



# 2009 **MODEL PROXY- VOTING GUIDELINES**

**Disclaimer:** These guidelines are provided as a model for pension funds in developing their proxy-voting policies and procedures. They are not to be taken as legal advice. Pension funds are strongly advised to seek independent legal and financial advice in developing their proxy-voting procedures to best suit the interests of their plan members.

**About these guidelines:** These guidelines have been developed by SHARE as a model for use by Canadian pension funds. The guidelines are written in the first person—“[the fund]”—to make them similar to guidelines that would be adopted by a board of trustees.

In addition to having a set of proxy-voting guidelines, pension funds should also ensure that plan documents provide the appropriate authority for trustees to execute or delegate the execution of their voting rights and that procedures for proper accountability are in place. For information about the incorporation of proxy-voting policies in plan documents, please refer to the SHARE publication *How to Incorporate Active Trustee Practices into Pension Plan Investment Policies*. More information about proxy-voting procedures and how to order publications is available on the SHARE website at [www.share.ca](http://www.share.ca).

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**The views expressed in this document are those of SHARE and do not necessarily reflect the views of the Advisory Committee, their organizations or affiliates.**

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## FOREWORD

The Shareholder Association for Research and Education (SHARE) is pleased to release its 2009 Model Proxy-Voting Guidelines.

SHARE's Model Proxy-Voting Guidelines are a set of responsible voting policies that set a high standard investors can use when they vote on proposals made by management and shareholders. The Guidelines spell out the factors that long-term investors should consider when they evaluate the acceptability of company auditors and director nominees, as well as what they expect from boards regarding executive pay and a host of other issues.

As in past years, the Guidelines highlight the many serious concerns investors have about corporate conduct on social and environmental matters that impact their investments. The Guidelines are in keeping with our understanding of the United Nations Principles for Responsible Investment, to which SHARE is a signatory.

Decision-makers who are responsible for pension funds and other funds invested in public company shares are currently coping with unprecedented challenges. They know that providing public companies with well informed feedback when they vote their shares is more important than ever.

SHARE reviews its Guidelines every year to ensure that they equip shareholders with the information they need on corporate governance best practices. This year, SHARE went back to the basics, taking a particularly hard look at guidelines on the issues that most frequently appear on proxy ballots. In many cases, the decision was made to move the bar higher for 2009 in an effort to drive home the importance of solid corporate governance practice.

Proxy voting is an investment decision. I believe that the Guidelines can be very useful to trustees as they decide what corporate decisions they will and will not support, and shape their proxy-voting policies accordingly. In doing so, trustees can play a crucial role in protecting the economic security of working Canadians.

Kenneth V. Georgetti

**Chair, Board of Directors**

Shareholder Association for Research and Education

# 01

## GENERAL PRINCIPLES

### Proxy-voting responsibilities

[The fund] manages its assets in a manner that will provide benefits to plan participants and their beneficiaries over a span of many decades. Consequently, [the fund's] actions must support these parties' long-term interests.

Equities held by [the fund] usually carry voting rights. Voting rights are valuable assets of [the fund]. Trustees have an obligation to ensure that shares owned by the plan are voted in a way that supports their participants' interests over the long term.

### Duties of loyalty and prudence

The trustees of [the fund] and anyone appointed to vote proxies on the trustees' behalf have a duty of loyalty to exercise their proxy-voting authority solely in the interests of plan participants and beneficiaries. They have a duty of prudence to exercise their proxy-voting authority with the care, skill, and diligence that a prudent person would exercise in managing the property of others.<sup>1</sup> Failing to vote the plan's shares, voting without consideration of the effects of the vote, or voting arbitrarily with or against management violates these duties. Those who are responsible for voting [the fund's] shares also have a duty to take reasonable steps to ensure that they receive and act on the proxies for all [the fund's] shares in a timely manner.

The duties of loyalty and prudence also mean that trustees, and the service providers to whom they delegate their voting authority, have a duty to communicate to the companies in which the plan invests about which courses of action would, in the trustees' view, be in the best interests of plan participants. This includes encouraging companies to adopt the current best practices in corporate governance and corporate social responsibility, because such practices will enhance shareholder value in the long term.

### Application of these guidelines

[The fund] will vote its proxies in accordance with these proxy-voting guidelines. These guidelines apply to companies in Canada and in other countries.

<sup>1</sup>The definition of the duty of care varies from province to province. The definition above complies with the general spirit of all of them. However, fiduciaries should consult the specific definition for their province.

In deciding how to apply the guidelines, [the fund] will consider the circumstances of each vote as well as the general principles contained in these guidelines. If it is not clear how to apply the guidelines for a particular vote, decisions on how to vote should be based on what will best serve the long-term interests of plan participants and their beneficiaries. This may include deviating from these guidelines if doing so would best serve participants' interests in the long term. Those responsible for voting may need to seek out information from a variety of sources and consult with trustees to determine what is in the long-term interests of plan participants and beneficiaries.

- [The fund] will vote in a manner that is consistent with the duties of loyalty and prudence, and with the current best practices in corporate governance and social responsibility.
- Above all else, [the fund] will always vote in the best long-term interests of its participants and their beneficiaries.

If questions arise about the application or interpretation of these guidelines for any issue, they should be resolved in consultation with [the fund's] trustees by taking the course of action that will best serve the long-term interests of participants and beneficiaries.

[The fund] will not attempt to manage companies by shareholder referendum, and will ensure that any attempts to influence a company do not harm its financial viability.

### Retention of voting authority

In cases where [the fund] delegates its voting authority to external investment managers or a proxy-voting service, it reserves the right to direct the vote on any particular resolution or issue.

### Annual review of guidelines

The best practices and standards for corporate governance and corporate social responsibility evolve over time, and new proxy issues emerge each year. These guidelines will be reviewed, updated and approved by [the fund's] investment committee on an annual basis.

# 02

## INSTRUCTIONS FOR VOTING PROXIES

We encourage funds to put their instructions or procedures for voting proxies in this section of the guidelines. Instructions and guidelines vary greatly from fund to fund, depending on the extent to which responsibility for proxy voting is delegated, and how and to whom it is delegated. For more information or guidance on proxy-voting procedures see *A Guide to Incorporating Active Trustee Practices into Statements of Investment Policies and Procedures* on SHARE's website at [www.share.ca](http://www.share.ca).

Any investment manager or adviser who, under the terms of a contract, is responsible for voting the stock held by [the fund] is expected to follow these proxy-voting guidelines in making voting decisions. Where the guidelines call for decisions to be made on a case-by-case basis, voting agents should base their decisions on what would best serve the plan's participants in the long term. If a voting agent believes the interests of participants would be best served by deviating from the guidelines, [the fund's] trustees should be consulted before such a vote is cast.

### **Reporting requirements and transparency**

[The fund] will make these guidelines available on request to all companies in which we invest, to any plan participant, and to the public. [The fund's] full voting record is available on our website or by request from [the fund].

Where voting decisions have been delegated, trustees must monitor these voting decisions as part of their duty to manage [the fund] in the best interests of the plan members. The fiduciary responsible for voting should report regularly to the trustees on how each proxy was voted. This report should include a written account of the reasons for the votes, any instance in which [the fund] authorized a vote that deviates from these guidelines, and the outcome of the votes at the shareholders' meeting. [The fund] and its voting fiduciary will agree on the details, timing, and frequency of these reports at the beginning of the fiduciary's contract and will review their agreement annually.

# 03

## CORPORATE GOVERNANCE

### General guidelines

Good corporate governance is based on the relationships between the shareholders, the board of directors or supervisory board, and the management of a company. The shareholders are the company's owners. The company's management, led by the CEO, runs the company and works for the shareholders. The board of directors or supervisory board acts on behalf of the shareholders to oversee management. The relationships between these three bodies are vital to a company's success.

#### Amendments to articles of incorporation or articles of association

All major changes in a corporation should be submitted to a vote by shareholders.

Proposals to amend a corporation's articles of incorporation or association are often made in response to changes in the rules, laws, or regulations affecting the corporation, such as changes in stock exchange listing rules. Most of these changes are of a technical or administrative nature and will not affect shareholders' interests. However, the wording of these amendments must be carefully considered because small changes in the wording of an article can have a significant effect on corporate governance.

Management often combines multiple amendments into a single item to be voted on in the proxy ballot. This makes it impossible for shareholders to approve some amendments and vote against others. [The fund] encourages companies to give shareholders the opportunity to vote separately on all amendments.

- [The fund] will assess on a case-by-case basis proposals to amend articles of incorporation or articles of association, with primary consideration given to how the proposals affect shareholders' long-term interests.
- In cases where shareholders must vote on a group of amendments as one item, [the fund] will vote against the entire group of amendments if it has objections to any of the amendments.

#### Approval of "second" or "casting" votes

Some companies include in their bylaws a provision that allows the board or committee chair to cast the deciding vote in the event of a tied vote at a meeting of shareholders, the board, or a board committee. This additional vote is called a "casting vote" or a "second vote." [The fund] is opposed to this practice, because, in certain circumstances, it gives the chair of the board or the committee one vote more than other directors or shareholders.

- [The fund] will vote against amendments to bylaws or articles if they include a provision for a casting vote or second vote to decide tied votes at meetings of shareholders, the board, or a board committee.

#### Approval of financial reports

Proposals to approve the company's financial reports are routine matters at companies outside North America. However, some companies present the reports for which approval is sought only at the shareholders' meeting, rather than sending the reports to shareholders before the meeting. As a result, shareholders who are not present at the meeting do not see the report the companies are asking them to approve. [The fund] finds this unacceptable.

- [The fund] will vote for proposals to approve financial or directors' reports only if the reports are available to all shareholders before the shareholders' meeting.

#### Votes to approve "other business"

Sometimes companies include the approval of "other business" as an item on the proxy ballot without specifying what the "other business" consists of. [The fund] believes approval of such ballot items gives the company broad discretion to act without specific shareholder approval on issues that would otherwise require such approval.

- [The fund] will vote against the approval of unspecified "other business."

### Reports on corporate governance standards and practices

[The fund] believes disclosure helps to improve corporate governance. We will support proposals that ask corporations to report to shareholders on how well their corporate governance practices measure up to the guidelines established by a widely accepted and authoritative set of corporate governance standards.

At a minimum, a corporation's annual report to shareholders should include a statement of the company's governance standards and practices and an evaluation of the effectiveness of these practices.

- [The fund] will vote for proposals to require companies to include in their annual reports a comparison of how well the company's corporate governance practices comply with a widely accepted and authoritative set of corporate governance standards.

### Allocation of profits and/or dividends

Outside of North America, many companies must have the approval of their shareholders to allocate their profits among dividends, compensation for the directors and statutory auditors, and other uses.

[The fund] will approve these allocations unless the dividend payout ratio is consistently below 30% and the company provides no explanation for lower payouts. [The fund] will also oppose dividends that are higher than the company's total profit or that are higher than the company's financial position warrants, because the company would need to take money from its retained earnings or other funds in order to pay them.

- When a company's proposed dividend is higher than the company's total annual profit, [the fund] will vote case by case, based on the company's ability to maintain sustainable operations.
- [The fund] will vote against dividend/profit allocations if the dividends have been consistently less than 30% and no adequate explanation for the lower amount has been given.
- [The fund] will vote against dividend/profit allocations if the dividends are higher than they should be given the company's ability to continue to operate sustainably.

#### *Scrip dividend alternative*

Companies in some jurisdictions may give shareholders a choice of taking their dividend in additional shares instead of cash. This is called a scrip dividend. Scrip dividends allow the company to keep more of its cash in retained earnings, which may

improve the value of the company in the long term. Scrip dividends may also give shareholders certain tax benefits. However, shareholders should be allowed to receive their dividend in cash if they prefer.

- [The fund] will vote for scrip dividend alternative proposals as long as shareholders have the option of receiving the dividend in cash.

### Approve the transfer or use of reserves

Normally, a company that pays dividends and has a financial loss in a given period will pay a lower dividend or withhold dividend payments for that period. However, some companies have a policy to make all dividends the same or nearly the same amount. This is called a "stable dividend policy."

Companies with such a policy may use some of their reserves to pay the dividend or, if shareholders approve, may transfer reserve funds to other accounts in order to cover some of the company's losses. Shareholders should view this practice with caution. If a company is losing money regularly or losing substantial amounts, and if the losses are due to strategic management problems or an economic downturn, the use of reserves to pay dividends or cover losses is not justified because doing so threatens to deplete the company's reserves.

- [The fund] will vote against proposals to transfer reserve funds or to use reserves to pay dividends, unless the financial losses that make this use of reserves necessary are transient and not due to strategic problems within the company.

### Approve legal formalities

These proposals ask shareholders to give management the authority to complete any formalities needed to validate the decisions made at shareholder meetings.

- [The fund] will vote for proposals to approve legal formalities.

## Capital structure

### Share issuances

(Also see "Unequal voting shares and dual classes of shares," page 9.)

[The fund] recognizes that directors need the flexibility to issue shares to address a company's financial needs and conditions. However, it does not support giving directors unlimited discretion to increase the number of shares that may be issued without the consent of shareholders. The term "shares" in this case means shares, share warrants, or bonds that can only be converted into shares.

In some jurisdictions, companies can ask shareholders for blanket authorization to issue shares up to a set percentage of the company's share capital for a fixed term, such as up to 50% of share capital for a term of five years. [The fund] opposes this practice because it does not give shareholders sufficient control over the potential dilution that a blanket authorization could create.

Companies in some jurisdictions, primarily in Europe, routinely place authorizations to issue shares on proxy ballots, regardless of whether or not the companies intend to actually issue any new shares. In these cases, [the fund] will not take the frequency of a company's request for share issuances into consideration. Companies in other jurisdictions, including North America, only ask for the authorization to issue shares when the company intends to issue shares or anticipates that it may need to do so. In determining how to vote on such a request, [the fund] will consider the frequency with which the company requests share issuances.

All share issuances should be made at the market price for the shares at the time they are issued. [The fund] will oppose any issuances of discounted shares.

- [The fund] will vote against proposals to issue shares where the potential aggregate dilution is more than 20% unless the company gives an acceptable business case for issuing additional shares.
- [The fund] will vote against proposals to issue shares where the number of shares to be issued is not specified.
- [The fund] will vote against proposals for blanket authorizations to issue shares for fixed periods of time, unless the proposal sets a cap on the total number of shares that can be issued during that period. The number of shares that can be issued must be no more than 20% of the number of shares outstanding prior to the issuance.
- [The fund] will vote against proposals to issue shares if the shares will be issued at a discounted price, that is, less than their market price at the time of issue.

[The fund] may also vote against share issuance proposals if doing so is warranted by the reasons given for the requests.

#### **Pre-emptive rights**

Outside of North America, companies often issue shares with pre-emptive rights, which allow shareholders to share proportionally in any new issuances of shares in the same class.

- [The fund] will vote for proposals to issue shares with pre-emptive rights if the potential aggregate dilution is 50% or less or if the company provides a sound business reason for the issuance.
- [The fund] will vote on proposals to issue shares with pre-emptive rights on a case-by-case basis when the potential aggregate dilution is more than 50% and the company provides no reason for the issuance.
- [The fund] will vote against share issuances with pre-emptive rights if the amount of shares to be issued is not specified.

#### *Waiving pre-emptive rights*

Companies that issue shares with pre-emptive rights sometimes ask their shareholders to waive their pre-emptive rights for issuances of shares, share warrants, and/or bonds with warrants.

The National Association of French Shareholders opposes waiving pre-emptive rights for shares, because pre-emptive rights protect shareholder value against dilution and give shareholders the ability to sell their subscription rights. However, waiving the pre-emptive rights attached to warrants or bonds does not raise the same concerns.

- [The fund] will vote against proposals that ask shareholders to waive their pre-emptive rights, unless doing so would benefit shareholders in the long term.

#### **"Blank cheque" preferred share issues**

"Blank cheque" preferred shares give the board of directors broad discretion to determine the voting, dividend, conversion, and other rights of these shares. The board may also have discretion to determine the number of preferred shares to be issued. These shares carry a fixed dividend and are better secured by company assets than are common shares.

[The fund] opposes the issuance of "blank cheque" preferred shares, because directors have complete discretion over the conditions of these issuances and because the shares can be used to thwart a takeover bid without presenting the bid to shareholders. If directors can determine the number of shares to be issued, the issuance of blank cheque preferred shares can also be excessively dilutive.

- [The fund] will vote against the authorization of blank cheque preferred shares.

#### **Share buybacks or repurchases**

Share repurchases can benefit shareholders, but only under certain conditions. Share buybacks near or

below book value benefit shareholders. But when stock market values are high, share buybacks provide less benefit to shareholders. The use of surplus cash to buy back shares can add to the volatility of the share price.

Share repurchases also tend to inflate the value of stock options, making executive compensation more expensive to the company. Furthermore, if a company uses earnings per share (EPS) as a measure of executive performance for determining compensation, it can inflate its EPS by repurchasing shares, thereby giving executives an unearned bonus.

