK

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[80] *R. v. Blair* (1995), O.J. No. 3111 at para. 213 (G.D.)(QL), rev'g (1993), 106 D.L.R. (4th) 1 (Ont. Prov. Div.)

[81] Roberto Tomassini, "Fiduciary Responsibilities" in Koskie et al., *supra* note 46, 23 at 25.

[82] *Supra* note 52. *See also* cases cited in Koppes and Reilly, *supra* note 66 at 427-429.

[83] Stapledon, *supra* note 13 at 6 citing Koppes and Reilly, *supra* note 66.

[84] SHARE, *supra* note 12.

[85] Imeson, *supra* note 71 at 4.

[86] SHARE *2003 Key Proxy Vote Survey*, *supra* note 12.

[87] Gil Yaron and Freya Kodar, *How to Incorporate Active Trustee Practices into a Statement of Investment Policies and Procedures* (Vancouver: SHARE, 2002). Available at www.share.ca.

have a formal written policy on corporate engagement with a wide variation observed in each policy's level of detail and the extent to which each covers corporate governance, social, environmental and ethical issues.[88]

Delegation without instruction has several significant implications for the interests of plan members. First, investment managers have a greater tendency to vote in accordance with the recommendations of corporate management. According to Geoffrey Stapledon, US empirical studies of voting behaviour on anti-takeover proposals (generally found to be wealth-decreasing for shareholders) have found evidence of a bias towards pro-management voting by institutional investors having actual or potential business ties with the companies concerned."[89] Investment managers are often in a conflict situation in these instances because they manage assets or other related business for the same corporations for which they are voting the proxies of their investor clients.[90] The late commissioner of the SEC, Paul Carey, commented in 1999:

> "Unfortunately, sometimes, fund advisers may not do more, because, to do more, might conflict with the interests of the adviser. A fund adviser could have an economic interest to vote the fund's shares to please company management, even if such a vote might not be in the best interests of the fund. This could be because a fund adviser might manage – or hope to manage – the retirement plan of a company whose stock is owned by the fund. If the fund adviser wants the pension business of XYZ Company, or it wants to continue to manage XYZ's pension business, it might think twice before voting against the recommendation of XYZ's management – even if voting against the recommendation could increase the value of the funds' holdings. Clearly, this result is contrary to a fund adviser's fiduciary duty to the fund and its shareholders."[91]

Second, absolute delegation of authority normally means that pension funds do not receive any information about the issues under consideration by corporate shareholders. Consequently, beneficial owners remain uninformed about the business and affairs of the corporation and their potential material impact on firm performance and share value.

In keeping with the principle that trustees should not divest themselves of the trust[92], where responsibility for voting proxies and engaging corporations is delegated to an agent, trustees should retain the ultimate discretion to exercise these responsibilities directly. This point was alluded to in the case of *Cowan* v. *Scargill,* where the court noted the absence of any discretion in the pension plan's investment policy allowing the trustees to deviate from a proposed policy that would exclude investments in energies other than coal.[93]

If one accepts the foregoing, a significant number of trustees are arguably in breach of their duty of care for failing to establish guidelines for corporate engagement and proxy voting and monitoring their agents' performance, where responsibility for these activities has been delegated. Again, lack of attention to this

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[88] Imeson, *supra* note 71 at 4.

[89] J.A. Brickley, R.C. Lease and C.W. Smith, "Ownership Structure and Voting on Antitakeover Amendments" (1988) 20 *Journal of Financial Economics* 267; J. Brickley, R. Lease and C. Smith, "Corporate Voting: Evidence from Charter Amendment Proposals" (1994) 1 *Journal of Corporate Finance* 5; T. H. Payne, J.A. Millar and G.W. Glezen, "Fiduciary Responsibility and Bank-Firm Relationships: An Analysis of Shareholder Voting by Banks" (Working Paper, Department of Finance, University of Arkansas, 1995).

[90] *See e.g.* Daniel Brooksbank, "ING adopts "more active" voting policy" (April 22, 2004) *Investment & Pensions Europe (www.ipe.com).* According to Baums, *supra* note 31 at 15, some proxies for foreign shareholders of Dutch companies "have refused to vote against management's positions, despite instructions, because of their concerns for business relationships with the company."

[91] Stephen I. Erlichman, "Canadian Institutional Investor Activism in the 21st Century: The Sleeping Giants Awaken" (Draft: November 8-9, 2003) at 5. Presented at the 9th Queen's Annual Business Law Symposium at Queen's University, Kingston, Ontario. See also findings of the Government Accountability Office (2004).

[92] Tomassini, *supra* note 81 at 25.

[93] *Cowan* v. *Scargill* [1985] 1 Ch. D. 270, [1984] 2 All E.R. 750.

issue is arguably due, in part, to the absence of guidance or enforcement by Canadian pension regulators.[94]

3.5. To what extent do agents incur a fiduciary obligation to plan members when responsibility is delegated to them?

With significant numbers of Canadian pension plans delegating their shareholder responsibilities to intermediaries, it is necessary to consider whether the fiduciary obligations of pension trustees extend to agents of the plan. Certain provinces impose the same standard of care on the pension plan's trustees, agents, and employees.[95] For jurisdictions that are silent on this issue, common law dictates that the extension of fiduciary obligations to a voting agent depends on the nature of the principal-agent relationship.

The courts have indicated that the principal-agent relationship is one of the prerecognized categories of fiduciary relationship, however not all actions are necessarily fiduciary in nature. Whether a particular action is deemed to have a fiduciary quality will be determined on a case-by-case basis on the particular facts in question.[96] The courts have yet to settle on a firm test or set of indicia for ascertaining whether a fiduciary relationship exists. In the leading fiduciary case, *Hodgkinson v. Simms*, the Supreme Court of Canada found the defendant investment advisor had breached his fiduciary duty by advising his client to purchase real estate without disclosing the defendant's relationship to the developer through whom he received a commission for attracting investors.[97] In a very wide-ranging decision borrowing on statements of the court from earlier cases, the majority made reference to the existence of a "power relationship" where the beneficiary reposes his trust and reliance in the fiduciary[98], maintaining the reasonable expectation that the agent will act solely in the interests of the beneficiary. Contradicting earlier decisions by the court, the majority stated that vulnerability is not a prerequisite element, but merely an indicia of a fiduciary relationship.

