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Citation Details
Janis P Sarra, "The Corporation as Symphony: Are Shareholders First Violin or Second Fiddle?" (2003) 36:3 UBC L Rev 403.

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THE CORPORATION AS SYMPHONY: ARE SHAREHOLDERS FIRST VIOLIN OR SECOND FIDDLE?

JANIS SARRA†

I. INTRODUCTION

Amidst the cacophony of recent failures of large U.S. publicly traded corporations, the discord between these events and investor protection, and the prelude to the *Sarbanes-Oxley Act of 2002*,[1] safeguarding shareholder interest has become a central concern in corporate and securities law. This concern built to a crescendo with the enactment of new regulatory protection in the United States. The questions for Canada are how have these events influenced Canadian capital markets and what statutory or other responses are necessary to protect investors. Shareholders are like the string section of an orchestra, the largest section in numbers, a solid underpinning without which few classical or modern symphonies could exist or excel. Corporate officers as conductors harmonize the inputs of equity, debt and human capital, determining the corporate tempo, investments in particular modes, and strategies for moving *allegro* or *andante* in the generation of corporate wealth. Regulators are like "arrangers"; they assign the corporate players their parts within the score provided by the composer. The challenge for regulators is to strike the appropriate balance between the ability of corporate officers to conduct business affairs and the rights of shareholders and other corporate players to hold them accountable for the overall tone or stewardship of the corporation.

This article focuses on shareholders and whether the current regime affords them adequate protection and participation rights. Recent changes to corporate and securities laws have facilitated the exercise of shareholder voice. These changes are important to capital markets in that they are aimed at increasing investor confidence and hence the strength of markets. The lead in shareholder activism is being taken by institutional shareholders who are utilizing new proxy and proposal provisions to express governance preferences regarding key issues such as independence of audit committees and enhanced transparency in financial disclosures. However, there continue to be barriers

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[1] Pub. L. No. 107-204, 116 Stat. 745 (2002).

that institutional and other investors face in terms of holding corporate officers accountable for their governance decisions. There is also a live issue as to whether recent legislative changes will adequately protect smaller capital investors and others who are implicated in corporate activity. This article suggests that this may not be the case and analyses why.

The ability of equity investors to enter or exit a particular market is itself a protective device that allows for diversification of risk and the ability to act on informed decisions regarding the risk/benefit of particular investment strategies. It is also a form of participation, in that investor exit can signal dissatisfaction with the governance of the corporation. The choice of investment and the ability to exit, while private decisions, are situated in a broader public law framework that values and promotes capital markets by creating capital investment mechanisms of disclosure and enforcement. Shareholder voice presents an alternative to exit by investors when they are dissatisfied with the governance of a corporation. Yet most investors do not have the time, information or resources to actively monitor corporate activities and rely on ease of exit as sufficient protection of their investments.

In addition to private contracts, buttressed by corporate statutes that enable unanimous shareholder agreements, shareholders are more broadly protected through both corporate and securities law. There is some confluence of these regimes, particularly in respect of proxy regulation, but they are principally aimed at different public policy goals. Corporate law provides protection through the limited liability regime, the granting of limited control rights, and specific remedies where the corporation or its officers have engaged in oppressive conduct. It is a mechanism to regulate both privately held and publicly traded corporations and their agents *vis-à-vis* multiple stakeholders. Corporate law also protects the public by requiring disclosure of corporate status, so that those dealing with the corporation are aware of the limited liability status of its shareholders. Complementary to corporation law is securities law, which provides a form of consumer protection *vis-à-vis* issuing corporations. The continuous disclosure regime is the principal regulatory instrument, accompanied by prohibitions on some forms of self-dealing and regulation of the proxy decision process. Securities law is thus similar to labour law, human rights law or personal property security legislation, in that it provides a public policy framework to protect the interests of a particular set of stakeholder interests in corporate activity. This distinction and overlap is essential to appreciate as one considers the scope and limit of shareholder rights and remedies.

Part II commences this discussion by examining shareholders as the string section of the corporate orchestra, comprised of controlling and institutional shareholders as "first violins" and smaller investors as "second fiddles". The scope of shareholder protection cannot be assessed based on a single normative standard. Equity capital investors have different investment

timelines and risk capabilities. There is also an ever-increasing range of mixed debt-equity investment options, each carrying particular risk/benefit considerations. Moreover, growing securitization of assets may create new distributional effects among capital investors. Hence, any discussion of shareholder protection requires as a starting point, an appreciation of these conflicts of interest and divergent risk capabilities among capital investors. The design of corporate and securities regulatory systems needs to account for these differences and in particular, the distributional consequences of choices about policy tools.

Part III assesses the degree of harmony or discord in the current proxy and proposal processes, including the effect of giving different shareholders differential access to these mechanisms. Recent changes will enhance the ability of institutional investors to participate in governance activities, but this ability for minority shareholders is somewhat less clear. Part IV examines disclosure as an investor protection mechanism, and specifically, whether "knowing the score" offers investors adequate protection. It suggests that the definition of materiality needs to be recast to include social and environmental risks associated with corporate activities, in the context of what the "reasonable investor" would consider material. Part V considers other interests implicated in corporate activity in terms of the consequences for shareholder protection. An assessment of the current system requires recognition of how investors are differently positioned in their relationship to the corporation.

It is too early to assess the performance of the corporate orchestra in response to revisions to the regulatory "score". However, this article sounds some cautionary notes. The investor protection score is pitched at too high a level to offer the same level of protection to those less sophisticated investors who are being encouraged to invest their future in the performance of capital markets. The corporate law contribution to this score is also premised on the sufficiency of enhanced reporting as an effective curb on threats to all types of investors. Concentration on the use of this regulatory instrument may ignore the risks to less sophisticated investors. It may also subtly influence the interpretation of oppression and other remedies available to these small investors in a manner that reduces the scope of the protection offered by these provisions.

II. THE STRING SECTION

Shareholders as the string section of the corporate orchestra are integral to almost every performance, frequently playing solo or quartet in conjunction with other players. In combination with debt instruments, shareholders provide the capital necessary to generate economic activity. Given the closely held nature of many Canadian publicly traded corporations, the first violin, the controlling shareholders, set the pace and timing of the section, entering and

exiting, and in their assertion of control rights, shifting the tempo. As with any string section, shareholders bring different skills, information, interest and risk capacities. Hence, shareholder rights and remedies have to be viewed with an understanding that the interests of diverse shareholders do not always align.

Corporate law statutes specify a bundle of rights that shareholders possess in respect of their investments in the corporation.[2] Depending on the type of security held, shareholders can exercise control rights over election of corporate directors, appointment of auditors, participation at annual meetings, special general meetings and voting rights in respect of fundamental changes.[3] Dissent and appraisal remedies also facilitate the ease of exit when shareholders are dissatisfied with governance. Historically, shareholders, particularly those in publicly traded companies, were unable to bargain complete contracts in respect of their equity investments. Corporate and securities law responded through codification of particular rights and remedies, facilitating the ability of corporations to raise capital cost-effectively, while reducing associated transaction costs because shareholders need not bargain particular rights each time they invest in a firm. Thus while directors and officers are empowered to oversee and manage the business and affairs of the corporation, corporate law creates limited participation and default control rights, particularly in respect of fundamental change or capitalization decisions, that allow at least some measure of "voice" in corporate decisions, although the exercise of this voice by non-controlling shareholders has been limited.[4] While the statutory fiduciary obligations require directors and officers to act in the best interests of the corporation, judicial pronouncements have cast this primarily as "best interests of shareholders", buttressed by the language of securities law protections. The underlying premise is that shareholders, as equity investors, are the "owners" of the corporation's assets.[5] While this is a contestable notion, fiduciary obligation developed as a response to harms caused by incomplete contracts

[2] Janis Sarra, "Shareholders as Winners or Losers under the Amended Canada Business Corporations Act" (2003) 39 Can. Bus. L. J. 1.

[3] See *e.g. Canada Business Corporations Act*, R.S.C. 1985, c. C-44, ss. 140, 146, 173, 176, as am. by S.C. 2001, c. 14 [*CBCA*].

[4] *Ibid.*, s. 102.

[5] Daniel R. Fischel, "The Corporate Governance Movement" 35 Vand. L. Rev. 1259 at 1264; Thomas A. Smith, "The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty" (1999-2000) 98 Mich. L. Rev. 214; G. S. Crespi, "Rethinking Corporate Fiduciary Duties, The Inefficiency of the Shareholder Primacy Norm" (2002) 55 South. Meth. U. L. Rev. 141.

between shareholders and the corporation, complementing the market for corporate control.[6]

Corporate scholar Lynne Dallas has suggested that the current system of shareholder voting rights is inadequate to meet the needs of the modern corporation. Exit can send ambiguous messages to managers in terms of the reason for exit, allowing managers greater latitude to avoid responding to shareholder concerns.[7] Yet voting rights do not allow shareholders to vote on the full range of fundamental changes, rather, they relate primarily to capitalization decisions. Thus operational shifts, changes in control and power structure can frequently be cast as non-economic and thus there are no default control rights.[8] Dallas observes that shareholder participation in corporate governance began in recognition of the corporation's dependence on capital investors, yet as public corporations grew less dependent on shareholders for capital, shareholder voting also became a strategy to legitimate the decision making structure. In order to avoid governmental interference in managerial discretion, the corporation was cast as private property with private owners in control.[9] Dallas points out, however, that managers avoided real shareholder control through dual class capitalization, managerial control of proxy machinery and other strategies that deprived shareholders of effective control rights. This historical understanding of shareholder/managerial relationships helps to identify current barriers to shareholder participation.

A. FIRST VIOLIN

In an orchestra, first violin plays a resonant and significant role. The movements are higher pitched, complex and often flamboyant. The other players in the string section follow its lead in pace and tempo. In the context of Canadian closely held corporations, controlling shareholders play much the same role. Control can be defined several ways. Under most corporations statutes, it is defined by the percentage of votes that may be cast to elect directors.[10] Yet statutory definitions of control do not take account of *de facto*

[6] For a critique, see Crespi, *ibid.*; Janis Sarra, "Corporate Governance Reform: Recognition of Workers' Equitable Investments in the Firm" (1999) 32 Can. Bus. L. J. 384; Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvent Corporations* (Toronto: University of Toronto Press, 2003).

[7] Lynne L. Dallas, "The Control and Conflict of Interest Voting Systems" (1992) 71 N.C. L. Rev. 1 at 10.

[8] *Ibid.*

[9] *Ibid.* at 14.

[10] See *e.g. CBCA, supra* note 3, s. 2(3) ("control" is defined under the *CBCA* as a person or bodies corporate that hold securities amounting to more than 50% of the votes that may be cast to elect directors and the votes attached to these securities are sufficient, if exercised, to elect a majority of the directors).

control, when a single or small group of shareholders together hold voting power that directly influences the strategic direction of the corporation's activities. 70% of Canadian publicly traded corporations are under legal or *de facto* control of a single or small group of shareholders.[11] This capital structure creates particular dynamics in respect of shareholder-manager relations. It also creates accountability problems in respect of minority shareholders. Controlling shareholders have been active not only in selection of directors and officers and exercise of shareholder voting rights, but in more direct control of corporate activities.[12] Governance challenges thus differ from those in the widely held corporation. In both instances, the exercise of control has distributional consequences for equity capital investors. The issue for a widely held corporation is how to align the interests of corporate officers with those of shareholders, to protect against *ex post* shifts of wealth away from shareholders in favour of managers. In the context of closely-held Canadian corporations, controlling shareholders can exercise direct control over corporate decisions, posing accountability challenges for smaller investors. This is a significant difference that must be borne in mind when considering shareholder protection in the Canadian context.

