CAPITAL MARKETS MODERNIZATION TASKFORCE RECOMMENDATIONS – PROXY SYSTEM CORPORATE GOVERNANCE AND MERGERS AND ACQUISITIONS

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In July 2020, the Capital Markets Modernization Taskforce (the "**Taskforce**") issued a Consultation Report (the "**Consultation Report**") seeking input from market participants on a number of proposals aimed at modernizing Ontario's capital markets. In January 2021, following extensive consultations and the review of over 130 stakeholder comment letters, the Taskforce issued a Final Report (the "**Final Report**") of over 70 recommendations to the Minster of Finance (Ontario).

Section 2.4 – *Proxy System, Corporate Governance and Mergers and Acquisitions* ("**Section 2.4**") of the Final Report recommends measures to increase regulatory oversight of proxy advisory firms, increase transparency around the ownership and voting structure of public companies, limit empty and over-voting and enhance environmental, social and governance ("**ESG**") disclosure. This bulletin provides a high-level overview of and our commentary on the recommendations set out in Section 2.4 of the Final Report.

At the outset, we should note that most of these recommendations would have to be adopted by each of the Canadian Securities Administrators (the "**CSA**") in order to ensure our regulatory system remains efficient and responsive. Accordingly, much work needs to be done with the CSA even if the Ontario government is inclined to proceed with these recommendations.

Recommendation 38

Introduce a regulatory framework for proxy advisory firms ("**PAFs**") *to: (a) provide issuers with a right to "rebut" PAF reports, and (b) restrict PAFs from providing consulting services to issuers in respect of which PAFs also provide clients with voting recommendations.*

The Taskforce recommends implementing a regulatory framework by September 1, 2022 that would provide issuers with a statutory right to rebut recommendations made by a PAF to vote against the proposals of management, with the rebuttal required to be included in the PAFs report, at no cost to the issuer. In order to provide sufficient time to include the rebuttal in the PAFs report, the proposed framework would require

issuers who may wish to exercise their right to rebut to file their management information circulars at least 30 days in advance of a shareholders' meeting. The proposed framework would also restricts PAFs from providing consultation services to those issuers in respect of which they provide voting recommendations.

We understand that this recommendation is responsive to the significant concerns raised by issuers in Canada and is intended to mitigate the risk of inaccuracies in PAF reports and to address potential conflicts of interest, both of which are laudable intentions. However, we are concerned that the Taskforce's recommendation is too restrictive and is unlikely to be feasible, as it would compel the financial cost of an issuer's rebuttals to be borne entirely by PAFs and would restrict conflicts entirely, causing the elimination of a significant segment of the PAFs' business.

A statutory right of rebuttal would undermine harmonization efforts by misaligning Ontario's proxy regime with those of other jurisdictions. Both the European Securities and Markets Authority and the European Commission considered a right to rebut and decided to issue non-binding guidance rather than impose regulatory requirements. The CSA have previously offered similar guidance, maintaining alignment with international standards. In addition, the amendments by the US Securities and Exchange Commission (the "**SEC**") to its proxy rules in 2020 to regulate certain activities of PAFs are not as restrictive as the Taskforce's recommendation. As a condition to being exempt from the SEC's proxy information and filing requirements, the SEC's amendments require a proxy voting advice ("**PVA**") business to adopt and disclose policies to ensure that: (i) issuers that are the subject of PVA have access to the advice prior to or concurrently with such advice being made available to a PAFs' clients, and (ii) the PAF provides its clients with a mechanism by which they can view issuers' responses to such advice prior to the relevant shareholders' meeting. The approach taken by the SEC aims to ensure that clients of PAFs have timely access and accurate and complete information, while mitigating concerns about undermining the relationship between PAFs and their clients that arise from providing issuers with access to PVA before the PAFs' clients.

Furthermore, while the SEC requires PAFs to have policies to address conflicts, the recommendation in the Final Report restricts the existence of conflicts entirely by prohibiting PAFs from providing consulting services to issuers in respect of which they also provide voting recommendations.

Notwithstanding the laudable goals of this recommendation by the Taskforce, we would suggest that the Minister of Finance and the CSA consider less restrictive mechanisms to address the concerns raised about the activities of PAFs. We would be surprised if the recommendation is implemented as currently proposed.

Recommendation 39

Decrease the ownership threshold for early-warning reporting disclosure from 10 to 5 per cent for non-passive investors.

The Consultation Report initially proposed that the reduced early-warning disclosure threshold be applicable to all investors. The Final Report narrowed the recommendation to be applicable to only non-passive investors in order to provide greater transparency, particularly since holders at the 5% threshold can affect control by requisitioning shareholders' meetings.

We believe that while narrowing the applicability of the reduced threshold is appropriate, the recommendation fails to adequately consider liquidity issues that may arise. This same proposal was rejected in 2013 by the CSA primarily due to concerns that it would negatively impact liquidity in market sectors that need it most.