The degree to which the beneficiary has placed trust and confidence in the agent depends on extent of the responsibilities delegated. Where an agent is given discretion about how to act, the law would suggest that the agent is deemed a fiduciary with respect to performance of that discretionary act.[99] In such instances, the principal may be viewed to have placed his/her trust in and relied on the agent to exercise his/her discretion for the benefit of the principal. Put in the context of corporate engagement and proxy voting, agents given discretion to decide how to vote will be deemed to be acting in a fiduciary capacity. Where a pension plan provides guidelines to its investment manager and monitors the manager's compliance, discretion is absent, except possibly in specific instances where the guidelines are silent on an issue and the manager is given the discretion to determine how to vote in that instance. While some degree of reliance remains in this instance, there is arguably no power relationship and therefore no fiduciary relationship.

Where a fiduciary relationship is found, certain obligations flow. Agents as fiduciaries have an obligation to act in the best interests of the principal and to fully disclose all information to the principal.[100] This requires that voting agents apply their minds to consider what the interests of their client's members are with respect to each vote. It also requires managers to fully disclose their guidelines and records to their

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[94] American regulators have carried out some compliance studies and enforcement under *ERISA*. *See* Stapledon, *supra* note 13 at 29-30.

[95] Ontario PBA*, supra* note 79*,* s. 22(8); BC PBSA, s.8(8); Manitoba PBA, s.28.1(8); New Brunswick PBA, 18(3); Nova Scotia PBA, 29(6); Ontario, s.22(8).

[96] *Hodgkinson* v. *Simms,* [1994] 3 S.C.R. 377.

[97] *Ibid.*

[98] *See also Lafrenier v. Bouffard,* [1929] 4 D.L.R. 183 (Sask. C.A.).

[99] *Alwest Properties Ltd. V. Roppelt* (December 17, 1998), Doc. Edmonton 9603-06070 (Alta. Q.B.).

[100] *Upper Canada College v. Jackson* (1852), 3 Gr. 171 (U.C.C.A.); *Ring* v. *Potts* (1903), 36 N.B.R. 42.

clients. It is suggested that a failure to meet these responsibilities constitutes a breach of the agent's fiduciary duty where such exists.

In the United States, delegation of responsibility for voting to an external money manager results in "the obligation to vote rest[ing] with the money manager unless the trustees have expressly retained the voting right."[101] Comments by the past Chair of the Securities Exchange Commission, Harvey Pitt, uphold this position of a duty of loyalty by the investment advisor to their client. According to Pitt, "[we] believe, however, that an investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with...its fiduciary duties under federal and state law to act in the best interests of its clients."[102] And yet, one study confirms long held suspicions that managers tend to oppose shareholder proposals and side with management on social or political issues. Nine of the top 10 American investment managers surveyed, accounting for 66% of total pension equities, "promised to vote with management or to abstain on such issues" ostensibly regardless of the implications of the issue to the corporation.[103]

Furthermore, investment managers and proxy voting services will likely be held to a higher standard of care when voting proxies than plan trustees by virtue of their professional expertise and the fact that they are paid for their services:

> "In the case of an agent who is paid for his services, a higher standard is exacted than in a case of an agent acting without reward. The care, skill or diligence required is not merely that which the agent in fact possesses, but rather is such as is reasonably necessary for the due performance of his undertaking. If he is an agent following a particular trade or profession, and holding himself out to the world for employment as such, he represents himself as reasonably competent to carry out the business which he undertakes in the course of such trade or profession. He must then show such care and diligence as are exercised in the ordinary and proper course, and such skill as is usual and requisite, in the business for which he receives payment."[104]

In conclusion, trustees have a fiduciary obligation to put in place and to supervise a prudent process for the voting of proxies. There is some support for the view that this extends to corporate engagement activities as well. The better view would be that these responsibilities apply with respect to any matter relating to the business and affairs of enterprises in which the plan invests, including social and environmental practices. Where trustees delegate these responsibilities, they must select, direct and supervise the agents. Agents in many jurisdictions have the same fiduciary responsibilities as trustees. In others, the nature of the relationship and the responsibilities which arise in relation to it will depend on the degree of discretion afforded to the agent and the specific facts in each case.

4. LEGAL BARRIERS TO COMPLIANCE

The preceding discussion reveals a fiduciary obligation of pension trustees and their intermediaries to ensure that plan proxies are voted in a prudent and responsible manner. There is also some support, particularly from the United States, that suggests an obligation exists to develop, implement, and monitor a policy on corporate engagement to the extent that it can reasonably be expected to influence investment performance. If such obligations exist, why, as surveys suggest, do the majority of pension plans not have policies and processes addressing these practices?

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[101] Stapledon, *supra* note 13 at 6. *See also supra* note 52.

[102] William Baue, "SEC Chair Calls Proxy Voting a Fiduciary Duty" (March 29, 2002) *www.socialfunds.com.* Available at www.socialfunds.com.

[103] Burton Rothberg, *Analysis and Implications of the New Proxy Voting Rules for Mutual Funds* (Financial Executives Research Foundation: New Jersey, 2004).

[104] *Metropolitan Toronto Pension Plan v. Aetna Life Assurance Co. of Canada* (1992), 98 D.L.R. (4th) 582 at 597 (Ont. G.D.).

The answer is found, in part, in a number of legal barriers that impede pension trustees from properly exercising their obligations. This section identifies these barriers, grouping them into three categories: Legal barriers that impact both proxy voting and corporate engagement activities; legal barriers that hinder the voting of proxies; and legal barriers that specifically affect corporate engagement efforts. In addition, a number of significant non-legal barriers are identified.