Moreover, the availability of the unanimous shareholder agreement (USA) mechanism under many Canadian corporate law statutes allows shareholders to transfer some or all of the control rights from directors to shareholders.[13] Given the closely held nature of many Canadian corporations, this provides an effective mechanism for the reallocation of governance and control rights over particular transactions or decision-making functions. Shareholders who are parties to an USA acquire all the rights, powers, duties, liabilities and defenses of directors to the extent that the USA restricts the powers of the directors to manage or supervise the management of the business and affairs of the corporation, giving that power to the shareholders.[14] Activism under an USA, in which the shareholders act in concert to acquire control rights, does not have the profile of shareholder activism utilizing proxy and proposal provisions. Yet it has a much stronger normative and practical influence on

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[11] Ronald J. Daniels & Paul Halpern, "Too Close for Comfort, The Role of Closely Held Public Corporations in the Canadian Economy and the Implications for Public Policy" (1996) 26 Can. Bus. L.J. 11; Ronald J. Daniels & Randall Morck, "Canadian Corporate Governance: The Challenge" in Ronald J. Daniels & Randall Morck, eds., *Corporate Decision-Making in Canada* (Calgary: University of Calgary Press, 1995) 1; Randall K. Morck, "On the Economics of Concentrated Ownership" (1996) 26 Can. Bus. L.J. 63 at 69.

[12] While there continues to be a lack of empirical research regarding the precise scope and influence of these control rights, it is evident that shareholders of closely held corporations exercise their influence to protect their investments.

[13] *CBCA, supra* note 3, s. 146.

[14] *Ibid.*, s. 146(5).

the strategic direction of the corporation. Such shareholders rarely seek remedies through the courts, as they can wield power and control internally.

In Canada, there have been major statutory reforms in the past two years to the *Canada Business Corporations Act* (*CBCA*), and more recently, the enactment of the British Columbia *Business Corporations Act* (not yet proclaimed).[15] These changes are in part a response to an increasingly vocal shareholder community that has argued for increased shareholder democracy and increased accountability of corporate managers. The *CBCA* amendments in 2001 were aimed at increasing the voice aspect of the shareholder relationship.[16] The principal amendments were directed at enhanced shareholder participation, including: permitting corporations to have electronic shareholder meetings and voting through the use of new technologies; new provisions for shareholder proposals; revised proxy rules aimed at facilitating shareholder communication; and the ability to commence a civil action for insider trading, expanding the definition of insiders to align with securities laws and to include those who receive confidential material information from "tippees".[17] Amendments to the shareholder proposal provisions, including the extension of these rights to beneficial owners of shares has resulted in increased use of the proposal mechanism, an issue explored in Part III below.

If controlling shareholders are first violin, institutional shareholders are likely second violin. Second violin is another significant player, also one of the largest in number, with great depth in tone, stepping into the first violin role when that player is absent or inactive. In Canada, institutional investors have $2.86 trillion in assets, 12.5% of which is equity investment.[18] In 2000,

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[15] *CBCA*, *supra* note 3; *Business Corporations Act*, S.B.C. 2002, c. 57 (not yet proclaimed in force as of June 1, 2003) [*BCBCA*], replacing the British Columbia *Company Act*, R.S.B.C. 1996 c. 62. See also Bill 60, *Business Corporations Amendment Act*, 4th Sess., 37th Parl., British Columbia, 2003 (first reading 27 May 2003, amending the new *BCBCA*).

[16] *CBCA, supra* note 3; *Canada Business Corporations Regulations*, S.O..R./ 2001-512, online: Canada Gazette <http://canadagazette.gc.ca/partII/tempAscii/g2-13525_e.txt> (last accessed: 6 August 2003) [*Regulations*]; Regulatory Impact Analysis Statement (Industry Canada), C. Gaz. 2001.II, v.135, No.25, online: Canada Gazette <http://canadagazette.gc.ca/partII/tempAscii/g2-13525_e.txt> (last accessed 6 August 2003) [*Regulatory Impact Analysis*].

[17] *CBCA, supra* note 3, ss. 130-132 (the *CBCA* now imposes civil liability for "tipping", with liability to the other party in the transaction as well as to the corporation for any benefit or advantage that the tipper receives as a result of the tip. Yet liability does not appear to extend to those advising others to trade where the person tipping does not actually disclose the confidential material information. Prohibitions on insider trading have been liberalized, with the former prohibition on insiders from all trading in puts and calls, amended to one where the insider is prohibited from buying a put or selling a call), s. 130.

[18] Gil Yaron, "Canadian Institutional Shareholder Activism in an Era of Global Deregulation," online: SHARE (Shareholder Association for Research and Education) <http://www.share.ca/files/pdfs/02_02_11_final2.pdf> (last accessed 6 August 2003) at 7.

institutional shareholders owned 31% of all Canadian based corporations listed on the Toronto Stock Exchange (TSX).[19] Trusteed pension plans in Canada manage assets valued at $568 billion, 10% of all equity of Canadian based TSX companies.[20] Canada's institutional shareholders have exercised a different form of activism from those in the United States. Canadian institutional investors have a history of collaborative intervention or "quiet voice", as opposed to confrontational or public proxy battles as the primary means of seeking governance change. They meet with corporate officers when they are concerned about particular strategies or corporate conduct.[21] Only very recently is there evidence that institutional investors are seeking a greater public voice in governance. This collaborative culture is shifting as institutional investors face increasingly limited options for their domestic capital investments and where they perceive that quiet intervention is not effective in securing governance reform. Given the depth and breadth of their holdings, it is the institutional investors who present the greatest possibility for shifting Canadian corporate governance.

B. SMALL INVESTORS AS SECOND FIDDLE

In contrast to first or second violins, small investors are "second fiddles" in corporate law. They have basic protections, created by the limited liability regime, the continuous disclosure system, protections against insider trading, dissent and appraisal rights, and oppression remedies. Beyond these limited remedies, the assumption has been that small investors will exit if they are dissatisfied with corporate performance or direction and thus, there is no need to enable greater expression of preferences through "voice". There is also an assumption that small investors have diversified portfolios, such that the combination of proportionately small holdings and diversity of portfolio results in little incentive to engage in monitoring or exercise other participation rights. While this is true of many small investors, it ignores the diversity of investors, as well as their varying degrees of interest in the corporation. For example, there are investors who invest primarily in Canadian held corporations out of national sentiment or long standing loyalties. Employees as investors, through share purchase plans or labour

[19] TSE Review (now TSX), December 2001, Statistics Canada National Balance Sheet Accounts 1806, Table 3780-004, CANSIM II database, online: Statistics Canada <http://cansim2.statcan.ca/cgi-win/cnsmcgi.exe?CANSIMFile=CII/CII_1_E.HTM&RootDir=CII/> (last accessed 31 May 2003).

[20] *Ibid.*

[21] Tom Gunn, Ontario Municipal Employees Retirement System (OMERS), (Remarks to Queen's Law School, Business Symposium, 9 November 2002) [unpublished].

sponsored investment funds, have a strong interest in the ongoing success of the firm and thus in the effectiveness of its governance.

In Canada, there has been little minority shareholder activism. One factor has been the difficulty in shareholder communication generated by limited word counts on proposals and the rigid proxy solicitation requirements of the *CBCA* prior to 2001. It is also a function of the agency costs associated with monitoring and the classic free rider problem in terms of incentives to monitor corporate activity.[22] Moreover, given the shift to share registry systems that facilitate trading, many investors do not fully appreciate that they are beneficial, as opposed to registered, shareholders, and hence that they may face limits on the exercise of voice.

Where employees have invested in their own firms, preliminary studies have shown that employees are generally reluctant to shift their equity investments away from the corporation, out of institutional loyalty.[23] The *ex post* effect of such loyalty became evident with Enron's failure. Enron's misconduct was particularly egregious because of the large number of smaller investors who sustained losses, including workers who had invested much of their surplus income in Enron as a retirement strategy. However, even where there is no misconduct by corporate officers, employees with undiversified portfolios suffer disproportionate losses when firms are financially distressed. There are Canadian examples, such as the failures of Canadian Airlines, where sizeable equity investments of employees were lost, and where there may have been a failure to adequately diversify and reduce the risk of investment loses. There is a distinction between equity investors who have tied their life savings in the markets in hopes of securing future financial security and larger investors, whose actual capital investment is a more substantial amount in dollar terms, but represents a smaller portion of their equity investments at risk. Institutional investors are obligated through their fiduciary and trust obligations to diversify risk and thus the impact of one corporate failure to overall capital is minimized. Many larger investors are managers of other people's capital and thus their personal equity capital is not at risk.

Optimal investment practice assumes diversification of portfolios and ease of exit if equity investors are dissatisfied with corporate performance. These assumptions about the sophistication and preferences of investors are often adopted by regulators. However, one requires a deeper appreciation of the power relationships, even among shareholders, in order to create a regulatory framework that recognizes these differences. The information asymmetries faced by small investors can result in increased down side risks for such

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[22] Sarra, "Shareholders as Winners or Losers," *supra* note 2 at 6.

[23] Ronald B. Davis, "The Enron Pension Jigsaw: Assembling Accountable Corporate Governance by Fiduciaries" 36 U.B.C. L. Rev. 541.

investors, in terms of both inability to discern when their investments are at risk and an inability to easily exit because their holdings have become "illiquid" by the time they do discern the risk. Practically, voice, of which they may have little, may be the only recourse to protect their investments. Yet, given the closely held and controlled nature of Canadian corporations, there are powerful *ex ante* incentives for corporate officers, who are dependent on controlling shareholders for their continued tenure, to exclude minority shareholder voice from governance and to undertake opportunistic decisions that inappropriately place those investments at risk.

Small investors do have some important remedies under corporate law. The oppression remedy protects against conduct by directors and officers that is oppressive, unfairly prejudicial to, or unfairly disregards the interests of the complainant.[24] Enacted as an equitable remedy in response to the failure of the common law doctrine of fiduciary obligation to adequately protect minority shareholders, oppression remedies provide powerful but limited protection. The court has jurisdiction to order whatever remedy is just and equitable in the circumstances to rectify the matters complained of.[25] The courts have held that the remedy is available to protect the reasonable expectations of the party complaining; reasonable expectation defined in the particular context, history and relationship of the parties.[26] The courts have held that officers are entitled to act in a manner that is prejudicial or disregards particular interests, but that they can not do so in a manner that is unfairly prejudicial, unfairly disregarding or oppressive. Given the availability of the remedy based on a threshold of reasonable expectations, practically, the remedy is available primarily for minority shareholders of closely-held corporations. This is because the limited number of shareholders and their arrangements may have created particular expectations in governance or direction of the corporation.[27] However, reasonable expectations are also judged against the background created by the rest of the regulatory regime. If that background is changed, then the reasonable expectation protection offered by the oppression remedy may also be changed.

Generally, law and economics scholars have suggested that shareholders, as residual claimants to the value of the firm's assets, have the greatest

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[24] See e.g. *CBCA*, *supra* note 3, s. 21; *Business Corporations Act*, R.S.O. 1990, c. B-16, s. 248; *Business Corporations Act*, R.S.A. 2000, c. B-9, s. 242; *Company Act*, R.S.B.C. 1996, c. 62, s. 200 (to be replaced by the recently enacted British Columbia *Business Corporations Act*, *supra* note 14).

[25] See *e.g. CBCA*, *supra* note 3, s. 241.

[26] *Naneff v. Con-Crete Holdings* (1993), 11 B.L.R. (2d) 218 (Ont. Ct. Gen. Div.), rev'd in part (1994), 19 O.R. (3d) 691 (Div. Ct.), rev'd (1995), 23 O.R. (3d) 481 (C.A.).