European companies usually ask their shareholders for blanket authority to repurchase a percentage of the company's outstanding shares (often 10%), with upper and/or lower limits on prices. Companies may ask for blanket authorization to repurchase a set percentage of their shares as a takeover defence. These requests should be evaluated, as with other takeover defences, for their capacity to protect management at the expense of shareholders. Companies may also set a very high upper price limit for share repurchases or not set an upper limit at all. These proposals could effectively become an authorization to pay greenmail. However, the criteria for determining whether or not the repurchase price is too high depends on the context of the proposal. Thus, these votes must be assessed case by case.

In Japan, share buybacks are used to undo the cross-shareholdings that have protected management against potential takeovers and efforts at corporate reform. In these cases, share repurchases benefit shareholders in the long term regardless of the market conditions in which they occur. However, the company should specify the number or monetary value of the shares it intends to repurchase, so that shareholders can estimate the likely effects of the repurchase on their shares.

Japanese companies are permitted by law to amend their bylaws to allow share buybacks without shareholder approval. [The fund] is opposed to this because buybacks can hurt shareholder value in some circumstances.

- [The fund] will assess share buybacks on a case-by-case basis for their effect on shareholders' interests.
- [The fund] will vote against proposals to repurchase shares if the company uses earnings per share as a measure of executive performance in its executive compensation plans.
- [The fund] will vote against proposals to repurchase shares if the number of shares to be repurchased is more than 10% of the total shares outstanding, or if the company does not specify the quantity of shares to be repurchased.

- [The fund] will vote against proposals to amend a company's bylaws to permit the company to repurchase its own shares without shareholder approval.

### Reissue repurchased shares

Some companies ask shareholders for authority to reissue shares that have been repurchased. This proposal is most common at companies incorporated in Hong Kong, where it is sometimes referred to as a Share Reissuance Mandate. Companies in Hong Kong may also seek to reissue repurchased shares through a General Issuance Mandate that includes authorization for the reissuance.

Companies may seek to reissue repurchased shares to related parties at a discount. [The fund] is opposed to this practice. [The fund] will vote for proposals to reissue repurchased shares only if the shares will be reissued at their market price.

- [The fund] will vote against proposals to reissue repurchased shares unless the proposal stipulates that the shares will be reissued at their market price.

Proposals to reissue shares will also be subject to the same voting guidelines as other share issuances, including limits on the percent of share capital that can be issued. See "Share issuances" on page 7.

### Unequal voting shares and dual classes of shares

Common stock traditionally carries one vote per share. Companies with dual-class share structures or shares with multiple voting rights have a class or classes of shares with more votes per share than the company's common stock. Dual-class share structures allow some shareholders to maintain control of the corporation without holding an equivalent amount of equity. SHARE advocates that, under most circumstances, Canadian stock exchanges ban shares with unequal voting rights. The Pension Investment Association of Canada has taken a similar position.

[The fund] is opposed to unequal voting rights for several reasons. First, they violate the principle of one share, one vote, making it possible for the company to act without the support of a true majority of shareholders. Second, when shares with multiple voting rights are initiated, they are likely to dilute the voting power of shares already issued. Third, it is not in the best interests of the majority of shareholders for one investor or a group of investors to control the corporation without a corresponding financial stake in the company.

- [The fund] will vote against the creation, issuance, or continuation of capital structures with common shares that carry unequal voting rights.

- [The fund] will vote for the replacement of multiple-voting shares with shares carrying one vote per share, unless the terms of conversion are more detrimental to the interests of the holders of subordinate-voting shares than the continuation of the dual-class structure.
- For companies where a dual-class structure is already established, [the fund] will vote for proposals for a mandatory review of the share structure and regular re-approval by shareholders.

## Boards of directors

There are two broad types of corporate board structures. Some companies have a unitary board structure, also known as the Anglo-American model. This consists of a single board of directors that is responsible for overseeing the management of the company on behalf of its shareholders.

Other companies have two boards. The role and makeup of the boards at dual-board companies varies with the jurisdiction. At companies in Japan, Spain, Italy, and some other European companies, one board is a board of directors similar to the board of a unitary company. The second board is a board of statutory auditors, who are formally responsible for ensuring that the company's acts are legal and/or that the annual audit is conducted properly. Companies in Germany and some other European countries are governed by a board of supervisors that includes employees' representatives. The board of supervisors chooses the management board, which is responsible for running the company.

The guidelines below are applicable to all of these types of boards.

### Independent boards of directors

At companies with a unitary board, the company's management is responsible for running the company, and is accountable to the board of directors. The board of directors is responsible for overseeing management's performance in a way that ensures the long-term maintenance of shareholder value. The board is accountable to the shareholders, who are the owners of the corporation.

Directors have a legal obligation to act in the best interests of the company. However, it is difficult for anyone to avoid being influenced by conflicts of interest. This is why boards of directors must be largely independent of the company's management. Directors are not in a good position to hold management accountable if they depend on the corporation for any benefit or consideration other than their stock in the company and the compensation they receive as directors, or if they have a relationship to the company other than as shareholders and directors.

For this reason, two-thirds of the board of directors should be independent, as defined below.

- [The fund] will vote for proposals to require two-thirds of directors to be independent.
- [The fund] will vote for proposals to increase the number of independent directors on the board, unless two-thirds of the directors are already independent. If two-thirds of the directors are already independent, [the fund] will determine how to vote on each case individually based on how the proposal will affect the long-term interests of shareholders.
- If at least two-thirds of directors are not independent, [the fund] will withhold votes from those directors who are not independent. If it is not possible to vote on individual directors, [the fund] will vote against the entire slate of director candidates.

It is often difficult for shareholders to determine whether or not a director is independent. For this reason, [the fund] believes companies should disclose annually whether or not each director is independent and the basis on which that determination is made.

- [The fund] will vote for proposals to require the company to annually disclose whether or not each director is independent and the basis on which that assessment was made.

### *Definition of an independent director*

A director is independent if he or she has no material relationship with the company other than that of director and shareholder. This excludes directors who

- » are or have ever been employed by the corporation or an affiliate;
- » have any contract, agreement, or arrangement with the company that pays the director any compensation or benefits other than the payments that person receives as a shareholder and a director (such as dividends and director's fees);
- » are currently employed, or have been employed within the past five years, by the company's current or former auditor;
- » have an employment or family relationship with any person or entity that does business with the company, including advisers, consultants, accountants, attorneys, investment bankers, customers, or suppliers;
- » have interlocking directorships—that is, executives who serve as directors on the boards of each others' companies;
- » have family relationships with any of the corporation's executives or management employees;

- » are employed by one of the company's customers or suppliers;
- » have a significant interest in the company or is affiliated with, is an insider of, or is designated a shareholder with a significant interest in the company. This includes shareholders who control less than 50% of the company's voting power if they have business transactions with the company or a relationship to management;
- » are indebted to the corporation or any subsidiary in an amount that exceeds US\$60,000 or Can\$100,000, except for bank executives with a residential mortgage from their institution that carries the same conditions and rates provided to customers;
- » are employed by any organization, including a university or research institute, that receives financial support from the company;
- » own an equity interest in or has extended credit to, or have an immediate family member who owns an equity interest in or has extended credit to an entity over which the corporation or any executive officer of the corporation exercises significant control. "Significant control" should be defined with reference to the contractual and governance arrangements between the corporation or executive officer and the entity;
- » have provided, or have an immediate family member who has provided any professional services to any executive officer of the corporation in the last five years; or
- » have any other relationship similar in scope and nature to any of the the relationships listed above.

This definition is similar to the standard definition of an independent Non-Executive Director (NED).

#### Independent Chair of the board

The Chair of the board of directors must be an independent director, as defined above, in order to guide the board in fulfilling its responsibility for overseeing management's performance. No one can carry out both the responsibilities of Chair and those of a senior management position without potential conflicts of interest. Former executives and executives of client or vendor companies also have potential conflicts of interest and should not serve as Chair. This provision includes the president-directeurs general of French companies, because such individuals are effectively both CEOs and board Chairs.

- [The fund] will withhold votes from any director who is not independent if that director is also Chair of the board or if, upon becoming director, he or she would become Chair of the board.

- [The fund] will vote for proposals to require the Chair of the board to be an independent director as defined in the preceding section.

#### Independent lead directors

Some companies whose CEOs are also the board Chair have sought to address concerns about potential conflicts of interest by appointing an independent lead director. However, it is extremely difficult for shareholders to know how much of the chair's job a lead director has assumed, or to what extent the person who still holds the title of Chair actually runs the board.

[The fund] believes that the appointment of an independent lead director may be suitable as an interim step in separating the positions of Chair and CEO, but it is not a substitute for that separation. If a company chooses to appoint an independent lead director as an interim position, that person should serve as lead director for no longer than one year before an independent Chair is appointed.

- [The fund] will not withhold its vote from the Chair and CEO of a company if the board has a lead director who is independent (according to the definition on page 10 of these guidelines) as long as the position of lead director exists for no longer than one year.
- [The fund] will vote for proposals to create an independent lead director position as long as the position exists for no longer than one year.

#### Key board committees

All boards of directors should have audit, compensation, and nominating committees made up entirely of independent directors. These committees are essential in overseeing a company. They are also in the best position to prevent corporate malfeasance and protect shareholder value.<sup>2</sup>

Japanese companies traditionally have not had board committees. However, legislation passed in 2002 encourages Japanese boards of directors to have compensation, nominating, and audit committees with independent members. In Germany, supervisory boards often have committees. These are discussed in the section on supervisory boards that follows.

#### Independent audit committee

A board of directors should have an audit committee that is responsible for oversight of the annual external audit of the corporation. This is required by American

<sup>2</sup> The independence of these committees is inversely related to allegations of corporate fraud. See, H. Azun, S. Szewczyk, R. Varma, "Board Composition and Corporate Fraud," *Financial Analysts Journal* May/June 2004: p. 33–43.

securities law and by Multilateral Instrument 52-110 in Canada. All of the members of the audit committee should be independent directors. The committee members should be free of ties to the company's auditor, including past employment with the audit firm.

Members of the audit committee also need to be financially literate in order to oversee the complexities of the annual audit and deal with the technical aspects of financial information. [The fund] will support training for directors in financial matters.

- [The fund] will vote for proposals to create audit committees in which all of the members are independent.
- [The fund] will withhold its votes from individual directors who are not independent and sit on the audit committee.

#### *Independent compensation committee*

Every board should have a compensation committee that is responsible for the direction and oversight of the company's executive compensation program and for regularly evaluating the performance of senior management. In order to be effective and avoid conflicts of interest, this committee must be made up entirely of independent directors. Directors who are chief executive officers of other companies should not sit on the committee. Members of this committee should not be nominated or selected by management.

If a company's compensation committee includes members who are not independent, [the fund] will give special scrutiny to the company's compensation plans. It may vote against the plans if it believes the committee's lack of independence is influencing the executives' compensation.

Executive compensation is complex and continues to be controversial. It needs to be designed and administered carefully. Directors on compensation committees should be knowledgeable in the field of executive compensation and should obtain training in this area if they are not.

- [The fund] will vote for proposals to create independent compensation committees.
- [The fund] will withhold votes for individual directors who sit on the compensation committee and are not independent of management.
- [The fund] will withhold votes for individual directors who sit on the compensation committee if they are chief executive officers of other companies.

- [The fund] may vote against compensation plans if the compensation committee includes directors who are not independent.

#### *Independent nominating committee*

Boards should have a nominating committee to identify the need for directors and to recruit, nominate, and orient new directors. In order for the board to function independently of management, the nominating committee must be made up entirely of independent directors.

- [The fund] will vote for proposals to create nominating committees made up entirely of independent directors.
- [The fund] will withhold votes from directors who sit on the nominating committee and are not independent.

#### *Corporate governance committee*

A large board of directors should have a corporate governance committee responsible for oversight of the governance of the corporation. This committee should be able to function independently of management. A majority of the members should be independent directors.

- [The fund] will vote for the creation of an independent corporate governance committee.

#### **Statutory auditors**

In some jurisdictions, a board of statutory auditors is responsible for ensuring that the company's actions comply with all applicable laws. All Japanese companies are required to have a board of statutory auditors unless their board of directors has compensation, nominating, and audit committees. The board must include at least three statutory auditors, who are usually elected to three- or four-year terms.

In practice, the role of statutory auditors may be ceremonial. However, the statutory auditors are officially responsible for reviewing the work of the company's outside auditor.

Statutory auditors are often not independent, and when so-called "outsider" statutory auditors are nominated, they may still have close ties to the company. However, many companies are under pressure from international investors to change this practice. [The fund] supports efforts to make boards of statutory auditors independent of management.

- [The fund] will vote against statutory auditors who are not independent, according to the criteria for independent directors given above.
- [The fund] will vote against statutory auditors if there are serious questions or concerns about the company's annual audits, such as

evidence that the auditor's independence has been compromised or frequent restatements of financial reports.

### Supervisory boards

Supervisory boards are most common at German companies, but they can also be found in other jurisdictions. Under German law, companies are accountable first to their employees and creditors and second to their shareholders. The structure of supervisory boards reflects this; employees appoint representatives to half of the positions on the supervisory boards of a company. The other supervisory board members are elected by shareholders. The chair of the supervisory board is typically a shareholder representative.

The supervisory board is responsible for appointing, removing, and overseeing the company's management board, which is made up of executive directors and manages the company. The supervisory board is not involved in the day-to-day management of the company, but its approval may be required for decisions that would substantially affect the company's financial position or financial results. Members of a supervisory board cannot serve on the management board, and vice versa.

The presence of so many employees on the supervisory board means that these boards cannot have the degree of independence, as we have defined it, that [the fund] prefers on unitary boards of directors.<sup>3</sup> German corporate governance includes measures to mitigate potential conflicts of interest on supervisory boards. Supervisory board members cannot, by law, provide any other services to the company without the approval of the supervisory board. Germany's Corporate Governance Code recommends that nominating committees take potential conflicts into account in selecting supervisory board nominees, and that any board member who has a conflict of interest during his or her tenure be removed from the board. The Code also recommends that supervisory boards include no more than two former members of the management board and that former management board Chairs should not be Chair of the supervisory board or any of its committees.

Companies in other jurisdictions may also have supervisory boards. Some of these boards have employee representatives and function much like the boards of German companies. Other supervisory

boards do not have employee representatives. These supervisory boards should meet the same criteria for board independence that apply to boards of directors, as described on page 10.

- At companies where the supervisory board includes worker representatives, [the fund] will vote for members of supervisory boards, unless:
  - more than two members of the board are former members of the management board;
  - the candidate is a former member of the management board and chairs or would chair a supervisory board committee;
  - the candidate has a potential conflict of interest; or
  - voting for the candidate would, for some other reason, not be in the best interests of shareholders.

### Committees of supervisory boards

German supervisory boards are required to have a mediation committee to resolve disputes that may arise from the appointment or dismissal of management board members. Germany's Corporate Governance Code also recommends that supervisory boards have an audit committee, and boards often also have compensation and nominating committees.

The German corporate governance code recommends that no former members of the management board sit on the audit committee.

- [The fund] will vote for the creation of audit, compensation, and nominating committees on supervisory boards provided that these committees are not chaired by former members of the management board or members who have potential conflicts of interest.
- [The fund] will vote against members of the supervisory board if they are former members of the management board and serve on the audit committee.

### Shareholder nominations for director

Currently, it is difficult at best for investors to put forward candidates for director on the proxy ballot. Many investors have sought to change this. At the time these guidelines were being prepared, the rules governing shareholders' right to nominate candidates for director were being reviewed in the United States, and they may change in Canada as well. Voting agents should check the current status of these rules before voting on matters that might be affected by these rules.

[The fund] supports giving shareholders the right to nominate directors, provided that the nominees are

<sup>3</sup> The Trade Union Advisory Committee of the OECD argues that employee representatives on boards are, by definition, independent, because they are independent from management and thus more willing to question the CEO on sensitive issues. Trade Union Advisory Committee, *Workers' Voice in Corporate Governance: A Trade Union Perspective*, Global Unions Discussion Paper series (Paris: OECD, 2005), p. 20.

well qualified and prepared to act in the interests of all shareholders. Shareholders should be required to own between 3% and 5% of the company's shares, either individually or collectively, before they can nominate directors. This threshold discourages frivolous nominations.

Shareholders who nominate candidates for director should provide the same information about their candidates' qualifications, independence, and potential conflicts of interest as companies provide for their nominees. Nominations should be provided to the company in time to include candidate information in the company's proxy information circular and on the proxy ballot.

- [The fund] will vote for proposals to allow shareholders to nominate directors if they include an ownership threshold of 3% to 5% and a requirement that the nominating shareholders provide adequate information to other shareholders about their candidates' qualifications, independence, and potential conflicts of interest.

#### Voting for directors

(Also see "Independent board of directors," page 10, and "Independent nominating committee," page 12.)