4.1. General Legal Barriers

4.1.1. Lack of one uniform set of rules

Proxy voting and corporate engagement are governed by a complex and overlapping set of rules in corporate and securities law. Corporate law covers the rules for filing shareholder proposals, shareholder communications and certain aspects of voting proxies (e.g. the rule that prevents shareholder's from voting against routine management proposals). Securities law governs disclosure requirements for proxy circulars and vote totals. In addition, federal and provincial governments exercise overlapping jurisdiction in these areas. Consequently, different rules may apply to shareholders depending on the jurisdiction in which a company is incorporated.

Much has been written about the creation of one national securities regulator, but there has only been backroom discussions about a national corporate regulator. Similarly, tensions exist between corporate and securities regulators over how to distribute responsibilities for corporate governance. In the absence of any movement in these areas, the lack of one set of rules and clear jurisdictional authority continues to foster confusion, increase the costs associated with proxy voting and corporate engagement by requiring compliance with different regimes, and create an inequitable environment for shareholders of different companies in Canada.

4.1.2. Short and inconsistent deadlines

The time between the circulation of proxy voting materials to registered shareholders, transmission to the beneficial shareholder and deadline for voting of shares means that beneficial shareholders and their voting agents often have very limited time to consider issues and cast their votes. Regulations in Canada require that proxy circulars be issued at least 30 days prior to the vote; however, in practice beneficial shareholders often receive the materials less than two weeks in advance. In the case of foreign equities, the time can be considerably less. Consequently, trustees and voting agents have little time to make decisions. Where the plan administrator faces competing priorities, voting can take second place.

With respect to filing shareholder proposals, shareholders face a complex array of deadlines depending on the jurisdiction in which the company is incorporated. Some deadlines are tied to the anniversary date of the annual general meeting while other jurisdictions link it to the date of the Notice of Meeting. Each jurisdiction sets its filing deadline according to a different prescribed number of days from the reference date. The result is that filing deadlines vary from jurisdiction to jurisdiction and company to company. Federal regulations now require federally incorporated companies to disclose the filing deadline for the following year in the proxy circular, however compliance with this requirement is not uniform.[105]

4.1.3. Lack of transparency

As in other areas of corporate governance, lack of transparency remains a significant barrier to shareholder activism. In regards to proxy voting, the failure of company's to disclose vote totals in a timely manner and the refusal of investment managers and voting agents to publicly disclose their proxy voting guidelines and voting records continue to frustrate pension plans.

Until March 2004, companies were not required to disclose vote totals to shareholders or the public. In Fairvest Corporation's annual survey, Canadian Western Bank and Cinram International Inc. both

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[105] CBCA Regs., *supra* note 27, s.57(z.9).

expressly refused to disclose vote totals publicly.[106] In response to the refusal by issuers to provide this information to the market, the Canadian Securities Administrators recently introduced a disclosure requirement as part of new continuous disclosure obligations under National Instrument 51-102. As of March 31, 2004, NI51-102 requires all non-venture reporting issuers to "promptly" file a report with the regulator (on SEDAR) following a shareholder meeting providing a brief description of each matter voted on and the outcome of the vote, including the number or percentage of votes cast for, against or withheld where the vote is conducted by ballot.[107] A compliance survey of disclosure practices under the new rule indicates great disparity in the promptness and quality of disclosure amongst companies on the S&P/TSX Composite Index. The Canadian Coalition for Good Governance's survey of 172 S&P/TSX Composite Index companies with annual meetings held after March 31, 2004, found that more than half took over 5 days to report vote totals. According to the survey, "76 (51.4%) of those companies reporting had 'show of hand votes' for directors and 83 (56.1%) for auditors. For companies reporting the voting results of other resolutions, this number was dramatically lower as 22 out of the 99 companies with resolutions (22%) reported voting via a show of hands."[108]

As an aside, although Canadian law allows a shareholder to request a poll at an annual general meeting in order to ascertain the exact vote, most votes continue to be conducted by a show of hands. A show of hands means that only those shareholders represented at the AGM have their votes counted. A vote by show of hands does not recognize anyone who votes in advance of the meeting, nor the number of votes being cast by person's that are present at the meeting and vote by show of hands. In practice, a show of hands is generally not contested because the majority of votes are cast in advance of the meeting making the outcome known. However, the practice voting by a show of hands impacts the perception of shareholders. Without vote totals being disclosed, shareholders may be left with an inaccurate picture of the views of the company's ownership. The Pension Investment Research Council in the UK has recommended that the system of show of hands be abolished.[109]

Another critical barrier is the lack of disclosure of proxy voting guidelines and voting records by investment managers. Many pension plans do not receive compliance reports from their investment managers describing how proxies were voted. Where reports are provided, quality varies considerably. In addition, the issue of whether voting guidelines and records should be disclosed publicly continues to be hotly contested. Proponents assert that such disclosure is needed by prospective clients to better inform the manager selection process. Furthermore, they contend that disclosure will lead intermediaries to place more attention on corporate governance. Opponents argue that such information is proprietary and confidential. Concerns are also raised about the potential adverse impact of an "activist" reputation on a management firm's other areas of business.[110] Investors respond that many managers do not provide such information to their clients on a regular basis and public disclosure provides an efficient and uniform means of ensuring that all investors are receiving the same information in a timely manner.

In 2003, the US Securities Exchange Commission addressed investor concerns by adopting a set of rules requiring all mutual funds and investment advisors to publicly disclose their proxy voting guidelines and records as of August 31, 2004.[111] Following recommendations in a June 2000 report to the Canadian Securities Administrators[112], securities regulators are now considering a new provision as part of

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[106] Tan, *supra* note 34 at 2.

[107] National Instrument 51-102 (Continuous Disclosure Obligations), s. 11(3).

[108] CCGG, *supra* note 41; Janet McFarland, "Shareholders deserve disclosure of vote tallies" (February 25, 2004) *Globe & Mail* B2.

[109] *Supra* note 51, provision 4(1).

[110] Stapledon, *supra* note 13 at 30-31.

[111] 17 CFR Parts 239, 249, 274 and 275 (Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies).

