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Leveraging Canadian Shareholders to Effect Change in Corporate Governance:

A Case Study

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Leveraging Canadian Shareholders to Effect Change in Corporate Governance: A Case Study

Abstract:

In the face of growing enthusiasm for market-based solutions to societal problems, the state's role in reigning in risky corporate behaviour is increasingly unclear. The state has abandoned its traditional regulatory role, yet the market has not proven successful in regulating itself. Drawing from recent theoretical and empirical research and a case study on an investor organization, SHARE, this paper considers the potential for corporate engagement to address this gap through investigating the salience of shareholders as active owners to effect change in corporate environmental, social and governance (ESG) behaviour, with a particular focus on executive compensation. Semi-structured interviews and quantitative analysis contribute to a multi-dimensional analysis of the factors that lead to successful engagement from the perspectives of both the corporation and the investor. The paper finds that smaller firms and firms with poor corporate governance performance are less likely to adopt an advisory vote on executive compensation in Canada than firms with strong corporate governance. The paper concludes that cooperation between the state and institutional investors leads to effective leveraging of the investor's legitimacy, urgency and power to coerce or encourage more corporations to change their ESG behaviour. This cooperation is more likely to result in more meaningful societal benefits than if the state was to rely entirely on the voluntary actions of shareholders.

This work contributes to building a theory upon which the interaction between the policy environment and shareholder engagement can be examined across different jurisdictions and cultural groupings. Practical implications for public policy are identified. In addition, the paper reflects the corporate experience with engagement, which could have practical implications for investors seeking to improve their engagement strategies.

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Introduction

Despite the many positive contributions corporations make to society, including employment, the provision of goods and services and technology transfers, some of the most serious problems facing us today are a result of the profit maximizing behaviour of these same corporations and the limited capacity or willingness of states to devise and enforce regulatory controls on corporate practices. Specifically, the current market system provides financial incentives for corporations to exploit market failure under an inadequate regulatory system, leaving the negative consequences to fall on employees, taxpayers, depositors and shareholders. The British Petroleum oil spill in the Gulf of Mexico, which was the result of a focus on short term profits and regulatory failure, is a testament to this statement.[1]

Political and logistical challenges over recent years with monitoring and enforcing international and state intervention in the market have led many policy makers and academics to turn to the market for solutions to societal problems. Despite the recent attention to 're-regulation', particularly in the financial sector in response to severe weaknesses exposed by the most recent financial crisis, market proponents argue that no credible alternative to the market economy exists and some argue the states' role in regulating corporations is being displaced by large institutional investors (e.g. Hawley and Williams, 2000; McLaren 2004).[2] These investors are motivated by their material interest in influencing the environmental, social and governance (ESG) performance of firms (Sullivan et al., 2006; Camejo, 2002; and Waddock and Graves, 1997).

While market-based solutions have gained traction over recent years, others suggest that the choice is not polar, pointing to the success of East Asian economies during the developmental state era and the varieties of

1 See BP Oil Spill, April 2010 Globe and Mail,Yves Guillaume A. Messy, CSR Thinking or Die: Reflections on the BP Oil Spill
http://www.socialfinance.ca/blog/post/csr-thinking-or-die-reflections-on-the-bp-oil-spill/

2 Wolf, Martin. (2009). Why Obama's New TARP will Fail to Rescue the Banks, Financial Times, February 11.

capitalism thesis.[3] Regardless of which projection proves accurate for Canada, the important point underlying the debate is that path dependency prohibits a return to regulation in the traditional sense, as experienced during the embedded market era.

This paper focuses on active ownership[4] strategies and considers the potential of shareholders to fulfill the role of a regulator and monitor of corporate behaviour. It proposes that homogeneous (state or market) approaches to regulating risky corporate behaviour are less effective than a heterogeneous approach. In particular, cooperation between the state and institutional investors can lead to effective leveraging of the investors' relationship with corporations to coerce or encourage change in corporate ESG behaviour. At the same time, this cooperation prevents the over-empowerment of shareholders and is therefore more likely to result in effective engagement that credibly fulfills the role of the state as corporate monitor and regulator, than if the state was to leave it up to voluntary actions of shareholders.

The paper explores two avenues for the state to leverage institutional investors to effect change in corporate behaviour. The first is for the state to work with investors who already recognize the importance of engaging with corporations on ESG issues by implementing favourable policies that complement shareholders' legitimacy, urgency and power, which are identified as the most salient factors contributing to successful engagement (see Mitchel et al, 1997; Gifford, 2009). Public policy has the potential to increase the effectiveness of institutional investors who are already actively managing their portfolios by creating more avenues for engagement (Davis and Thompson, 1994; Higgs, 2005 and Gifford, 2009), contributing to what Gifford (2009) calls the 'social legitimacy' of engagers.

3 See “Hall and Socike, (2001) Varieties of Capitalism, The institutional foundations of comparative advantage. Oxford University Press, Oxford, UK.

4 UN Principles of Responsible Investment – The second principle asks signatories to engage in active ownership strategies “We will be active owners and incorporate ESG issues into our ownership policies and practices.”

The second avenue that this paper explores for the state to leverage the position of the investor is through implementing policies that encourage and in some cases require investment managers to address the ESG performance of corporations in their holdings. This approach assumes that voluntary engagement will not effectively address all areas of poor corporate ESG performance, even if the state provides a supportive environment for engagement.

To interrogate this relationship between the policy environment and corporate engagement, the paper builds on Gifford's work, which examines the interaction of moderating factors with stakeholder salience. Moderating factors are defined by Gifford as “important variables that operate across and affect all attributes, rather than fitting neatly within them” (Gifford, 2009, pp. 240). However, he excludes the policy environment from his list of moderating factors, instead identifying it as an internal sub-attribute of legitimacy (social legitimacy). This paper re-evaluates the characterization of the policy environment as a sub-attribute of shareholder salience and applies it as a moderating factor. In doing so, this work contributes to building a theory upon which the interaction between the policy environment and shareholder engagement can be examined across different jurisdictions and cultural groupings, an area acknowledged by Gifford as requiring more research.

Some jurisdictions have already identified the benefits of using regulation and other policy tools to encourage institutional investors to become concerned with ESG risks and to create more avenues for enhancing shareholder salience. This paper focuses on the shareholder vote on executive compensation (say on pay) as one mechanism for shareholders to encourage improved corporate governance practices. It is widely acknowledged that skewed executive compensation practices played a significant role in unraveling the financial system in 2008. “Compensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability” (Bernanke, 2009). The United Kingdom, United States, Australia, the Netherlands, Norway, Spain, France and Sweden have implemented binding or non-binding say on pay votes for public companies.

In Canada, the legal environment for engagement is less supportive than these other jurisdictions (Yaron, 2002, 2006; Davies, 2007; Dihr, 2008). Under Canadian law, shareholders do not have the authority to interfere with a corporation's decisions regarding regular business operations (Osler, 2008). Under the corporate statutes, specific matters are considered fundamental to the corporation's financial success, requiring shareholder approval, yet these areas are very limited and it is not clear whether environmental and social performance falls under this category (Osler, 2008). With respect to say on pay (SoP), there has been little public policy discussion of the issue in Canada (Kraus, 2010) until recently, when the Ontario Securities Commission announced that it is monitoring developments in the international community on SoP and considering whether Canadian securities regulators should consider introducing the mandatory vote.

Through exploring the most salient corporate engagement strategies from the perspectives of both the corporation and the investor, this paper identifies gaps and proposes a way forward for Canadian policymakers to more effectively leverage the position of shareholders to effect change in corporate behaviour. The paper proceeds as follows: Section 2 reviews academic literature in an attempt to integrate corporate social responsibility, international political economy and responsible investing literature to identify the evolution of thought on the relationships among corporations, states and institutional investors. Section 3 provides a review of case literature on SoP in the UK, the US and Canada, highlighting key debates. Section 4 contributes to building an analytical framework for understanding the relationship between the policy context and salience of shareholders, drawing on agency, stakeholder and institutional theory. Section 5 explores quantitative data on the SoP engagement, reflects on investor and corporate perspectives based on interviews and considers the Canadian policy landscape with respect to shareholder rights and limitations. Section 6 concludes with implications and recommendations for Canadian policymakers.

Methodology

To explore the potential for corporate engagement to fulfill the role of the state in monitoring and regulating corporate behaviour in Canada, this paper employs single-case study methodology. The complex nature of the research requires in-depth interviews and multi-stakeholder perspectives that are generated by the case study approach (Yin, 2002). Quantitative data and public documents inform and complement interviews. The case study creates the conditions under which intentional focus draws out the contextual factors as they interact with other variables (Yin, 2002). In addition, it is important that the 'social action theory' that this research seeks to develop is grounded on experiences of those most likely to be affected by the policy decision and those contributing to the problem (Walker, 2000).

A literature review, which identifies and traces the relationships among corporations, states and institutional investors frames the overall case study. The review identifies both convergence and divergence in empirical evidence and theory related to responsible investing as it contributes to share value and the broader social agenda. Case literature relevant to SoP provides the context for the study, identifies relevant debates in the literature and explains the need for research in the Canadian context. An analytical framework is identified and tested for its ability to explain the interaction between the policy environment and shareholder salience.