- [The fund] will vote for directors on a case-by-case basis, taking into consideration these guidelines and the long-term performance of the corporation and the directors. In addition to the reasons listed in the preceding sections, [the fund] will vote against management's nominees if:
  - the board of directors has consistently not responded to shareholder proposals that have been approved by a majority vote;
  - the board of directors consistently acts in the interests of a particular group of shareholders rather than in the interests of all shareholders;
  - an individual director has a conflict of interest; a conviction for financial, corporate, or securities crime, including insider trading; or a history of serious misconduct, regulatory sanctions, or ethical violations relating to corporate responsibilities;
  - there is evidence that directors have purposely misstated or concealed the financial condition of the company; or
  - the board has regularly failed to exercise its duty of care, such as by approving corporate restructurings that are not in the shareholders' best interests or refusing to provide information to which shareholders are entitled.

There are many other reasons [the fund] might vote against a nominee for director. Other factors to be considered in voting for directors are addressed in following sections.

#### Majority vote for elections of directors

(See also "Cumulative voting," page 15.)

Currently, shareholders of most North American companies cannot vote against directors. Proxy ballots only allow shareholders to vote "for" or "withhold" on director nominees. Some companies count the "withhold" votes as votes against a director, but others do not. The result is that, unless no votes are cast for a nominee, all directors who are nominated are elected, regardless of how many "withhold" votes they receive. In the words of David Beatty, the former managing director of the Canadian Coalition for Good Governance, "Withholding is called a 'precatory' vote. It means your vote is worth diddly."<sup>4</sup> This state of affairs makes it difficult for shareholders to hold boards of directors accountable for their actions.

In the past few years, shareholders have expressed their objections to this arrangement by filing proposals to require that directors be elected by a majority of the votes cast. This would effectively turn "withhold" votes into votes against a nominee and make it possible for shareholders to remove a director from the board. In a variation on majority elections for directors, directors who do not win a majority of shareholders' votes must submit their resignations to the board, which decides whether or not to accept the resignations. This non-binding type of majority election is often referred to as a "Pfizer-style" election, after the American company that first adopted it.

Most of the objections to these proposals have been based on concerns about the consequences of a director nominee losing an election and how a resulting vacancy on a board would be filled. However, removal of a director is not likely to be a common event. British companies elect directors by a majority of shareholders and board vacancies created as a result are rare.

Majority elections may not be the best way to solve some corporate governance problems, such as an insufficient number of independent directors on a board, that are often addressed now by withholding votes from board members. In these cases, shareholders should engage with the company in question before resorting to votes that could remove a substantial portion of the board, even if this outcome is unlikely. In addition, the plurality elections should still be used if an election for directors is contested.

<sup>4</sup> Quoted in W. Lilley, "We're Not Gonna Take It," *Report on Business Magazine, The Globe & Mail*, June 2005, p. 54-64.

[The fund] supports proposals for majority elections of directors because they allow shareholders to actually elect directors, rather than simply confirming the choices of the board. The potential problems created by majority elections are more than outweighed by the benefits of allowing shareholders to hold their boards of directors accountable. Pfizer-style elections are a second choice. They are an improvement over plurality elections, but they still allow the directors to determine who sits on the board, instead of giving that power to the shareholders. If a majority of shareholders vote for a proposal to implement majority elections, [the fund] will not consider the adoption of Pfizer-style majority elections to be an adequate substitute.

- [The fund] will vote for proposals to require that directors receive a majority of affirmative votes to be elected.
- Unless [the fund] has the opportunity to vote for majority elections instead, [the fund] will vote for proposals to require directors who do not receive a majority of affirmative votes to tender their resignations to the board.

#### *Cumulative voting and majority elections for director*

As majority voting for directors becomes more common, considerable debate has occurred about whether or not companies that have cumulative voting in elections for directors should adopt majority votes. Some experts on corporate governance argue that majority elections are incompatible with cumulative voting. Others claim that the two compliment and enhance each other.

The combination of cumulative voting and majority elections for directors clearly decreases each director's chances of being elected. However, if companies have a procedure for addressing vacancies on their board when directors are not elected - as they should - then failure to elect a director is not a serious problem.

- [The fund] will vote for majority elections at companies with cumulative voting, unless the company does not have a procedure in place to address board vacancies that may result.

#### *Elections for individual directors*

Most Canadian companies present their nominees for director as a slate, and shareholders must vote for or against the entire slate rather than voting for each director individually. This practice protects directors whose attendance or performance is unsatisfactory, because shareholders are less likely to withhold their votes from an entire board than they would be to withhold votes from one or a few directors. [The fund] prefers to vote for each director nominee individually.

- [The fund] will vote for proposals to allow shareholders to cast individual votes for each director nominee.

#### *Contested elections for directors*

When an election for directors is contested, the candidates not nominated by the board usually want to make a significant change in corporate policy. In deciding how to vote in contested elections, [the fund] will assess how any policy changes advocated by the opposing candidates will affect the long-term interests of shareholders.

Alternative slates of directors will be given special consideration when the corporation's performance has been inferior to its peers for two years or more, there are reasonable doubts that the current board can improve the situation, and the opposing director nominees have the qualifications and a business plan to improve the corporation's performance.

- In contested elections, [the fund] will assess votes for directors on a case-by-case basis using the criteria described above.

#### **Term limits for directors**

Directors must remain open to new ideas and be willing to critically re-examine the status quo, but must also maintain continuity and focus on the long term. Term limits for directors are used to increase the likelihood that the board will remain open to new ideas and will not become entrenched in the status quo. However, term limits do not guarantee that directors will have this openness and can force valuable, experienced directors to leave the board solely because of length of service.

In general, [the fund] does not favour term limits. They impose an arbitrary limit on directors' tenure regardless of the director's performance, and they tend to inhibit directors from taking a long-term view of a company's performance.

However, there may be instances in which term limits are in the best long-term interests of shareholders, and [the fund] will support term limits in those cases.

- [The fund] will vote against term limits for directors, unless circumstances are such that term limits are in the long-term interests of shareholders.

#### **Directors' ability to devote sufficient time and energy: attendance**

Candidates for director must be able to devote a sufficient amount of time and energy to the board in order to oversee the corporation well. [The fund] rejects the argument that investors should vote

against any director who sits on more than a fixed number of boards; the number of boards a director can serve on effectively depends on that individual's abilities and commitments. However, a director's other commitments, attendance at board meetings, and overall performance as a director can be indicators of his or her ability to serve effectively.

Attendance at board meetings is not the sole determinant of a director's performance, but poor attendance makes it difficult for a director to fulfill his or her responsibilities to the board. Since boards customarily schedule their routine meetings and committee meetings at least a year in advance, anyone who agrees to be nominated for director should be prepared to attend all board meetings.

- [The fund] will withhold votes for directors who appear to have too many existing commitments to fulfill their duties as director. Indications that a director has too many commitments could include serving on more than five other boards and/or employment as a senior officer at another company.
- [The fund] will withhold votes for existing directors if they have missed 25% or more of the board's meetings, including committee meetings, unless extenuating circumstances are set out in the proxy materials.
- [The fund] will vote for shareholder proposals to require companies to disclose directors' attendance at meetings.

### Diversity on boards of directors

In order to foster the long-term success of corporations, boards should include directors with a wide variety of backgrounds and expertise, including women and people from various racial, cultural, and economic backgrounds.

Diversity on a board of directors is not mere tokenism. Women and visible minorities make up more than half of the work force and own roughly a third of all small businesses in Canada.<sup>5</sup> Women also make the majority of consumer buying decisions in North America. Studies of corporate performance have found that companies with diverse boards of directors and senior executives are more profitable than companies without this diversity.<sup>6</sup> The varieties of experience and

5 R. Shaw, "Small Business driving growth, and women are in control," *The Globe and Mail*, 29 June 2005, p. B3.

6 For example, a study of the 500 largest US companies found that those with at least three women directors had higher returns on equity, sales, and invested capital than companies with fewer women on their boards. L. Joy, N.M. Carter, H. Wagner, S. Narayanan, "The Bottom Line: Corporate Performance and Women's Representation on Boards," *Catalyst*, 1 Octo-

perspectives on a diverse board of directors can give a corporation a distinct competitive advantage.

[The fund] generally supports proposals that ask boards to appoint qualified directors in such a way that the board's composition reflects, as closely as possible, that of the country where the company has its headquarters. [The fund] is concerned that implementing specific targets for directors from under-represented groups may result in the target numbers becoming the maximum, rather than the minimum, number of people from under-represented groups serving as directors. [The fund] recognizes, however, that in some circumstances, specific targets may be necessary to improve board diversity.

- [The fund] will vote for proposals to promote greater diversity on boards of directors.
- [The fund] will vote for all well-qualified candidates, unless doing so would violate another guideline.

### Classified boards/staggered terms for directors

On a classified or staggered board, directors are elected for a term that is longer than one year, and their terms are staggered so that only a portion of the directors come up for election each year. Typically, one-third of the board is elected each year for a three-year term. On an unclassified or non-staggered board, all of the directors are elected annually. Classified boards are not common in Canada, but they are quite common in other jurisdictions.

[The fund] opposes classified boards. Classified boards can provide for continuity on a board. However, most boards of directors have relatively little turnover from year to year even without staggered terms. In addition, classified boards reduce corporate accountability to shareholders and make it unnecessarily difficult to change control of a board.

- [The fund] will vote against proposals to adopt a classified board of directors.
- [The fund] will vote for proposals to eliminate classified boards and institute annual elections of all directors.

### Cumulative voting

(See also, "Majority vote for elections of directors," page 14.)

With cumulative voting for directors, each shareholder has as many votes as he or she has shares, multiplied by the number of directors to be elected.

ber 2007. [www.catalyst.org/publication/200/the-bottom-line-corporate-performance-and-womens-representation-on-boards](http://www.catalyst.org/publication/200/the-bottom-line-corporate-performance-and-womens-representation-on-boards).

Shareholders may cast all of their votes for one candidate, or distribute them among any combination of candidates. This makes it easier for a minority of shareholders to elect director nominees of their choice to the board, enhancing the power of minority shareholders to influence the board.

Experts on corporate governance disagree about whether or not cumulative voting is in the best interests of most shareholders. Proponents of cumulative voting see it as a way to discipline directors, ensure minority shareholders a voice in corporate affairs, and give the board some measure of independence from management. This can be especially important when board independence and minority representation are threatened by controlling shareholders. Opponents of cumulative voting argue that it gives a minority of shareholders disproportionate control over the board and violates fundamental principles of fairness and equity. A minority-controlled board may also be preoccupied with the agenda of a special interest group rather than the welfare of all shareholders.

[The fund] evaluates proposals on cumulative voting case by case. At companies where an individual shareholder or a small group of shareholders control the majority of the votes, cumulative voting makes it easier for minority shareholders to have representation on the board. Cumulative voting may also help a previously unresponsive board to be more alert to shareholders' interests and concerns. But in other circumstances, cumulative voting may be inimical to shareholder democracy.

- [The fund] will vote for cumulative voting if the company has a controlling or dominant shareholder or shareholder group, the board has proven to be unresponsive to the interests of all shareholders, or there are other indications that cumulative voting is in the best interests of shareholders.

[The fund] will not alter its voting guideline on cumulative voting for companies that have majority voting for elections of directors.

### Size of boards of directors

The number of directors on a board is a factor in the board's effectiveness. A board needs enough directors to maintain diversity in opinion and expertise, but not so many that the board becomes unwieldy or individual directors lose the opportunity to be heard. In general, a board should have between five and fifteen directors. However, the appropriate number of directors will vary with the size and nature of the corporation. [The fund] prefers boards with odd numbers of directors, because they are less likely to have tied votes. A board cannot carry out all of

its responsibilities effectively with fewer than five directors. It is rare for a board to function well with more than 21 directors.

Fixing the number of directors can limit the flexibility companies may need to alter the size of their boards as they change. Companies that need to add independent directors to their boards may also need this flexibility. However, fixing the number of directors also prevents management from changing the size of the board in order to maintain or enhance its control of the board. [The fund] will give proposals to increase or decrease the number of directors careful consideration.

- [The fund] will vote against proposals to fix the range of the number of directors at fewer than five or more than 21.
- [The fund] will consider voting for proposals to fix the number of directors at fewer than five if the board does not have the usual full range of responsibilities of a public company board.
- [The fund] will vote against proposals to fix or set a range for the number of directors if fewer than a majority of the board's directors are independent.

### Director indemnification

Directors are indemnified when the company pays the expenses of directors who become involved in litigation as a result of their actions as directors.

- [The fund] will vote for proposals to indemnify directors in cases where the company makes a persuasive argument that indemnification is necessary to attract and retain directors, and if the indemnification applies to actions undertaken honestly, in good faith, and with a well-founded belief that the actions are lawful.

### Ratification of the acts of the board and/or auditors

Companies in some jurisdictions require shareholders' approval for the acts of their management and supervisory boards, and/or their auditors, over the previous year. In most cases, this is a symbolic vote that does not release the boards or auditors from liability to the company or its shareholders. Companies may also ask shareholders to release their boards and/or auditors from liability. These votes require greater caution.

- [The fund] will vote for the ratification of the acts of boards, unless it has a reason for serious concern about the board's oversight of the company.
- [The fund] will vote against proposals to discharge auditors and/or directors from liability

if the voting agent or [the fund] has concerns about the actions of either.

### Director compensation

Companies must compensate directors adequately for the time and work required to fulfill their responsibilities. However, directors are in the awkward position of having to establish their own compensation. The potential conflicts this presents can be alleviated to some extent by requiring all compensation packages for directors to be fully disclosed and explained in the annual proxy circular and to be subject to shareholder approval.

Directors' compensation packages should not provide greater compensation than the task of overseeing management on behalf of the shareholders of the corporation warrants. If they do, [the fund] will vote against their approval.

- [The fund] will support proposals to require directors' compensation packages to be fully disclosed and explained in the annual proxy circular.
- [The fund] will support proposals to require directors' compensation packages to be subject to shareholder approval.
- [The fund] will vote against director compensation that is greater than the careful oversight of the corporation's management warrants.
- [The fund] will vote against director compensation if the amounts or details of the compensation are not disclosed to shareholders before the shareholders' meeting.

### Directors' equity-based compensation

Because the board of directors represents the shareholders of a corporation, directors should hold shares in the corporation in order to align their interests with the interests of shareholders. Directors should hold shares in the corporation for the long term, ideally for the duration of their tenure on the board. However, requiring high levels of share ownership without compensation in shares could preclude individuals who are well qualified but not wealthy from becoming directors. Equity-based compensation for directors needs careful scrutiny to ensure that it aligns directors' interests with those of shareholders rather than those of management.

Directors should not be granted stock options, because options tend to align the directors' interests with management rather than shareholders.

Plans to compensate directors with shares should not be structured to encourage short-term holdings. These plans are subject to the same concerns

about appropriateness, dilution, and so forth as compensation plans for management. In all cases, director compensation must be structured in a way that will preserve the independence of the board of directors and promote the long-term interests of all shareholders.

Finally, amendments to directors' compensation plans must be analyzed carefully to ensure that director compensation remains subject to shareholder approval.

- [The fund] will vote against stock option plans that are for or include non-management directors.
- [The fund] will vote against amendments to directors' share-based compensation plans that would allow those plans to be established, renewed, or changed without shareholder approval.

### Retirement benefits for directors and statutory auditors

[The fund] believes that, in general, retirement benefits are not appropriate for directors, because they increase directors' financial reliance on the corporation and may compromise directors' independence. If directors are also employed by the corporation, they may receive pensions for their employment but not for their service as directors.

This guideline also applies to statutory auditors.

- [The fund] will vote against proposals to provide retirement benefits to directors and statutory auditors.

### Severance pay and/or bonuses for directors and statutory auditors

[The fund] believes that bonuses and severance pay are not appropriate for directors or statutory auditors for the same reasons that it is opposed to directors or statutory auditors receiving retirement benefits.

- [The fund] will vote against proposals to provide bonuses or severance pay for directors or statutory auditors.

### Supervisory board compensation

Members of supervisory boards who are employee representatives are not shareholder representatives in the same way that directors are. Thus, they are not subject to the same requirements for share ownership as directors.

Otherwise, the same guidelines for the compensation of boards of directors can be applied to the compensation of supervisory boards.

*Disclosure of directors' compensation*

Details of directors' compensation packages, including an estimate of the value of their equity-based compensation and all other aspects of their compensation, should be disclosed to shareholders, so that shareholders can cast informed votes on their compensation arrangements.

This disclosure should include the compensation paid to individual directors, members of supervisory and management boards, and statutory auditors. Disclosing only the aggregate value of their compensation is not sufficient.

- [The fund] will vote for proposals to disclose all of directors' compensation, including the value of equity-based compensation, to shareholders.
- [The fund] will vote against directors' compensation if that compensation is not disclosed to shareholders in sufficient detail for them to understand fully what directors are being paid for their services.