[27] Jeffrey MacIntosh, "The Oppression Remedy, Personal or Derivative?" (1991) 70 Can. Bar Rev. 29.

incentive to monitor managers and thus the shareholder primacy norm will prevent managerial opportunism or shirking. Yet the logic of this rationale is questionable in light of Enron and other recent corporate failures. It was not merely the alleged fraud of Enron's senior officers, but a more deeply pervasive problem. As long as Enron appeared to be providing incredible returns to shareholders, the Board of Directors was not going to closely question the transactions. This created *ex ante* incentives for corporate officers to neglect their fiduciary and statutory duties in favour of the mantra of shareholder return, reinforced by short-term return pressures by some U.S. institutional investors.[28] It also created incentives to engage in self-dealing transactions, fraud and less than transparent reporting on financial and other corporate activity. Thus the relationship between shareholders, corporate "conductors" and the other instruments of corporate wealth generation needs further conceptualization. Shareholders have different risk capabilities, investment timelines, risk diversification capabilities, and information and resources to monitor corporate activity. Not only does this influence the short-term versus long-term investment and return timelines, but it also has direct implications for the type of risks and opportunities in which shareholders wish corporations to engage. There is also growing indication that investors represent a complex mix of both self-interest and concern for broader economic and social issues, hence they are also interested in long-term environmental sustainability and international labour standards in their investment decisions.[29]

III. THE PROXY AND PROPOSAL PROCESS, HARMONY OR DISCORD?

Under corporate and securities legislation, proxy and proposal provisions provide a means for shareholders to express their preferences and to exercise some limited control rights over the strategic direction of the corporation. Proposals are non-binding recommendations that ostensibly provide normative direction to corporate officers.[30] They also allow shareholders to communicate with one another, in turn encouraging increased transparency in corporate decisions. In contrast, proxy voting is the exercise of control rights, either on a proactive or default control basis. Regulation of management proxy

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[28] William W. Bratton, "Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value" (2002) 76 Tul. L. Rev. 1275.

[29] See *e.g.* the strategies of the Global Reporting Initiative, online: Global Reporting Initiative <http://www.globalreporting.org>.

[30] *CBCA*, *supra* note 3, s. 102. See also *Automatic Self-Cleaning Filter Syndicate Co. Ltd. v. Cuninghame*, [1906] 2 Ch. 34 (C.A.).

solicitation is recognition of the strong normative influence of corporate managers and tempers their decision making by setting basic standards of what they are required to communicate, disclosure of conflicts of interest and at least some transparency that is aimed at encouraging investors to exercise their proxy voting power in an informed manner. They are a principal mechanism through which shareholders review the stewardship of the corporation.

With the increasing concentration of capital in the hands of institutional investors, the governance agenda of shareholders of U.S. publicly traded corporations has shifted during the last two decades. "Relationship investing" situates institutional shareholders as a complement to the market for corporate control in enhancing efficiency and value for shareholders.[31] The merits and problems associated with these developments have been well documented by legal scholars and are beyond the scope of this article.[32] It is evident that there is a growing tension between those who believe that exercise of institutional shareholder voice in corporate governance should be aimed exclusively at maximizing short-term share value, and those that believe institutional shareholder pressure is likely an avenue to force corporations to act in a socially responsible manner.[33] These tensions reflect the different investment priorities by investors and their accountability to beneficiaries for their investment and governance decisions. In the U.S., institutional shareholders utilize proposals as part of an integrated strategy of shareholder activism that includes proxy voting, intervention at the officer and board level, and litigation under securities and corporate laws. Institutional investors often bargain for governance change, including independent directors, financially literate audit committees, separation of CEO and board chair roles, and establishment of board compensation committees.[34] CalPERS' interventions in governance in underperforming firms in its portfolio resulted in better performance of these companies, with stock trailing the S&P 500 Index by

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[31] Bernard Black, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 U.C.L.A. L. Rev. 811 at 887 [Black, "Investor Voice"].

[32] *Ibid.* Jeffrey MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1995-96) 26 Can. Bus. L. J. 145; John Coffee, Jr., "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum. L. Rev. 1277; Edward Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 Geo. L. J. 445.

[33] See *e.g.* Black, "Investor Voice," *supra* note 31. See also the articles in a special issue on corporate governance and socio-economics, (2002) 76 Tul. L. Rev. 1187.

[34] Black, *ibid.*

96% in the five-year period prior to CalPERS intervention and then outperforming the index by 14% in the five years following intervention.[35]

A. EARLY DISCORD

In contrast to the U.S., the shareholder proposal provisions of Canadian corporations' statutes have been used infrequently.[36] As a result, there have been few judicial determinations of the scope of rights and remedies under the proposal provisions, with less than ten reported cases in Canada at the end of 2002. In the few cases in which shareholders have sought to enforce their rights, the courts have been historically inclined to give a narrow interpretation to the statutory language, reflecting judicial deference to business judgments.[37] Raymonde Crête suggests that by significantly restricting shareholder access to proxy machinery, Canadian judges perpetuated the misconception that the proxy system was simply an instrument encouraging shareholder abuse.[38]

Moreover, the previous statutory language, in which corporate officers had the right to refuse to circulate a proposal on the ground that the proposal was submitted primarily for the purpose of promoting general economic, political, racial, social or similar causes, halted efforts by shareholders to inject corporate accountability or social responsibility into decision making.[39] Hence, while the proposals were also linked to shareholder value in terms of articulating the detrimental economic risks to the corporation, the narrow judicial interpretation hindered the market for corporate accountability. Thus, while the U.S. experienced an evolution in shareholder proposals on diverse

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[35] CalPERS is the California Public Employees Retirement System, online: CalPERS Shareowner Forum <www.calpers-governance.org> (last accessed 6 August 2003); Wilshire Associates, *Study of the CalPERS Effect*, available online: CalPERS Governance <www.calpers-governance.org>. See also, CalPERS Financial Market Reform Initiative (November 2002), online: CalPERS Governance <www.calpers-governance.org > (last accessed 31 May 2003); "TIAA-CREF Policy Statement on Corporate Governance," online: TIAA-CREF <http://www.tiaa-cref.org/libra/governance> (last accessed 6 August 2003).

[36] In British Columbia, until the recently enacted (but not yet proclaimed) *BCBCA, supra* note 15, the company law statute did not contain any provisions for shareholder proposals.

[37] *Re Varity Corp. v. Jesuit Fathers of Upper Canada* (1987), 59 O.R. (2d) 459 (H.C.J.), aff'd (1987), 60 O.R. (2d) 640 (C.A.) [*Re Varity*]. See also *Greenpeace Foundation of Canada v. Inco Ltd.*, [1984] O.J. No. 274 (S.C.) (QL), Montgomery J., aff'd (1984), 25 A.C.W.S. (2d) 149 (Ont. C.A.).

[38] Raymonde Crête, *The Proxy System in Canadian Corporations: A Critical Analysis* (Montréal: Wilson, Lafleur-Martel ltée, 1986) at 351.

[39] *CBCA*, *supra* note 3, s. 137(5), prior to the 2001 amendments. Cases such as *Re Varity*, *supra* note 37, upheld directors' exclusion of proposals on the basis that they were primarily for political purposes, in that case eliminating apartheid in South Africa.

corporate activities, the efforts of non-controlling shareholders of Canadian-based corporations to utilize the proposal mechanism to align corporate decision making with their preferences were effectively stymied. At the heart of this resistance by corporate managers was a normative view of corporate decision-making that did not include the voices of shareholders, other than those with a controlling interest.

Corporate law has also tended to construct the shareholder as the artificial "rational investor" seeking only to maximize short-term returns. While this is an important objective of investment activity, it ignores shareholders as socially situated individuals that might have interests more broadly aimed at generating economic wealth in an environmentally or socially sustainable manner.[40] Shareholders expressing such preferences were frequently considered irritants to corporate decision makers, detracting from the focus on generating wealth. Yet, any discussion of increased shareholder activism must give voice and weight to shareholder preferences, particularly where they align with public policy objectives. The costs to the corporation of a more active proposal regime, given the non-binding nature of proposals, are really the transaction costs of circulating the proposal and any costs associated with negative publicity. The former are a relatively small price for shareholder participation, the latter identifies a problem of incentive effects. The aim should not be to prevent the circulation of proposals that may generate negative public attention, but rather to assess the substance of the proposal, particularly where socially situated shareholders have expressed strong preferences for independent audit committees, diversity on corporate boards, independence of directors, environmental sustainability or other governance measures.

B. NEW CHORDS

It was not until 1996 that the Supreme Court of Canada held that the shareholder proposal mechanism in Canadian corporation statutes and the *Bank Act* represent a legislative commitment to the promotion of shareholder participation in corporate governance.[41] This shift in emphasis was adopted in *Michaud* c. *La Banque nationale du Canada* in 1997.[42] This was one of the first indications that the courts viewed shareholder participation as a legitimate part of corporate law. Michaud sought circulation of shareholder proposals to separate the role of CEO and board chair, place limits on executive compensation, and impose some restrictions on insiders or service providers

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[40] Davis, *supra* note 23.

[41] *Verdun v. Toronto-Dominion Bank*, [1996] 3 S.C.R. 550 at paras. 10-12, 32 [*Verdun*].

[42] [1997] R.J.Q. 547 (S.C.), appeal for stay refused [1997] A.Q. No. 14 (C.A.) [*Michaud*].

serving as directors.[43] The Quebec Superior Court held that the refusal to circulate Michaud's proposals denied him the only realistic means through which a small shareholder can communicate directly with and seek the support of other shareholders in their common interests. In both *Michaud* and another judgment that followed it, *McVety v. Sintra*, the court held that while corporate officers are to manage the corporation, shareholder proposal provisions are a unique means for shareholders to develop dialogue on corporate affairs and that there are benefits to managers listening to shareholders' concerns regarding governance of the corporation.[44] While ultimately, the vote in support of Michaud's proposals was relatively small, the case generated considerable public attention on the potential role of proposals in the governance process.[45]

Yet post-*Michaud*, shareholder activism did not materialize, primarily due to the language of the statutes and restrictions on who could table proposals. Beneficial shareholders were prohibited from submitting proposals.[46] Pension funds could not submit proposals directly because they were almost always beneficial owners of shares.[47] This has been remedied with the 2001 amendments to the *CBCA*. In combination with the reduced scope of exclusions, this amendment is likely to result in increased shareholder activism by pension funds and other beneficial shareholders.[48]

Yet institutional investors have been major players in Canadian corporations prior to these amendments. Why haven't they been more active? In Canada, additional factors have played a role in the infrequent use of the shareholder proposal mechanism, including shareholder apathy and freerider problems arising from the agency costs associated with monitoring corporate officers. These factors are exacerbated in closely held corporations where controlling shareholders are believed to be absorbing the costs associated with

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[43] *Michaud* sought a remedy under the *Bank Act* provisions that are similar to the remedies in the *CBCA, supra* note 3: see *Bank Act*, S.C. 1991, c. 46, s. 143. The Quebec Superior Court rejected the Bank's argument that the amount of shareholdings was so small that Michaud could not be "sufficiently aggrieved" by not having his proposals circulated.

[44] *Michaud, supra* note 42 at para. 53; *McVety* c. *Sintra Ltd.* [1999] J.Q. No. 5810 at paras. 7, 11 (C.S. civ.) (QL).

[45] See Richard Blackwell, "Royal Meeting Rejects Governance Proposals" *Financial Post* (6 March 1997) 3 (the proposal that garnered the highest support was 27% support for separation of the CEO and chair roles).

[46] *Verdun, supra* note 41 at paras. 10-12.

[47] The shares are held in the name of the pension fund's custodial trustee, and the pension funds are only the beneficial owners.