SHARE is chosen as the case study based on the organization's experience with Canadian engagement activity over several years (since 2000) and more recently, with several large Canadian financial corporations on behalf of Meritas.[5] SHARE offers consulting services to investors and although it is not an investor itself, the organization is represented as the investor perspective throughout the paper. SHARE selected SoP as the focus engagement for this case.[6] The focus on SoP is useful for exploring the engagement experience in Canada because it involves several Canadian companies and is an issue that is both relevant and visible in Canadian

5 Meritas Mutual Funds is devoted solely to creating and marketing socially responsible investments ("SRI") for individuals, and also for corporations, endowments, foundations, pension plans and other large investors. www.meritas.ca
6 SHARE offers proxy voting, shareholder engagement and consulting services, courses and conferences, policy advocacy and timely research that help investors integrate ESG issues into their investment management process. www.share.ca

policy circles. One limitation of using a single-case study of an investor organization that represents mostly smaller institutional investors is that it inhibits drawing comparisons and conclusions for larger institutional investors. However it does allow for focus on unique aspects of the advisory organization, acting on behalf of investors in addition to providing insight on specific challenges to smaller Canadian investors (Yin, 2002).

The case study explores publicly available data on corporate governance ratings, shareholder resolutions, compensation levels of Canadian companies and performance measures to describe the current impact of SoP engagement in Canada. Data from Jantzi-Sustainalytics corporate governance ratings are also used to investigate characteristics of SoP adopters.

In addition to public documents and quantitative data analysis, semi-structured interviews are conducted with institutional investors and corporations in the financial sector that have been exposed to the SoP engagement. Interviews with investors and corporations take place with the individuals who have direct experience with the engagement. Interview questions reflect both evaluative and strategic variables related to the corporate engagement policy environment in Canada, with the purpose of assessing the current state of corporate engagement in Canada and avenues for improvement (Huberman and Miles, 2002). Interviews are conducted in person where possible and by telephone alternatively. Interviews explore the interviewee's overall engagement experience, the impact of the engagement and the influence of the policy environment. The interaction between these variables contributes to developing a framework for understanding unique engagement experience within the Canadian policy context and its impacts on corporate behaviour in both an individual and aggregate sense.

Section 2: Corporate Engagement

The responsibilities and duties of corporations to society and the role of the state in enforcing these have long been debated in the literature (Berle and Means, 1933; Friedman, 1970; Galbraith, 1976; Campbell, 2003;

Vogel, 2005). This debate has come to a head in corporate social responsibility and public policy scholarship over recent years, driven by the recognition that in situations of market failure, poor corporate governance and negligent environmental and social practices can be good for profits, thereby necessitating some form of intervention (MacKenzie and Sullivan, 2008). Further, this debate is fueled by increasing evidence that in the long run, these negligent actions are value destroying. This is of particular relevance to investors, who are placing more emphasis on monitoring company ESG behaviour. (Hawley and Williams, 2000; Dihr, 2006; Hebb, 2008).

It is widely recognized that beyond providing forms of legislation and regulation deemed necessary to the profitability of corporations, state intervention is often unpopular politically, as it works against the prevailing ideology of neoliberalism (Gunningham, 1998; Reis, 2004; Dihr, 2006). This ideology has shifted institutional power from the state to the corporation (Gunningham, 1998; Yaron, 2003). Clark and Hebb advance this idea further, suggesting a fifth stage of capitalism[7] has emerged, where the institutional investors have become the most powerful actors through aggregating individual power of a diverse group of beneficial owners. "Corporate engagement of this kind reflects a power shift within the firm away from managers and toward shareholders and the institutional investors who represent them" (Clark and Hebb, 2004, pp. 143).

Recognition of the influence associated with shareholders' unique ownership position has given rise to corporate engagement literature, which regards shareholders and institutional investors representing them as a strong source of influence over corporate behaviour and as a potential monitor (Zeckhauser, 1990; Hawley and Williams, 2000; Hebb, 2008). Investors have essentially two possible responses when they are concerned with the behaviour of the firm. The first option is to 'exit' (divest from poorly performing stocks) to send a message to other companies about the investors' preferences (Hirschman, 1970; Wright and Ferris, 1997).

7 See Clark, Robert. (1981) "The four stages of capitalism" Harvard Law Review, Vol 94, 561-582.

The second option facing investors is to voice their concern with firm behaviour, attempting to improve the performance through dialogue and pressure. Investors have an interest in mitigating externalities of firms in which they invest, rather than divesting (Hischrman, 1970). Although investors may benefit directly for not having to internalize the externality of one corporation, these harmful externalities will be felt in other areas of their portfolio (ibid). Hawley and Williams build on this in their *universal owner hypothesis*, suggesting that large institutional investors have an incentive to reduce negative externalities and increase positive externalities (Hawley and Williams, 1997, 2000; Monks, 2000). This is particularly relevant over recent years, with the increase of block ownership and increased capacity for smaller institutional investors to pool their resources through collaborative initiatives. There is increasing recognition that shareholder engagement is a superior solution to divestment in achieving the goal of mitigating ESG risks (Monks, 2000; Sullivan and MacKenzie, 2006; Hebb, 2008).

In addition to the factors that motivate institutional investors to engage with corporations, the approach taken by investors to engagement is also well documented. Activist shareholders use a variety of approaches to address issues related to ESG policies and behaviour of companies (Hebb, 2008). Building on Mitchel et al. (1997), Gifford (2009) identifies the most salient approaches used by shareholders and other stakeholders. Exploring sub-attributes of legitimacy, urgency and power based approaches to engaging with corporations, Gifford finds that legitimacy is the most important, with a degree of urgency and power being applied only when other options are exhausted.

Noting that the motivation and approach to engagement are well understood in the literature, a gap exists in the understanding of the impacts of this engagement. While impacts have been explored by some studies, there is still no consensus on the effectiveness of engagement in reigning in the risky behaviour of firms. Positive impacts of engagement efforts have been documented through some case studies, most notably the CalPERS effect (Smith 1996; Barber, 2006) and the Hermes effect (Becht et al., 2006). Yet other studies have found negligible effects (Karpoff, 2001; Romano, 2001; Gillan and Starks, 2007). However, the studies that do find negligible impacts focus on the more public forms of engagement such as proxy voting and shareholder proposals, yet do not explore the impact of dialogue that occurs behind the scenes between corporations and the investors (Hebb et al., 2010). Further, these studies define success of engagement in terms of financial returns, but do not consider the social or environmental impacts. Although shareholder activism may be effective at aligning interests of shareholders with management, the evidence supporting the convergence of interests between shareholders and the broader society is lacking (Joerg, 2005; Johnson et al., 2009).

Interdisciplinary studies that explore policy and legal mechanisms related to shareholder rights provide a potential answer to bridging this gap between the interests of shareholders and society at large. Yet the policy and legal environment for engagement is often treated as a fixed input rather than a variable that is capable of interacting with the engagement process. These studies focus on regulatory and legislative instruments to promote engagement, drawing comparisons between US and UK policy environments, recognizing the UK as an ideal institutional setting for engagement (Aguierela and Williams, 2006; Bebchuk, 2005; Becht, 2006; Black and Coffee, 1995; Hendry, 2004; Bethel and Gillan, 2002). "Activism in the United States is often confined to public "naming and shaming" via focus lists and filing nonbinding shareholder proposals in proxy statements" (Becht et al., 2008, pp. 3). Increasing shareholder rights is strongly opposed by others who view activism as destructive to the existing corporate governance frameworks and the efficiency benefits of the current allocation of power (Bainbridge, 2008; Mirivs, 2007). "Shareholder activism threatens to undermine the advantages of director primacy without offering significant countervailing gains" (Bainbridge, 2008, pp.1). Gox (2009) also cautions against increasing shareholder rights, arguing that this will not lead to the desired impact and in some cases may lead to unintended consequences.

In Canada, a few academics have considered an enabling policy environment, with particular focus on extending shareholder rights. There is a consensus that the environment is sufficiently lagging behind other jurisdictions (Yaron, 2002; Dihr, 2006). "Despite Industry Canada's rhetoric touting recent CBCA amendments as liberalizing the shareholder proposal mechanism and enhancing the input of shareholders in corporate decision making, it is clear that "significant constraints" remain in the existing rules" (Dihr, 2006, pp. 408). Although these authors focus on policy instruments to enhance shareholder rights, the authors do not explicitly consider how these interact with shareholder salience.

Davis and Thompson (1994) and Gifford (2009) do allow for interaction between policy and the engagement process, finding that public policy contributes significantly to the legitimacy of the investor. Davis and Thompson (1994) attribute this finding to the fact that the threat of regulation may lead corporations to adhere to shareholder requests rather than meet demanding requirements of future regulation. Higgs echoes this, arguing that "further regulation could unleash more client demand to push SRI (and engagement in particular) into the mainstream" (Higgs, 2005, pp. 31).

Retrenchment of enthusiasm for market solutions has led to a re-visioning of state intervention in corporate governance (Robins, 2006). Waygood (2006) explores these synergies between market actors and the state in a case study of health and safety policy, finding great potential. Robins argues even if all investors were to adopt screening and activist strategies, "this would be insufficient to address some of the structural problems raised by sustainable development" (Robins, 2006, pp. 315). "Regulation is essential to assign rights and responsibilities to achieve both private and public interests" (Robins, 2006, pp. 312).