**Performance evaluations of directors and board**

Boards of directors must evaluate their own performance as a board, as committees and as individual directors. This requirement presents the same challenges and potential for conflicts of interest as the board's obligation to design directors' compensation. In order to evaluate themselves effectively, boards should adopt a written statement of governance principles as a benchmark for their own conduct. They should stay informed about developments in corporate governance and revise their statement of governance principles, as needed, to keep it current. They should also establish performance criteria for themselves and their committees and periodically review their own performances against those criteria.

It is the responsibility of the chair of the board to ensure that these evaluations are carried out on a regular basis. A summary of the board's collective evaluations should be included in the annual proxy information circular.

- [The fund] will support proposals to institute and develop performance evaluations for boards of directors.
- [The fund] will support proposals to include a summary of the board's collective performance evaluations in the annual proxy information circular.

**Training for directors**

The role of director is becoming more complex, and the field of corporate governance has rapidly

expanded to include areas where directors often have little background. Even knowledgeable directors may find that they need additional training in order to guide the company effectively. [The fund] recommends that directors participate in training programs in order to improve their performance and the performance of the company.

- [The fund] will vote for proposals to provide training for directors.

**Shareholder representatives on the board**

Directors should act on behalf of shareholders and should be shareholders themselves. Therefore, the inclusion of shareholder representatives on a board should be unnecessary, since directors are shareholder representatives.<sup>7</sup> Calls for shareholder representatives may indicate that the board needs other changes, such as better communication between shareholders and the board or the election of new directors. However, some forms of shareholder representation can be a useful part of corporate governance.

Shareholder advisory committees are usually established on an ad hoc basis to study and advise the directors on issues of concern to shareholders. These committees are helpful when their scope is limited to specific issues and does not include the day-to-day management of the company or duplicate the work of the board.

Longer-term shareholder committees, also called "shadow boards," are sometimes advocated as a way to add to the board's expertise or increase the board's responsiveness to shareholders. [The fund] prefers to meet boards' needs for expertise by electing directors with the necessary background or providing additional training for directors. If directors are not responsive to shareholders' concerns, the board may need better procedures for communicating between directors and shareholders. Directors who are consistently unresponsive to shareholders should be removed.

- [The fund] will vote for proposals for ad hoc shareholder advisory committees when such committees are needed to study a specific issue and advise the board.
- [The fund] will vote against proposals for longer-term "shadow boards" or shareholder representatives on boards of directors. However, if proposals for "shadow boards" or shareholder representatives are made, [the fund] will consider

<sup>7</sup> We are not referring here to dissident candidates for director. Although they may seek election in order to give shareholders better representation on a board, they seek to do so as directors.

whether or not to give greater scrutiny to the board's performance and to its communications with shareholders.

#### **Auditor independence and the appointment of auditors**

Auditor independence is vital to shareholders. A company's annual financial statement is usually the only independently verified information shareholders have about the company's performance and financial condition. Shareholders must be confident that they can rely on this information and that the auditors who reviewed the information have not been compromised.

From time to time, companies hire their outside auditors to provide them with tax advice or other services. Some of these services are permitted under securities regulations. However, [the fund] believes that hiring the outside auditor to perform other work has the potential to compromise the independence of those auditors. We strongly prefer auditors who have not performed other services for a corporation for which they serve as auditors and do not hold contracts to perform services for the corporation other than the annual audit.

- [The fund] will vote for proposals to prevent the outside auditor from doing any work for the company other than work related to the annual audit, except in those cases where a company's location, the nature of its business, or some other factor severely limits the number of accounting firms it can work with.
- [The fund] will vote against auditors if more than one-third of the fees paid to them in the previous year were for services other than the annual audit, except in those circumstances mentioned above.

#### *Disclosure of audit fees*

At a minimum, companies should disclose all of their relationships with their auditors and all fees paid to their auditors. The fees for auditing and non-auditing services should also be reported. [The fund] considers fees for tax services to be non-audit services. This disclosure is required for Canadian companies.

- [The fund] will vote against auditors if the company does not disclose the fees it paid its auditor for the annual audit, audit-related services, and non-audit services in the previous year.
- [The fund] will vote for proposals to require companies to disclose the fees paid to its auditor for the audit and for non-audit services.

#### *Approval of auditors' fees*

In some jurisdictions, companies must seek shareholders' approval to pay its external auditor.

[The fund] will vote for these proposals unless it has concerns about the auditor's independence, as described in the section on the appointment of auditors on page 11.

- [The fund] will vote for the approval of the auditor's fees, unless there is a reason to question the auditor's independence.

#### *Rotation of auditors*

Companies that use the same accounting firm to conduct their audits for long periods of time run the risk of developing a close relationship that can compromise the independence of their annual audit. [The fund] prefers that companies rotate their audit firms every five to ten years. At a minimum, companies should change their audit partner every five years, regardless of whether or not they are required to do so by law.

- [The fund] will vote against the auditors if the company has kept the same accounting firm as its auditor for more than ten years.
- [The fund] will vote for proposals that ask the company to change audit firms every five to ten years. [The fund] will assess proposals for a greater or lesser period on a case-by-case basis.

#### *Certification of financial statements*

Canadian and American securities regulations require the CEO and chief financial officer (CFO) of a company to certify the accuracy of the company's financial statements. Certifying that their companies' financial statements are accurate makes CEOs and CFOs more accountable to shareholders. It also gives shareholders a greater level of confidence in the financial statements they rely on to make investment decisions.

- [The fund] will vote for proposals to require CEOs and CFOs to certify the accuracy of the company's financial statements, where they are not required to do so by law.

## **Executive compensation**

Executive compensation is a controversial area of corporate governance. Compensation must be attractive enough to draw, motivate, and keep qualified executives. However, executive compensation is widely perceived to be excessive. For example, Gary Wendt, the former Chair and CEO of GE Capital Services, told a gathering of corporate directors in the United States, "Right now, executive compensation, particularly [for the] chief executive, is out of control."<sup>8</sup>

<sup>8</sup> "Executive Compensation: Getting Ready for the CD&A," *Directorship*, Online edition, Feb/March 2007, [www.directorship.com/executive-compensation--cd-a/](http://www.directorship.com/executive-compensation--cd-a/).

Directors are under growing pressure to be careful in setting executive compensation. In some cases, courts have permitted shareholders to sue directors for excessive executive compensation. High levels of executive compensation have also been found to correlate with financial misrepresentation. A 2005 study showed that high levels of executive pay substantially increased the probability that a company would misreport its financial results.<sup>9</sup> Directors face not only pressure from executives for increased compensation but also greater risks if they pay their executives too much.

[The fund] does not intend to design executive compensation plans; this is the job of the independent compensation committees. However, in cases where we believe that executive compensation has been consistently excessive, we may vote against the compensation committee or the entire board of directors. Furthermore, we intend to give executive compensation close scrutiny at all companies.

Executive compensation plans must also be consistent with the long-term interests of shareholders. These plans are usually complex and must be tailored to the company, the industry, and the individual executive.

#### Executive compensation and performance

Executives are motivated to excel when their compensation is tied to their performance. As a general rule, executive compensation should be based on and reflect performance rather than tenure or other criteria. Above average pay should be reserved for above average performance.

Goals for executive performance should be objectively tied to the company's performance, preferably relative to the performance of other companies in the same industry. Performance goals must be within the control or influence of the employee being evaluated. This excludes goals such as increases in stock price, which are not necessarily within the control of an individual employee and may have little to do with the performance of the company itself. Performance goals should also focus on the company's profitability in the long term. This includes qualitative goals that contribute to long-term shareholder value, such as customer satisfaction, product quality, or employee development.

Executive performance should be evaluated by the board's compensation committee and, when appropriate, with the assistance of an independent group of evaluators. If compensation consultants are used, they should be retained by the board's compensation committee, not by executives or

candidates for executive positions. The consultant should not be engaged by the company for any other services in order to avoid potential conflicts of interest.

Companies that use earnings per share as a measure of executive performance can raise their EPS by repurchasing shares and thus artificially improve their executives' performance, giving them unearned compensation. [The fund] opposes this practice.

- [The fund] will vote for executive compensation plans that it believes are fair, and oppose those it believes are excessive. Compensation plans are fair if
  - they are linked to objective parameters of the company's performance, such as the cost-of-management ratio, return on capital, employee retention, or other relevant measures;
  - they are affordable given the company's overall financial position;
  - they provide an incentive for excellent performance over the long term and do not reward poor performance; and
  - the total compensation for each executive is understandable and reasonable compared to pay levels for comparable positions in the industry and compared to all pay levels within the company.
- [The fund] will vote against executive compensation plans that are not based on performance.
- [The fund] will vote against compensation plans if earnings per share is a significant performance criterion and the company has or asks for the authority to repurchase its shares.
- [The fund] will vote against incentive compensation plans if the company does not disclose the criteria on which the compensation is based. It will also vote against plans when the company's disclosure about the performance criteria is so vague that shareholders cannot determine the criteria used to award performance-based pay.

#### Executive performance and corporate social responsibility

Long-term shareholder value is not measured entirely by annual financial statements. The value of a company includes such factors as the environmental sustainability of its practices, its employees' morale and safety, and the well-being of the communities in which it operates. These factors all contribute to a company's profitability in the long run. For this reason, [the fund] encourages directors to evaluate

<sup>9</sup> J. Harris and P. Bromiley, "Financial Misrepresentation, Executive Compensation and Firm Performance: An Empirical Study," paper presented at the Academy of Management Annual Meeting, August 2005.

executives' contributions to the company's financial, environmental, and social performance. Measures of executives' social and environmental performance should be reasonable, and within the executives' control.

- [The fund] will vote for proposals asking directors to link executive compensation to reasonable measures of performance on social and environmental issues as well as to traditional measures of financial performance.

For further discussion see "Corporate Social Responsibility," page 35.

#### *Performance-based compensation and restated financial reports*

From time to time, companies award performance-based pay to their executives based on financial results that later have to be restated. In other words, the companies' financial results—and the executives' performance—were not as good as originally stated.

In some of these cases, executives have been asked to or required to pay back part of their compensation to reflect the restated financial reports. [The fund] supports this practice. We believe executives should not benefit from inaccurate accounting, and requiring repayment is a good incentive for executives to be cautious about their financial reports.

- [The fund] will vote for proposals to require executives to pay back an appropriate portion of their performance-based compensation when that compensation is based on financial information that must later be restated, unless the restatement does not affect the performance criteria on which the bonuses were based.

#### **Executive salaries and employee wages**

In 2006, the average compensation of the 50 highest-paid executives at Canadian companies was approximately 378 times the average annual income of payroll employees in Canada.<sup>10</sup> This disparity between executives' and workers' salaries has been shown to lower employee morale and productivity, factors that affect shareholder value.<sup>11</sup>

<sup>10</sup> "Top 50 Highest Paid Executives," *The Globe and Mail*, 28 June 2007, [http://www.reportonbusiness.com/v5/content/tp1000-2007/index.php?view=top\\_50\\_execs](http://www.reportonbusiness.com/v5/content/tp1000-2007/index.php?view=top_50_execs); "Seasonally Adjusted Estimates of Average Weekly Earnings, for All Employees, for Selected Industries, Canada, Provinces and Territories, (2003-2007)," Table 2 in *Employment, Earnings and Hours*, Catalogue No. 72-002-XIB (Ottawa: Statistics Canada, 2007), <http://www.statcan.ca/english/freepub/72-002-XIB/72-002-XIB2007007.pdf>, p. 36.

<sup>11</sup> C. Hymowitz, "Pay Gap Fuels Worker Woes," *Wall Street Journal*, 28 April 2008, p. B8; P. Singh and N. C. Agarwal, "Union Presence and Executive Compensation: An Exploratory Study," *Journal of Labor Research* 23, 2002, p. 631–636.

Shareholder proposals addressing this issue have asked companies to report on the gap between their highest- and lowest-paid employees or set a maximum range or ratio that the companies will allow between the highest- and lowest-paid employees. These proposals have become more common as concern about excessive executive compensation grows among investors.

It is not in the shareholders' best interests for the gap between executive and employee compensation to be so great that it hurts productivity and morale. [The fund] encourages directors to consider these issues in designing executive compensation.

- [The fund] will vote for proposals that ask companies to report on the gap between their lowest- and highest-paid employees, provided the reports can be produced without undue expense or revealing confidential information.
- [The fund] will vote for proposals to establish a specific ratio between executive compensation and workers' compensation when the difference between the two is large, company performance is poor, and the board of directors has not addressed the issue.

#### **Executive compensation during layoffs**

Increasing the pay of management while laying off employees contradicts the principle that compensation should be linked to performance. If the company's performance is so poor that employees must be laid off, then that performance does not warrant an increase in executive compensation or benefits. [The fund] encourages directors to adhere to the principle of compensating executives based on their contribution to the company's performance.

- [The fund] will vote for proposals to require the company to halt any increase in executive compensation during layoffs, including freezing executives' salaries, restricting the exercise of stock options, and cancelling bonuses.

#### **Approve compensation committee report and/or compensation policies**

Companies in Britain, Australia, and many European countries must put their compensation reports or policies to a shareholder vote at the annual shareholders' meeting. This gives shareholders a vote on the types and amounts of compensation given to executives.

[The fund] will use its vote on these proposals to express its disapproval of executive compensation plans that are not in shareholders' interests.

- [The fund] will vote against compensation policies or compensation committee reports if it believes executive compensation is excessive,

or if it has concerns about any aspect of the company's compensation plan.

- [The fund] will vote against compensation policies or compensation committee reports if the company fails to provide an adequate explanation of how and why the compensation committee decided to structure the company's executive compensation as it did.
- [The fund] will vote for proposals that ask companies to submit their compensation policies or compensation committee reports to an advisory vote by shareholders.

### Share-based compensation plans

In principle, the inclusion of equity-based compensation in executive compensation plans benefits a company's shareholders. Equity-based compensation encourages executives to own shares in the company, thereby aligning their interests with shareholders.

However, equity-based compensation has been a common source of excessive executive compensation. At many companies, equity-based compensation is growing at a much faster rate than the company's performance, the compensation of non-executive workers, or the economy as a whole. For this reason, equity-based compensation requires careful scrutiny from shareholders.

All equity-based compensation plans should be subject to regular reapproval by shareholders, even if applicable regulations do not require it.

#### *Stock option plans*

Stock option plans have been a focus for concern about excessive compensation for some time. There are several reasons for this. First, stock option awards may be based on the performance of the market as a whole or on sector performance, rather than on the performance of the company or the individual being compensated. This undermines the principle of compensating executives for their performance. Second, in the past few years some companies were found to have manipulated the timing of their option grants to executives in order to make the award when the share price was low, so that executives made more money when they exercised the options.

Controversy surrounding stock options has led many companies to substitute other forms of equity-based compensation for options. However, stock options are still widely used and abused. For this reason, stock option plans need particular attention in order to ensure that they harmonize managements' and shareholders' interests and do not provide excessive compensation to executives.

[The fund] does not favour giving compensation committees broad discretion to set the terms of stock option plans. Instead, the board should submit a formula for the plan to shareholders for approval and rely on that formula in designing and administering the plan.

### Price

Stock options should be issued at the fair market price of the underlying shares at the time of issuance.

- [The fund] will vote against executive compensation plans that offer options at a price below the shares' market price.

### Repricing

When the market price of a company's shares is lower than the exercise price of the stock option (so-called "underwater" options), companies sometimes change the exercise price to match the lower market price or withdraw the option and reissue it at the lower rate. In either case, this practice undermines the purpose of awarding share-based compensation by eliminating for executives the risk that other shareholders must accept to invest in the company. Some jurisdictions require companies to seek shareholder approval for repricing, but others do not.

- [The fund] will vote against re-pricing stock options or reissuing "underwater" options.
- [The fund] will vote against stock option plans that do not explicitly prohibit repricing or reissuing underwater options and the exchange of underwater options for other kinds of compensation, such as restricted stock.
- In general, [the fund] will vote against stock option plans if, in the past three years, the company has repriced or replaced stock options without shareholder approval. [The fund] may make exceptions if the plan and the directors responsible for it have been replaced.

### Reload grants

A reload grant automatically gives the recipient additional stock options when the original options are exercised. The typical reload stock option is for the same number of shares as the recipient has already purchased under the original option at the market price on the date the reload option is granted. The term of the grant may be the same as the original stock option or may be accelerated. Reloading options are dilutive. They also make it possible for the recipient to lock in increases in share price with no attendant risk, a benefit not available to other shareholders.

- [The fund] will vote against stock option plans with reload grants.

#### *Restricted shares*

Restricted share plans award shares to recipients or allow the recipients to purchase shares when they are awarded or at some point in the future. The shares carry some restrictions; in particular they cannot be sold until after a vesting period and/or until after certain performance criteria are met.

The purpose of restricted shares as compensation is to align recipients' interests with those of shareholders and encourage executives to manage the company for the long term.