[48] Early evidence of increased activism can be found in the formation of the Canadian Coalition for Good Governance amongst the largest Canadian institutional investors, coincidental with the enactment of the amendments, see discussion below.

monitoring, given their higher incentives to protect their investments. There have also been pragmatic cost/benefit decisions by institutional investors, such that intervention occurs only where it is likely to be profitable or where necessary to remedy conduct that negatively affects portfolio value.[49] Moreover, some of the statutory liability imposed on corporate directors and officers tempers incentives for self-dealing and enhances certainty in standards of conduct expected, possibly reducing shareholders' perceptions of a need for intervention.[50] While clearly defined statutory liability can assist in controlling agency costs, there continue to be costs associated with ensuring enforcement of those statutory standards. The more recent push for increased use of outside or unrelated directors is also viewed as a protective device for minority shareholders, in that such directors are arguably less vulnerable to pressure from controlling shareholders than nominee directors.[51]

However, despite these voice-inhibiting factors, institutional shareholders can exit less easily because there is frequently not a readily available market for all their shares or the market could adversely react to a large disposition of holdings. Thus, realistically, voice in governance becomes more important to them than smaller investors. There is the added tension of the governance role played by a controlling shareholder of a Canadian closely-held publicly traded corporation. Hence, there is less likelihood that intervention by a shareholder, even an institutional shareholder, will have the same impact that similar intervention would have in a U.S. widely held corporation, because the controlling shareholder has an effective veto over the proposal. On a cost/benefit analysis, the value to be gained from tabling shareholder proposals in such instances may be marginal at best. Yet while the controlling shareholder is likely to invest in the monitoring costs to ensure its interests are protected, there is a potential for these shareholders to extract rents that shift value away from the other equity holders and other corporate investors, broadly defined. This potentially enhances the interest of institutional shareholders in monitoring the activities of corporate managers for such rent-extracting activity. While it is too early to assess the actual effect that the statutory changes will have on corporate governance in Canada, it is likely to have a significant impact.

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[49] Crête, *supra* note 38 at 81.

[50] See generally, Ronald Davis, "The Bonding Effects of Directors' Statutory Wage Liability: An Interactive Corporate Governance Explanation" (2002) 24 Law & Pol'y 403.

[51] Although Enron's recent experiences suggests that outside directors need to meet more than just a statutory definition of independence if they are to perform this monitoring function.

C. MISSING REFRAINS: *DE FACTO* EXCLUSION OF SMALLER INVESTORS

One disturbing factor in the new "score" is the risk of diminution of smaller investors' ability to exercise "voice". The advent of book-entry or book-based securities record systems means that the Canadian Depository for Securities and other depositories are frequently the registered holder of share certificates. The introduction of computerized purchase and sale records and use of centralized depositories have assisted capital markets and reduced the transaction costs of trading. Yet, there have been problems with the ability of beneficial shareholders whose shares are registered under the depository to exercise voting rights and survive challenges to the validity of proxies when they attempt to vote on their own behalf.[52] Often small retail investors do not appreciate that their status is that of beneficial as opposed to registered shareholder. There is a tension between the need to have a form of proxy that protects the integrity of the shareholder voting process and the litigation over alleged defects in form of proxy that consume considerable resources and act as a serious deterrent to exercise of shareholder voice.[53] This has serious and as yet unresolved challenges for any increased shareholder democracy. The recent Canadian Securities Administrators National Instrument on communication with beneficial owners of securities and National Policy on delivery of documents by electronic means are aimed at increasing shareholder communication, allowing for enhanced delivery of documents via the internet and facilitating the use of electronic communication in the proxy solicitation process.[54] It is likely to counter balance some of the deterrent

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[52] See *e.g. Re Coral Gold Corporation* (1999), 62 B.C.L.R. (3d) 52 (S.C.) (the court held that the corporation was not required to provide a list of beneficial shareholders). See also *Fama Holdings Ltd. v. Powertech Industries Inc.* (1997), 34 B.C.L.R. (3d) 357 (C.A.); *Vella-Zarb v. Canhorn Chemical Corp.* (1996), 9 O.T.C. 182, [1996] O.J. No. 2495 (Ct. Gen. Div.) (QL); *Brio Industries Inc.* v. *Clearly Canadian Beverage Corp.* (1995), 8 C.C.L.S. 1, [1995] B.C.J. 1441 (S.C.) (QL) (for a discussion on oppression).

[53] *Langset v. Langtec Capital Corp.*, [1997] B.C.J. No. 137 (S.C.) (QL); *Re Sepp's Gourmet Foods Ltd.*, [2002] B.C.J. No. 33 (S.C.) (QL), rev'd (2002), 98 B.C.L.R. (3d) 217 (C.A.), application for leave to appeal dismissed [2002] S.C.C.A. No. 144 (QL); *Ambassador Industries Ltd.* v. *Camfrey Resources Ltd.*, [1991] B.C.J. No. 1073 (S.C.) (QL); *Value Investment Corp.* v. *Caldwell Gundy Inc.* (1989), 44 B.L.R. 142, [1989] B.C.J. No. 1680 (S.C.) (QL); *Pressello v. Venture Pacific Development Corp.* (2001), 20 B.L.R. (3d) 96, 2001 BCSC 1733.

[54] Canadian Securities Administrators, *Communication with Beneficial Owners of Securities of a Reporting Issuer*, NI 54-101 (1 July 2002), online: British Columbia Securities Commission <http://www.bcsc.bc.ca:8080/comdoc.nsf/0/1c9b3eea2c1bbbf388256be6005bb5c8 /$FILE/NI%2054-101.pdf>; Canadian Securities Administrators, *Delivery of Documents by Electronic Means*, NP 11-201 (1 January 2002), online: British Columbia Securities Commission <http://www.bcsc.bc.ca:8080/comdoc.nsf/0/39edd6bf1f7515c288256ccd0068e4eb /$FILE/NP11-201.pdf> (last accessed 7 August 2003) (NI54-101 sets out the process by which

effects of the registry system in regard to shareholder participation, but in itself is not sufficient to address these problems.

There is a further barrier recently created. The *CBCA* has imposed for the first time in 2001, a threshold of a minimum level of shareholding to qualify to submit a shareholder proposal. The shareholder must hold either 1% of total outstanding voting shares on the date the proposal is submitted or shares with a fair market value of $2,000 or more at the close of the business day prior to submitting the proposal.[55] Shareholders can pool shares with others in order to meet the threshold.[56] The recently enacted (but not yet proclaimed) B.C. *Business Corporations Act* also creates a threshold 1% of shares.[57] These thresholds are curious, given that there is no history in Canada of abuse of the proposal process. Officers can also exclude proposals where "substantially the same proposal" was submitted to shareholders in a management proxy circular or a dissident's proxy circular within the previous 5-year period and garnered less than 3% of the total number of shares voted at an annual meeting of shareholders.[58] An explanation of the need for a 5-year ban on a particular resolution in the context of Canada's underutilized shareholder proposal provisions has not been provided.[59] These provisions appear to unnecessarily exclude small investors who do not currently have the power or resources to express voice in the same manner as controlling shareholders or institutional investors.[60]

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brokers of the CDs can appoint the beneficial shareholders as their proxy holder, thus allowing them to exercise the vote).

[55] *Regulations*, *supra* note 16, s. 46; *CBCA*, *supra* note 3, ss. 137(1.1), 261(1)(c.1).

[56] *CBCA*, *ibid.*, s. 137(1.1)(b).

[57] *BCBCA*, *supra* note 15, ss. 187, 188 (specifying 1% or an amount to be prescribed).

[58] Or less than 6% the second time submitted, or less than 10% the third or subsequent times submitted, *CBCA*, *supra* note 3, s. 137(5)(d); *Regulations*, *supra* note 16, ss. 51(1), (2); *Regulatory Impact Analysis*, *supra* note 16.

[59] Nor has any underlying policy rationale for embracing the U.S. standard, when the U.S. operates in a very different governance climate: see Sarra, "Shareholders as Winners or Losers," *supra* note 2.

[60] *CBCA*, *supra* note 3, s. 137(5.1); *Regulations*, *supra* note 16, s. 52. While the alternative of $2,000 in market value under the *CBCA* may be an easier threshold to cross than 1% of total outstanding voting shares, the shareholder must retain that value in the shares for the entire period leading up to and including the date of the shareholders meeting, failing which the shareholder will be barred from having the matter considered at that meeting and barred for 2 years from resubmitting a proposal. A shareholder could submit a proposal because it is unhappy with the governance of the corporation and its share value is plummeting. If there is any risk that the value will drop below the $2,000 threshold (particularly likely where the corporation may be entering a period of financial distress), the thresholds set under the *CBCA* and its regulations could effectively deprive the shareholder of any voice in the governance of the corporation. This would leave the shareholder with exit as the only option.

These changes arguably have minimal impact because exit as opposed to voice is the only realistic option for shareholders with small holdings. Even so, why does the legislation deny minority shareholders the option to make that decision themselves? While they may not have the resources to communicate and garner the support of other shareholders outside of the meeting, should they not be afforded access to shareholders through the proposal provisions? Moreover, why the two-year bar on future proposals if share value drops below the $2,000 threshold prior to the shareholder meeting? The continued drop may be precisely the reason that the shareholder has determined a proposal is necessary. This statutory provision appears punitive in nature. Regardless of the practical impact, the reform also communicates a message to all players in the corporation and the judiciary that legitimates disregarding small investors' interests and preferences for those of larger investors. This message has some disturbing implications for public regulation in a country in which equality is an informing value; the concern here is that the message will subtly infect other areas such as the judiciary's assessment of reasonable expectations in the oppression remedy.

Finally, a shareholder proposal can be excluded where the rights "are being abused to secure publicity".[61] This exclusion, which appears innocuous on its face, seems to have potential for its own abuse by corporate officers, given the cost barriers to disputing directors' decision to exclude proposals. Does "securing publicity" mean that shareholders seeking to draw public attention to particular environmental practices that the shareholder believes harmful to the environment and the corporation's bottom line may have their proposals excluded? This exclusion may in fact undermine the proposal provisions. Arguably, the shareholder who publicly announces its intention to vote on a particular issue that is considered controversial by the corporation could then find the corporation refusing to submit the proposal based on publicity generated by the shareholder's compliance with the communication provisions of the statute. The *ex ante* incentives created by the discretion granted to corporate officers is likely to result in costly litigation and unnecessary exclusion of shareholder proposals.[62]

Generally, the proposal provisions encourage voice for large institutional shareholders, but create considerable barriers to small investors. While the greatest barrier to shareholder proposals has been removed, the language of the new exemptions to management's requirement to circulate shareholder proposals is fraught with the potential for abuse. The provisions may also contribute to the rational apathy problem, as shareholders will be reluctant to

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[61] *CBCA*, *supra* note 3, s. 137(5)(e).

[62] Sarra, "Shareholders as Winners or Losers," *supra* note 2.

expend resources to submit shareholder proposals because they will then have to defend their ability to do so in costly court dispute resolution proceedings.

D. FUTURE SONATAS

Notwithstanding the problems discussed above, there is clearly potential for change in the reformed regulatory scheme. Even where shareholder proposals have failed to garner majority support, there is some evidence to suggest that today's proposals may become tomorrow's corporate policy. One notable example has been shareholder pressure for resource companies to produce annual sustainability reports.[63] There also appears to be a greater willingness for institutional shareholders to express their governance preferences. As of August 2002, a record 56 shareholder proposals had been submitted on a range of corporate governance, social and environmental issues.[64] In the first half of 2003, fifteen Canadian corporations had reported shareholder proposals seeking to require companies to expense their stock options in income statements.[65] Currently, stock option practices are not sufficiently linked to performance and they frequently distort earnings reporting because they are not recorded as a charge against earnings. Arguably, the ability to immediately exercise options creates incentives for managers to set short-term goals. Reported short-term earnings from short-sighted transactions can create windfall income for managers. Enhanced transparency and accounting of stock options will help ensure that shareholdings are not unnecessarily diluted from share options.