But despite the enthusiasm over recent years for market-based solutions to societal problems, Yaron (2002) argues that "it is important to emphasize that none who advocate for increased shareholder rights view it as a surrogate for government regulation" (pp. 16). The challenge of developing an enabling policy environment for shareholder engagement has not been addressed in a systematic way in Canada and the literature that does address the issue focuses on specific legal and regulatory tools but does not attempt to qualify the unique

Canadian experience with respect to shareholder engagement that multi-stakeholder interviews in the context of a case study achieve. In addition, most of the literature focuses on the investor perspective, thereby failing to capture the experiences of the corporation. In light of recent work by Gifford on stakeholder salience, this paper takes advantage of the opportunity to integrate his findings with considerations for an enabling policy environment that leverages shareholder salient factors to address the problem that inadequately regulated corporate behaviour presents within the Canadian context. This discussion is set in the broader context of identifying gaps that exist in homogeneous solutions to societal problems.

Section 3: Regulating Executive Compensation: Debates and trends

The governance structure of corporations has long faced scrutiny from policy makers, investors and citizens who recognize the relationship between corporate governance performance and the viability of the corporation (Yermack, 1999; Gompers, 2000). Strong corporate governance is especially important for large financial corporations such as banks and pension funds, as the failure of these institutions would resonate several times over (Goodhart et al., 1998; Palley, 2009). Measures to secure sound corporate governance are implemented not only by the state, but also shareholders who use the rights granted to them as owners to influence governance decisions (Jensen and Meckling, 1976). More recently, the literature has turned its attention towards the extension of shareholder rights over key governance practices to include executive compensation practices. (Yermack, 1999; Bebchuk and Grinstein, 2005; Davis, 2007; Bhagat and Ramano, 2009). The majority of this literature focuses on the US and the UK.

This increased attention to executive compensation is in part due to the widespread recognition that compensation schemes encouraged excessive risk taking by management of large financial institutions and this was a significant cause of the most recent financial crisis (Bebchuk, 2009). In 2005, the average CEO compensation of 1400 large companies in the US increased by 16% since the year before (Bebchuk and Grinstein, 2005). In 1991, the average CEO of a large corporation in the US earned approximately 140 times the pay of an average worker and by 2003, this ratio increased to 500 to 1 (ibid). While some view this as a deeply problematic trend with devastating consequences for not only the shareholder but society as a whole (Bebchuk and Grinstein, 2005; Bebchuk and Fried, 2007; Palley, 2007), others perceive the growth of executive compensation as parallel to productivity growth (Kaplan, 2007; Mirvis, 2007; Bainbridge, 2008) and only a symptom of growing inequality rather than the cause (Mirvis, 2007). Essentially, the debate revolves around the assumption that compensation is linked to performance.[8]

This assumption has been identified as a fallacy by many academics, including Bebcuk and Grinstein (2005), who interrogate the significant increase in aggregate executive pay in the US over the period of 1993-2003 and find it cannot be explained by market forces. Although they do not find conclusive evidence linking the increase in compensation with managerial influence over compensation, they do consider that this could be a possibility in explaining the increase in executive compensation. For Walker (2009), the flawed assumption is attributed to the short-term nature of compensation schemes. In response to this concern, he argues that “policy makers should consider focusing regulation solely on the 'term' of pay while leaving the choice of instrument to individual companies in order to preserve as much efficient diversity in pay arrangements as possible” (pp. 4). Bebchuk and Fried (2004) blame inadequate corporate governance for the problem, arguing that “flawed compensation arrangements have been widespread, persistent, and systematic, and they have stemmed from defects in the underlying governance structure that enable executives to exert considerable influence over their boards” (Bebchuk and Fried, 2004, pp. ix).

Within the Canadian context, executive compensation has not been a high profile issue as it has been in the US because Canada does not face excessive compensation problems of the same magnitude. Average executive

8 For discussion on measuring the link between compensation and performance- see Clarkson Centre for Board Ethics (2010 Report on Corporate Governance in Canada

compensation is at least 50% higher in the US than Canada (ICR, 2006).[9] However, executive pay levels have been on the rise in Canada over the past five years (ibid). [See Appendix, Figure 1] This is due to the significant increase in equity-based compensation. Further, Howell (2007) argues that with the increasing expansion of Canadian companies and competition with US corporations, Canada's compensation levels will likely converge with the US because many Canadian corporate CEOs are viable candidates in US markets.

The most prominent and perhaps contentious approach to addressing excessive executive compensation has been a shareholder advisory vote on executive compensation. Those who support an advisory vote (either binding or non binding) suggest that it would provide shareholders with a critical monitoring and engagement tool over executive compensation (Bebchuk and Fried, 2004; Davis, 2007; Ertimur, 2008; Ralipen, 2009; ISS, 2009) and would enhance corporate governance by increasing communication between shareholders and managers (Davis, 2007). Also, Davis suggests that "advisory votes are seen by government as having succeeded not only in handing investors a voice on compensation, but in contributing to the competitiveness of the British economy" (pp. 14). But supporters of SoP do not view it as a panacea. One report issued by a UK investment manager argues that SoP is part of a larger corporate governance process, and not an end in itself (Ralipen, 2009). Davis (2007) suggests that advisory share-owner votes on executive compensation policies "represent a lever that could strengthen both boards and shareholders in the quest to better align top corporate pay with performance" (pp. 3).

Opposition to SoP presents itself broadly in two forms in the literature; the first takes issue with the allegation that executive compensation practices require any intervention at all. Denying a gap between pay and performance, Kaplan (2007) argues "the U.S. economy and, particularly, the U.S. corporate sector, have performed extremely well in the last 15 years, the period in which corporate governance and CEO pay have been criticized. During that period, the productivity of the U.S. economy has increased substantially" (Kaplan,

9 ICR report provides evidence showing that Canada has significantly lower compensation levels than the US. However, the report also highlights the importance of the link between compensation and performance rather than absolute levels. The Report provides specific details on the Canadian executive compensation experience, relying on interviews with the corporate sector, investors, advisers and policy makers.

2007, pp. 6). Further, critics argue that any intervention by shareholders into the day-to-day business of firms would impose significant costs on the firm because it interferes with the key mechanism of the public corporation, which is the transfer of authoritative control to the board of directors (Bainbridge, 2009). Mirvis et al. (2007) express similar concerns, suggesting that SoP attempts to fix something that is not broken, thereby imposing unnecessary costs on firms.

The second form of opposition to SoP accepts that intervention in compensation decisions may be required but does not concede that an advisory vote on executive compensation is the most effective mechanism. SoP has been criticized for being a 'blunt instrument' which interferes with responsibilities of the board of directors, undermines the compensation committee, privileges some shareholders over others and does not allow for adequate communication between boards and shareholders (Slipp and Knieriem, 2009; Ralipen, 2009; ISS, 2010). Further it is suggested that an advisory vote does not lead to desired results because votes alone do not contain sufficient information for communicating to companies with which aspects of their compensation program shareholders are concerned (Ralipen, 2009). Companies that are poor performers in terms of executive compensation practices often have lower corporate governance standards. Therefore, these companies are less likely to have the proper structures in place for shareholders to voice their concerns and are less likely to implement the advisory vote (Allair, 2010).

Consideration for the effectiveness of advisory votes in terms of improving alignment between pay and performance or what impact they have had where implemented is a relatively new and growing addition to the literature (Eritmur, 2008). Maber and Ferri (2009), Ferri and Sandino (2009), Ertimur et al. (2008), Carter and Zamora (2009) Thomas and Martin (1999) and Johnson, Porter and Shackell (1997) consider evidence based on data in the UK and the US to investigate whether boards are responsive to engagement on executive pay. The results vary and although most studies do find a correlation between the adoption of SoP and a change in executive compensation practices, there are often specific conditions under which this is true. Johnson et al. (1997) find no evidence of a change in executive compensation levels or pay for performance sensitivity follows the submission of a shareholder proposal. Ertimur et al. (2008) suggest that executive compensation proposals have a lower probability of implementation (30%) in comparison with other types of proposals and suggest that shareholder pressure is the main determinant of the implementation decision. Although Maber et al. (2007) find no change in the level and growth rate of CEO pay after a corporation adopts SoP, they do find an increase in sensitivity to poor performance and this is more evident in firms with higher voting dissent. Similarly, Cai et al. (2009) find that on average, CEOs are more likely to see declines in pay the year following a vote in which members of the compensation committee receive lower votes in a director election.

An aspect of impact that has received much less attention in the literature is financial returns associated with SoP, although a few studies have taken up the task. Cai and Walkling (2008) find significantly positive abnormal returns after a SoP bill was passed in the US. In a later study, Cai and Walkling (2009) find mixed results that suggest SoP creates value for companies with inefficient compensation and a weak pay for performance link, but can lead to negative results for companies that are performing well in terms of corporate governance and in particular when these proposals are sponsored by special interest groups such as labour unions. "Say-on-pay creates value only in those firms which could benefit from an improvement in compensation practices and where the vote is likely to lead to changes in firm compensation policy" (ibid, pp 30). This result can be attributed to the fact that these proposals were not targeting firms with abnormal compensation practices but rather firms that were large (Johnson et al., 1997 and Cai and Walkling, 2008). In contrast, Gox et al. find that advisory votes are largely ineffective at curbing excessive executive compensation and that binding votes have more potential to reduce executive compensation but also firm profit. This is because they distort executive investment incentives, making CEOs risk adverse to the point where it negatively impacts firm profits. He suggests conditional binding votes as an alternative, finding that they do impact compensation without effecting profits.