Vesting periods for restricted shares should be at least three years; [the fund] prefers to see vesting periods of five years or more. [The fund] prefers restricted share plans that include performance vesting criteria, because such plans reward executives for performance instead of tenure. When performance-vesting restricted share plans are established, the company should disclose to shareholders what the performance criteria are.

Dilution levels for restricted stock alone should not exceed 3%, and share-based compensation of which restricted shares are a component should not exceed 10% potential dilution overall.

- [The fund] will vote against restricted share awards that do not have a vesting period or that vest in less than three years.
- [The fund] will vote against performance-vesting restricted stock awards if the performance criteria for vesting are not disclosed or are so vague that shareholders cannot determine what recipients are being rewarded for.
- [The fund] will vote against restricted stock plans if the dilution exceeds 3%.

#### *Share subscription rights (Japan)*

Under Japanese law, boards can issue options called new share subscription rights, without specifying the purpose of the options, who the recipients of the options will be, or what the strike price of the options will be. [The fund] is opposed to this practice because the options can be discounted or priced at a premium at the board's discretion, which is unfair to other shareholders, and because unspecified share issuances have the potential to dilute the value of existing share holdings.

- [The fund] will vote against the issuance of new share subscription rights unless
  - the price of the shares is specified and is comparable to the market price of the company's shares;

- the number of shares to be issued is specified;
- a specific purpose is given for the shares to be issued; and
- the recipients of the rights are identified.

Share subscription rights can also be used as a takeover defence. See "Shareholder rights plans or poison pills," page 28.

#### *Other kinds of equity-based compensation*

Other forms of equity-based compensation include stock appreciation rights and phantom stock. Stock appreciation rights give recipients the difference between the exercise price and the market price of shares on the date of exercise. Stock appreciation rights do not involve the actual purchase or sale of shares. Phantom stock is similar in that it gives recipients bonuses for increases in the value of shares, but it does not require them to own any shares.

Both kinds of awards do not cause any dilution and may discourage insider trading, but they do not encourage recipients to own shares in the company. They may also reward executives for increases in the price of the company's shares that are unrelated to the performance of the executives or the company.

- [The fund] will vote for alternative share-based compensation only if the awards are based on the executive's performance and if the compensation plan effectively aligns executives' interests with those of shareholders.

#### *Omnibus equity-based compensation plans*

Omnibus equity-based compensation plans, which bundle more than three kinds of equity-based compensation into one plan, do not allow shareholders to vote on each component of the plan separately. Omnibus compensation plans have become quite common.

[The fund] will review each part of an omnibus equity-based compensation plan for its dilution, vesting schedule, performance criteria, etc. As with other omnibus proposals, if any aspect of the plan does not conform to our guidelines, we will vote against the entire plan.

- [The fund] will vote against omnibus equity-based compensation plans if any aspect of the plan does not conform to these guidelines.

#### *Expiry*

All forms of equity-based compensation should expire within five years of the date they are awarded unless applicable laws require that the expiry date be longer.

- [The fund] will vote against plans that have no expiry date or an expiry date longer than five years.

- [The fund] will vote against any proposal that would allow the board to extend the expiry date of equity-based compensation without shareholder approval, unless the expiry date falls within a trading blackout period.

#### *Dilution*

Equity-based compensation plans dilute the earnings and voting strength of the company's shares. The level of acceptable dilution is relative to the size of the firm. Small companies may have a dilution rate of as much as 10%, but larger companies should have less dilution.

In isolated instances, a dilution rate slightly higher than 10% may be in the best interests of shareholders; these instances will be determined on a case-by-case basis.

- [The fund] will vote against equity-based compensation plans if the company's total dilution is more than 10%.
- If a company's overall dilution is more than 5%, [the fund] will vote for equity-based compensation plans if
  - the plan is open to all employees or a large proportion of them;
  - the company is a growth company;
  - the company is in a difficult financial situation;
  - the company has set its grant rate at a maximum of 1%;
  - the company was recently created by a merger, and two or more compensation programs are being combined, requiring a period of adjustment;
  - the company's compensation policy is below competitive levels for the industry; or
  - the plan is consistent with competitive compensation levels in the industry.

#### *Grant rate*

The grant rate or "burn rate" of a plan is the percent of outstanding shares granted as compensation in a year. This rate should be no more than 1% of the company's outstanding shares. High grant rates are dilutive; grant rates above 1% warrant particular scrutiny of the plans' dilution.

- [The fund] will oppose plans with a grant rate of 2% or more. Plans that grant options above 1% will be given special scrutiny, especially if their dilution is also above 5%.

#### *Automatic replenishment features or "evergreen" plans*

Share-based compensation is granted from a pool of shares set aside for that purpose. Traditionally, the number of shares in the pool is subject to shareholder approval. Normally, when that pool of shares is becoming depleted, the company must seek shareholder approval to set aside additional shares for compensation. However, share-based compensation plans with automatic replenishment features automatically replace the shares available to be granted as compensation, without prior shareholder approval. [The fund] does not approve of plans with automatic replenishment features, because they tend to be highly dilutive.

There may be cases in which the grant rate of a company's compensation plans is so low that, even with the automatic replenishment feature, the company's overall dilution is still well below 10%. For example, many Japanese companies that have stock option plans have very low grant rates and overall dilution rates of only 1% or 2%. In these cases, an automatic replenishment feature may be acceptable provided the company's overall cumulative dilution will not exceed 10% over the duration of the plan.

The Toronto Stock Exchange (TSX) rules allow companies to include automatic replenishment features in their compensation plans provided they seek reapproval from shareholders every three years and cap their overall dilution at no more than 10%. However, this has made 10% the standard level of dilution rather than the maximum. For this reason, [the fund] does not believe TSX-approved automatic replenishment features are in the best interests of shareholders.

- [The fund] will vote against stock option plans that include an automatic replenishment feature. An exception to this guideline may be made if the company's cumulative overall rate of dilution is so low that it is unlikely to exceed 10% for the duration of the stock option plan.

#### *Vesting*

Stock-based compensation granted to employees should have a minimum holding period before it can be exercised. Options are not effective tools for encouraging executives to manage for the long term when the options can be exercised as soon as they are granted. (Also see "Change in control provisions," page 26, regarding accelerated vesting contingent on changes in control of the company.) [The fund] believes stock-based compensation should be held for at least three years in order to promote long-term stock holdings.

This may not apply to share-based compensation that vests according to performance criteria. There

are some situations in which a board should be able to extend or waive vesting periods, such as when an executive's position is made redundant by a merger, but these should be exceptional cases.

- [The fund] will vote against equity-based compensation plans that have a vesting period of less than three years.
- [The fund] will vote for performance-vesting equity-based compensation awards, which vest as specific performance goals or standards are met.

#### *Concentration of stock awards*

- [The fund] will vote against plans that allocate 20% of the stock available for compensation in a given year to a single individual. This includes grants of "super options" with more restrictive vesting and performance provisions. Exceptions to this may be made for small companies that have few employees with equity-based compensation or companies that do not use much equity-based compensation.

#### *Awards for consultants and contractors*

Companies sometimes extend their executive equity-based compensation plans to their consultants or contractors. [The fund] is opposed to this practice. Equity-based compensation is intended to motivate employees to improve shareholder value over the long term. However, people whose work for the company is short term have no reason to be motivated to improve long-term shareholder value.

- [The fund] will vote against equity-based compensation plans that include consultants, contractors, or other temporary employees.

#### *Company loans for stock purchases*

[The fund] opposes the practice of making loans to employees to allow them to purchase shares, even if the loans are made at market rates. This practice may leave the company with uncollectible debt and inhibit the termination of employees who have outstanding loans with the company.

- [The fund] will vote against compensation plans that provide for loans to employees to make share purchases.
- [The fund] will vote for proposals to prohibit companies from making loans to employees for share purchases.

#### *Change in control provisions*

(See "Vesting," page 25, and also "Severance benefits [golden Parachutes]," below.)

Accelerated vesting in the event of a change in control of the company is a common provision of executive severance plans known as golden parachutes. These plans are discussed more generally below.

Equity-based compensation plans often include provisions that allow equity-based grants to vest immediately if the company changes hands. These provisions have come under increased scrutiny, because they have been used to pay executives and directors substantial amounts for changes in control of the company that were initiated but never completed. The plans may also provide an incentive for executives and directors to pursue changes in control that benefit them but not other shareholders.

One way to address this problem is to require that the change in control be completed before equity-based compensation can vest. Another approach is to allow an executive's equity-based compensation to vest if a change of control takes place, but only if the executive also loses his or her job with the company as a result. These plans are called "double-trigger" plans—as opposed to "single-trigger" plans, which require only a change of control for equity-based awards to vest.

- [The fund] will vote against equity-based compensation plans with change-in-control provisions if they allow option holders to receive more for their options than shareholders receive for their shares.
- [The fund] will vote against change-in-control provisions that are developed in the midst of a takeover fight.
- [The fund] will vote for proposals to require change-in-control transactions to be complete before any change-in-control provisions of compensation plans come into effect.
- [The fund] will vote against proposals that allow executives' equity-based compensation to vest if a change in control takes place unless the executive's employment with the company is terminated as a result of the change in control.

#### **Severance benefits (golden parachutes)**

(Also see "Change in control provisions," above.)

Golden parachutes are severance arrangements for executives and directors that are contingent on a change of control in a company. Golden parachutes are intended to ease managers' and directors' concerns about losing their jobs in the event of a successful takeover and thus help them to make decisions that are in the best interests of the company and its shareholders.

Severance benefits for directors are inappropriate, because they may create potential conflicts of interest and compromise director independence. If the benefits are large, they may also give directors an incentive to pursue a change in control of the company that is not in the best interests of shareholders.

- [The fund] will vote against change-in-control or severance benefits for directors.

The amounts of compensation in executives' severance arrangements can be excessive, especially in light of the amounts of other compensation that executives typically receive. In general, [the fund] believes severance packages are excessive if they provide benefits worth more than two times an executive's base salary plus bonus.

- [The fund] will vote against golden parachutes, except in those cases where management can demonstrate that the severance arrangements are in the shareholders' long-term interest and do not create a conflict of interest for the recipients, and that the amounts involved are reasonable compared to similar benefits for all employees of the company.
- [The fund] will vote against any severance plan that is not contingent on the completion of a change of control of the company, that is, a completed change in the ownership of more than 50% of the company's shares or voting rights.
- [The fund] will vote against "single-trigger" change-in-control provisions of severance packages, which do not require an executive to be terminated as the result of a change in control in order for the severance plan to take effect.

#### *Shareholder approval for executive severance compensation*

- [The fund] will vote for proposals that require all severance packages for executives and directors be approved by shareholders.

#### **Bonuses**

Bonuses should be rewards for excellent performance. They become meaningless if they are given routinely or to employees whose performance is less than excellent. Employees, including executives, should be awarded bonuses when they exceed their performance goals or standards but not otherwise."

- [The fund] will vote against bonuses that are not based on performance.
- [The fund] will vote against compensation plans that provide bonuses for average or poor performance.

- [The fund] will vote for bonus plans that reward excellent performance

#### **Compensation caps**

Compensation caps are a somewhat arbitrary way to control excessive executive compensation. In general, they violate the principle that employees should be rewarded for their performance, and they have the potential to make a company's compensation plan uncompetitive. However, there are instances in which they may be the best means available to rein in runaway executive compensation.

- [The fund] will assess proposals for compensation caps on a case-by-case basis. In general, it will vote against them, unless executive compensation is excessive given the company's performance and there is no other effective way to limit that compensation.

#### **Disclosure of executive compensation**

In order to vote wisely on compensation issues, shareholders must understand the company's executive compensation plan and philosophy. The company should describe its entire executive compensation plan clearly in its proxy circular, including the rationale for salary levels, incentive payments and bonuses, equity-based compensation, severance arrangements, retirement benefits, perquisites, and any other contractual obligations of the company to named executives. The company should disclose the basis on which awards are made for each plan, such as the specific performance criteria. It should also disclose the full value of all compensation, including stock option awards. Where the value of a benefit must be estimated (such as with retirement benefits), companies should disclose the basis on which the estimate was made.

The company should also name any compensation consultants who have advised it, identify who retained the consultants, and describe the consultants' mandates. The company should also disclose information about any potential conflicts of interest the consultants may have, such as contracts with senior managers.

[The fund] anticipates that this disclosure will go beyond what the company is legally required to disclose about its executive compensation.

[The fund] recommends the Canadian Coalition for Good Governance's Best Practices in Compensation Disclosure as a model for disclosure of executive compensation.

- [The fund] will vote for proposals to require companies to disclose and fully explain their executive compensation plans to shareholders.

- [The fund] will vote for proposals that require companies to disclose the full cost of retirement benefits, severance packages, and all other contractual obligations they have to their named executives.
- [The fund] will vote for proposals to require companies to disclose the names of their compensation consultants, the consultants' mandates, and information about any potential conflicts of interest.
- [The fund] will vote against compensation plans if the information described in this section is not disclosed for the plan, or if the disclosure is otherwise found to be inadequate.

## Takeover protection

Takeovers and mergers have been common in Canada in recent years.<sup>12</sup> Shareholders must be vigilant about protecting their interests in these transactions. Takeovers may pay a premium to shareholders and/or improve a company's performance, but they can also injure the company's long-term profitability. A growing body of research indicates that mergers and acquisitions do not necessarily benefit shareholders, and many of them decrease shareholder value.<sup>13</sup>

Measures designed to protect companies from takeovers also must be evaluated carefully. Takeover defences often depress the price of a company's shares and protect directors' and executives' interests more than they protect shareholder value. When presented with a takeover defence, shareholders should ask: Will it protect the company and its employees from acquirers who are not concerned with the company's long-term growth and profitability? Will it help shareholders get the best possible price for their shares? Or will the defence entrench management at shareholders' expense? Takeover defences require special scrutiny to ensure that shareholders' long-term interests are protected.

### Shareholder rights plans or "poison pills"

Shareholder rights plans, also called "poison pills," involve issuing stock purchase rights. These rights cannot be exercised unless a takeover offer is tendered or a potential acquirer of the company purchases a specified percentage of the shares. If the company cannot negotiate a takeover

arrangement with a prospective acquirer, the rights allow shareholders other than the acquirer to buy additional shares at very favourable prices. This makes the takeover much more expensive for the acquirer.

Shareholder rights plans are intended to push potential buyers of the company to negotiate with a company's board of directors, since buyers can avoid triggering the plan by doing so. Shareholder rights plans have two legitimate purposes: they can ensure that all shareholders are treated equally in a takeover, and they can give the board time to negotiate a better deal with the acquirer or solicit and consider competing bids that would maximize the value of the company's shares.

However, shareholder rights plans also have drawbacks for shareholders. They commonly thwart takeover attempts, including those that would benefit shareholders. They often cause the price of the company's stock to drop. And like other takeover defences, shareholder rights plans can protect the directors and management rather than promoting the best interests of shareholders. Plans must be designed to protect shareholder value rather than the board and management.

In many jurisdictions, including Canada, companies must submit shareholder rights plans to a vote by shareholders. In other jurisdictions, boards can adopt poison pill plans without shareholder approval. [The fund] believes all shareholder rights plans should be submitted to shareholders for their approval regardless of whether or not this is required by law.

- If shareholder rights plans are adopted without shareholder approval, [the fund] will withhold votes for the directors who adopted it. (See also "Voting for directors," page 14.)
- When shareholder rights plans are submitted for shareholder approval, [the fund] will assess them on a case-by-case basis. It will vote for them only when the plan ensures that shareholders will receive a fair price for their shares in a takeover and the plan will not protect management or the board at the expense of the shareholders' interests. Specifically, [the fund] will vote for a plan only if
  - the threshold for triggering the poison pill is at least 20% of the company's shares;
  - the plan's definition of "acquiring person" excludes anyone, such as a passive institutional investor, who strays across this threshold without intending to take over the company;
  - the plan's definition of beneficial ownership does not include references to voting agreements or dispositive power, because definitions that

<sup>12</sup> See, for example, "Canada M&A deals hit record high in 2007 —Crosbie," Reuters, 21 February 2008, <http://in.reuters.com/article/asiaCompanyAndMarkets/idINN2145010820080221>; "M&A Activity Seen Holding Up Despite Credit Crunch," *Research Recap*, 7 January 2008, <http://www.researchrecap.com/index.php/page/2/?tag=m%26a/>.