In the U.S., there were an estimated 800 shareholder proposals in the most recent proxy season.[66] Post-Enron, many of the proposals are aimed at the independence and integrity of the audit functions of corporations, including external auditors and audit committees of corporate boards. In addition, institutional investors are utilizing the shareholder proposal provisions to seek

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[63] See *e.g.* Suncor Energy, *2001 Report on Sustainability: Our Journey Toward Sustainable Development* (September 2001), online: Suncor <http://www.suncor.com/SD_Report01/pdfs/2001report.pdf> (last accessed 7 August 2003), and previous reports since 1995.

[64] SHARE (Shareholder Association for research and Education), "Shareholder Proposals Reach Record Numbers" (spring/summer 2002) 3 *Prospectus* 1, online: SHARE <http://www.share.ca/files/newsletters/prospectus3.pdf> (last accessed 7 August 2003).

[65] Peter Dey & David McIntyre, "Institutional Shareholder Proposals Forcing Companies to Reform Stock Option Practices" (20 May 20 2003), online: Osler, Hoskin & Harcourt LLP <http://www.osler.com/index.asp?menuid=86&miid=86&layid=124&csid=3033&csid1=1366> (last accessed 7 August 2003).

[66] CalPERS, *supra* note 35.

the appointment of independent directors as members of audit committees.[67] Another area of increased shareholder activism is in regard to excessive executive compensation that has become increasingly uncoupled from performance.[68]

Some shareholder activity has also focused on human rights issues and a push for greater transparency in corporate decision-making in respect of foreign labour practices.[69] A recent proposal regarding sweatshop employment practices garnered 36% of shareholder support at the corporation's annual meeting, the largest vote ever recorded in support of a social resolution submitted to a Canadian corporation.[70]

In 2002, institutional shareholders representing $500 billion in assets, $350 billion invested in Canadian publicly traded corporations, formed the Canadian Coalition for Good Governance.[71] The group includes 19 pension funds, mutual finds and money managers, and its express goal is to align the interests of managers with those of shareholders. Such a coalition is likely to enhance corporate governance practices, particularly if it utilizes its proxy voting power to influence change. The Coalition may also provide an avenue that will permit beneficial owners to overcome potential for free-rider problems and management abuse of its discretion by providing a forum for communication, cost-sharing, and share-pooling outside of the statutory framework.

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[67] SHARE, "Shareholder Proposals," online: SHARE <http://www.share.ca/index.cfm/fuseaction/page.inside/pageID/751215E5-B0D0-157F-F405B9A1ABA8AE7B/index.cfm> (last accessed 7 August 2003).

[68] For example, shareholders of British based GlaxoSmithKline in their May 19, 2003 shareholder meeting voted more than 50% to reject a costly executive pay scheme: Ben Hirschler, "Shareholders Reject Glaxo Executive Pay Deal" *Globe and Mail* (20 May 2003) B9.

[69] SHARE, "Labour Investors Gather Broad Support in Anti-Sweatshop Vote" (spring/summer, 2001) 1 *Prospectus* 4, online: SHARE <http://www.share.ca/files/newsletters/prospectus1.pdf> (last accessed 7 August 2003). Similarly, Real Assets Investment Management Inc. and Meritas Mutual Funds recently jointly filed a shareholder resolution with Calgary-based Enbridge Inc. calling on it to adopt a human rights policy. The shareholder proposal was withdrawn after Enbridge agreed to adopt the U.S.-U.K. Voluntary Initiative on Security and Human Rights, and to engage in discussions with shareholders and human rights groups on how it will be implemented.

[70] SHARE, News Release, "Record Numbers Support Shareholder Resolution at The Bay on Sweatshops" (23 May 2002), online: SHARE <http://www.share.ca/files/news/02-05-23-HBC.pdf> (last accessed 7 August 2003).

[71] OTPP (Ontario Teachers' Pension Plan), News Release, "Institutional Investors Form Coalition to Fight for Improved Corporate Governance" (27 June 2002), online: OTPP <http://www.otpp.com/web/website.nsf/web/coalitionforcorpgov> (last accessed 7 August 2003).

E. THE POTENTIAL ANTIPHONY OF PROXY VOTING

Antiphony is the effect created when two groups of musicians, positioned some distance apart, perform alternatively so that one group appears to be answering the other and together, the effect is a collaborative piece of music. The most recent amendments to the *CBCA* were aimed at removing impediments to shareholder communication and thus promoting shareholder activism and accountability. Prior to 2001, most forms of communication to a shareholder could be deemed to be a solicitation.[72] Any solicitation required a dissident proxy circular to be issued and circulated to all shareholders, an extremely expensive and time consuming process. Solicitation has now been redefined to allow broader communication without triggering dissident proxy requirements under the *CBCA*, including a public announcement by a shareholder of how the shareholder intends to vote and the reasons for that decision, or a communication for the purposes of obtaining the number of shares required for a shareholder proposal.[73] A person may now solicit proxies without sending a dissident's proxy circular if the total number of shareholders whose proxies are solicited is fifteen or fewer.[74] There is a further exception for solicitation by "public broadcast", where a person may solicit proxies without sending a dissident's proxy circular if the solicitation is conveyed by public broadcast, speech or publication.[75] The new communication provisions will allow shareholders that were previously distanced by proxy solicitation prohibitions, to communicate and build support for particular governance strategies. The proxy requirements of corporate and securities statutes frequently overlap, often with express

[72] *CBCA*, *supra* note 3, s. 147(c), prior to the 2001 amendments, now repealed. Solicitation was defined to include: "the sending of a form of proxy or other communication to a shareholder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy".

[73] *CBCA*, *ibid.*, s. 147. The *Regulations*, *supra* note 16, s. 67 further codify solicitation, specifying that solicitation does not include a public announcement that is made by a speech in a public forum; or a press release, an opinion, a statement or an advertisement provided through a broadcast medium or by a telephonic, electronic or other communication facility, or appearing in a newspaper, a magazine or other publication generally available to the public.

[74] *CBCA*, *ibid.*, s. 150(1.1) (two or more joint holders being counted as one shareholder; person does not include solicitation by or on behalf of corporate managers).

[75] *CBCA*, *ibid.*, ss. 150(1.1), (1.2) (solicitation conveyed by public broadcast, speech or publication must contain specified information such as name of the corporation, details of identity and background of each dissident, including name, address, occupation, shareholdings, any convictions in connection with corporate and securities laws, and disclosure of any direct or indirect material interests in the matter).

statutory language specifying that compliance with the proxy requirements of one is deemed compliance with the other.[76]

Improved ability to communicate publicly will enhance the exchange of information between shareholders and is likely to be an important means of enhancing corporate governance. For example, the Ontario Teachers Pension Plan (OTPP) has created transparency in its voting record by posting its proxy and proposal voting record on its website, communicating its governance preferences publicly.[77] This, in turn, offers smaller investors at least one avenue to assess proposals being circulated by managers. OTPP has focused on relationship investing, aimed at maximization of long-term shareholder value through promotion of good governance practices, voting all its proxies and meeting with corporate officers.[78] OTPP also seeks regulatory change to require corporations to comply with corporate governance standards. It advocates requiring corporations to publicly disclose the details of all votes taken at annual or special meetings of shareholders.[79] OTPP also promotes pension law change to emphasize the duty of investment managers to vote their proxies and to disclose to beneficiaries how they voted. Currently only 60% of these shares are regularly voted.[80]

In summary, many of the changes will improve the ability of investors, and particularly, institutional investors, to exercise voice in controlling corporate management and/or controlling shareholders through corporate governance initiatives. However, there are disturbing undertones to the new score, generated by the recent amendments in the exclusion of small investors from the new regime.

IV. KNOWING THE SCORE: ENHANCED DISCLOSURE AND SECURITIES REGULATION

Shareholders, as key investors, require information in order to make informed decisions about the extent of their participation, the expectations they have of

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[76] See *e.g. Securities Act*, R.S.O. 1990, c. S.5, ss. 116-119, as am. by S.O. 2002, c.22 [*OSA*].

[77] OTPP, "Proxy Votes," online: OTPP <http://www.otpp.com/web/proxyvot.nsf/proxyvotes?openform> (last accessed 7 August 2003).

[78] *Ibid.*

[79] OTPP, "Submissions to the Senate Committee on Banking, Trade and Commerce Regarding Enron" (26 May 2002) at 4, online: OTPP <http://www.otpp.com/web/website.nsf/web/CG_SenatePresentation/$FILE/SenatePresentationMay02.pdf> (last accessed 7 August 2003).

[80] *Ibid.* at 3.

other investors (broadly defined) and the overall objective of the enterprise.[81] Transparency and disclosure are key factors in shareholder protection and a hallmark of our securities regime. Financial statements provide a source of information about a company's financial condition, allowing investors to make informed investment choices. Disclosure is viewed as the key element underpinning an effective capital market structure and corporate directors are assumed to be exercising effective oversight in the reporting of such information. In a post-Enron era, the question is whether Canadian listed corporations, in complying with financial reporting requirements and in following generally accepted accounting standards in their disclosure practice, are really providing investors with information in a form that allows them to assess the risks and benefits of investing in the firm. The debate has also centred on whether or not there is a need for enhanced regulatory protection or better enforcement of existing protection.

Securities legislation is aimed at fostering fair and efficient capital markets, creating confidence in capital markets and providing protection to investors from unfair, improper or fraudulent practices.[82] In regulating the activities of publicly traded corporations in the protection of investors, the securities regime sets the framework for how securities are offered and traded, disclosure standards, proxy rules, and protection against insider and other self-dealing transactions. These are aimed at transparency and creating a "level playing field" for investors in their assessment of the risks and benefits of investing in a particular enterprise. Given that the securities regime is focused on the protection of property, it is focused on protecting equity investors. This is a vitally important regulatory function that assists in promoting economic growth and productive activity, but its narrow construction as consumer protection legislation for securities investors must be borne in mind in considering the scope. Canadian and U.S. securities regulators have developed multi-lateral instruments in terms of disclosure and communication with beneficial owners of securities.[83] This may facilitate increased shareholder communication and allow issuers to directly electronically communicate with beneficial shareholders.

Unlike the United States, Canada has had a continuous disclosure regime, the underlying premise being that continuous disclosure is essential to

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[81] A musical score contains not only the music of the particular instrument, but the instrumental parts of all others, including where and how each contributes to the overall piece.

[82] See *e.g. OSA*, *supra* note 76, s. 1.1.

[83] See *e.g.* Canadian Securities Administrators, *The Multijurisdictional Disclosure System*, NI 71-101 (23 October 1998), online: British Columbia Securities Commission <http://www.bcsc.bc.ca:8080/comdoc.nsf/comdoc.nsf/webpolicies/5420F3F7C997D6DB882566A600782FA9?OpenDocument> (last accessed 7 August 2003), 21 OSCB 6919; NI 54-101, *supra* note 53, 25 OSCB 3361.

promotion of active securities markets and enhanced investor protection.[84] Corporations are required to disclose material changes that affect a corporation on an ongoing basis, as changes occur. The requirement of continuous dissemination of information to the market, at least on paper, suggests that Canadian investors may be less vulnerable to an Enron type disclosure failure. A reporting issuer in Canada must comply with continuous disclosure requirements through electronic filings on the SEDAR system and public website.[85] A continuous disclosure regime is not without risks. A key feature of the Canadian disclosure regime is reporting "material changes".[86] In terms of disclosure requirements themselves, there is considerable latitude in defining what is a "material" event, such that it should be disclosed. Corporate officers, accountants or other agents of the corporation may meet the letter of the continuous disclosure regime, without meeting its spirit and intent, which is to provide investors with disclosure such that they can make informed choices. Short-term advantage from a liberal interpretation of "non-material" can cause a loss of investor and market confidence, and have negative financial consequences for the corporation.