A 5% threshold risks discouraging investments in smaller issuers, which make up a large portion of the Canadian capital markets. The smaller market capitalization of such issuers means that a relatively low dollar amount of investment would trigger the disclosure threshold. Investors may cap investments at under 5% to avoid being subject to the early-warning disclosure regime, reducing access to capital for small and mid-sized issuers. The end result could be an adverse effect on liquidity and the growth of Canada's capital markets, notwithstanding that the lower threshold would not apply to eligible institutions. Ultimately, the CSA will have to address head on the concerns raised by numerous stakeholders regarding the liquidity impact of such a regulatory change.

Recommendation 40

Require all publicly listed issuers to have an annual advisory shareholders' vote on the board's approach to executive compensation.

The Taskforce recommends the adoption of mandatory annual non-binding say-on-pay votes for shareholders of public companies. The Consultation Report had previously recommended such votes for TSX-listed issuers. This recommendation aligns with the requirement for advisory say-on-pay votes for companies incorporated under the *Canada Business Corporations Act* ("**CBCA**") and is similar to requirements in other jurisdictions such as the US, the UK, Australia, France and Netherlands. The implementation of this recommendation would increase shareholder engagement.

Recommendation 41

Require enhanced disclosure of material ESG information, including forward-looking information, for public issuers.

The Consultation Report initially proposed that enhanced ESG disclosure be required only for TSX-listed issuers. The recommendation of the Taskforce in the Final Report is that enhanced disclosure be required for all reporting issuers, other than investment funds.

The Final Report recommends mandating disclosure of material ESG information that is compliant with the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures ("**TCFD**") on a "comply-or-explain" basis, with a phased-in approach to implementation that is dependent on an issuer's market capitalization. The transition phase for the new disclosure requirements would be two to five years, depending on the issuer's market capitalization at the time the requirements are implemented. Although there are various frameworks for ESG-related disclosures, the TCFD recommendations, even though they were crafted with climate-related risks in mind, are considered as a relevant framework for reporting on all material ESG factors. A TCFD recommendations-based disclosure framework would also provide issuer's flexibility to complement their disclosure with other industry standards, such as Sustainability Accounting Standards Board and Global Reporting Initiative, which are currently utilized by several Canadian issuers. The use of a market capitalization based test to phase in ESG reporting is an innovative solution in response to comments suggesting that enhanced disclosure could be an additional burden on venture issuers.

ESG-related disclosure has become a global priority and the TCFD framework has garnered international support. We believe the implementation of this recommendation would be consistent with the approach taken in other jurisdictions and we agree with the framework proposed by the Taskforce.

Recommendation 42

Require the use of universal proxy ballots for all contested meetings and mandate voting disclosure to each side in a dispute when universal ballots are used.

The Taskforce initially proposed in the Consultation Report that universal proxy ballots be used for contested meetings where one party elects to use a universal ballot, but the Final Report recommends universal proxy ballots be used for all contested meetings commencing September 1, 2022. The use of universal ballots would provide shareholders voting by proxy with greater flexibility to vote for a combination of board nominees. The recommendation of the Taskforce would require certain additional requirements to be implemented in corporate and securities legislation to facilitate the use of universal proxies, including form requirements, notice requirements and minimum solicitation requirements. These requirements are similar to requirements that have been proposed by the SEC.

Recommendation 43

Amend securities law to provide additional requirements and guidance on the role of independent directors in conflict of interest transactions.

The Consultation Report proposed the codification of the best practices for independent committees of directors identified in Multilateral CSA Staff Notice 61-302 *Staff Review and Commentary on MI 61-101* and in

various OSC decisions. In addition to codification, the Final Report also recommends mandating the formation of independent committees to oversee material conflict of interest transactions.

To mandate the formation of independent committees in all material conflict of interest transactions may, in our view, be too broad, as an independent committee may not be necessary in certain circumstances. For example, it seems that it would be unnecessary to form an independent committee in a situation where the board is comprised entirely of independent directors. The appropriate process is unique to each specific transaction and the formation, process and involvement of an independent committee in a transaction will vary depending on the particular facts. The Taskforce recommendation raises concerns about adding regulatory burden in circumstances where an independent committee may not be necessary.

Recommendation 44

Provide the OSC with a broader range of remedies in relation to mergers and acquisitions (M&A) matters and modernize the private issuer take-over bid exemption.

The Taskforce recommends in the Final Report that the OSC be granted new powers to enhance its public interest remedies. This would ensure that the OSC is provided with similar remedies to those available to the British Columbia Securities Commission (the "**BCSC**"), whose powers were recently expanded. Notably, the BCSC now has the power to rescind a transaction, require the disposition of securities acquired in connection with an M&A transaction, and prohibit a person from exercising voting rights attached to a security. The implementation of the Taskforce's recommendation would help avoid further fragmenting Canada's regulatory landscape. Although we are concerned that the expansion of remedies for the OSC may cause it to increase the use of its public interest power, which should be used sparingly, we do acknowledge that in certain circumstances it is critical for the OSC to have these additional powers in order to address abusive conduct.