<sup>13</sup> "Executives Report That Mergers and Acquisitions Fail to Create Adequate Value," *Business Wire*, 14 June 2006, [http://findarticles.com/p/articles/mi\\_m0EIN/is\\_2006\\_June\\_14/ai\\_n26896147/](http://findarticles.com/p/articles/mi_m0EIN/is_2006_June_14/ai_n26896147/).

include such references can interfere with the legitimate corporate governance activities of institutional investors;

- the plan allows a permitted bid, that is, a bid to acquire the company that does not trigger the shareholder rights plan, to go directly to the shareholders for a vote. The board should not be able to refuse to allow a permitted bid;
- partial bids are permitted with a minimum deposit requirement;
- the permitted bid stands for a maximum of 60 days, in which time the board must either announce an alternative bid or allow the permitted bid to go to the shareholders. Many plans set 60 days as the minimum period of time for a bid to stand. [The fund] believes 60 days is long enough for directors to solicit other offers for the company, and that periods longer than this discourage takeovers;
- potential acquirers can continue purchasing the stock in accordance with applicable regulations during the period in which the permitted bid stands;
- if the board wants to waive or redeem the plan in order to allow the company to be acquired by means other than a takeover bid, the shareholders' prior approval is required;
- the board can waive the plan to allow a non-permitted takeover bid to be made by sending a takeover bid circular to all shareholders, as long as this waiver is extended to any other contemporaneous bids. In this case, all takeover bids must be made by sending a takeover bid circular to all shareholders before the expiry of the initial bid;
- rights can be redeemed only with shareholders' ratification;
- private placements are not exempted from the plan;
- "soft" lock-up agreements, in which shareholders can break the agreement to sell their shares to a competing offeror, are exempted from the plan;
- break fees, if any, do not exceed 2.5% of the price payable under a lock-up bid;
- the terms "beneficial ownership" and "acting jointly or in concert" are based on ownership of shares at law or in equity, not voting rights or agreements;
- the offer will be considered approved if a majority of the votes cast by independent shareholders at a shareholders' meeting are in favour;

- the potential acquirer has the right to amend the offer before the shareholders' meeting;
- the plan will be resubmitted to shareholders for approval at least every three years; and
- any amendments to the plan will be submitted to shareholders for approval.

#### *New share subscription rights and stock warrants as "poison pill" takeover defences*

New share subscription rights are most common at Japanese companies. The rights do not have a specified price at the time they are issued and can be priced at a premium in the event of an attempted takeover. They function in much the same way as a poison pill takeover defence, by making a takeover of the company very expensive. Companies strengthen the defence by issuing the shares to a friendly third party, or even to employees, in order to make it more difficult for the acquiring party to purchase the company's shares.

The use of stock warrants as a poison pill takeover defence is more common at European companies. The warrants are issued to all shareholders except the would-be acquirer of the company. The exercise price of a stock warrant is usually higher than the current value of the shares, making it more expensive for a would-be acquirer to purchase the company's shares.

Some jurisdictions require companies to submit the use of warrants as a takeover defence for shareholder approval. If a company adopts any version of a poison pill without shareholder approval, [the fund] will vote against the entire board at the next opportunity.

- [The fund] will vote against the issuance of new share subscription rights or stock warrants when they could be used as takeover defences.

#### *Other variations on poison pill takeover defences*

There are many other variations on poison pill takeover defences. All are designed to make it expensive for a prospective acquirer to buy the company without negotiating with the board of directors. Poison pill takeover defences are acceptable if they are designed to allow the board to negotiate the best possible deal for shareholders. However, the plans require careful scrutiny in order to be sure they benefit shareholders rather than management and/or the directors. These takeover defences must be evaluated individually. As with all other takeover defences, they should not be adopted without shareholder approval.

- [The fund] will vote on other poison pill takeover defences case by case. It will vote against plans that
  - allow the board to reject, without shareholder input, offers to acquire the company that do not trigger the plan;

- are likely to discourage takeovers that could benefit shareholders before shareholders have had a opportunity to vote on the takeover offer; or
- do not require the board to give equal treatment to all offers that comply with the rules of the plan.
- [The fund] will withhold votes for all of the directors of a board that adopts a “poison pill” takeover defence without shareholders’ approval.

### Crown jewels takeover defence

In a crown jewel defence against a takeover, the target company sells its most valuable assets to a friendly third party to make the company less attractive as a takeover target. In Canada, crown jewel defences usually require the approval of shareholders. Shareholders can also seek the fair value of their shares from the potential acquirer if a substantial portion of the target company’s assets are included or if the takeover would change the essential nature of the company’s business. This is known as an appraisal remedy.

Crown jewel transactions are often made on very short notice, giving shareholders little time to consider how the transaction will affect the value of their shares or control of the company.

- [The fund] will vote against crown jewel transactions unless the company can show clearly that the shareholders’ interests will be protected.

### Lock-up agreements

Lock-up agreements are private agreements made by certain shareholders to sell their shares to a third party that intends to make a takeover bid. No other bids for the shares are allowed, and the offer is not made to other shareholders. Prospective acquirers use lock-up agreements to try to lock in a price for the company by purchasing a minimum number of shares at that price. No appraisal remedy or shareholder vote is required for lock-up agreements, because the sale of shares is private and voluntary.

Lock-up agreements may be “hard” or “soft,” depending on how difficult it is for the selling shareholders to cancel the agreement to sell. In a hard lock-up agreement, the selling shareholder would have a difficult time reneging on the agreement to sell to a competing acquirer. Thus, hard lock-up agreements are more likely to discourage competing bids for the company.

All shareholders have the right to sell their shares as they see fit. However, a lock-up agreement does not serve the interests of all shareholders if it prevents them from getting the best value for their shares in

the transaction. The best value can only be known if the company solicits and responds to competing offers for its shares.

Unfortunately, dissenting shareholders can do little to protest a lock-up agreement, because the agreements are private.

### Private and targeted share placements

A company’s management or directors may protect themselves from a takeover by placing a large block of shares in a safe place, such as their employee stock option plan or with a sympathetic individual shareholder, so that those shares cannot be purchased. Private and targeted share placements do not benefit shareholders if they result in dilution or if a takeover would be in the best interests of shareholders.

- [The fund] will vote for proposals to require companies to seek shareholder approval before making any targeted or private share placements that involve more than 5% of the existing shares.
- [The fund] will vote for private or targeted share placements if they are negotiated at arm’s-length and are based on the fair market value of the stock.

### Opting out of takeover laws (United States)

In the United States, some states have laws that protect corporations from hostile takeovers. These laws often include provisions that allow corporations to opt out of their protections. In general, takeover-protection laws prohibit prospective buyers from making well-financed bids for a company and thus providing a benefit to shareholders. Takeover-protection laws may also limit directors’ fiduciary obligations to shareholders.

- [The fund] will vote for proposals to opt out of takeover protection laws.

### Reincorporation

(Also see “Reincorporation in off-shore tax havens,” page 38.)

Companies may reincorporate in a different jurisdiction for sound business reasons but also as a takeover defence or as a way to limit the directors’ liability. [The fund] will assess votes on reincorporation case by case.

- [The fund] will vote for reincorporation proposals when management can demonstrate that there are sound financial or business reasons for the move.
- [The fund] will vote against reincorporation as a takeover defence or to limit director liability.

- [The fund] will vote against reincorporation if shareholders' rights would be limited as a result.

### Greenmail

A company pays greenmail when it buys the stock of a would-be acquirer at a price above the market price, usually in exchange for the would-be acquirer's agreement to end a takeover attempt.

Provincial securities laws do not permit greenmail payments in Canada. However, they do occur in some jurisdictions. Greenmail is unfair to the shareholders who do not get the preferred price for their stock. It also decreases the value of the company's stock, which further hurts shareholders. In addition, greenmail denies shareholders the opportunity to decide whether or not the prospective takeover is in their best interests.

- [The fund] will vote for anti-greenmail proposals.
- If shareholders have the opportunity to vote on a greenmail payment, [the fund] will vote against it.
- If greenmail is paid and no vote is offered on the greenmail payment, [the fund] will withhold votes from the directors who approved it. (See also "Voting for directors," page 14.)

### Fair price proposals

Fair price proposals require a bidder for a corporation's shares to pay the same price for all of the company's shares purchased. The fair price is usually defined as the highest price paid by the bidder for any shares acquired before the start of the tender offer. These proposals ensure that all shareholders are treated equally in a takeover. They defend against two-tiered offers in which a higher price is paid in the initial offer (often to make a takeover bid attractive to shareholders), but a lower price is offered for the remaining shares. Two-tiered offers are effectively prohibited in Canada but are allowed in other jurisdictions.

- [The fund] will vote for fair price proposals.

### Miscellaneous takeover defences

When a company proposes or invokes other takeover defences not listed here, those defences should be evaluated on a case-by-case basis to determine what the overall benefits of the proposal are to shareholders in the long term.

- [The fund] will assess votes on other takeover defences individually, based on how they will affect shareholder value in the long term.

### Considering the effects of takeovers and mergers

As we noted at the beginning of this section, takeovers are common but do not always create

value for shareholders. Therefore, shareholders must consider whether or not proposed mergers and acquisitions are in their best interests in the long term and be prepared to vote against transactions that are not.

The shareholders of some companies have proposed requiring directors to consider the effects of mergers or acquisitions on employees, suppliers, the surrounding communities and other stakeholders. [The fund] believes that these proposals can enhance long-term shareholder value. An evaluation of the broader effects of mergers and acquisitions may reveal hidden costs, such as reduced productivity due to job losses or responsibility for environmental damage.

- [The fund] will vote for proposals that require directors to consider the effects of mergers, takeovers, or acquisitions on employees, suppliers, the surrounding communities, and other stakeholders.

### Shareholder approval of takeover defences, mergers, and acquisitions

Any action that alters the relationship between shareholders and the board, or that results in major changes in the structure or control of the corporation, should be submitted to the shareholders for a vote. This includes takeovers, takeover defences, mergers, and acquisitions. Shareholders should be given adequate information and time to make informed, well-considered decisions about these issues.

- [The fund] will support proposals that require directors to submit to shareholders any changes to the structure or control of the corporation or to the relationship between shareholders and the board.

## Protection of shareholder rights and interests

### Supermajority approval of transactions

Supermajority requirements require the vote of more than a simple majority—usually two-thirds of the vote—to approve a decision or transaction. [The fund] believes supermajority requirements have a legitimate purpose but are also subject to misuse.

Companies sometimes require supermajority approval to change their by-laws or provisions of their charters to ensure that there is broad agreement on such fundamental changes in the corporation. [The fund] believes this is a legitimate use of supermajority requirements. However, supermajorities are also used by management to fend off hostile takeovers or to secure their own control of the corporation.

In some countries, such as Germany and Britain, companies are required by law to win the approval of a 75% supermajority in order to amend their statutes or bylaws. In these cases, [the fund] will not vote against a 75% supermajority for changes to the company's statutes.

- [The fund] will vote for supermajority provisions for changes to company bylaws, statutes, or charters if the majority required is no more than 67% or no larger than is required by applicable laws.
- [The fund] will vote against supermajority requirements if they apply to votes on any other issues.

#### Omnibus or linked proposals

Omnibus proposals combine two or more issues into a single proposal, which is presented to shareholders for a yes-or-no vote. Examples are presenting all nominees for director to be voted on as a slate, combining a group of bylaw changes into one proposal, or combining several types of stock-based compensation for executives into a single proposal for shareholders' approval.

[The fund] objects to omnibus proposals, because they lump together issues that shareholders should be permitted to vote on separately. Omnibus proposals may also combine an issue that shareholders are likely to support with one they are unlikely to support in order to get approval for proposals that shareholders would not otherwise approve.

Votes on slates of directors are addressed in the section on boards of directors, on page 10.

- [The fund] will vote against omnibus proposals other than slates of directors if it is opposed to any of the issues in the proposal, unless the overall effect of the proposal would benefit shareholders in the long term.
- [The fund] will vote for proposals to prohibit the use of omnibus or linked proposals.

#### Confidential voting

Proxy voting typically is not done by secret ballot. This allows management to contact dissenting voters and urge them to change their votes. [The fund] believes the proxy-voting process should be confidential, impartial, and free from coercion. It supports proposals to institute confidential voting.

- [The fund] will vote for proposals to institute confidential proxy voting.

#### Related-party transactions

Companies in some European and Asian markets ask their shareholders to approve related-party transactions in which the company engages in business transactions—usually buying services or products—from a company with ties to its directors or senior officers. [The fund] is opposed to these transactions. They create potential opportunities for self-interested deals and conflicts of interest, which can compromise the board's independence or the perceived integrity of the company. The products and services obtained through these transactions can be obtained from other, competitive sources that do not pose a risk to the board's independence or the company's reputation.

- [The fund] will vote against proposals to approve related-party transactions unless the company has demonstrated persuasively that the assets or services at issue were valued independently, that the transaction was negotiated at arms length, and that the terms and conditions of the transaction meet reasonable commercial standards.

#### Quorum requirements for shareholders' meetings

The quorum for a shareholders' meeting is determined as a percentage of total voting shares represented either in person or by proxy. The Canadian Business Corporations Act allows companies to call a quorum with as little as 10% of the voting shares represented. [The fund] believes this threshold is too low. It allows companies to make decisions that require shareholder approval without consent from the owners of up to 90% of the shares.

The appropriate quorum size for a company depends on how widely held the company is. No company should have a quorum of less than 25%; even at this level, companies can make decisions without the participation of up to three-quarters of the shareholders. [The fund] encourages companies with dominant shareholders to set higher quorum requirements.

- [The fund] will vote against proposals that would set the quorum requirement at fewer than 25% of voting shares.

#### Shareholder-called meetings

Shareholders have a fundamental right to call special meetings, and this right should not be eliminated or abridged without the approval of the shareholders. If shareholders are required to own a certain percentage of shares before they can call a meeting, the percentage required should be one that shareholders could reasonably own, given the size of the company.

- [The fund] will vote against proposals to limit or deny shareholders' rights to call special meetings.
- [The fund] will vote for proposals to allow shareholders to call special meetings. If an ownership requirement is set, it should be reasonable for the size of the company.

### Shareholder proposals

Shareholders should be permitted to bring proposals to the annual meeting. These proposals should be included on the proxy ballot, and proponents should be given adequate space in the proxy circular to explain the proposal. The board should implement any shareholder proposal that is approved by a majority of the shareholders.

Although it is unlikely that a proposal calling for shareholder proposals to be allowed would appear on the proxy ballot of companies that do not permit shareholder proposals, [the fund] would support such a proposal should it come up.

- [The fund] will vote for proposals to allow shareholders to bring proposals to the annual meeting.
- [The fund] will withhold votes from directors who fail to implement shareholder proposals that win majority approval. (See "Voting for directors," page 14).

### Shareholder action by written consent

Some companies in the United States have provisions in their by-laws to act by the written consent of shareholders without holding a shareholders' meeting or proxy vote. A company or shareholder sends a proposal to all shareholders asking for their consent to act on the proposal. Shareholders who agree return a signed consent card within a set time period, usually 60 days. This procedure was intended to be used on non-controversial issues where the unanimous consent of shareholders is likely, in order to avoid the time and expense required to hold a special shareholders' meeting. Either management or shareholders can use the procedure but, in practice, they rarely do.

Some companies seek to eliminate or restrict shareholders' right to act by written consent in order to prevent a takeover of the company. However, as with other takeover defences, this often protects management at the expense of shareholders.

- [The fund] will vote against proposals to limit or deny shareholders' right to take action by written consent.
- [The fund] will vote for proposals to restore shareholders' right to take action by written consent.

### Shareholders' meetings

Participation in shareholders' meetings is a basic right of shareholders. Companies should encourage shareholder attendance at the annual general meetings. They can do this by making shareholders' expense and convenience primary considerations in deciding when and where to hold the annual meetings.

Some companies propose to hold their shareholders' meetings entirely by electronic means, without any shareholders being physically present. Technology such as teleconferencing can supplement shareholders' meetings by making it easier for shareholders to observe the proceedings. However, [the fund] believes that meetings held entirely by electronic means, without the opportunity for shareholders to attend in person, could inhibit shareholder participation and are not an adequate substitute for meetings in which shareholders can be physically present.

- [The fund] will vote against proposals to hold shareholders' meetings entirely by electronic means.

### Shareholders' voting rights

(Also see, "Unequal voting rights and dual classes of shares," page 9.)

Companies in some jurisdictions are permitted to change shareholders' voting rights under certain circumstances. For example, shareholders of French companies may lose their voting rights if they hold bearer shares that have not been registered with approved brokers or if the company believes the shareholder may have a conflict of interest. [The fund] believes that voting rights are an essential part of owning shares in a company, and the voting rights of shareholders should not be altered. In addition, all shareholder votes should be given equal weight.

Shareholders often have no say in how a company alters or limits their voting rights. However, [the fund] will vote against a company's efforts to change or limit shareholder voting rights whenever it has an opportunity to do so.

- [The fund] will vote against proposals that would limit or change shareholders' rights to vote their shares.
- [The fund] will vote for proposals to protect shareholders' voting rights.

**Shareholder access to proxy information**

All shareholders should be given timely and sufficient information about the date, location, and agenda of shareholder meetings and about the issues to be decided at the meetings. All shareholders should have access to proxies and adequate time in which to consider and vote on the issues.

**Other corporate governance issues****Employee share-ownership plans**

Employee share-ownership plans promote employee participation and create an additional incentive for good performance. Employee share-ownership plans differ from executive equity-based compensation in that they are open to all or the vast majority of a company's employees. Most of these plans offer employees the opportunity to purchase shares or stock options at a discount. Discounts on option or share prices should be no more than 15%. These plans are subject to the same concerns about dilution as other equity-based compensation plans.