This empirical and theoretical literature informs a larger debate around legislating SoP. The majority of policy-oriented literature focuses on the UK experience with the legislation and considers possibilities for adapting it to the US and Canada (Davis, 2007; Ralipen 2009; and ISS, 2009). Davis (2007) takes up some of the key concerns related to implementing the policy in the UK and concludes that SoP should be adopted in the US. The Ralipen and ISS reports consider lessons from the UK experience with SoP and take a more cautious approach to recommending SoP in other jurisdictions such as the US. In response to fears that SoP raises within the public policy domain, Coates suggests that "general say-on-pay legislation will weaken the ability of special interest shareholder activists to exploit executive compensation as an issue, and will lower the costs of the broad run of shareholders to use their advisory votes on pay to target firms that are most in need of pressure to improve pay practices" (Coates testimony, 2009).

Despite this support, there is a strong opposition to the proposed legislation in both the US and Canada (Bainbridge, 2009; Slipp and Knieriem, 2009; and Allair, 2010). Bainbridge warns against state intervention in executive compensation practices, arguing that "legislation that 'fixes' a nonexistent problem by upsetting basic principles of federalism ought to be a nonstarter" (pp. 47). Another study suggests that "the adoption of a SoP procedure should be reserved for companies where shareholders have reasons to be dissatisfied with their executive compensation programs" and argues that legislation is not desirable (Allair, 2010, pp. 29). In the Canadian context, Slipp and Knieriem argue that the success of the UK is not sufficient evidence that SoP would be successful if implemented domestically. "Differences in the regulatory environment, corporate governance systems, executive compensation practices, and the role of shareholders might make say-on-pay policies less effective corporate governance tools in Canada" (Slipp and Knieriem, 2009, pp. 4). Specifically, the authors point to Canada's corporate ownership patterns, which are less concentrated than the UK, the lack of 'clout' Canadian shareholders possess in comparison with the British and the geographic characteristics of Canada which reduce the opportunities for in-person meetings.

With respect to regulatory conditions, Slipp and Knieriem (2009) suggest that the recently revised CSA regulations do increase the information disclosure on executive compensation, a necessary condition for the success of the SoP vote. "Under the new CSA proxy disclosure rules, companies must provide investors with far more detail on executive pay than in the past" (pp. 5). Yet they remain skeptical of whether Canada's preference for principles based regulation extends to corporate governance issues. "This more prescriptive nature of Canadian rules, which influence the organization and responsibilities of corporate boards of directors, may reduce a board's ability to respond to a shareholder vote by changing its pay program" (pp. 4).

Evidently, SoP is a highly contentious topic and the debate is just starting to take hold in Canada (Slipp and Knieriem, 2009; ICR, 2006). Impact studies of SoP on compensation practices and financial returns in other jurisdictions have produced conflicting results, warranting more research in this area. In addition, the unique Canadian policy context requires consideration. Despite policy impetus for an advisory vote on executive compensation, thirty-four Canadian corporations have adopted SoP.[10] Through semi-structured interviews with investors and corporations and the use of descriptive statistics, this paper interrogates the development of SoP in Canada and seeks to provide insight into the interaction between the public policy and shareholder salient factors, identify any impacts of the vote to date and determine gaps that are unaddressed by shareholder engagement with corporations. This case is imposed on the overarching theme of this paper, which is about optimizing the relationship between states and institutional investors (shareholders) to produce socially desirable outcomes.

Section 4: A framework for understanding the interaction between the policy environment and shareholder salience

This section identifies an analytical framework for understanding the factors that lead to effective change in corporate behaviour, which is tested in this thesis. Agency, stakeholder and institutional theories are considered for their contribution to explaining the impetus, process and outcomes of change.

10 As of July, 2010, 34 corporations have adopted say on pay (see www.share.ca for updated list of say on pay adopters)

Both agency and stakeholder theories provide useful insight in their explanation for internal and external pressures acting on a firm and highlight specific aspects where the policy environment could be useful in correcting problems they identify. However, independently, neither theory can comprehensively explain the influence of the policy environment in which internal and external pressures operate. Agency theory lacks capacity to account for complex scenarios and both fail to account for the context in which engagement is taking place.

Institutional theory on the other hand, places political and economic context at the centre of its analysis. In particular, institutional theory provides the ability to consider not just individual corporate behaviour and how management, shareholders and other stakeholders influence this behaviour, but also the wider phenomenon of institutional change itself. The theory has the capacity to explain how the process occurs over a range of corporations within a jurisdiction. This can be useful for understanding the differences across jurisdictions and providing a basis on which to identify desirable policy.

Agency Theory

Agency theory recognizes the information asymmetries between management and ownership. The unit of analysis is the relationship between the owners (shareholders) of the firm and management. Traditionally, these two actors have had separate roles and this divide has long been disputed (Berle and Means, 1933; Jensen and Meckling, 1976; Bebchuk and Grinstein, 2005; Bainbridge, 2006).

This separation between management and ownership (agent and principal) has been acclaimed as a foundation of effective corporate management (Friedman, 1970; Bainbridge, 2009). Bainbridge argues that providing shareholders with more discretion over management decisions and responsibilities would create severe distortions and waste in management resources that would have to be dedicated to engagement, imposing costs that would negatively impact share value. Further, some argue that shareholders do not have sufficient information to legitimize increasing their powers over the governance of the firm. Agents are more informed and have the skills required to effectively manage the corporation.

This separation however has also been identified as leading to the creation of the principal/agent problem (Jensen and Meckling, 1976). Under conditions of separation between the powers of agents (managers) and principals (shareholders), combined with market failure, firms are often managed to best meet the needs and interests of corporate executives rather than shareholders. As one example, under conditions of skewed incentive schemes such as a severed link between pay and performance, agents are likely to maximize their own utility at the expense of the principals (ibid). Therefore, shareholders have an interest in monitoring the behaviour of management to protect their own interests, avoiding problems associated with moral hazard (Eisenhardt, 1989).

Agency theory has some particular attributes that make it a useful framework for understanding the role of public policy. It clearly identifies a problem that it suggests causes undesirable corporate behaviour, which is the disconnect between the principals and agents. The theory suggests that policy intervention directed at mending this disconnect would be effective at bringing about change in corporate behaviour. Policy that aims to enhance disclosure requirements of management to shareholders for example is one potential solution to this problem. Others include increasing shareholder rights through extending the areas over which shareholders are able to monitor corporate behaviour and providing incentives to management to act in the best interests of shareholders.

Although agency theory does identify the impetus for engagement and a process of using policy to align interests of the principal and agent, for the purposes of this paper, agency theory does not go far enough to address the complex relationships with other actors in society and the solutions are too narrowly focused on economic incentives and monitoring (Gifford, 2009). The theory ignores 'socializing factors' including trust building and enhanced dialogue between industry, state, shareholders and other stakeholders (McLaren, 2002). It also has little to say in cases where shareholder interests do not align with the rest of society (see Bebchuk, 2009; Joreg et al., 2005; Johnson et al, 2009) and cases where information asymmetries cannot be corrected by state regulation (see SHARE report, 2008). Finally, agency theory assumes that shareholders are represented by a single voice, which this is often not the case and can pose significant policy challenges.

Stakeholder theory

As an alternative to agency theory, stakeholder theory expands the focus beyond the management and ownership relationship in the firm to include consideration for other stakeholders affected by the firm's actions. The theory identifies the roles of the corporation and the stakeholder to whom the firms' responsibilities lie, provides a basis for a framework to manage stakeholder interests and describes the link between stakeholder management and traditional goals of the corporation such as profitability, stability and growth (Campbell, 2003). The main tenants behind this theory are that management has a fiduciary responsibility for balancing a variety of stakeholder interests and these interests translate into pressures that influence the decisions taken by the firm. Some of these relationships between the firm and its stakeholders are bound legally, such as those of shareholders and employees, while others rely on informal normative and cultural contracts (Thompson and Davis, 1997).

Stakeholder theory implicitly suggests numerous avenues where policy intervention could be used to enhance the legitimacy, urgency and power of stakeholders to effect change in corporate behaviour. For example, the state could mandate corporations to engage with shareholders on a regular basis, as the most recent CSA rules propose.[11] Enhanced disclosure rules provide shareholders and other stakeholders with information to support their engagement efforts. States could also provide shareholders with greater rights over management of the firm, thereby leveraging shareholder power.