A key question concerning the efficacy of the current disclosure regime is the adequacy of corporate financial statements. Accounting standards in the United States have resulted in narrowly written, detailed, prescriptive rules, allowing corporations to "check the boxes" in disclosing their accounting practices. Enron's SPEs were a classic example of this problem, creating liabilities not consolidated on the financial statements. Absent an overall shared understanding of a standard of financial reporting and enhanced transparency on corporate performance, narrow rule compliance creates inappropriate *ex ante* incentives to obscure the financial implications of particular transactions.[87]

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[84] In contrast, Enron operated under the periodic disclosure regime of the United States and thus there were periods during which numerous transactions could occur, that did not need to be immediately reported to the market. Moreover, while the U.S. regime requires accuracy in corporate disclosures, it does not require issuing companies to immediately disclose all material changes. Post-Enron, statutory changes initiated by the Securities and Exchange Commission (SEC) will move the U.S. system towards an enhanced disclosure regime: Peter Ramjug, "SEC Rules to Quicken Firms' Filings" *Globe & Mail* (28 August 2002) B5.

[85] Canadian Securities Administrators, *Continuous Disclosure Obligations*, NI 51-102, online: Ontario Securities Commission <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_51-102_20030620_continuous-disclosure.htm> (last accessed 7 August 2003).

[86] See *e.g. OSA*, *supra* note 76, ss. 1, 55-83.

[87] Janis Sarra, "Rose-Coloured Glasses, Opaque Financial Reporting and Investor Blues: Enron as Con and the Vulnerability of Canadian Corporate Law" (2002) 75 St. John's L. Rev. 715.

In the U.S., corporate financial restatements aimed at reducing liability and restoring investor confidence, have been buttressed by legislative initiatives such as the *Sarbanes-Oxley Act of 2002*, aimed at protecting investors by improving the accuracy and reliability of corporate disclosure pursuant to U.S. securities laws.[88] The CEO and CFO are now required to certify that the financial statements fairly present the financial condition the corporation, that there are internal controls to ensure that material information is conveyed to decision makers, and that they have disclosed to the corporation's auditor and audit committee any significant deficiencies in internal control and any fraud, material or not, that involved managers or other employees who have a significant role in the company's internal controls.[89]

In Canada, there are numerous initiatives currently being undertaken by securities regulators to respond to current problems of investor confidence and to align Canadian securities regulation with initiatives that have been undertaken in the United States. Canadian securities regulators had generally concluded that Canadian laws adequately protect investors from selective disclosure, if effectively enforced, but that fluctuating investor confidence required a response to recent U.S. initiatives.[90] In July 2002, Canadian securities regulators issued a new policy of best practices in disclosure, including that companies must have written disclosure policies and a senior officer or committee must police this policy, specifying financial, operational and structural data that companies must release in a fair and careful manner.[91] "Material" information was expanded to include data on changes to accounting policies, changes in rating agency decisions, and any exceptions to corporate ethics or practices that are put in place for key employees. Blackout periods are to be used to prevent insiders from trading around key reporting periods. The Policy suggests that the board or audit committee should review any disclosure regarding earnings guidance or any news releases containing new financial data. All information filed on the SEDAR website should also be immediately posted on the corporation's website and any investor should be able to listen to analyst conference calls. This new policy of best practices also suggests that companies should be cautious in circulating analysts' reports

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[88] *Supra* note 1.

[89] It also creates a public company accounting oversight board to protect interests of investors and the "public interest". Canadian companies listed in the United States must comply with the *Sarbanes-Oxley Act of 2002*, *ibid.*

[90] Doug Hyndman, Chair B.C. Securities Commission and Chair of the Canadian Securities Administrators, online: OSC <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rules.html> (last accessed 1 June 2003).

[91] Canadian Securities Administrators, *Disclosure Standards*, NP 51-201 (12 July 2002), online: OSC <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/policies.html> (last accessed 21 August 2003).

to shareholders because this could be construed as endorsement of the report. Legislation introduced by the federal government in mid-2003 will create new indictable criminal offences for insider trading, tipping and whistle blower retaliation, as well as increasing penalties for capital markets fraud.[92]

The Canadian disclosure regime will receive major improvements over the next year, including: harmonizing continuous disclosure requirements among Canadian jurisdictions;[93] new requirements to discuss off-balance sheet arrangements;[94] new requirements to establish strong, independent, and financially literate audit committees;[95] and a new 24 hour electronic filing for disclosure by insiders.[96] There are proposed new CEO and CFO certification requirements, specifically requiring CEOs and CFOs to personally certify that their issuer's annual and interim filings do not contain misrepresentations, and to certify that the financial statements and other filing information fairly present the financial condition, results of operations and cash flow of the issuer.[97] "Fairly present" means a materially accurate and complete picture of the issuer's financial condition. Certification requirements will apply to annual

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[92] Bill C-46, *An Act to Amend the Criminal Code (capital markets fraud and evidence gathering)*, 2nd Sess., 37th Parl., 2003 (first reading 12 June 2003).

[93] Canadian Securities Administrators, *Notice and Request for Comment, Changes to National Instrument 51-102 Continuous Disclosure Obligations*, anticipated to apply in 2004, created new requirements for disclosure in financial statements, annual information forms, MD & As (management discussion and analysis), significant business acquisitions, etc., online: OSC <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_51-102_20030620_notice-roc.htm> (last accessed 7 August 2003).

[94] *Ibid.*

[95] Canadian Securities Administrators, *Request for Comments, Notice of Proposed Multilateral Instrument 52-110, Forms 52-110F2 and 52-110F2 and Companion Policy 52-110CP*, online: OSC <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_52-110_20030627_roc-pro-mi.htm> (last accessed 7 August 2003) (requiring audit committee to oversee the work of external auditors, review financial statements, MD&A and press releases before public disclosure, and setting requirements for composition and financial literacy of audit committees. Comments on the Proposed Instrument are to be received by September 25, 2003, with regulation to follow).

[96] The System for Electronic Disclosure by Insiders (SEDI) facilitates issuers filing reports and allows investors free access to insider trading disclosures, aimed at increasing transparency, launched June 2003. For a description of SEDI, see David A. Brown, Q.C. "Giving Conscience a Helping Hand: A Robust Response to Financial Reporting Scandals", (Remarks by David A. Brown, Q.C. Chair, Ontario Securities Commission, at the National Press Club, Ottawa, 18 June 2003), online: OSC <http://www.osc.gov.on.ca/en/About/News/Speeches/spch_20030618_press-club-ottawa.htm> (last accessed 7 August 2003).

[97] Canadian Securities Administrators, *Request for Comment, Notice of Proposed Multilateral Instrument 52-109, Companion Policy 52-109CP and Forms 52-109F2 and 52-109F2*, online: OSC <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_52-109_20030627_roc-pro-mi.htm> (last accessed 7 August 2003).

information forms, annual and interim financial statements, annual and interim MD & As. Mirroring the *Sarbanes-Oxley* requirements, there will also be obligations to establish and maintain internal controls in respect of financial reporting.

In Ontario, securities regulators have moved to provide greater investor protection, amending the Ontario *Securities Act* to provide expanded enforcement powers, create several new offences and substantially increase penalties for violations of Ontario securities legislation.[98] Issuers, their directors, officers and other influential persons will be personally liable to investors who purchase in secondary markets for failures to make timely disclosure or for misrepresentation in public disclosure.[99] Investors will not have to establish that they relied on the failure to disclose or misrepresentations. The civil liability regime will apply to both reporting issuers in Ontario and other publicly traded issuers with a substantial connection to Ontario. The legislation also creates new rule making power for the OSC relating to the composition and conduct of audit committees, internal control systems of issuers, auditing standards, and CEO and CFO certification of disclosure controls and procedures. These amendments provide further protection for investors. They may also facilitate the availability of class actions for smaller investors who previously were precluded from effectively seeking remedies for securities violations.

New disclosure initiatives by securities regulators are running parallel to deregulation initiatives proposed by the British Columbia Securities Commission. The Commission's Deregulation Project is aimed at "streamlining the securities system", and replacing the current prospectus based system with a regime of periodic continuous disclosure of all material information.[100] The "continuous disclosure" element of this project is critically important, and definitions of materiality and quality of disclosure are essential to investor confidence. Moreover, the detailed code of conduct will be replaced with a "principles-based code of conduct".[101] The deregulation project also proposes new investor remedies in terms of actions against issuers, their directors and officers, and in some cases underwriters, for

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[98] Bill 198, *Keeping the Promise for a Strong Economy Act (Budget Measures)*, 3rd Sess., 37th Parl., Ontario, 2002 (assented to 9 December 2002), S.O. 2002, c. 22, amending *OSA*, *supra* note 76; ss. 10, 12, 13, 14, 177-181, 183, 184, 186-188 proclaimed into force April 2003, O.C. 655/2003 dated March 19, 2003; ss. 40, 103, 112 and Schedule in force March 2003, O.C. 750/2003 dated March 27, 2003.

[99] These claims are subject to specified statutory defenses and limitations on liability.

[100] British Columbia Securities Commission, *New Proposals for Securities Regulation*, BCN 2002/20, online: BCSC <http://www.bcsc.bc.ca:8080/Historycomdoc.nsf/0/5410b7178 79629b388256bcf006f9ab0/$FILE/BCN%202002-20.pdf> (last accessed 7 August 2003).

[101] *Ibid.* at 2.

misrepresentations or failure to disclose material information on a timely basis. It includes increased enforcement powers for the commission. Again, this is potentially very positive or negative, depending on how the code is to be administrated, what the financial statement requirements will be, the quality of disclosure standards to protect investors, and who in the system provides the accountability check through enforcement of standards. Measures are only as good as effective enforcement.

Although a fulsome discussion of these initiatives is beyond the scope of this article, the initiatives described above raise a pressing question concerning the effect of multiple regulation in securities law. Canadian regulators, with the exception of British Columbia, are moving to create uniform standards. While ongoing discussions about regulatory reform include all regulators, there is growing discord between B.C. and the rest of Canada. This is most evident in differences in the amounts of disclosure that will be required and whether public or private enforcement is the optimal means of protecting investors and capital markets generally. The British Columbia model seeks to largely shift the costs of securities enforcement onto shareholders. Yet it is unclear whether such initiatives will empower equity investors or merely create a two-tiered system whereby large investors have the resources to enforce legislative standards while smaller investors do not. It raises a more fundamental question regarding the place of claims in public policy for the protection of property in the form of shares. This is an area of further research.