- [The fund] will vote in favour of employee share-ownership plans, provided the plans discount options or shares by no more than 15% and conform to other relevant sections of these guidelines, such as dilution and loans for share purchases.

**Approval of inter-company contracts**

This proposal may appear on the ballots of German companies that are required to seek shareholder approval for agreements between the company and its subsidiaries to transfer assets and liabilities. These proposed transfers are usually carried out for tax purposes.

- [The fund] will vote against the approval of inter-company contracts if the terms of the contract are not disclosed in enough detail for shareholders to assess how the transactions will affect shareholder value.
- [The fund] will vote against the approval of inter-company contracts if they involve potential conflicts of interest.

# 04

## CORPORATE SOCIAL RESPONSIBILITY

Financial managers' views on corporate social responsibility have changed considerably in the past five years. Environmental and social concerns were once seen as superfluous to business at best and often as impediments to maximizing corporate profitability. But more and more, the investment community has come to recognize that environmental and social issues are part of the value of a company, especially in the long term. As such, addressing these issues is part of managing a business.

[The fund] agrees that socially and environmentally responsible business practices are necessary for sustained profitability. In order to succeed, businesses need to treat employees, suppliers, and customers well, be environmentally responsible, and be responsive to the interests of the communities in which they operate. These considerations may provide reasons to exceed the minimum requirements set by law. [The fund's] proxy-voting guidelines on social and environmental issues were developed on this basis. [The fund] is mindful of its social responsibility as an institutional investor, a responsibility that obliges it to consider the consequences of its own investment decisions on society and the environment.

As a practical matter, proxy votes on social responsibility issues differ from those on corporate governance issues in several key ways. First, these issues are usually addressed by shareholder proposals rather than by proposals from management. Second, the range of possible issues within corporate social responsibility is vast—certainly much larger than the range of topics covered by corporate governance. This makes it virtually impossible to anticipate and devise a guideline for all of the possible social responsibility proposals that could be presented in a given proxy season. These guidelines address this problem by identifying a set of broad, internationally accepted standards and norms against which to assess corporate social responsibility proposals, augmented by specific guidelines for common types of proposals.

Pension fund fiduciaries must keep in mind their funds' long-term commitment to provide pension benefits many decades into the future and exercise their proxy-voting rights in a way that will maintain the social, economic, and environmental structures upon which long-term investment returns are based.

## General guidelines

### International standards and norms

International law and agreements provide useful standards for evaluating socially responsible business practices. [The fund] will be guided in its proxy voting by the principles concerning the fair treatment of workers, environmental protection, and economic development at the local level that are expressed in the following international agreements. All of these agreements have the support of the Canadian government.

- The Universal Declaration of Human Rights ([www.un.org/Overview/rights.html](http://www.un.org/Overview/rights.html))
- The Geneva Conventions ([www.genevaconventions.org](http://www.genevaconventions.org))
- The International Labour Organization Fundamental Principles and Rights at Work ([www.ilo.org/public/english/standards/index.htm](http://www.ilo.org/public/english/standards/index.htm))
- The International Labour Organization Tripartite Declaration of Principles on Multinational Enterprises and Social Policy (<http://www.ilo.org/public/english/employment/multi/forum.htm>)
- The Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises ([www.oecd.org/document/28/0,2340,en\\_2649\\_201185\\_2397532\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/28/0,2340,en_2649_201185_2397532_1_1_1_1,00.html))

[The fund] will also be guided by the principles of the following international standards:

- The United Nations Global Compact ([www.unglobalcompact.org](http://www.unglobalcompact.org))
- The Global Reporting Initiative Guidelines ([www.globalreporting.org](http://www.globalreporting.org))

The primary responsibility for determining what a company should do to be socially responsible rests with management. However, when a company's actions violate international standards and/or expose shareholders to increased liability or financial risk, fiduciaries have a responsibility to act to protect the value of their investments.

- In general, [the fund] will vote for shareholder proposals that call on companies to adhere to principles established in the international agreements listed above.
- [The fund] will vote for proposals to endorse the United Nations Global Compact.

### Reports on social and environmental performance

Corporations have a responsibility to disclose to their shareholders the social and environmental risks and potential liabilities of their operations. This disclosure, usually called a sustainability report, should be made in the normal course of reporting to shareholders. [The fund] recommends the Global Reporting Initiative guidelines for creating sustainability reports.<sup>14</sup>

- [The fund] will vote for proposals to provide shareholders with sustainability reports.
- [The fund] will vote for proposals to provide shareholders with other reports related to social and environmental operations, including risks and liabilities, provided the information is not already easily accessible to shareholders and the costs of providing the information are reasonable. Disclosure of this information should not require companies to reveal confidential or proprietary information.
- [The fund] will vote for proposals calling for companies to report to shareholders using the Global Reporting Initiative Guidelines.

### Labour rights

The International Labour Organization's Fundamental Principles and Rights at Work spells out certain basic labour rights; these are described in more detail in the section on labour practices in international operations, on page 41. [The fund] encourages companies to adopt the ILO Fundamental Principles and Rights at Work as a minimum commitment to labour rights in all of their operations.

### Workplace practices

Companies whose employees are satisfied with their work conditions are more likely to enjoy greater customer satisfaction, higher productivity, and greater profitability.<sup>15</sup> Employers who provide employee training, employment security, and a supportive work environment are more likely to enjoy improved productivity and long-term financial gain. [The fund] encourages companies to adopt such policies because they contribute to long-term profitability and consequently benefit shareholders.

<sup>14</sup> Global Reporting Initiative, *Sustainability Reporting Guidelines on Environmental, Economic and Social Performance*, Amsterdam, 2006, <http://www.globalreporting.org>.

<sup>15</sup> See, for example, J.L. Heskett, T.O. Jones, G.W. Loveman, W.E. Sasser, Jr., and L.A. Schlesinger, "Putting the Service-Profit Chain to Work," *Harvard Business Review*, 86, 2008, p. 118–129.

- [The fund] will vote for proposals to require companies to report on their workplace practices and on their efforts to improve the quality of their workplaces.
- [The fund] will vote for proposals to require companies to establish a board committee to examine and report on its workplace practices, unless doing so would be unduly burdensome or would not improve the workplace or benefit shareholders in the long term.

### Layoffs and reductions in force

One aspect of treating employees as partners is avoiding layoffs except as a last resort. Layoffs can damage a company's reputation, employee morale, and community relations, and they tend not to be in the best long-term interests of shareholders.

[The fund] recognizes that layoffs may be unavoidable under some circumstances. However, some layoffs are initiated because of the perception that they are a quick way to cut costs and boost profits. Research conducted since the mid-1990s has shown that companies that use this strategy only see an improvement in their financial performance in the very short term and hurt their profits in the longer term.<sup>16</sup>

- [The fund] will assess shareholder proposals concerning layoffs on a case-by-case basis. This assessment will include consideration of the likely consequences of any proposal for the employees, local communities, and the long-term profitability of the company.
- [The fund] will vote for proposals to implement programs to assist laid-off workers, provided the costs of the programs are reasonable.

### Discrimination in employment

(See also "Labour practices," page 41.)

All jurisdictions in Canada and the United States have laws prohibiting discrimination in employment on the basis of race, religion, national origin, ancestry, sex, age, and physical disability. Many jurisdictions also have laws prohibiting employment discrimination on the basis of sexual orientation and/or promoting pay equity and affirmative action. [The fund] encourages companies to comply with the International Labour organization's standard on non-discrimination.

<sup>16</sup> K. DeMeuse, T. Bergmann, P. Vanderheiden, and C. Roraff, "New Evidence Regarding Organizational Downsizing and a Firm's Financial Performance: A Long-term Analysis," *Journal of Managerial Issues*, 16, 2004, p. 155–177; see also M. A. Farrell and F. Mavondo, "The Effect of Downsizing-Redesign Strategies on Business Performance: Evidence from Australia," *Asia Pacific Journal of Human Resources*, 43, 2005, p.98–116.

Some shareholder proposals raise concerns in this regard if they ask companies to hire or promote a quota of people from certain groups. Such goals for hiring or promotion are compatible with hiring or promoting based on candidates' qualifications if companies actively recruit highly qualified members of under-represented groups.

- [The fund] will vote for proposals asking companies to report on diversity in their workforce, except when those reports already exist and are readily available to shareholders.
- [The fund] will vote for proposals to improve diversity and equity in the workplace as long as those plans do not set arbitrary or unreasonable goals or require companies to hire people who are not well qualified for their positions. It will assess these proposals on a case-by-case basis.
- [The fund] will vote for proposals that prohibit discrimination in employment, including proposals to expand or clarify anti-discrimination policies.
- [The fund] will vote against proposals that would exclude any group of people from policies against employment discrimination.<sup>17</sup>

### Workplace health and safety

Each year, approximately 330,000 Canadians are compensated for injuries at work, and over 900 Canadian workers die as a result of their work.<sup>18</sup> In addition to the human costs, work-related injuries and illnesses are financially expensive for companies. The costs can include lost work time, damage or loss of product and raw materials, repairs to equipment, additional wages to replace the injured worker, production delays, investigation time, fines, loss of contracts, legal costs, lowered productivity or morale, loss of business reputation, increased insurance and workers' compensation premiums, and loss of investor confidence.

Furthermore, a good workplace safety record can give companies a competitive advantage. A growing body of literature links positive workplace safety practices to cost savings and improved productivity.

Companies should disclose to their shareholders detailed information on the key health and safety

<sup>17</sup> The Canadian Human Rights Act prohibits discrimination on the basis of race, national or ethnic origin, colour, religion, age, sex, sexual orientation, marital status, family status, disability, or conviction for which a pardon has been granted. *Statutes of Canada* 1985, c. H-6, s. 3; 1996, c. 14, s. 2.

<sup>18</sup> Association of Workers Compensation Boards of Canada, tables: "Number of Accepted Time-loss Injuries, by Province, 1982–2006," and "Number of Fatalities, by Province, 1993–2006," <http://www.awcbc.org/en/nationalworkinjuriesstatisticsprogramwisp.asp>.

risks they face, such as the rates of injury, illness, and accidents, including the potential costs of these risks where it is appropriate to estimate them. Reports should also include the steps the company is taking to mitigate these risks. If companies have had health and safety problems in the past, a report on their progress in improving health and safety conditions is also appropriate.

- [The fund] will vote for proposals to require companies to report on their occupational health and safety policies, practices, risks, estimates of the costs of health and safety risks where possible, and their progress on improving conditions, unless these reports are already easily available to shareholders.
- [The fund] will vote for proposals to require companies to take steps to reduce their risks of workplace illness and accidents, including appointing a committee responsible for health and safety.
- [The fund] will vote for proposals to include health and safety performance criteria in setting executive compensation.

## Relationships with communities

### Political contributions and positions

[The fund] discourages companies from taking positions on political issues or making political contributions of any kind. There are several reasons for this. First, [the fund] believes shareholders' money should not be used to support political parties and causes. Second, this policy prevents the appearance of a quid pro quo and possible scandal if politicians or governments adopt policies favourable to the company. Third, this policy prevents political parties, candidates, or other organizations from exerting pressure on companies to contribute to political campaigns. Finally, corporations that use their resources to influence public policy can distort the democratic process by having more input into policy-making than ordinary citizens have.

[The fund] recognizes that, in countries whose safeguards against bribery are inadequate, companies that do not make political contributions may be at a competitive disadvantage. However, making political contributions under these circumstances contributes to corruption and undermines fair competition. Furthermore, being associated with such practices damages a company's reputation, which harms its profitability.

- [The fund] will vote for proposals to ban corporate political contributions.
- [The fund] will vote against proposals to make corporate political contributions, including contributions in Great Britain or the European Union.

At a minimum, companies should disclose to shareholders the full amount they spend on political contributions and any other activities they engage in to influence public policy, such as lobbying or sponsoring public relations campaigns on public policy issues.

- [The fund] will vote for proposals to require companies to disclose the amounts, rationale, and recipients of any monetary political contributions and non-monetary contributions to individuals or organizations to influence public policy, provided that this can be done without undue expense and such reports are not already easily available to shareholders.

### Predatory lending

Predatory lending is the practice of advertising and making loans in ways that obscure the full cost of borrowing. These loans are usually made to borrowers who are not considered good candidates for credit. Predatory lending exposes corporations to uncollectible debt, litigation, and penalties from regulatory agencies. Even where they are unregulated, these practices pose a significant risk to the lender.

- [The fund] will vote for proposals to require companies to develop and enforce policies barring predatory lending practices and to report to shareholders on the implementation of such policies, unless such reports are already easily available to shareholders.

### Reincorporation in off-shore tax havens

(Also see "Reincorporation," page 30.)

So-called "tax havens" are countries with no or nominal taxes, weak requirements for corporate transparency, no effective exchange of taxpayer information with other countries, and no requirement that a company engage in substantial activities in the country in order to incorporate there. Companies can reincorporate in these countries with a minimal investment—sometimes nothing more than renting a mailbox—and shield their finances from taxation and regulatory authorities in other countries.

The Organisation for Economic Cooperation and Development calls these countries harmful preferential tax regimes, because they undermine fair competition and public confidence in tax systems by shifting more of the tax burden onto less-mobile sectors of national economies, such as consumption and labour. By reincorporating in tax havens, companies escape paying taxes in the countries where they earn profits and where they benefit from the infrastructure and services provided by taxpayers. [The fund] believes this practice gradually undermines the economies of countries without harmful preferential tax regimes.

- [The fund] will vote against proposals to reincorporate in countries that the OECD has identified as having harmful preferential tax regimes. This includes harmful preferential tax regimes that apply only to specific locations within a country or to certain business sectors.<sup>19</sup>
- [The fund] will vote for proposals to prohibit companies from reincorporating in tax havens.

## Dangerous products and product liability

Although no responsible business would intentionally cause public harm, some products prove to be clearly or potentially dangerous. In these circumstances, the products in question become a potential liability to the companies that produce and sell the products, and to those companies' shareholders. [The fund] encourages companies to take a precautionary approach to products that could cause harm by conducting their own studies of the product and following the progress of independent research.

Where companies use processes or substances in their operations that have been shown to be hazardous, [the fund] encourages companies to develop and implement plans to end the use of those processes or substances.

- [The fund] will vote for proposals that ask companies to report to shareholders on the potential hazards of their products, processes, or services and/or on the steps taken to manage risks related to their processes and products, as long as competitively sensitive information can be excluded and the reports are not already easily available to shareholders.
- [The fund] will vote for proposals to require companies to disclose any known potential liabilities of their processes and of products the companies make or sell.
- [The fund] will vote for proposals to require companies to report on standards for advertising potentially hazardous products responsibly and their compliance with those standards, provided such reports are not already easily available to shareholders.
- [The fund] will vote for proposals to require boards to establish a committee to examine and report on issues related to product safety, unless doing so would not benefit shareholders in the long term.
- [The fund] will assess proposals to end the use of a process or the production or sales of a product on a case-by-case basis. This assessment will include the potential hazards and liabilities associated with the process or product and the costs of eliminating it.

<sup>19</sup> These countries change from time to time. Current lists can be found in the OECD's updates on tax havens. See [http://www.oecd.org/docuement/57/0,3343,en\\_2649\\_33745\\_30578809\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/docuement/57/0,3343,en_2649_33745_30578809_1_1_1_1,00.html).

## Genetically modified organisms

Shareholder proposals concerning genetically modified organisms (GMOs) normally ask the companies to report on their use of GMOs and/or the attendant risks of such use, label their products that contain GMOs, or stop producing or using GMOs altogether.

Most of shareholders' current concerns are about the risks of genetic modification in food crops and animals. For example, the contamination of non-modified food crops by the genetic material of transgenic crops has resulted in lawsuits, regulatory sanctions and product recalls costing billions of dollars.<sup>20</sup> Transgenic material has been shown to spread over larger distances, and into a wider variety of other organisms, than was originally anticipated. This spread greatly increases the risk of contamination and its attendant liabilities. Such risks have led insurers in Europe and Australia to refuse to insure transgenic crops or companies that produce them.

In addition, food products containing GMOs are subject to market rejection due to consumer concerns about their safety. Consumer concerns have led to restrictions on GMO-containing products in some countries and rejection by individual food manufacturers and retailers. Consumers have also demanded that products containing GMOs be labelled. The European Union, Japan, and Australia are among the markets that require foods containing GMOs to be labelled as such. Surveys done in the United States consistently show that roughly 70% to 90% of consumers there want products containing GMOs to be labelled.