[112] Stephen I. Erlichman, "Making it Mutual: Aligning the Interest of Investors and Managers – Recommendations for a Mutual Fund Governance Regime in Canada" (the Erlichman Report) (June 2000) cited in Erlichman, *supra* note 94 at 10.

proposed National Instrument 81-106 (Investment Fund Continuous Disclosure) that would impose similar requirements on Canadian mutual funds. This also accords with the position of the Standing Committee of the International Organization of Securities Commissions (IOSCO) that "public disclosure of CIS ("collective investment scheme") practices relating to corporate governance both encourages proper exercising of rights and allows CIS investors to make informed investment decisions."[113]

Currently, both proxy voting and corporate engagement are hampered by a lack of reliable information on which to base assessments about the corporations in which pension plans are invested. With respect to corporate engagement, pension plans must incur additional costs in order to obtain information where inadequate disclosure is provided by companies, particularly with regards to information about social and environmental practices, necessary to evaluate the value of pursuing an engagement strategy.[114] A UK government survey of pension trustees found that less than one in five believe that companies are providing sufficient information to enable interested parties to assess effectively environmental and social impacts and risks.[115] Studies in the United States reviewing environmental disclosure compliance bear out this perception.[116]

4.1.4. Conflicts of Interest

As discussed, investment managers may find themselves in a conflict of interest when pursuing the interests of both pension clients and corporate clients for whom they manage investments. Similarly, private sector plan administrators may find themselves in a conflict situation when having to consider issues related to their company or related companies. Stephen Erlichman summarizes the situation as follows:

> "...Canadian institutions have not taken public activist roles in the past...because of potential conflicts that consciously or unconsciously may have affected the decision to take an activist role. These conflicts could be merely the clubby relationship between certain Canadian institutional shareholders and the boards of directors or management of portfolio companies, but it is also probable that there may be real economic conflicts which act as disincentives against institutional shareholders taking and activist role."[117]

At the international level, the International Organization of Securities Commissions (IOSCO) has recognized the potential conflict of managers (referred to as "operators") in relation to all "collective investment schemes" (CIS):

> "18. CIS operators must be aware of their obligations to the CIS and the potential for conflicts of interest when they exercise shareholder rights or otherwise become involved in corporate governance on behalf of a CIS."[118]

Managers argue that they have adequate procedures in place to deal with conflicts and that eliminating all such conflicts is not possible because it would prevent them from representing investor and corporate clients. However, a prohibition on such conflicts would be similar to existing restrictions on lawyers who must conduct conflicts checks prior to being retained by a client. In the absence of such regulatory

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[113] Technical Committee: Standing Committee 5 Investment Management, *IOSCO Report – Collective Investment Schemes as Shareholders: Responsibilities and Disclosure* (2002) 25 OSCB 4509 (Request for Comments), c.6.

[114] *Infra* note 119.

[115] Chris Gribben and Adam Faruk, *Will UK Pension Funds Become More Responsible* (JustPensions, January 2004) at 3.

[116] Government Accountability Office, *Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information* (July 2004) GAO-04-808; Michelle Chan-Fishel, *Third Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical, and Utilities Companies* (San Francisco: Friends of the Earth, July 2004); Sanford Lewis & Tim Little, *Fooling Investors & Fooling Themselves: How Aggressive Corporate Accounting & Asset Management Tactics Can Lead to Environmental Accounting Fraud* (Oakland, CA: Rose Foundation, July 2004).

[117] Erlichman, *supra* note 94 at 4.

[118] *Supra* note 116.

measures, the best means for pension plans to ensure that managers are voting and actively engaging companies in the interest of plan members is to provide guidelines to their managers and to monitor compliance.

4.1.5. Investment options of pension plans

The vehicle chosen for investing pension assets can often have a direct impact on access to the proxy and engagement options. Currently in Canada, more than $200 billion dollars, or one third of trusteed plan assets, are invested through pooled funds -- an investment vehicle that combines the assets of a number of investors in a fund managed by an intermediary.[119] With such investments, pension plans do not have direct access to the proxy nor do they have rights as shareholders in stocks held by the fund. Consequently, the company has no legal obligation to recognize them. Depending on the nature of the pooled vehicle and the number of contributors, determining the percentage of the pooled fund or a specific stock within the pooled fund that is owned by an individual contributor can be difficult. Hence, all rights are exercised at the discretion of the manager.[120]

The problem is also present for members of defined contribution pension plans. As of 2000, there were 554 defined contribution (money purchase) plans registered in Canada representing 156,000 members with total gross assets of CDN$15.378 billion.[121] For these individuals, retirement contributions are invested by each plan member individually in any number of pooled investment vehicles (e.g. mutual funds) selected by the pension plan. The plan member is a unitholder of each fund in which he/she invests with no direct rights as a shareholder in the companies owned by the respective fund. The mutual fund is the beneficial shareholder and the investment manager exercises the attendant rights at its discretion.

These two arrangements pose a formidable barrier to mobilizing a significant portion of retirement capital in Canada and speak

to the need to address the way in which ownership rights are handled when setting up a trust or drafting contracts with intermediaries. While the situtation prevents trustees in these instances from exercising rights as shareholders, pension plans may still influence intermediaries managing pooled assets by communicating their preferences to them on issues and requesting voting guidelines, engagement policies and compliance reports.

4.2. Legal Barriers to Voting Proxies

4.2.1. Inability to oppose routine business proposals

The inability for shareholders to cast a vote against the election of directors or the appointment of auditors poses a significant barrier to a healthy corporate democracy. Corporate regulations limit the ability of shareholders to vote for or withhold their vote on such matters.[122] As a result, it is not possible to defeat a candidate for election to the board.[123] If shareholders cannot influence a company on these matters, what justification is there as a fiduciary to invest the time and resources necessary to vote? This situation

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[119] Statistics Canada, *Canada's Retirement Income Programs 1991-2001* (Ottawa: Statistics Canada) at table 9. Available in CD-ROM. Catalogue no. 74-507XCB.

[120] The author is aware of one instance where a manager has agreed to manually process a portion of the votes in a pooled fund for an individual institutional investor for a fee based on their ownership stake in the fund.