11 See 2009 changes to CSA legislation on disclosure rules

Although stakeholder theory has been the foundation for a significant amount of shareholder engagement literature, it inherently contains ambiguities, giving rise to several criticisms. Management face trade-offs between addressing different stakeholder groups' interests, making it difficult for managers to balance and prioritize these interests. Stakeholder theory offers little if any guidance for management or policymakers in this respect (Campbell, 2003). The theory suggests that stakeholder interests to which a firm has a legal obligation or which are anticipated to impose significant costs if left unaddressed are met first (primary stakeholders) leaving the interests of tax payers, community members and organizations often unaccounted for (Clarkson, 1995). Stakeholder theory fails to address the context in which engagement by the different stakeholders takes place and as a result neglects identifying the conditions under which firms act in socially responsible ways (Campbell, 2003). “Stakeholder theory has failed to attend to the social and economic imperatives that often confront organizations in contradictory ways” (Margolis & Walsh, 2003, pp. 280)

Institutional theory

Unlike agency and stakeholder theory, institutional theories address the broader political and economic context in which engagement takes place, focusing on the regulatory and legal framework, and cultural and normative factors (Davis and Thomas, 1999). There are several strands of institutional theory, distinguished by their description of the impetus for change, the process of change and the outcomes (Kingston, 2006). This paper identifies three prominent variations of institutional theory that are of significant relevance to shareholder engagement: transaction cost economics, theories that focus on formal rules and theories that integrate formal and informal rules. These theories differ in their treatment of regulation, culture and norms, and in their explanations of the factors influencing convergence and divergence of corporate governance practices between different jurisdictions and cultural groupings.

Transaction cost economics (TCE) suggests that institutional change occurs as a result of an exogenous parameter that creates inefficiency in the current governance framework. The main strength of the theory is its ability to explain the existence of the firm and the organizational framework in which it operates (Williamson, 2006). As a result of a change in the attributes of a transaction, "particular sets of rules ("governance structures") will be able to govern this transaction more efficiently than others" (Kingston, 2006, pp. 3). Convergence of corporate governance practices in similar markets and legal jurisdictions is expected. Firms and shareholders inherently want to minimize costs and will therefore seek to change their governance structures. The impetus can come from a change in state policy, such as the introduction of a tax on carbon, which would cause shareholders to become more concerned with the environmental performance of corporations in their investment portfolios to avoid the costs that eventually harm shareholder returns. However, as North points out, "economic markets … are frequently very imperfect, beset by high transaction costs and defined by institutions that produce incentives that work against economic efficiency," suggesting that there are other forces in play (North, 1990, pp. 6).

Academics such as North, Libecap and Ostrom emphasize centralized political processes rather than seeing change as a natural and decentralized process. SoP legislation for example imposes a set of rules under which shareholders and corporate managers are forced to negotiate. The path dependent nature of institutions constrains central decision maker's choices (North, 1990). However the focus on formal rules fails to acknowledge that "institutions have no meaning if the constraints they impose are not enforced (Roland, 2000). Further, the focus on centralized decision making is criticized for its failure to account for the influence of norms and culture (informal rules) on shaping these rules in the first place. North does acknowledge the importance of informal rules; "We need to know much more about [informal rules] and how they interact with formal rules" (1990, p. 140).

Equilibrium theories address North's concern, giving attention to the interaction between informal rules and the political processes. The theory recognizes that informal and formal rules are just mechanisms that are used by 'players' to achieve a shared set of beliefs about each others' behavior thereby allowing them to coordinate their actions. Institutional change therefore is a result of a change in expectations rather than a change in formal or informal rules. A rule that fails to shift people's expectations in the desired way may have no effect at all (Aoki, 2001, pp. 231). Aoki suggests that "in order to understand the nature and public policy implications of diverse institutional arrangements across economies, it is desirable to adopt the comparative, interactive approach by which comparative information is accumulated, context specific models are constructed and analyzed, and their predictions are confronted with comparative evidence" (pp. 232). Akoi explains differences in policy for engagement across jurisdictions, suggesting that there could be several equilibria upon which an institutional arrangement exists.

A theory of enabling policy environment

This paper argues there is a lack of theory relating the policy environment to shareholder salience factors that lead to impact on corporate behavior, pointing to Gifford's omission of the policy context as a moderating factor. To fill this gap, it is useful to consider how institutional factors (political and economic) interact with stakeholder salience to bring about change in governance structures and outcomes of positive firm behavior. The underlying assumption is that shareholder interests align with society in most cases and in areas where they do not, more state intervention is required.

As Gifford argues, "agency, stakeholder and institutional theory all provide valuable contributions to the field and help explain the phenomenon of shareholder engagement and point towards strategies for making it effective" (pp. 53), yet the political and economic context addressed by institutional theory needs to be drawn out more clearly in this framework. By focusing on the policy context, it is important not to neglect the informal processes and role that cultural and normative rules play in supporting shareholder engagement. For example, in Canada the shareholder engagement environment is currently ahead of regulatory and legal regime with respect to SoP. Equilibrium theory, although complex, can shed light on the process of institutional change that occurs in spite of regulatory impetus. This framework, which places more emphasis on institutional theory, will be tested in the rest of this paper for relevance and explanatory power with respect to salience of shareholders.

Section 5: The Canadian Engagement Experience: Quantifying Trends

This section employs descriptive statistics to investigate the impact of engagement in Canada, focusing on the advisory vote on executive compensation. This includes identifying characteristics of the corporations that are engaged on the issue, investigating the circumstances under which the adoption of the vote occurs and considering any preliminary impacts of the engagement that can be observed. The intention is to identify gaps in the engagement process, identify conditions under which engagement is successful, and better understand the Canadian environment with regard to executive compensation and the process of institutional change. Corporate governance ratings are used to test whether SoP adopters are more likely to have higher scores compared to non-adopters in the periods preceding and following adoption; shareholder proposals are analyzed for content and strategy; and pay for performance links are explored for the largest 50 Canadian corporations.

Data are collected from both public and private sources, including Jantzi Sustainalytics, the Clarkson Centre for Business Ethics Board Confidence Index, the SHARE resolution database, Canadian Industry 500 annual report and Globe and Mail Annual Executive Compensation report.

SoP is commended for raising the corporate governance performance of firms because it provides an additional and important layer of responsibility and accountability. Although some corporate governance rankings now include the advisory vote on executive compensation in their rating systems, such as the Globe and Mail 'Board

Games' ratings and Risk Metrics, the Clarkson Centre (BCI) ratings do not include the vote in their scoring system. This allows the data to be used to investigate the relationship between the advisory vote and corporate governance performance of the firm, because it avoids variable independence problems facing other metrics that include the vote in overall scores.

The Clarkson Centre Board Confidence Index 2009 ratings of 155 listed Canadian public corporations range from AAA to C. Of the 30 SoP adopters listed in the index, 22 have a rating of AAA under the executive compensation sub-section. In total 70 AAA scores are assigned for compensation practices. Of the total 20 B ratings for compensation practices, only one is an adopter of SoP. Turning to the total corporate governance score, two adopters are given AAA rating out of a total of four. Six adopters received a B and one adopter received a C. Numerical weightings are given to each letter score to observe average scores. The average total corporate governance rating for adopters is 7.65 (out of 10). The average rating for non- adopters is 6.84. Using the same weighting system, on average adopters received a compensation score of 9.53 and non- adopters on average scored 8.82.

Although the data show that on average adopters of the advisory vote score higher on executive compensation and total corporate governance performance, it is not possible to determine the presence or direction of causation from this analysis. It is possible that SoP causes adopters to increase their corporate governance performance. However, it is also possible that adopters are more likely to have effective corporate governance frameworks in place prior to adoption and it is the corporations that do not have good practices that fail to adopt the vote (Allair, 2010).

To better understand the presence and direction of causality, corporate governance data from Jantzi Sustainalytics from 2004 to 2007 are used because they precede SHARE's SoP engagement campaign, thereby removing this factor from the analysis. After consolidating data and removing corporations that do not have scores for all four years, on average the scores for corporations that have adopted SoP in 2009 and 2010 are higher than for non-adopters during the period 2004-2007. The average four year corporate governance score for adopters of SoP is 7.2 (var =0.5) and for non-adopters is 6.5 (var =1.03). On average, adopters of SoP had higher corporate governance scores than non-adopters, suggesting that causation stems from better corporate governance leading to adoption of SoP. The correlation coefficient using binary variables to represent adoption and non-adoption is +0.17. Yet there is a third possibility, which is the presence of a confounded variable. It is possible that more visible (larger) corporations experience greater pressure from stakeholders to attain high corporate governance scores and also face pressure to adopt SoP.

The Globe and Mail Report on Business provides a list of the largest hundred Canadian corporations by market cap in 2009. From this list, 50% of the top ten largest corporations have adopted the advisory vote, and 28% of the largest hundred have adopted the vote. Gennum Corporation is the only firm to receive a proposal with market cap under $1billion. This evidence supports the possibility that larger corporations face more public scrutiny and are therefore more likely to have higher corporate governance ratings.

[See Appendix, Figure 2]

Shareholder proposals

To further investigate the factors leading to successful engagement and the currents driving institutional change, shareholder proposals filed on the SHARE resolution database on the issue of executive compensation are analyzed. Of the 630 proposals filed from 2005 to 2010, 154 focus on the issue of executive compensation. There are a total of seven institutional filers and seven independent filers over this period. Content of the proposals are analyzed to understand the approach of the engagers and how it corresponds with outcome of the proposal. Categories include: the use of aggressive/emotional language, reference to regulation/legislation in other jurisdictions, appeal to forthcoming Canadian regulation, appeal to shareholder rights and/or value, reference to academic and industry reports and appeal to reputation management. These variables are selected because they represent overall appeal to legitimacy (appeal to regulation/legislation, academic and industry reports), urgency (number of proposals filed, time period) and power (aggressive language). Aggressive language is identified as using threats, accusations and strong language ('greedy, egregious violation of shareholder rights').