[The fund] believes that shareholders must be aware of the risks presented by a company's use of GMOs. This information should be provided to shareholders regularly. [The fund] also believes that companies

<sup>20</sup> Aventis has lost nearly US\$1 billion because genetic material from its StarLink corn, which was not approved for human consumption, has been found in corn intended for human consumption. This has led to the recall of over 300 products to date and lawsuits by farmers and food retailers. See Julie Vorman, "StarLink Recall Climbs to 300 Different Items," *Reuters*, 1 November 2002; Stuart Laidlaw, "StarLink Fallout Could Cost Billions," *Toronto Star*, 9 January 2001. More alarming is the potential contamination of food crops by genes that have been modified to produce pharmaceutical substances. In 2002, more than 500,000 bushels of soybeans and corn produced by ProdiGene were found to be contaminated by corn that had been genetically modified to produce a pig vaccine. In late 2004, Syngenta AG informed US regulators that it had mistakenly sold about 1,000 tons of an unapproved strain of modified corn seeds that contained a gene for resistance to ampicillin. Both producers were fined. ProdiGene was required to destroy all of the contaminated crops. T. Hesman, "Crop Experiments Get More Watchful Look: USDA Ordered Destruction of Soybeans After Contamination," *St. Louis Post-Dispatch*, 22 November 2002; C. Macilwain, "US Launches Probe into Sales of Unapproved Transgenic Corn," *Nature*, 434, 2005, p. 423.

should label or otherwise identify their products that contain GMOs. The high consumer demand for labelling and the labelling requirements in other countries make it likely that companies will enjoy greater access to markets, a better reputation, and greater consumer satisfaction if they label their GMO products.

- [The fund] will vote for proposals to require companies to report on their use of GMOs and the attendant risks of such use, provided that these reports are produced at a reasonable cost, proprietary information is safeguarded, and the information is not already easily available to shareholders.
- [The fund] will vote for proposals to require companies to label their products that contain GMOs.
- [The fund] will assess proposals to stop producing or using GMOs on a case-by-case basis. This assessment should include careful consideration of the potential liabilities from the GMOs at issue, the anticipated market for products containing GMOs, the costs of market failure, the findings and status of current independent research on the safety of the GMOs, and any issues that may arise related to insurance.

## Environmental issues

Companies' responsibility for protecting the environment is being recognized as a component of shareholder value. Environmental damage risks not only harm to public health and the environment, but also legal liability, remediation costs, the costs of unplanned and possibly significant changes in operations, and a damaged reputation. The best way to minimize these risks is through the use of the precautionary approach, that is, by investigating and testing operations and products for their effects on the environment before they are put into use. The precautionary approach is described in greater detail in the United Nations Global Compact.

The Coalition for Environmentally Responsible Economies, or Ceres, works with corporations, investors, and environmentalists to foster environmentally sound business practices, including the establishment of the Global Reporting Initiative. Ceres has established a set of broad environmental principles for corporations. The UN Global Compact also includes three environmental principles that will help corporations to be environmentally responsible.

- [The fund] will vote for proposals to require companies to adopt the Ceres principles and report to shareholders on their progress in implementing them.
- [The fund] will vote for proposals to require companies

to adopt and comply with the Global Compact Guidelines and to report to shareholders on their progress in implementing them.

- [The fund] will vote for proposals to require companies to adopt environmental standards specific to their industry or sector, as long as these standards are at least as stringent as the Ceres principles.

## Environmental reporting

[The fund] encourages companies to report on their environmental performance. These reports should include companies' potential environmental liabilities, their plans for improving their environmental performance and/or addressing their liabilities, and their progress in making those improvements.

Voting guidelines on environmental reporting proposals can be found in the section "Reports on social and environmental performance," on page 36.

## Climate change

The consequences of climate change are being widely accepted as risks that businesses of all kinds must address. In some cases, climate change may also create business opportunities, such as carbon emission trading schemes. Climate change has investment implications for shareholders, especially for institutional investors whose diverse portfolios expose them to risks across a wide range of economic sectors. The Investor Network on Climate Risk publishes a guide to evaluating the potential risks for investors.<sup>21</sup>

The Global Framework for Climate Risk Disclosure is a set of guidelines, created in consultation with the Global Reporting Initiative and the Carbon Disclosure Project, on how corporations can report on their climate change risks and management strategies. [The fund] encourages companies to report using the Framework.<sup>22</sup>

- [The fund] will vote for proposals to require companies to examine and/or report on the risks and opportunities they face related to climate change, provided this information is not already easily available to shareholders. [The fund]

<sup>21</sup> *Investor Guide to Climate Risk: Action Plan and Resource for Plan Sponsors, Fund Managers and Corporations*, Investor Network on Climate Risk, <http://www.incr.com>.

<sup>22</sup> The Framework can be found at <http://www.ceres.org/NET-COMMUNITY/page.redir?target=http%3a%2f%2fwww.incr.com%2fNETCOMMUNITY%2fDocument.Doc%3fid%3d167&srcid=259&erid=0>.

prefers that these reports be consistent with the Global Framework for Climate Risk Disclosure.

- Proposals calling for companies to reduce their greenhouse gas emissions will be evaluated on a case-by-case basis, taking into account companies' current levels of emissions and the effectiveness of any programs they already have to reduce those emissions.

## International operations

International operations are highly complex; they demand that corporations reconcile differences in legal regimes, cultural values and practices, and consumers' and workers' interests. The Organisation for Economic Cooperation and Development (OECD), of which Canada is a member, has established Guidelines for Multinational Enterprise that set standards for international operations in labour, the environment, consumer protection, fair competition, science and technology, and taxation. These guidelines were developed in cooperation with representatives from business, labour, and the governments of OECD member countries. [The fund] recommends that companies adhere to the OECD Guidelines for Multinational Enterprise.

All of [the fund's] guidelines on environmental and social issues apply equally to companies' international and domestic operations. International operations also raise some additional issues, which are addressed here.

### Labour practices

One of the appeals of moving production overseas is that doing so allows corporations to take advantage of lower prevailing wages in some countries. Unfortunately, some corporations have sought an unfair competitive advantage by lowering their labour standards for overseas operations. As a result, multinational corporations and their host countries have been perceived as being in a labour-standards race to the bottom, promoting child labour, forced labour, long hours at lower-than-subsistence wages, and dangerous working conditions. When a company becomes associated with poor labour standards the result is often negative publicity, consumer boycotts, and divestiture or avoidance by institutional investors.

To ensure that consistently high standards are used in global employment practices, [the fund] encourages companies to adopt the International Labour Organization's Fundamental Principles and Rights at Work. These standards are also included in the United Nations' Global Compact as its four principles on labour, and they have been incorporated into the OECD's Guidelines for Multinational Enterprise. The core labour standards include

- » freedom of association, including the right to organize, hold meetings, and bargain collectively without coercion or interference;

» abolition of forced labour such as indentures or labour as punishment for the expression of political views;

» and end to discrimination in employment based on race, creed, colour, political opinion, social origin, or sex. This includes equal access to employment and training and an end to discrimination in working conditions. It also includes equal pay for men and women for work of equal value; and

» the effective abolition of child labour. There are situations in which children must work in order to survive. The UN Global Compact has helpful guidelines for companies regarding child labour.<sup>23</sup>

- [The fund] will vote for proposals to require companies to adopt and comply with the ILO standards, or employment standards that are consistent with the ILO's.
- [The fund] will vote for proposals to require companies to provide shareholders with independently verified reports on their progress in implementing the ILO standards or equivalent standards, unless this information is already easily available to shareholders.

### Human rights

Conducting business in a country that has been accused of persistent, gross, and systemic violations of human rights can jeopardize a company's reputation, even if the company tries to distance itself from the human rights abuses. Companies that do business in countries with a record of systemic human rights violations may be subject to consumer boycotts or divestment campaigns, which can damage corporate reputations and hurt shareholder value.

In 2003, a subcommittee of the United Nations Commission on Human Rights adopted the *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*.<sup>24</sup> These norms are specific standards that companies should use when applying the UN Declaration on Human Rights, the principles of the Global Compact, and other international human rights standards to their operations.

In assessing the effects of their operations on human rights in these circumstances, companies should consult with reputable civil society organizations and human rights experts. Adhering to the *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights* will

<sup>23</sup> <http://www.unglobalcompact.org/aboutthegc/thetenprinciples/principle5.html>.

<sup>24</sup> [http://www.unhchr.ch/huridocda/huridoca.nsf/\(Symbol\)/E.CN.4.Sub.2.2003.12.Rev.2.En?Opendocument](http://www.unhchr.ch/huridocda/huridoca.nsf/(Symbol)/E.CN.4.Sub.2.2003.12.Rev.2.En?Opendocument).

help companies avoid being associated with human rights abuses.

- [The fund] will vote for proposals to require companies to adopt and/or comply with international human rights standards, including the *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*.
- [The fund] will vote for proposals to require companies to report on their human rights policies and practices, including reports on their compliance with international human rights standards, provided these reports are not already easily available to shareholders. This includes proposals that ask companies to establish board committees to examine and report on their human rights policies and practices.
- [The fund] will vote for proposals to require companies to consult with stakeholders on the effects of their operations on human rights, including organizations with expertise in human rights.
- [The fund] will assess on a case-by-case basis proposals to require companies to cease operations in countries with human rights abuses, taking into account the potential for harm or benefit to the people of the country in question and the effects on shareholder value in the long term.

#### *Operations in zones of conflict*

Companies sometimes find it desirable to operate in zones of conflict. However, doing so is fraught with risk. It is difficult—some would say impossible—for companies to operate in these areas without becoming aligned or appearing to be aligned with parties to the conflict. Harm may come to their employees and physical assets, their reputations may be sullied, and they may be exposed to litigation or public divestment campaigns.

[The fund] encourages corporations that choose to operate in conflict areas to use the OECD's *Risk Awareness Tool for Multinational Enterprises in Weak Governance Zones*<sup>25</sup> for guidance on protecting human rights and ethical standards in these conditions.

- [The fund] will vote for proposals to require companies operating in conflict zones to establish policies to protect the rights of local communities and to avoid participating in or exacerbating conflicts.

- [The fund] will vote for proposals to require companies to monitor compliance with those policies and to provide shareholders with independently verified reports on their adherence to those policies, provided these reports are not already easily available to shareholders.

#### *Freedom of expression and internet censorship*

Some countries use computers and software to monitor their citizens, enforce censorship, or suppress dissent. In November 2005, a group of 26 institutional investors from the United States, Canada, and Europe issued a *Joint Investor Statement on Freedom of Expression and the Internet*<sup>26</sup>, calling on businesses to adopt and publicize codes of conduct that ensure they are not implicated in efforts to stifle free expression or commit human rights violations.

[The fund] recognizes that the right of free expression is not universally accepted and that the appropriateness of limits on free expression is hotly debated. Nevertheless, we believe that the protection of basic human rights, including freedom of expression, is necessary for sound long-term investment. Companies that associate themselves with regimes that do not protect freedom of expression, and companies that turn a blind eye to the uses to which these regimes put their products, may expose themselves to liability for the regime's human rights abuses and put their investors' confidence at risk.

- [The fund] will vote for proposals to require companies to adopt codes of conduct that include obligations to uphold freedom of expression and to prevent the companies' products or services from being used to violate freedom of expression.
- [The fund] will vote for proposals to require companies to report to shareholders on their progress in implementing these codes of conduct or in achieving compliance from their contractors, provided these reports are not already easily available to shareholders. This includes proposals to require companies to establish board committees to examine and report on their practices and codes of conduct related to the protection of freedom of expression.

<sup>25</sup> <http://www.oecd.org/dataoecd/26/21/36885821.pdf>.

<sup>26</sup> <http://www.rsf.org/fonds-investissement-en.php3>.

**Monitoring foreign contractors**

A large portion of overseas manufacturing is done through contracting and subcontracting, rather than at facilities owned directly by the companies. This makes it possible for a company's products to be produced in conditions that violate international labour and environmental standards, with all of the attendant liabilities, without the company's knowledge. Thus, companies must monitor their contractors' operations, and insist on operating practices that conform to international standards as a condition for awarding contracts. However, the number and diversity of contractors involved makes insisting on international standards and enforcing them a complex matter.

For this reason, [the fund] encourages companies to establish a monitoring process that includes independent verification of contractors' compliance with labour and environmental standards. [The fund] recommends involving local religious, human rights, and workers' organizations that are independent and well-respected in the monitoring process, and using incentives, rather than premature termination of contracts, to encourage suppliers to raise their labour and environmental standards.

- [The fund] will vote for proposals to require companies to use qualified, independent monitors to assess their contractors' adherence to labour and environmental standards.
- [The fund] will vote for proposals to require companies to provide shareholders with independently verified reports on their adherence to labour and environmental standards and their plans for improving their performance, provided these reports are not already easily available to shareholders.

# 05

## REFERENCES

**The following documents were used as references in developing these guidelines but were not cited in the text.**

*The proxy-voting guidelines of:*

Alberta Revenue's Investment Management Division  
Alberta Teachers' Retirement Fund Board  
American Federation of Labor–Congress of Industrial Organizations (AFL-CIO)  
British Columbia Investment Management Corporation  
Caisse de depot et placement du Quebec  
California Public Employees' Retirement System  
Calvert Group, Social Investment Funds  
Canada Pension Plan Investment Board  
Christian Brothers Investment Services  
State of Connecticut, Office of the Treasurer  
Domini Social Investments LLC  
The Episcopal Church  
The Ethical Funds Company  
Florida State Board of Administration  
Hermes Fund Managers Limited  
Hospitals of Ontario Pension Plan  
City of New York Board of Education Retirement System, City Employees' Retirement System, Fire Department Pension Fund, and Police Department Pension Fund  
Ontario Teachers' Pension Plan  
Ontario Municipal Employees' Retirement System  
Ontario Public Service Employees' Union Pension Trust  
Teachers' Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF)  
United Brotherhood of Carpenters and Joiners

United Methodist Church General Board of Pension and Health Benefits

State of Wisconsin Investment Board

Working Enterprises

“OECD Principles of Corporate Governance,” Paris: OECD, 2004,  
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United Nations, Economic and Social Council, Commission on Sustainable Development, *Rio Declaration on Environment and Development*, Pub. No. E/CN.17/1997/8, 1997,  
([www.un.org/documents/ecosoc/cn17/1997/ecn171997-8.htm](http://www.un.org/documents/ecosoc/cn17/1997/ecn171997-8.htm)).

### Internet Resources

*The following web sites are good sources of information on proxy voting, corporate governance, and corporate social responsibility.*

The Canadian Coalition for Good Governance

[www.ccg.ca](http://www.ccg.ca)

The Corporate Library

[www.thecorporatelibrary.com](http://www.thecorporatelibrary.com)

The Council of Institutional Investors

[www.cii.org](http://www.cii.org)

The Enhanced Analytics Initiative

[www.enhancedanalytics.com](http://www.enhancedanalytics.com)

The Pension Investment Association of Canada (PIAC)

[www.piacweb.org](http://www.piacweb.org)

Proxy Democracy (Includes the voting records of mutual funds and information on upcoming shareholders' meetings, mostly in the United States)

[www.proxydemocracy.org](http://www.proxydemocracy.org)

The World Bank, Corporate Governance page

<http://go.worksbank.org/4YWGMGXLNQ0>

*Several institutional investors are very active in proxy voting and have posted their guidelines on the internet. Many also post their proxy votes on their web sites.*

The British Columbia Investment Management Corporation

[www.bcimc.com/ResponsibleInvesting/default.asp](http://www.bcimc.com/ResponsibleInvesting/default.asp)

The California Public Employees' Retirement System, or CalPERS, Shareowners' Forum

[www.calpers-governance.org](http://www.calpers-governance.org)

The Ethical Funds Company

[www.ethicalfunds.com/en/Investor/ChangingTheWorld/HowWeWork/EngagingCompanies/Pages/ProxyVoting.aspx](http://www.ethicalfunds.com/en/Investor/ChangingTheWorld/HowWeWork/EngagingCompanies/Pages/ProxyVoting.aspx)

The Ontario Municipal Employees' Retirement System (OMERS)

[www.omers.com/Investments/Corporate\\_governance/Proxy\\_Voting\\_Guidelines.htm](http://www.omers.com/Investments/Corporate_governance/Proxy_Voting_Guidelines.htm)

The Ontario Public Service Employees' Union (OPSEU) Pension Trust

[www.optrust.com/Investments/proxy.pdf](http://www.optrust.com/Investments/proxy.pdf)

The Ontario Teachers' Pension Plan (OTPP)

[www.otpp.com/web/website.nsf/web/CGIntroduction](http://www.otpp.com/web/website.nsf/web/CGIntroduction)

[www.share.ca](http://www.share.ca)

The Shareholder Association for Research and Education (SHARE) is a social enterprise based in Vancouver, British Columbia. Since its creation in 2000, SHARE has provided leadership, expertise and advocacy in the area of responsible investment and active share ownership. SHARE assists institutional investors in implementing responsible investment strategies through our Active Ownership Services, including:

- **Pension Investment & Governance Education**
- **Proxy Voting & Advisory Services**
- **Shareholder Engagement**
- **Responsible Investment Advisory Services**