[121] Statistics Canada, *supra* note 122 at table 13.

[122] CBCA Regs, *supra* note 27, s.54(7).

[123] Shareholders representing a prescribed percentage of outstanding voting shares may nominate a dissident slate of directors, however the process is onerous and rarely utilized. Cite provision.

contributes to the general apathy amongst investors who elect not to vote their proxies. While some institutional investors choose to withhold their vote as a sign of protest, the impact is nominal.[124]

4.2.2. Lack of Confidential Proxy Voting

A related issue is the lack of confidentiality in the proxy voting process. When investors vote their proxies, the company typically is able to observe the vote results in advance of the shareholder meeting and to communicate with dissenting shareholders in order to encourage them to change their position. A confidential proxy voting policy prevents the company from obtaining knowledge of the vote in advance of a shareholder meeting, except under prescribed circumstances (e.g. a hostile take-over bid).

Recognizing the inherent conflicts in the investment industry, supporters of confidential proxy voting argue that the firm's ability to track shareholder voting leads intermediaries to vote in favour of management's position because they do not want to be seen as opposing management. In contrast, opponents of confidential voting assert that mandatory disclosure would result in a reduction of votes cast as managers abstain from voting entirely in order to avoid offending clients.[125] A recent study examining the impact of the adoption of confidential proxy voting policies on voting practices with respect to a sample of shareholder and management proposals found no significant effect on voting outcomes calling into question the material significance of the issue.[126]

4.2.3. Selling of voting rights

It is common practice for pension plans through their investment managers to engage in the lending of securities. Securities lending involves the temporary transfer of securities on a collateralized basis. For a fee, securities are transferred temporarily from one party, the lender, to another, the borrower; the borrower is obliged to return them either on demand or at the end of an agreed term. The supply of securities into the lending market comes mainly from the portfolios of beneficial owners, such as pension and other plans and insurance companies.

The lending of securities has an influence on active investing because it often involves the absolute transfer of title along with the voting rights associated with the shares against an undertaking to return the equivalent securities at some time in the future. In this way, pension plans relinquish their rights in the companies which they own. If shares are kept by the borrower until after a company's record date – the date on which the company closes the list of shareholders eligible to vote at an upcoming meeting - the lender may not vote the shares even if they are returned prior to the actual date of the vote. Similarly, shares that are not returned prior to a prescribed date may prevent a shareholder from filing a proposal. Accordingly, investors with securities out on loan must constantly balance the cost of recalling loaned shares against leaving them out on loan, which raises additional questions in light of the general obligation of pension trustees to vote plan proxies.

This has significant implications when one considers the extent of share lending practices. It is estimated that the balance of securities on loan globally exceeds CDN$2.5 billion.[127] A survey of 39 members of the International Corporate Governance Network in January 2004 found that "80 percent of the responding institutions lent shares. Of those, more than 10 percent of their portfolios on average were out on loan at any one time during the year. Lending activity peaked at 25 percent to 50 percent, apparently during principal proxy seasons, which take place in spring in most countries. Despite the prevalence of share lending, the committee found that most lenders do not recall shares for the purpose of voting them.

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[124] Tan, *supra* note 34 at 3.

[125] Stapledon, *supra* note 13 at 30-31.

[126] R. Romano, "Does Confidential Proxy Voting Matter?" (2003) 32 *Journal of Legal Studies* 465.

[127] For a fuller treatment of the issue *see* Mark C. Faulkner, *An Introduction to Securities Lending* (2004). Available at www.bba.org.uk.

Furthermore, most investment managers and beneficial owners lending shares have no actual knowledge of when and how many shares have been lent."[128]

4.2.4. Share blocking

Corporate law generally requires that anyone voting shares be a shareholder on the date of the Shareholders' Meeting. In order to achieve this otherwise sound objective, many European countries require that shares be 'blocked' from trading for five to ten days after the meeting date. The International Corporate Governance Network (ICGN) is critical of this requirement because they argue it imposes significant costs and inconvenience on shareholders, preventing them from trading or depositing shares in a designated institution for a period of time, while providing little incentive for cross-border voting. [129] Furthermore, many European countries only permit registered shareholders to vote.

In contrast, other countries – such as Canada, the United States and Japan – employ a record date to determine who holds the voting rights associated with a share. Those who own the shares as of a prescribed date hold the rights to vote the shares at the annual general meeting even if they subsequently sell the shares in between the record date and meeting date. According to the ICGN, this approach is rejected by Continental European theoreticians who argue it permits those with no further economic interest in the company a say in its affairs. Britain has developed a compromise by setting the record date as close as possible to the date of the Shareholders' Meeting (48 hours). This approach has been found to have some practical drawbacks, but it is anticipated that they will be overcome by advances in technology. According to the International Corporate Governance Network, "...the continued requirement to block shares... creates a powerful disincentive to vote, ultimately disenfranchising institutional investors and perhaps many individuals as well."[130]

4.3. Legal Barriers to Corporate Engagement

4.3.1. Lack of dispute resolution process for shareholder proposals

When shareholders file proposals with a company incorporated in Canada, the company may refuse to circulate the proposal to shareholders for a number of prescribed reasons.[131] The only recourse for shareholders in such instances is to go to court to seek an application to have the proposal circulated; a time-consuming and costly option, which few pension plans can justify as part of a fiscally prudent engagement strategy. An alternative approach adopted by the SEC is the creation of an alternative dispute resolution mechanism which provides a faster, low-cost administrative approach to addressing disputes.[132] The lack of an efficient dispute resolution process for shareholders of Canadian companies creates a disincentive for pension plans to engage corporations because as fiduciaries they cannot justify the cost of enforcing their rights as shareholders.

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[128] Clearfield, "Why is Stock Lending a Governance Issue? And Why Now?" (March 5, 2004) *Friday Report* at http://www.issproxy.com/articles/2004archived/073.asp. The author is aware of one large Canadian manager that recalls lent shares to vote as part of its long-term investment orientation irregardless of the short-term associated cost.