The divergence of securities regulators has also become evident in the recent discussions as to whether there ought to be one national securities regulatory regime or a "mutual passport" system, in which regulators would recognize one another's processes or delegate decision making authority to another regulator. In Ontario, the *Final Report of the Five Year Review Committee on the Ontario Securities Act* recommended that all governments work towards the creation of one national securities regulator responsible for capital markets across Canada.[102] In the interim, the Five-Year Review recommended the idea of a mutual recognition "passport" system, where securities regulators would be empowered to delegate their powers and functions to another securities regulatory authority in Canada and where the rules of one authority could be recognized by another authority in order to enhance capital market efficiency. The Canadian Securities Administrators (CSA) released a report in July 2003 specifying plans to table uniform securities legislation in the fall of 2003 as a complement to provincial

[102] Ontario, Ministry of Finance, *Five Year Review Committee Final Report – Reviewing the Securities Act (Ontario)* (Toronto: Queen's Printer for Ontario, 2003), online: Ontario Securities Commission <http://www.osc.gov.on.ca/en/regulation.html> (last accessed 8 August 2003) [*Five Year Review*].

initiatives to pursue a passport system.[103] The British Columbia Securities Commission has expressed strong opposition to the idea of a uniform national securities system as it is currently being envisioned. The future of securities regulation is also currently being studied by the *Wise Persons Committee*, established by the federal government to examine this issue and report in November 2003.[104] Its mandate is to consider an improved regulatory model that will provide increased protection to investors, rigorous enforcement of standards, and encourage accessible and innovative capital markets in Canada. However, despite the potential for discord inherent in a multi-regulation regime, securities law does constitute an important part of capital markets and corporate activity. Materiality is one key issue underpinning the disclosure system.

A. The Role of Materiality in Clarifying the Tune

One way that shareholders may be protected is through a regime that provides sufficient warning of corporate transactions that may adversely affect their holdings, such that they can decide whether to exercise voice or exit in response. Materiality disclosure is one of the tools that offers this protection. Notwithstanding recent improvements in material change definitions, "material" in most securities and corporate law statutes refers to events or transactions that may affect share or property value. Thus harms that are externalized need not be costed on the corporation balance sheet and are not required to be reported as "material" because they allegedly do not have a material impact on shareholder value. Such harms are considered to be part of the public law regime in terms of labour standards or environmental law and thus not part of the securities law regime except where particular events have impacted on shareholder value. Given this definition of "material", transparency and disclosure are narrowly cast. Investors are not exposed to the social and economic costs of other harms being perpetrated by the corporation unless they are likely to influence the bottom line. Of course, this understanding of what is material leaves outstanding the question what bottom line, today's or tomorrow's?

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[103] Canadian Securities Administrators, Uniform Securities Legislation Project, *Blueprint for Uniform Securities Laws for Canada* (30 January, 2003), online: OSC <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Notices/conceptpro/cpro_11-402_20030130_csa-blueprint.htm> (last accessed 8 August 2003).

[104] At the time this article was going to press, the federal *Wise Persons' Committee*, chaired by Michael Phelps, was still conducting public consultations: see Department of Finance Canada, News Release, "Manley and Bevilacqua Announce Appointments to Wise Persons' Committee" (4 March 2003), online: Department of Finance Canada <http://www.fin.gc.ca/news03/03-014e.html> (last accessed 8 August 2003).

Internationally, there has been considerable debate regarding what constitutes a material transaction. Regulations that define material in relation to market price or value may exclude other material information that would influence investors' decision making.[105] Absent a universal shared understanding of this notion, many transactions that are considered material by some investors or jurisdictions, but not others, are not clearly disclosed. This means that shareholders are unlikely to have confidence in the quality of disclosure, in turn, this lack of confidence acts as a deterrent to effective capital markets. The Global Reporting Initiative, the International Corporate Governance Network and other cross-border organizations advocate more fulsome disclosure of material risks to particular transactions.[106] At the heart of these debates is how to create meaningful ongoing disclosure while ensuring that the costs of disclosure are not prohibitive. There is a need for securities regulators to consider a broader definition of material that includes financial reporting on social and environmental practices, including sustainability measures. Such "green accounting" would better identify the operating and strategic risks associated with particular firm activities.[107]

The Ontario Securities Commission Five-Year Review has also recommended adoption of the "reasonable investor" test, where material is defined as any transaction or decision that a reasonable investor would consider in whether or not their equity capital was at risk.[108] Amendments to Ontario Securities legislation, effective April 2003, have changed the definition of material change to include both changes in business, operations or capital of an issuer that would reasonably be expected to have a significant effect on the market price or value of securities and decisions by corporate boards that would be considered important by a reasonable investor in determining whether to purchase or continue to hold securities of the issuer.[109]

A corporation should be obligated to disclose all costs associated with corporate activity so that investors, creditors, and other stakeholders can

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[105] *R. v. Maxwell*, [1996] O.J. No. 4832 (Ct. J. (Prov. Div.)) (QL); *R. v. Coglon*, [1998] B.C.J. No. 2063 (Prov. Ct.) (QL), aff'd [1998] B.C.J. No. 2573 (S.C.) (QL).

[106] See *supra* note 35.

[107] Alan Willis & Julie Desjardins, "Environmental Performance: Measuring and Managing What Matters" (Toronto: Canadian Institute of Chartered Accountants, 2001), online: CICA <http://cpri.matrixlinks.ca/Archive/PMNE/PerfMeasNE.html>; Robert .I.G. McLean, "Performance Measures in the New Economy" (Toronto: The Premier's Council and Canadian Institute of Chartered Accountants, April, 1995), online: Canadian Performance Reporting Initiative <http://cpri.matrixlinks.ca/archive/PMNE/PerfMeasNE.html> (last accessed 11 August 2003).

[108] *Five Year Review*, *supra* note 102 at 86-88.

[109] *OSA*, *supra* note 76, ss. 1 (a)(i), (b)(i) as am. by S.O. 2002, c. 22, s. 177 (in force April 7, 2003).

assess their continued investments. Such costs are quantifiable using GAAP and economic indicators. Even if including such costs on the corporate balance sheet were too radical a notion for current legislators, the requirement to disclose a separate balance sheet of the estimated social and economic consequences of particular decisions would integrate securities laws with the social and economic reality in which corporations participate. Securities law is highly integrated with other public law protections such as consumer protection, occupational health and safety law, employment standards, and environmental protection. To treat these laws separately, or cast some activity as private and the rest as public law issues, ignores the highly integrated public/private regulatory regime in which Anglo-American corporations operate. One might argue that such disclosure would create too much volatility in the markets. That volatility current exists precisely because investors are not confident of current corporate disclosures. Shareholders and others should be given the information that allows for clearer expression of their preferences.[110] Imposing a fiduciary obligation to report full estimated costs of particular corporate conduct would certainly enhance the quality of these decisions at the front end of the decision process.

In addition to the shareholder empowerment argument for disclosure, it is equally important to recognize that not requiring disclosure of these harms as part of the securities regime creates *ex ante* incentives on the part of corporate officers to externalize the costs of some activities. Externalization results in the activity either not being reported or reported as benefits to the corporation. The social and economic effects of labour shedding are a good illustration of this. While the financial statement records a savings in massive downsizing, the costs to the individuals from loss of deferred income, pension benefits, costs of relocating, social costs to family and ripple economic effects on the community are not part of the disclosure as they are not "material" to the bottom line of corporate profit. Securities regulation does not operate in a vacuum; it is situated in complex public and private law norms regarding harms and protections for multiple interested parties. The securities system should better recognize that equity investors might well have an interest in greater disclosure of the nature of corporate transactions that impact on these multiple concerns. In the same vein, investor education has been aimed at discerning fraud, a focus reinforced post-Enron. Almost no attention is paid to education to promote diversification and reduction of risk, a key factor in the harms caused to Enron employees as shareholders. Moreover, few education or skill building opportunities are given to shareholders that facilitate their ability to make investment choices that reflect personal social and economic

[110] For an exhaustive treatment of the need for such disclosure under U.S. securities law, see Cynthia A. Williams, "The Securities and Exchange Commission and Corporate Social Transparency" (1999), 112 Har. L. Rev. 1197.

beliefs. These issues are symptomatic of much larger systemic change that is required, but which has not yet materialized. Until it does, investors will have to play their "part", while guessing at some of the notes that securities law could aid in clarifying.

B. CORPORATE LAW'S ADDITIONS TO THE SCORE

Other transparency measures, such as requiring directors and officers to disclose the nature and extent of any interest they may have in a material contract or material transaction, are a broader disclosure requirement than had existed previously, giving shareholders access to information in respect of director and officer involvement in material transactions, whether or not made with the corporation.[111] Shareholders now have access to portions of the minutes of directors, committee meetings or other documents that contain such disclosures.[112] Directors have new liability protection where shareholders confirm a contract or transaction in which the director or officer has a material interest, if statutory requirements are met, specifically, sufficient disclosure, special resolution by shareholders to approve or confirm and that the contract or transaction was reasonable and fair to the corporation when it was confirmed or approved.[113] On failure to meet these requirements, shareholders can apply to the court to set aside the contract or transaction and/or require the director or officer to account for any gain realized.[114]

Regulatory change enhancing information to be disclosed in management proxy circulars is aimed at increasing transparency of corporate transactions and thus enhancing shareholders' ability to make effective risk/benefit decisions in their investment choices. The *CBCA* and regulations set out detailed provisions for the contents of management proxy circulars, including: information about shareholder voting rights and particulars of shareholders holding greater than 10% of shares; information about directors, including debts owed by directors and officers to the corporation,[115] executive compensation;[116] a record of any opposition by a director to the actions

[111] *CBCA*, *supra* note 3, ss. 120(1), 120(6.1).

[112] *Ibid.*, s. 120(6.1).

[113] *Ibid.*, s. 120(7.1).

[114] *Ibid.*, s. 120(8). Under the *CBCA*, "transaction" and "proposed transaction" has broadened the scope to all transactions, not merely contracts, as previously specified, similar to the language of Ontario and other provincial corporations statutes: s. 120(1).

[115] Debts owed to the corporation in an aggregate amount that exceeds $25,000, except where the debt was entirely repaid before the date of the management proxy circular or "routine indebtedness", a defined term: *Regulations*, *supra* note 16, ss. 57(q), (r).

[116] *Ibid.*, s. 57.

intended to be taken by management; and information on the internal and external audit processes.[117] The management proxy must also disclose acts that will modify the rights of security holders, affect substantially all of the corporation's property or result in liquidation.[118] The federal government has also announced its intention to make further governance improvements in the fall of 2003, as a means of enhancing investor protection.[119] These enhancements in disclosure will clarify the specifics to which they are addressed, but the scope of the disclosure appears confined to traditional corporate governance concerns of conflict of interest. In the Canadian context, with its predominance of majority/controlling shareholders, disclosure of potential conflicts may enhance minority shareholder protection. The question is whether this enhancement is enough to balance the increasing emphasis on large institutional shareholders found in other corporate and securities law reforms.

V. PERCUSSION AND WOODWINDS

There are many other elements of the corporation that are implicated in any discussion of shareholder remedies. Arguably, creditors are the percussion section, entering with a great cymbal crash when there is default on debt covenants or the firm is financially distressed. Creditors share an interest with shareholders in heightened transparency and accountability. While senior secured creditors frequently have access to information, monitoring, and default control rights in their security arrangements, smaller unsecured creditors suffer from many of the same information asymmetries as small investors. In discerning how corporate laws are shaped to protect multiple investments, the attention given to securities law should not drown out the protections afforded under personal property security and other creditor consumer legislation. Employees also bring multiple inputs, both clear and

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[117] *Ibid.*

[118] *Ibid.*, ss. 57(z), (z.1), (z.2).

[119] While it is beyond the scope of this article, the stock exchanges in both Canada and the United States have been very active in the investor protection debate. See *e.g.* "Toronto Stock Exchange Company Manual," online: TSX <http://142.201.0.1/en/profile/tsxListedCompany .html> (last accessed 11 August 2003); Toronto Stock Exchange, "Request for Comments; Corporate Governance Policy – Proposed New Disclosure Requirement and Amended Guidelines" (26 April 2002), online: TSX <http://142.201.0.1/en/mediaNews/newsreleases/ news2355.html> (last accessed 11 August 2003); New York Stock Exchange, News Release, "NYSE Approves Measures to Strengthen Corporate Accountability" (1 August 2002), online: NYSE <http://www.nyse.com/press/1044027444976.html> (last accessed 11 August 2003); NASDAQ Stock Market Inc., "NASDAQ Approves Changes to Rules for Governance of Listed Companies" (3 June 2002), online: Bureau of National Affairs <http://pubs.bna.com/ip/BNA/ cgr.nsf/is/a0a5p7d3f4.

nuanced contributions to the generation of wealth. They are frequently shareholders and creditors as well as employees, and the debate about future corporate and securities protection of shareholders should recognize these multiple roles and interests.