In connection with this recommendation, the Taskforce noted that the OSC should provide clarity with respect to certain matters, including the circumstances when such remedies may be appropriate and how the apparent overlap between securities law, corporate law and the courts should be addressed. It is not clear to us that guidance on the exercise of remedies is appropriate in these circumstances, particularly since it would not be binding on the OSC. We would also note that there are court and securities regulatory decisions regarding the supposed overlap in the powers of courts and securities regulatory authorities and additional non-binding guidance from the OSC appears unnecessary.

We note that the recommendation to increase the maximum number of arm's-length security holders under the private issuer take-over bid exemption from 50 to 300 was not in the initial Consultation Report. It may be appropriate for the CSA to receive feedback from stakeholders as to whether "300" is the appropriate number.

Recommendation 45

Prohibit voting with borrowed shares and introduce rules to prevent over-voting.

The Final Report recommends that: (i) an intermediary must confirm that vote entitlement documentation has been submitted to the meeting tabulator prior to submitting proxy votes; (ii) an intermediary holding securities for another intermediary must provide vote entitlement documentation to the tabulator to establish its client's vote entitlements; (iii) a reporting issuer and any intermediary submitting proxy votes be notified if proxy votes are rejected because of insufficient vote entitlements; and (iv) a reporting issuer be required to provide its meeting tabulator with the DTC omnibus proxy at least 10 days before the meeting.

The recommendations are substantively the same as those proposed in the Consultation Report. The Taskforce also recommends in the Final Report that the OSC set up a technical implementation committee to address technical issues arising in operationalizing the recommended rules.

Recommendation 46

Allow reporting issuers to obtain beneficial ownership data.

The Taskforce proposes that, as of September 1, 2022, reporting issuers be able to obtain the identities and holdings of all beneficial owners of their securities. This would, in effect, eliminate the distinction between non-objecting beneficial owners ("**NOBO**") and objecting beneficial owners ("**OBO**"). The Taskforce recommends that until such time as such changes are implemented, securities laws be amended to provide that beneficial owners will be deemed to be NOBOs unless they elect to be OBOs.

Considering that the NOBO/OBO distinction remains in use in the US, its elimination in Canada would be inconsistent with harmonization efforts and would not give reporting issuers access to information about their US OBOs. Eliminating the NOBO/OBO distinction also introduces a risk that our capital markets may be less attractive to investors when compared with the US markets. The NOBO/OBO distinction is important to beneficial owners that utilize the system to address privacy concerns, such as investors that want to avoid unsolicited communications from issuers and agents or those with concerns about their trading patterns being revealed. We would raise the question of whether the elimination of the distinction might have a negative impact on the liquidity of our capital markets.

Recommendation 47

Require standardized granular disclosure of securities grants and option exercises.

This recommendation was not proposed in the Consultation Report and is new to the Final Report. The Taskforce recommends that disclosure of share-based share and option awards and the value of compensation

received through the exercise of options be required in compensation statements under Form 51-102F6.

The Taskforce has recommended that the OSC and CSA undertake consultation with respect to certain proposed changes, including requiring current disclosure of the vested or realized value of previously granted options or share-based awards. While this recommendation improves transparency, it also raises the question of whether increased compensation disclosure would increase pay competition. Nonetheless, we note that this recommendation harmonizes with similar standardized executive and director compensation disclosure required by the SEC under Regulation S-K – *Executive Compensation*, which includes disclosure of the amounts realized on previously awarded equity compensation during the most recent fiscal year.

Recommendation 48

Enshrine annual director elections and individual director voting requirements in securities law and implement majority voting in uncontested director elections.

This is another new recommendation that was not initially proposed in the Consultation Report. The Taskforce recommends requiring annual director elections, individual director voting and majority voting under securities laws, as such rules currently exist only under stock exchange rules (and are part of yet to be implemented amendments to the CBCA). With respect to the majority voting recommendation, the Taskforce recommends: (i) allowing a transition period for the recruitment of a replacement director in the event any director fails to achieve a majority of the votes in an uncontested director election; (ii) an exemption to the requirement for issuers that are compliant with substantially similar corporate law requirements; and (iii) permitting issuers to apply to the OSC for exemptive relief in exceptional circumstances.

The recommendation neglects to set out what circumstances may qualify as exceptional or the factors to be considered by the OSC. It is unclear whether this recommendation leaves open an avenue for issuers to refuse to accept a director's resignation. In addition, placing the OSC in a position of evaluating and granting exemptions would be an additional burden on the Commission.

For more insights on the Final Report, please check out our comprehensive series of bulletins here.

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A Cautionary Note


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