[129] Letter from Peter C. Clapman (Chairman, International Corporate Governance Network) and John C. Wilcox (Chairman, Standing Committee on Cross-Border Voting Concerning European Commission action on Cross-Border Voting) to Corinne van Ginkel (Ministry of Justice, Netherlands) concerning European Commission action on Cross-Border Voting (May 31, 2002). Available at http://www.icgn.org/organisation/documents/cbv/cbv_letter_van_ginkel_may2002.php.

[130] *Ibid.*

[131] CBCA, *supra* 22, s.137.

[132] Proposals of Security Holders, 17 C.F.R. 240, Rule 14-8 (2001).

4.3.2. Vote results not binding

In addition to the absence of a viable dispute resolution process, shareholders have little incentive to go through the process of filing shareholder proposals because there is no requirement for companies to implement resolutions that receive the support of a majority of votes cast.[133]

4.4. Additional Non-Legal Barriers

4.4.1. Costs

As fiduciaries, pension trustees must always ensure that the steps taken by the plan in order to protect the best interests of plan members are financially justifiable. Costs associated with shareholder activism practices are therefore a concern.

The voting of proxies is a recognized cost of managing plan investments. However, most trustees view proxy voting as an incidental activity to the plan's administration rather than a necessary and accepted cost of operating the plan responsibly. Before simply delegating responsibility for voting proxies to an intermediary, trustees need to balance the fiduciary obligation to implement a responsible process for voting plan proxies and the long-term impacts of voting on the plan's portfolio against the financial realities of the plan. An administrator's decision whether or not to vote should "...take into account the effect that the plan's vote, either by itself or together with other votes, is expected to have on the value of the plan's investment and whether this expected effect would out-weigh the cost of voting."[134] In practice, this is a difficult exercise.[135] If trustees elect to delegate their responsibility to their investment managers, it is important to identify what, if any, explicit or hidden costs investment managers are charging for that service. A similar approach must govern decisions to engage corporations.

Various options for voting proxies are available to pension plans at different costs and trustees can conduct a cost/benefit analysis to determine the appropriate process given the particular characteristics of their plan. For example, a large pension plan might be able to justify retaining the voting of proxies in house, whereas a smaller plan may find this approach cost prohibitive. One academic cites the issue of costs as a rationale for not voting: "Where the cost of exercising the proxy vote outweighs any benefit from casting the vote, it is likely that the plan administrator's fiduciary obligations permit it to not vote those securities."[136] While this might be so in extreme situations, it is clear that the fiduciary duties of pension trustees require that they implement a process for ensuring that proxies are voted responsibly.

There are also a number of ways that pension plans can reduce the costs associated with shareholder activism. Trustees can use existing proxy voting guidelines as a basis for developing their own. In evaluating the merits of various proposals, pension plans can utilize research done and positions taken by other investors such as the Ontario Teachers' Pension Plan, which posts its votes and reasons on its website. Similarly, pension plans can reduce costs associated with corporate engagement by working jointly with other investors.

4.4.2. Free Rider Phenomenon

Cooperation among investors also provides a partial solution to the long-standing free-rider phenomenon. Investors, particularly those with limited resources, have historically elected to let other shareholders address governance concerns, hoping to benefit from improvements to corporate performance at no cost.

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[133] Darcy L. MacPherson, "Shareholder Rights Under the New CBCA Amendments: Drawing the Wrong Lessons from the U.K. and U.S.?" (Draft presented to conference on shareholder rights and remedies at the Faculty of Law, University of British Columbia, 2003 on file with author).

[134] *Supra* note 51.

[135] The UK Department of Works and Pensions survey of 1,580 pension schemes, *supra* note 16, found 15% felt that actions taken on activism had delivered advantages or benefits, while 28% assessed no advantages and half (50%) felt that it was to early to judge.

[136] Dzuro et al, *supra* note 46 at 288.

This approach provides a pension plan with a justification for doing nothing. Investor networks address this problem in part by apportioning the costs associated with an activist strategy amongst a number of investors, although most plans continue to benefit from the actions of a few.

4.4.3. Rational apathy

As the statistics demonstrate, Canadian shareholders demonstrate considerable apathy when it comes to voting. Many historical, regulatory and market factors contribute to this condition some of which are discussed in this section. As described in section two *supra*, the process for voting proxies is complicated and time consuming. Investors may be overwhelmed by the number and complexity of issues they are asked to consider and determine that the costs associated with making an informed decision outweigh the benefits.[137] This is especially so with respect to small and mid-size pension plans that may only maintain a small position with each firm in its portfolio. Results of studies evaluating the impact of proxy voting and corporate engagement on firm performance and equity portfolio returns are mixed[138], and the exercise of assessing the value of such strategies to a pension plan may be costly and difficult. As mentioned, efforts are confounded when activism remains confidential. Nevertheless, when surveyed, 42% of UK pension trustees thought that pension plan activism would lead to substantial improvements in the way companies manage environmental and social impacts within the next ten years, suggesting some optimism and appreciation of the beneficial impacts of shareholder activism.[139]

The voting of proxies is also dependent on the collective action of all investors. Few pension plans can show that their vote independently affected a decision of a firm and subsequently the firm's performance. Therefore, the potential value of voting by a plan is dependent on the assumption that other shareholders will also vote responsibly. In the absence of empirical evidence, trustees are required to take a leap of faith in assuming that all investors will vote, thereby overcoming the collective action problem and that the voting will have a material influence on corporate decision-making. In addition, the fact that pension trustees serve outside of their professional capacity without pay limits the time they have to commit to governing the plan. More immediate concerns around funding and benefits administration occupy what limited time they have. Items that have less immediate and observable impact on plan performance are delegated or often ignored altogether.