Recognition of distinctions in the nature of equity investment could also make more visible investor preferences. The current paradigm assumes that shareholders' sole concern is the maximization of shareholder return. Yet small investors are more likely to identify with the need to prevent corporate misconduct because they are themselves workers, consumers and community members. A recent survey of 2,006 Canadian adults, 36% of whom were shareholders, found that 74% support the notion that corporate officers have a responsibility to take into account the impact of their decisions on employees, local communities and the country in addition to profit making.[120] The governance debate has not been particularly responsive to these indicators of public sentiment. 72% agree that corporations should make profits but also want corporations to accept a broader sense of accountability that extends beyond profit maximization.[121] 80% want corporate social responsibility standards established and a requirement that companies report their compliance with such standards so that shareholders and consumers can make informed decisions. The survey results revealed consistency in these views about corporate social responsibility across both shareholding and non-shareholding survey participants. This awareness needs translation into a corporate law paradigm that takes account of the collective interests of broader stakeholders and long-term generation of economic activity, not merely short-term shareholder return.

A. GATEKEEPERS: CHORUS OR INDEPENDENT CRITICS

Attached to the corporate endeavour in a number of ways, auditors, industry analysts and consultants provide voice to reported corporate activity and financial reporting. Many have questioned whether their corporate attachments are too strong, and urged they should assume the role of independent critic rather than chorus member. For example, accounting is integrally linked to investor protection. Historical "principles-based accounting" has experienced convergence pressure and a shift towards the rule-oriented approach of U.S. standards, with regulators issuing increasingly

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[120] Canadian Democracy and Corporate Accountability Commission, *The New Balance Sheet: Corporate Profits and Responsibility in the 21st Century – Final Report* (January 2002), online: Canadian Democracy and Corporate Accountability Commission <http://www.corporate-accountability.ca/pdfs/FullReport2002.pdf> (last accessed 12 August 2003) [*The New Balance Sheet*].

[121] *Ibid.*

detailed interpretations of the application of particular standards.[122] In turn, this has created the same sort of incentives to engage in financial reporting that utilizes loopholes in interpretation statements to avoid the reporting of particular events or transactions. The objective of audited financial statements is to advise investors of the financial position of an issuing company, thus the statements should be aimed at fairly representing that position. There may also need to be enhanced accountability of corporate officers in ensuring that representation is accurate. As a direct outcome of Enron, the FASB has issued new guidelines, aimed at enhancing transparency.[123] The draft guidelines on consolidation of special purpose entities (SPEs) and disclosure of guarantees are aimed at improving financing reporting of enterprises involved with SPEs.[124]

These developments are important, although they also highlight a more systemic underlying issue: the malleability of accounting standards in general. The Canadian ASB is also involved in discussions with the International Accounting Standards Board, which was recently established to promote harmonization of accounting standards that will provide reliable financial reporting to enhance investor confidence in global capital markets. It may also facilitate the exchange of lessons in respect of the rigour of accounting standards, and perhaps ultimately reduce those aspects of the malleability that work to the detriment of diverse investors who rely on the financial reporting in their investment decisions.

However, there appears to be a missed opportunity in rethinking securities protection. The operating paradigm is protection of equity investors. This is an important project, but should not be the only objective. For example, in addition to transparency requirements as a means of reducing managerial self-dealing, regulatory intervention could require reporting on human rights violations, environmental liability, and reporting on the social and economic cost/benefits of particular transactions. Increased requirements to discuss the risks of particular decisions to equity investors could be accompanied by disclosure of these social and economic risks. If investors are truly to make

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[122] The Canadian Institute of Chartered Accountants' MacDonald Commission emphasized that rules could not replace the need for overall sound judgment in assessing the financial affairs of corporations: Canadian Institute of Chartered Accountants, *Report of the Commission to Study the Public's Expectations of Audits* (Toronto: CICA, 1988).

[123] See Financial Accounting Standards Board, Exposure Draft No. E-167, *Proposed Interpretation – Consolidation of Certain Special-Purpose Entities: an interpretation of ARB No. 51* (June 2002), online FASB <www.fasb.org> (last accessed 1 June 2003).

[124] Accounting Standards Board, draft guideline, Consolidation of Special Purpose Entities (August 2002) at 1, online: Canadian Institute of Chartered Accountants <http://www.cica.ca /multimedia/Download_Library/news//Media_Center/e_SPE.pdf> (last accessed 12 August 2003).

informed decisions in respect of their diversified portfolios, then they should be provided with these disclosures.

Investors rely on corporate auditors to monitor the financial statements of the corporation and report any concerns to the audit committee. In assessing the quality of reporting and the lyrics of reported gains, there is a serious question of whether external auditors can make an objective assessment of the company's financial statements when the auditor's accounting firm is dependent on the lucrative fees from provision of other services to the corporation.[125] A key part of Anglo-American corporate board structure is the audit committee and its relationship to the external auditor. The auditor is responsible for providing an independent assessment of the firm's financial and economic status. Absent an effective and independent external audit process, directors, investors, and creditors are unable to make informed choices. If the external auditing firm is too close to the corporation's officers, there is both financial and normative pressure to report the financial affairs of the corporation in such a way as to present the most positive picture to the investing public.

Canadian firms suffer from the same conflicts in terms of provision of consulting services and the concurrent provision of audit services. Aside from whether objectivity in auditing is possible in such instances, it is evident post-Enron that there is a serious loss of investor confidence in financial disclosures when these relationships exist. The issue of public confidence is also important to any shift in accounting standards away from prescriptive rules and greater dependence on broader principles and the professional judgment of auditors. New standards issued by the Assurance Standards Board of the Canadian Institute of Chartered Accountants require that the auditors address with the Audit Committee both the quality and the acceptability of the accounting policies adopted by a company. The auditor should also disclose potential conflict of interest or other involvement in corporate activity that may impact on the ability to give an objective assessment of the financial status of the corporation, including reporting on all non-audit services provided to the company and related fees. Directors have an obligation to satisfy themselves that non-audit services do not impair the auditor's objectivity or integrity of the financial reporting. The CSA has also proposed a regulatory instrument aimed at enhancing independent auditing of reporting issuers by ensuring their participation in the independent oversight program of

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[125] For an insightful analysis of the role of Enron's external auditor, see John C. Coffee, Jr., "The Enron Debacle and Gatekeeper Liability: Why would the Gatekeepers Remain Silent?" (Testimony before the U.S. Senate Committee on Commerce, Science and Transportation, 18 December 2001), online: U.S. Senate Committee on Commerce, Science and Transportation <http://commerce.senate.gov/hearings/121801Coffee.pdf> (last accessed 12 August 2003).

the new Canadian Public Accountability Board (CPAB) created in 2002.[126] The CPAB is aimed at restoring investor confidence and protecting the public interest by creating a public independent oversight system for accountants and accounting firms that audit reporting issuers through external audits, inspection of practice standards, and training.[127]

There is also likely to be a shift in the manner in which securities analysts will be regulated in Canada. In August 2002, CIBC World Markets Inc. became the first Canadian-based brokerage firm to revamp its stock rating system since U.S. dealers were implicated in the Enron and other corporate crises.[128] In 2001, a Securities Industry Committee on Analyst Standards, chaired by Purdy Crawford, made 33 recommendations to deal with conflicts of interest and failure to disclose ties between securities analysts and the firms on which they were reporting.[129] The recommendations call for mandatory disclose of conflicts of interest for the broker and analysts, prohibition of certain relationships for analysts producing research, recommending best practices for the issuance of securities analysts reports, and a number of recommendations that focus on good governance. These measures, if fully implemented, will help reduce many of the serious problems that currently exist with utilizing analysts as one of the "gatekeepers" of the integrity of the securities regime.

In conclusion, Canadian shareholders are the beneficiaries of recent corporate failures south of the border in that Canadian regulators have moved to seriously address deficiencies in disclosure and prohibitions on self-dealing transactions. They are also likely to benefit from enhanced participation and communication rights granted through corporate and securities legislative change. However, many of these changes are geared to larger investors and their ability to influence corporate governance. While this is an important

[126] Canadian Securities Administrators, *Notice and Request for Comment, Proposal of Multilateral Instrument 52-108: Auditor Oversight*, online: Ontario Securities Commission <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_52-108_20030627_notice-roc.htm> (last accessed 12 August 2003). British Columbia is not participating in this initiative.

[127] David Smith, "New Independent Public Oversight for Auditors of Public Companies" (17 July 2002), online: CICA <http://www.cica.ca/index.cfm/ci_id/7795/la_id/1.htm> (last accessed 12 August 2003). For information on the U.S. board, see U.S. Securities and Exchange Commission, News Release, "Commission Formally Proposes a Framework of a Public Accountability Board" (June 20, 2002), online: SEC <http://www.sec.gov/news/press/2002-91.htm> (last accessed 12 August 2003).

[128] Richard Blackwell, "Move Follows Action at U.S. Firms" *The Globe & Mail* (26 August 2002).

[129] Securities Industry Committee on Analyst Standards, *Final Report – Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts* (Toronto: TSE Publications, 2001), online: TSX <http://142.201.0.1/en/mediaNews/newsreleases/news1897.html> (last accessed 12 August 2003).

move forward, it inadequately addresses the situation of smaller investors, whose individual investments are smaller in value but constitute a major portion of their personal wealth and future pension income. One danger posed by the reforms is the translation of the preference for the interests of larger institutional investors that is clearly expressed in some of the reforms, into a similar preference in other areas of corporate law, such as the oppression remedy or the dissent and appraisal rights. These protections will remain important to smaller investors while majority/controlling shareholders predominate in Canadian corporations.

There have been a number of changes made to the corporate symphony's "score" by regulatory "arrangers" in the wake of Enron and other corporate failures. These changes seek to enhance shareholders' voice through the proxy process as well as increase shareholder ability to exercise either voice or exit by mandating additional disclosure. An attempt has also been made to increase the checks on managerial discretion through enhanced requirements for independent directors and increased exposure of managers to litigation liability through certification requirements and the broadening of liability for securities law breaches. Regulators have enhanced the role of a number of different instruments in revamping the orchestration of the corporate symphony's "score". Whether the resulting symphony is harmonious or discordant remains to be seen, and that judgment may depend on where a particular shareholder is situated along the continuum of shareholding from small to large. This question is definitely worth re-visiting in a few years after all the corporate players have had a chance to practice their new "parts".

Finally, this discussion exposes a more fundamental problem of our current capital markets and shareholder protection. Corporations are dependent on the availability of cost-effective capital, in North America much of that capital is derived from securities markets and the cost of that capital is influenced by secondary trading. This dependence creates enormous power by large investors to influence corporate activity in their own interests. Absent externally imposed standards as to how capital is used and how costs are accounted for, corporations will necessarily conduct their activities with a careful eye on market reaction. While facilitating the expression of investor preferences should strengthen corporate accountability, investors represent only a fraction of society, the fraction that has surplus property to invest. Capital markets cannot and should not replace public law standards and enforcement. What is required is a conception of the corporation that integrates public policy across a range of issues, instead of isolating the securities regime as enabling private capital markets.