Results suggest there has been an increase in proposals filed related to executive compensation over the time period from 2005 to 2010 from 10% in 2005 to 50% of all proposals filed in 2010. In addition, the analysis suggests that the approach to engagement has changed. The use of aggressive language has decreased since 2005. Second, the incidence of appeal to regulatory and legislative requirements in other jurisdictions is increasing, particularly with reference to the UK and US. In more recent years, reference is also made to potentially forthcoming legislation and regulation in Canada on executive compensation practices. The analysis also finds that the appeal to shareholder rights and long-term share value has been present in almost all proposals filed since 2005. Appeals to reputation have decreased. A final observation is that all proposals filed after 2008 on an issue related to executive compensation include a reference to the recent financial crisis.

[See Appendix, Figure 3]

With regard to the success of proposals filed, the analysis suggests that proposals that are adopted tend not to contain aggressive language (only 1 containing aggressive language received more than 50% support) and are filed by institutional investors rather than individual shareholders. The advisory vote on executive compensation is the most successful proposal in terms of voting support. Other proposals related to executive compensation asking for binding resolutions on executive compensation or a ratio with average employee compensation received much less support and in most cases were not implemented. Another trend observed is the increase in support for SoP after subsequent proposals are filed (urgency-persistence). In 2008, the first round of resolution filings by SHARE on SoP received average support of 40.5%. In 2009, the average support for the proposal increased by 12 percentage points to 52%. In 2010, the majority of proposals filed on SoP were withdrawn because the corporation they were filed against had agreed to adopt the vote before the proxy-voting season (12 out of 23 were withdrawn because company and filer reached an agreement). In 2009, 14 out of 35 are withdrawn, compared to previous years in 2008 only 1 out of 42 were withdrawn.

By 2010, thirty-four (forty-nine in 2011) Canadian corporations have adopted SOP and fourteen have held the advisory vote on executive compensation. In 2009, Thomson Reuters was the only corporation to hold the vote, which gained support of 83% of the shareholders. In 2010, thirteen additional corporations held the vote and only three resulted in less than 90% support for the compensation plan. Thomson Reuters shareholder support increased to over 90% in 2010.

[See Appendix, Figure 4]

In addition to indirectly investigating the link of SoP with corporate governance and compensation practices using Jantzi Sustainalytics and BCI ratings, the link is explored more explicitly using performance and compensation data for the largest Canadian corporations. Some suggest that Canada does not have the same problem as the US with excessive compensation and therefore does not require intervention from the state or shareholders. However, although executive compensation has not increased at the same levels as the US, (see Appendix, Figure 1A and 1B) it is not the absolute level that is of most concern to this paper, but rather the provision of proper incentive structures through the linking of pay with performance.

The approach is based on the Hay Group, who develops an index, which ranks largest Canadian companies on performance and compensation of executives in 2008. Instead of using absolute values as the Hay Group study does, this paper uses change in performance over a one-year period and change in total compensation over the same time period. Equal weights of one-year % change in EPS, % change in 5 year ROE, % change in revenue from previous year and % change in returns are used to construct a measure of performance for each corporation relative to the previous year. These are graphed into a quadrant. The intercepts are determined using averages of the two measures (25 as average performance rank and +12% as average change in compensation). The 270-degree line represents the alignment of pay with performance. Companies falling into quadrants one and three are considered to be roughly aligning their pay with performance. Companies falling into quadrants two and four are considered to have poor performance and compensation alignment. Quadrant four contains companies that performed relatively poorly compared with the previous year, yet the compensation of CEOs increased significantly. SOP adopters are highlighted in red.

[See Appendix, Figure 5]

The process is repeated for 2009. Notice that in 2008 five future SOP adopters (in 2009/2010) fall into quadrant four, but in 2009 only one adopter falls into this quadrant and more fall into quadrants one and three. This change may be attributed to the increased shareholder pressure on executive compensation practices of these corporations since 2008, particularly with the financial crisis providing this momentum. However, causation cannot be determined from this data. It is possible that other sources of pressure are influencing compensation practices, such as international norms. Interviews with corporations and engagement teams are required to draw any substantial conclusions.

[See Appendix, Figure 6]

Although limited in its explanatory power, this analysis provides a descriptive review of the engagement experience in Canada and identifies emerging trends and areas for further interrogation. Direction of causation cannot be determined from the analysis, but some interesting characteristics of corporations adopting SoP are revealed, leaving policy implications to be explored. Larger corporations with a track record of good corporate governance performance are more likely to be adopters of SoP. Also, the data suggests that engagement on executive compensation has increased over the past five years and the approach to engagement has also changed. These trends leave some interesting questions with regard to institutional change: Will the change be incremental, with large adopters putting pressure on others to adopt? Is change being influenced by international norms? Are we at a tipping point? Will formal actors (policy makers) need to intervene to move the adoption of SoP any further? These questions are taken up in the discussion section.

The Canadian Engagement Experience: Investors and Corporations

To fill in some of the gaps existing in the quantitative analysis, semi-structured interviews are conducted. Interviews reflect not only the investor perspective of engagement, which has been well documented (Gifford, 2009), but also the corporate perspective, which is significantly underrepresented in the literature. Incorporating consideration for both sides of the engagement process allows for the interrogation of the same phenomenon from different perspectives to reveal convergence in views and points of conflict. Questions address factors that motivate investors to engage on ESG issues and corporations to respond, internal and external factors influencing the outcome of engagement, effective strategies of engagement and explicit consideration for the policy environment as a moderating factor influencing the success of engagement in Canada.

Drivers of engagement

Interviews begin by asking investors to describe what motivates their engagement on ESG issues. Although one respondent cites risk management as a factor, the strongest emphasis is placed on the acknowledgment that engagement is an integral part of their responsibility as a long-term investor. "Using the rights associated with share ownership, investors can influence companies to improve their management of environmental, social and governance (ESG) risks and opportunities, helping to build accountability and long-term shareholder value" (SHARE). Another investor claims "engagement is a very crucial part of what we do as investors. We take ownership very seriously."

With regard to the SoP engagement, motivation stems from recognition that the advisory vote is viewed as contributing to corporate governance. "I think it's good governance, so every company that we own should be providing it to us" (Hawton).[12] A restraint that all investors we interview acknowledge is the limited resources, thereby requiring the development of focus lists. As a result, concern for the likelihood of success plays a role in determining the issues on which investors engage. "Some issues are harder to engage with than others. Corporate governance is easier because there are mechanisms and support to make this work" (SHARE).

From the corporate perspective, both respondents recognize engagement as part of their duty as a public corporation. With respect to the two corporations interviewed in this study, both attributed the engagement to their visibility in the market as a factor. The number of stakeholders affected by a corporation's operations can serve as a proxy measure for 'visibility' in the market. In general, the more visible a corporation is, the more likely it is to be a target for engagement. Also, from the investor's point of view, it is strategic to engage more 'visible' companies early on, since this can help build momentum for other corporations to follow a leading company. This is reflective of the SoP engagement in Canada, as the larger and more visible corporations were engaged first. The growing trend in Canada and internationally was also cited as a contributing factor to their attention to the issue.

Shareholder salience:

In addition to exploring the reasons driving the engagement process, interviews consider corporate and investor perspectives on salient factors leading to successful engagements; legitimacy, urgency and power. A

12 See SRI Monitor, "Say on Pay to be Ramped up" March 25, 2010. available at: http://srimonitor.blogspot.com/2010/03/say-on-pay-campaign-to-be-ramped-up.html

strong theme that emerges in response to questions regarding investor's approach to engagement is the importance of establishing legitimacy with the corporation. Legitimacy is not strictly dependent on relative size and reputation of the engager, but on the approach that is taken in the engagement. “We do not treat annual meetings as theater, we don’t embarrass executives through press releases, we do not use the media to make our case. We are solutions oriented” (Hebb et al., 2010). SHARE agrees, suggesting “media attention gave it (SoP) the profile it needed for support, but it is always and ultimately an issue of legitimacy. The size of stake is not as critical” (SHARE).

The corporate reflections on salient engagement strategies diverged from the investors. Most significantly, corporate representatives we interviewed did not perceive legitimacy as the most important factor. Legitimacy it was agreed may be seen as a necessary condition, but the most significant driver of engagement is persistence. In one corporation's experience, “SHARE approached us three times before we came around to agreeing we would implement a vote” (Sun Life Financial). Another corporate representative interviewed agrees, arguing that “legitimacy is important, but there is a low threshold for legitimacy. As long as the engager is viable and is articulate and reasonable in their requests, we are open to engagement” (Royal Bank of Canada). Although legitimacy was recognized as the most important factor, investors did recognize the value of persistence. “We attribute our success to hiring knowledgeable staff, good research, a professional approach, and persistence” (SHARE).