In Canada, another significant reason for voter apathy is the prevalence of dual class share structures.[140] Most institutional investors hold a very small position in most companies, especially in the case of companies with dual class share structures. Shareholders of companies with two or more classes of shares, where a minority of individuals maintain voting control, do not vote because they believe that their vote will have no impact on the governance of the firm. Fairvest Corporation reports that average turnout of subordinate voting shares in 2004 was 58.0%, 5.5% less than total average voter turnout amongst S&P/TSX Composite Index companies. This contrasts with average turnout of 94.3% for multiple voting shares, which are generally controlled by management.[141]

4.4.4. Deference to intermediaries

As discussed in section three, Canadian pension trustees have traditionally elected to delegate the voting of proxies and corporate engagement entirely to investment managers (and in some instances, proxy voting services) as part of the responsibility of managing the plan's investment portfolio. Although trustees have a statutory obligation to review the plan's investment policy annually, there is no information on how many spend time reflecting on the specific provisions governing the voting of proxies. As noted

[137] Baums, *supra* note 31.

[138] See studies *supra* note 5.

[139] Gribben, *supra* note 115 at 3.

[140] Shareholder Association for Research and Education, *Second Class Investors: The Use and Abuse of Subordinated Shares in Canada* (Vancouver: SHARE, April 2004).

[141] Tan, *supra* note 6 at 3.

earlier, the majority of Canadian investment managers report that 85% or more of proxies are voted at their discretion. This delegation of ultimate authority over the voting process would appear to be a breach of the trustee's fiduciary standard of care.

5. PRUDENT POLICIES FOR SHAREHOLDER ACTIVISM

Having reviewed the law governing proxy voting and corporate engagement and identified barriers to these practices, the issue is what constitutes a prudent policy for managing these aspects of a pension plan's investment policy. It is well established at common law that investment decisions by pension trustees are evaluated based on the process of selecting investments, not investment performance.[142] Therefore, pension trustees should be focused on the process applied in developing their approach to proxy voting and corporate engagement. The following section suggests elements of five-step processes for proxy voting and corporate engagement that support the efforts of pension trustees to meet their fiduciary obligations in a prudent, efficient and effective manner, emphasizing the retention of ultimate trustee control over the processes.

5.1. Five Step Fiduciary Process for the Oversight of Proxy Voting

5.1.1. Develop a proxy voting policy and proxy voting guidelines

Developing a proxy voting policy and proxy voting guidelines is a critical first step to ensure a consistent and accountable voting framework. This step need not be overly time-consuming or costly. Pension plans can use other policies and guidelines as a starting template. Additional resources are also available to help determine what should be included and the questions that trustees need to ask.[143] The International Corporate Governance Network's (ICGN) *Draft Statement on Institutional Shareholder Responsibilities* affirms this approach stating that "voting guidelines need to be adopted to support the applied policy. In developing these, institutional investors are advised to take due account of already existing international and national influential standards..."[144]

No guidelines can be comprehensive and for that reason it is important that the plan's proxy voting policy retain discretion for the trustees to vote proxies directly. Trustees may also wish to attend a shareholder meeting on behalf of the plan in which case access to the proxy is required.[145]

5.1.2. Select the voting agent and enshrine voting guidelines in their mandate

Where the voting of proxies is delegated to the plan's investment manager, it is important to make sure that the manager has the necessary skill and capacity to manage the voting of proxies. As with any act of delegation, trustees have a duty to inquire into the abilities of the agent to ensure that they have the requisite expertise. The investment management industry in Canada is highly competitive and trustees should question managers on their commitment to corporate governance, voting arrangements, including who within the firm is responsible for voting the proxies, whether the firm will agree to use the plan's guidelines or their own, how conflicts are managed, and the quality of compliance reporting. Reports indicate that "some money managers have created formalized procedures and voting guidelines that are

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[142] *American Communications Association v. Retirement Plan,*488 F.Supp. 479, 483 (S.D.N.Y.), aff'd 646 F.2d 559 (2d Cir. 1980); *Donovan v. Walton, Donovan v. Walton*, 609 F.Supp. 1221 at 1238 (D.C.Fla. 1985); *DeBruyne v. Equitable Life Assur. Soc. Of the U.S.,* 920 F.2d 457 (C.A. 7th Cir. 1990), aff'g 720 F.Supp. 1349 ("The fiduciary duty of care requires prudence, not prescience"); *Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan,* 507 F.Supp. 378, 384 (D.Haw. 1980); *Leigh* v. *Engle,* 727 F.2d 113, 124 (7th Cir. 1984); *American Com. Ass'n v. Retirement Plan,* 488 F.Supp. 479 at 483 (1980) citing *Matter of Clark,* 257 N.Y. 132, 177 N.E. 397 (1931); *In re Morgan Guaranty Trust Co. of New York,* 89 Misc.2d 1088, 396 N.Y.S.2d 781, 784 (Sur.1977).

[143] Yaron and Kodar, *supra* note 87.

[144] International Corporate Governance Network, *ICGN Statement on Institutional Shareholder Responsibilities* (August 9, 2003) at 5. Available at http://www.icgn.org/documents/ShareComm-Guidelines.pdf.

[145] CBCA, *supra* note 22, s.153(5): "If a beneficial owner so requests and provides an intermediary with appropriate documentation, the intermediary must appoint the beneficial owner or a nominee of the beneficial owner as proxyholder."

basically window-dressing."[146] Therefore, trustees must exercise the same diligence in assessing a manager's capabilities in this area as with other investment management issues.

Where such delegation occurs, investment manager mandates should expressly detail the extent of the responsibilities delegated. "If an investment management agreement fails to delegate this responsibility to the investment manager, then, by implication, it may remain the responsibility of the plan administrator itself."[147]

5.1.3. Assess unique issues on a case-by-case basis

As stated, no guidelines are comprehensive. Unique issues will often arise for consideration that are not addressed in a pension plan's guidelines. For that reason, the pension plan should have a process for assessing such issues on a case-by-case basis as they arise. This may involve striking a proxy voting sub-committee or some other arrangement that balances the availability of plan trustees with the time required to oversee voting.

5.1.4. Direct the voting of proxies

As a matter of contract, trustees have the ability to require managers to vote all proxies. Stapledon argues that the ability to include such requirements in contract refutes the need for a government-imposed compulsory voting regulation.[148] However, this ignores the fact that many smaller plans may not have the necessary bargaining power, especially when it comes to requiring a manager to apply the plan's voting guidelines.