Gifford identifies persistence as a sub-attribute of urgency, suggesting that it contributes to intensity of the engagement. “Intensity, while incorporating the time-sensitivity aspect of urgency, does not privilege that factor, but treats it alongside others such as assertiveness and persistence, which are just as important in driving salience” (Gifford, 2009, pp. 15). Corporate representatives interviewed did not see the time-sensitivity factor of urgency as a salient factor. They viewed the momentum building behind SoP as a growing but not urgent trend. “We did not feel a great deal of urgency; it was a growing trend and we were moving in that direction" (Sun Life Financial). "We are not looking to be the first to adopt new trend, but we always keep up with trends; we like to be somewhere in the middle" (Sun Life Financial). Both corporate representatives highlighted their track record on corporate governance and recognition for disclosure on executive compensation.

With respect to power, there is a consensus between investors and corporations interviewed that it is the least salient factor and as a strategy it is used as a last resort. Investors all pointed to the harm that engaging in media campaigns or threatening divestment could lead to for share value and corporations were aware of investors' concern. Corporations also recognize that it is not usually in the best interest of investors to move an engagement into the public light to generate momentum from negative public pressure, as this also risks generating negative pressure on share prices. In addition, corporations recognize that shareholder power requires wide holdings in a corporation and this is not the case in Canada. SHARE suggests that "it is not taken to that level." Corporations tended to agree, claiming "we believe that if investors perceive you are willing to engage on an issue and talk about it, then they will be respectful and engage in a constructive manner" (Sun Life Financial).

Success of engagement:

Interviews also explore the success of engagement in Canada, with particular attention to how investors and corporations define this success. For one investor we interviewed, success is about "attention to an issue where there was no attention before and bringing about change where issuer willingness and/or shareholder consensus is found" (SHARE). Further, this investor suggests, "implementation of the proposal is the ultimate measurement of success." With respect to the advisory vote, "it is clear that say on pay would be nowhere in Canada without the engagement process and attention it has garnered to the issue" (SHARE).

Corporate representatives are asked to provide their view on the success of engagement. Investors are sometimes skeptical about the willingness of corporations to acknowledge the impact of engagement. Although corporate representatives did not exclusively attribute the decision to adopt the advisory vote to the engagement efforts of investors, they did acknowledge that investors played a role in bringing attention to the issue. "SHARE and Meritas did a good job of keeping attention and awareness on the issue" (Sun Life Financial). Another corporate representative responds, "although investors are good at raising the issue and getting it noticed, several factors accounted for the adoption of the vote, including public policy, regulation [and] disclosure" (Royal Bank of Canada).

Investors view the Canadian Coalition for Good Governance (CCGG) as a useful ally. For corporations, the CCGG adds an additional perspective and plays an important role in bringing attention to the issue. While both investors and corporations agreed on the value of the CCGG, each placed a different emphasis on the role the CCGG played in the say on pay engagement. SHARE pointed out that the CCGG was opposed to SoP in the beginning and it was therefore most influential in generating media attention to the issue. Corporations interviewed perceived the CCGG as unique to Canada and a valuable resource. One corporate respondent comments that the CCGG is "a luxury that US does not have; by appointing one representative group to make efficient use of time to prioritize the agenda" (Royal Bank of Canada). Another claims, "we go through the CCGG *Best Practices* line by line and identify and discuss with the board of directors and governance committee practices that do not meet the guidelines and seek policy direction on these areas from the board" (Sun Life Financial). CCGG best practices are "very helpful and save us from trying to develop corporate governance best practices on our own" (Sun Life Financial).

Impact of engagement

Investors and corporate respondents agreed that it is too early to determine the impact of SoP, as the vote has been adopted by most in 2009. Of the adopters, only half held the vote in 2010, with the rest to hold the first vote in 2011. Further, because voting results for the SoP votes that have been held thus far are so high (most above 90%), in the event that shareholder support for compensation plan is lower, it has not been tested what actions, if any would be taken by management. Both corporate representatives interviewed indicated that in the event of low support, they would engage in dialogue with shareholders to understand their concerns. In terms of the impact of the engagement on the vote itself, one investor suggests that it has brought more awareness to the issue of excessive executive compensation in Canada. "I applaud these companies for recognizing that a "say on pay" vote is quickly becoming recognized as a sign of good corporate governance" (Hawton).[13]

Although the interviews provide insight that reaches into some of the areas that are left unaddressed by quantitative analysis, a significant limitation in this study is the lack of interviews. SHARE invited corporations with which it engaged to participate in the research project, and two responded. Of the corporations that were approached by the researcher to participate, none responded. It would be desirable to interview corporations who were engaged on the issue and rejected the advisory vote. The change in the CCGG's position on the advisory vote in 2009 would also be an interesting inflection point to investigate. Finally, all interview respondents in this study are generally in favour of SoP. To give the topic due diligence, it is necessary to expand interviews to include views reflecting opposition to the vote.

The Canadian Engagement Experience: Current Policy Environment

Shareholders of public corporations vary in size and have distinct values and agendas, including white supremacist groups, religious organizations, universities, individuals, employees and ethical investors. This presents a significant challenge to policy makers, who are faced with deciding whose voices should be heard and how. Ideally, public policy makers should seek to find a balance between a) providing shareholders with sufficient rights and responsibilities as owners b) leveraging this power of shareholders to achieve social

13 See SRI Monitor, "Say on Pay to be Ramped up" March 25, 2010. available at: http://srimonitor.blogspot.com/2010/03/say-on-pay-campaign-to-be-ramped-up.html

objectives and c) managing risk associated with powerful 'special interest' shareholders. This section reviews Canada's policy environment with respect to shareholder rights and identifies some of the policy areas that could be enhanced, while counterbalancing this with considerations from opponents of increasing shareholder rights. Understanding our current policy environment is a significant undertaking and it is only the intention here to identify key aspects of the Canadian environment and discuss how these influence the limitations that currently confine our options for improvement.

Shareholder proposals

Engagement takes on many forms, including private dialogue, letter writing, proxy voting battles, shareholder proposals and in its most extreme forms, negative public campaigns and the threat of divestment (Hebb, 2008). These engagement practices often require sophisticated tools and significant resources. Public policy plays a central role in providing the rights and resources to shareholders. For example, disclosure requirements legislated by CSA provides grounds on which shareholders can engage in informed dialogue. Proxy voting rights and shareholder proposals provide opportunities for shareholders to initiate discussion with issuers as well as a visible forum for more formally voicing their concerns. Corporate governance principles and other legislation enhance investor's 'social legitimacy' (Gifford, 2009).

However there are limits to rights provided to shareholders that are required to maintain the balance between effective corporate governance and effective firm management. For example, although shareholders can file proposals and vote on matters likely to have serious consequences for the corporation, issues viewed as constituting 'routine business' are off limits, with the intention of avoiding excessive intervention from shareholders. The problem arises however in the definition of what constitutes matters of 'routine' business. Environmental and social policies have typically been assumed to fall under day to day business operations, however increasing evidence shows that these actually present serious risks to the viability of the company, warranting shareholder intervention (Freshfields, 2005, 2009).

Some argue that Canada has already gone too far in favour of shareholder rights and condemn any further extension of these rights. For example, management is now prevented from excluding proposals on the grounds that it “promotes economic, political, racial, religious, social or similar causes” (Industry Canada, 2008). While this seems to provide shareholders with adequate power over management, this does open possibilities for interpretation that could be construed as harmful to the welfare of society and oppressive mechanisms to prevent this from taking hold.

Yet others see significant room for improvement of shareholder rights in Canada. Recent changes have been made to the Canadian Business Corporation Act (CBCA) which on the surface have tipped the scales in favour of shareholders. Managers are still permitted to exclude proposals that pose publicity risks and proposals that do not meet specific criteria under the CBCA, including a 500-word limit, which has been revised from the previous 200-word limit (Yaron, 2006). This pales in comparison to the 1000 word limit in the UK. Critics argue that Canada does not provide sufficient space for shareholders to communicate, particularly in relation to management, who are not restricted in their response to proposals. In addition, shareholders are required to hold 1% of voting shares or own at least $2000 in shares. “Given a history of Canadian equity holders not abusing the proposal provision, it is difficult to see the necessity for this ‘‘threshold’’ requirement, which will only serve to exclude small investors.” (Dihr, 2006, pp.386) This threshold is even higher in some jurisdictions such as Alberta, which requires a 5% share holding to be eligible to submit a proposal, excluding the majority of non-management shareholders from filing a proposal (SHARE, 2008). “A shareholder proposal has not appeared on the ballots of ABCA companies since the threshold was established in 2005” (SHARE, 2008, pp. 4).

Proxy Voting

Another mechanism intended to provide shareholders with a voice in the management of corporations is proxy voting. Proxy voting rights are granted to the beneficial owner, who can in turn, delegate these voting rights to the registered owner to vote on their behalf. Consistent with the submission of proposals, Canadian shareholders are only permitted legally to vote against issues that do not qualify as “routine business'. Corporations are required to publish the vote results. Voting results are non-binding in Canada, but they do have the power to send a strong signal to management.