5.1.5. Monitor voting compliance

As discussed, trustees have a fiduciary duty at common law to monitor the performance of their agents. In the context of proxy voting, this requires that trustees receive compliance reports from their voting agents on a regular basis and that they inquire where the voting contravenes the plan's guidelines. The ICGN recommends that institutional investors "should as a matter of best practice disclose to [their] beneficiaries... regularly evaluate the performance of [their voting] agent on the basis of detailed reports and ensure that the institutional investor can override agent decisions if need be."[149] The quality of reporting by managers varies considerably and trustees need to ensure that they are receiving information in an intelligible and efficient manner.

Without such monitoring, voting agents have little reason to be concerned about compliance. As Stapledon notes in his paper, "there is little legal incentive for money managers to take their voting responsibilities seriously, because plan beneficiaries have not brought any actions for breach of fiduciary duty based on failure to vote, or failure to vote in an informed or proper manner."[150] Furthermore, Canadian regulators do not track voting practices as part of pension plan audits.[151]

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[146] Stapledon, *supra* note 13 at 29 citing J.C. Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 *Columbia Law Review* 1277 at 1353.

[147] Dzuro et al., *supra* note 46 at 287.

[148] Stapledon, *supra* note 13 at 28.

[149] ICGN, *supra* note 144 at 6-7.

[150] Stapledon, *supra* note 13 at 29 citing E.B. Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Georgetown Law Journal* 445 at 476-478 and A.F. Conard, "Beyond Managerialism: Investor Capitalism?" (1988) 22 *University of Michigan Journal of Law Review* 117 at 151-152.

[151] See Stapledon, *ibid.* for a review of the US Department of Labor's efforts in this regard.

5.2. Five Step Fiduciary Process for the Oversight of Corporate Engagement

5.2.1. Set policy, parameters and means of evaluating performance

A pension plan's investment policy should authorize the practice of corporate engagement, identify roles and responsibilities, and means of evaluating performance. Specifically, it is recommended that a plan's investment policy consider:

- The fiduciary duty of trustees to act in the long-term best interests of plan beneficiaries, with specific reference to the importance of engaging corporations in order to minimize investment risk;
- Criteria used to determine whether or not to engage a corporation (often reference is made to the plan's proxy voting guidelines);
- Authorization for trustees, plan staff, investment managers and/or consultants to engage corporations and specify approaches to be used;
- Responsibilities for coordinating and implementing the plan's engagement strategy; and
- Subject to any legal restrictions, any authorizations permitting cooperation with other shareholders, possibly through networks, in developing and executing engagement strategies.

5.2.2. Set agenda and delegate responsibilities

With the basic parameters for a plan's engagement strategy articulated in policy, pension trustees may work with their service providers and possibly other shareholders to develop a specific engagement agenda, identifying issues, companies and general approaches to be taken. Responsibilities should be delegated as required subject to any limitations set out in the plan's policy and the legal obligation of trustees to retain oversight over the process.

5.2.3. Research

Prior to dialogue with a company, research is required to fully understand the material impact of the issue on the investment and to identify best practices for risk management. A variety of resources on corporate practice are available to institutional investors including public documents released by companies, and information collected by service providers, specialized research agencies and proxy voting services.

5.2.4. Engage

Engagement can take a variety of forms depending on the nature of the issue, stakeholders, time and resources available. Whether pension plans elect to write letters, enter into dialogue with corporate representatives or file shareholder proposals, consideration must be given to the time and resources required to adequately prepare and conduct follow-up with the company. It may also be necessary to adopt a number of alternative strategies and consideration should be given at the outset to the potential of the exercise to further or hinder the interests of plan members and the plan's ability to stay the course. For example, if a company refuses to act on demands during face-to-face meetings, is the pension plan legally permitted to file a shareholder proposal and does it have the resources necessary to attend the annual general meeting and gather support from other shareholders? If the proposal is rejected by the company, is the shareholder prepared to take the necessary measures to have the proposal reconsidered, including circulating the proposal itself, going public with the issue, or going to court to get an order requiring the company to circulate the proposal?

5.2.5. Monitor and evaluate progress

As discussed, evaluating the effect of proxy voting and corporate engagement on a plan's portfolio is difficult. Some studies of large pension plans in the United States suggest a positive effect; however, the evidence is by no means conclusive. Accordingly, trustees should have a process in place to monitor and evaluate their policy and strategy, including a review of compliance by those to whom tasks are

delegated, corporate responses to concerns raised by investors, vote results on proposals and compliance by companies, and a review of studies evaluating the performance of companies in relation to the governance issues raised by the plan.

6. CONCLUSION

Pension trustees have a fiduciary obligation to act in the best interests of plan members. The impact of recent corporate scandals on capital markets has highlighted the fact that protecting the interests of plan members and beneficiaries extends to pension plans exercising their shareholder rights as a means of fostering good corporate governance and confidence in capital markets. Some jurisdictions have affirmed the role of the pension plan as shareholder through rules governing shareholder participation in corporate governance and statements interpreting the long-standing duties of pension trustees in the context of voting proxies and other shareholder activist practices. This review of the law in Canada, United States and the UK suggests that Canadian pension trustees have an fiduciary obligation as part of prudent and loyal stewardship to oversee the voting of proxies, including establishing policy and monitoring voting in the best interests of plan members in a manner that recognizes the financial limitations of the plan. There is also evidence to support a similar obligation with respect to corporate engagement with the companies that a pension plan owns, although the law is less precise in articulating the scope of this obligation. Yet, the fiduciary principles of prudence and loyalty adhered to so rigidly in the context of other pension plan investment practices generally continue to be ignored when it comes to voting proxies and corporate engagement. Even where pension plans recognize these practices as part of prudent trusteeship, legal and practical barriers hinder their implementation. It remains for pension regulators and trustees to focus the pension industry's attention on facilitating the participation of pension plans in corporate democracy as a contribution toward maintaining healthy capital markets, a stable economy, and the long-term term interests of plan members.