However Canada is seen to be failing to provide the proper systemic controls and regulatory guidance with regard to the proxy voting process. Many investors in Canada delegate their voting responsibilities to investment managers and leave the vote decision up to the intermediary’s discretion. According to a survey conducted in 2004 by SHARE, two thirds of investment managers surveyed were not advised by their client pension plans on how to vote their proxies on 85% or more of proxies voted.[14] This contradicts OECD corporate governance guidelines and CCGG best practices, which emphasize the importance of providing guidance to intermediaries on voting proxies. Another concern with the proxy voting process is the type of issues on which shareholders are permitted to vote. Routine business includes the election of individual directors and the appointment of auditors and executive compensation, thereby excluding shareholders from voting on these issues. Further, prior to 2004, Canadian companies were not required to publish voting results. Despite the rules companies are still able to avoid disclosing results as the rules do not provide sufficient guidelines on what information must be disclosed. A report by the CCGG finds that “most companies are not providing meaningful vote disclosure.”[15]

Advisory Vote on Executive Compensation

Unlike other jurisdictions such as the UK[16], Canada does not require a binding or non-binding vote on executive compensation. It is argued that a non-binding shareholder vote would not be effective in Canada until “more comprehensive disclosure was required of public companies by the CSA’s members.” (SHARE, 2009) This is

14 *2004 Key Proxy Vote Survey* conducted by the Shareholder Association for Research and Education (SHARE)
15 See Canadian Coalition for Good Governance, www.ccgg.ca
16 Norway, Sweden mandate binding votes on executive compensation and UK, Australia and US (TARP recipients) require non-binding 'advisory' votes on executive compensation.

consistent with concerns expressed by corporations. One interviewee claims, "if we anticipate new rules on executive disclosure, we do not want to adopt something that is coming into legislation. If we felt that it was, we would have waited and our response on the SoP engagement would have been to agree in principal and wait until the legislation comes into force". Another respondent, referring to the advisory vote describes it as "a result of constructive dialogue, a moderate approach and a mutually agreed upon position compared with the legislative approach in the US". Shareholders are viewed as effective monitors of the corporation, but in a general context. There are more players than just shareholders for companies. Companies first need to ensure that they comply with regulations and securities legislation and industry regulation. Hopefully they go beyond this compliance.

The new CSA corporate governance guidelines provides for enhanced disclosure under *Principle 8* on executive compensation, yet it remains to be seen whether this will have an impact on legislation requiring the advisory vote. Some like Bebchuk (2009) are skeptical that SOP has the potential to have a meaningful impact on corporate behavior. He argues for a prudential regulatory response to excessive compensation, particularly in the case of large financial institutions because shareholders may not have sufficient information and expertise to make decisions regarding executive pay (ibid). Further he argues that gains resulting from risky behaviour often go to both shareholders and bank executives, leaving the burden of losses from this behaviour to fall on tax payers, depositors, preferred shareholders and bondholders (ibid). As a result, there are incentives for both shareholders and executives to engage in excessive risk because they are not internalizing the negative effects of their risks. Wolf echoes these concerns, arguing, "if the financial system has proved dysfunctional, how far can we rely on the maximization of shareholder value as the way to guide business? The bulk of shareholding is, after all, controlled by financial institutions" (Wolf, 2009).

Regulating Investors

In order to have a substantial impact on corporate behavior, this paper has argued that the state cannot rely solely on the voluntary action of institutional investors. Free riding continues to be a concern, resources for engagement are costly and there is no guarantee that signatories adhere to their commitments. With the release of the Freshfields reports in 2005 and 2009 there is a growing consensus that in fulfilling their legal fiduciary duty, investors should take into consideration ESG risks.[17] Institutional investors in the UK are required to disclose in their statement of investment principles and policies "whether and to what extent they use social, ethical and/or environmental criteria in their investment selection" (UK, 1999).[18] In addition, British institutional investors are required to use discretion when voting proxies, meaning that they must provide direction for their investment managers when delegating voting rights. In Canada and the US, these requirements do not exist. The UK policy framework is recognized as a powerful driver of pension fund corporate engagement (Clark and Hebb, 2005). The question remains whether it should be adopted in the Canadian context.

International convergence?

Never-mind the engagement efforts of institutional investors or policy makers in Canada on executive compensation. Some argue that executive compensation is an emerging international trend and as such, will take hold in Canada regardless of domestic legislation or shareholder pressure. There is evidence to support the fact that corporations are changing to keep up with international principles. Although interviewees did not

17 Freshfields Report 2005 and 2009: "The report says consultants and asset managers' mandate contracts and operation under tort law as professional advisers mean they could be obliged to raise ESG considerations that could be "material" to the contract, or face action if they don't " (CSR International)

18 Section 2 of the Combined Code (2003) establishes principles applicable to institutional investors, including that "[i]nstitutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives (Combined Code, E.1)", and that they should make "considered use of their votes (Combined Code, E.3)".

claim to be influenced by their operations in other institutional environments, such as the UK, respondents indicated that they are closely monitoring international trends.

The Canadian policy environment with respect to shareholder engagement is complex, requiring multiple levels of analysis to identify where it could be improved. This review has incorporated with a review of regulation literature to address current issues with the policy context while identifying views on interaction with engagement process and its influence on salience of shareholders. One limitation of this data is the lack of interviews with relevant policy makers to understand constraints they face, and perspectives on shareholder engagement, executive compensation and their relationship with corporate governance. In addition, although some comparisons are drawn between Canada and the US and UK environments, the analysis requires more depth before broader comparisons like the ones that Gifford calls for in his dissertation can be made.

Section 6: Research implications

Shareholder engagement is increasingly recognized as a means of reigning in risky corporate behaviour and public policy plays an important role in providing shareholders with the leverage to achieve this goal. This paper has considered the impact of engagement on corporations to determine the most effective ways in which the policy environment interacts with engagement efforts of shareholders. The theory of shareholder salience is used to explore the factors that have led to this change (SoP adoption).

Agency and stakeholder theory contribute to an understanding of the engagement process and identifying factors of shareholder salience. The theories identify points of leverage for policymakers, such as the management/shareholder relationship and the importance of legitimacy, urgency and power. But extending beyond an isolated engagement experience between *firm x* and *engager y;* where characteristics of not only the engagers, but also the corporations are relevant and where the policy environment interacts with the engagement process, institutional theory has more to offer than agency and stakeholder theories. The analysis informs policy implications for Canada, identifying areas where engagement is not effective, requiring more direct forms of state intervention and areas where state leverage could be used to enhance the effectiveness of shareholders.

Through considering characteristics of corporations who have adopted or rejected say on pay, gaps are identified. Corporate governance scores of SoP adopters are on average higher than non-adopters both prior to and after the engagement was launched by SHARE and Meritas in 2007. Interviews confirm that corporations that have adopted the vote perceive themselves as good corporate governance performers, with proper incentives and processes in place with respect to their executive compensation schemes. Engagers may only be targeting the firms that are already meeting or exceeding corporate governance expectations and have sound executive compensation practices in place, leaving those with poor governance performance unregulated and free to continue practicing risky compensation practices.

On the other hand, shareholders may seek to target a wide range of corporations, but the issue is only being taken up by those who are comfortable with exposing executive compensation to shareholder scrutiny. This confirms Allair's criticism of the voluntary vote, which asserts that in absence of legislation, SoP is only adopted by corporations that already have the proper corporate governance and executive compensation structures in place (Allair, 2010).

A second condition that is explored is the size of the corporations that are adopting the vote. Evidence suggests that the largest corporations are adopting the vote, while smaller corporations are not. However, investors may only be targeting larger corporations because they are more visible. The only corporations to date not to adopt the advisory vote after receiving a resolution submitted by SHARE in 2010 is Gennum Corporation, which is also the only corporation in this group with market cap of less than $1 billion. The two large financial institutional representatives interviewed felt that because of their size, they receive a high proportion of media attention and pressure from stakeholder groups, including shareholders.

Relying solely on the voluntary adoption of SoP may not a viable option, as evidence suggests that the smaller corporations with weaker governance standards are not adopting the vote and may not even have the proper structures in place to do so. It is also possible that shareholder are allocating their resources to engagements where they are likely to be successful and visible. Legislating SoP as the UK and Australia have opted for is one option, but there are a host of other issues that are raised with this decision, such as whether it leads to a 'cookie cutter' approach to corporate governance, rendering it ineffective as a blanket approach. Current literature suggests that legislating SoP is only effective under specific conditions and Canada may not be a viable candidate.

Through interviews and document review, the paper has explored the three salient factors of shareholder engagement as proposed by Mitchel et al and Gifford; legitimacy urgency and power, to identify where state leverage would be most effective. Interviews reveal a divergence in views between investors and corporations. Evidence and literature suggest that investors find legitimacy to be the most important factor and attribute it to their success. Legitimacy is not only defined by size and reputation, but is also associated with the engager being prepared with solid research and having a professional and cooperative attitude. This is also evident in the review of shareholder proposals, which finds that reference to other jurisdictions' legislation, academic and industry reports and potential forthcoming regulation in Canada are the most common strategies of successful proposals, all contributing to the legitimacy of the engager. From this perspective, providing resources and public backing to shareholders to enhance shareholder legitimacy may be the most effective way to leverage shareholders to effect change in corporate behaviour.

However, corporations interviewed suggest that persistence is the most important factor driving successful engagement. Although they acknowledge that legitimacy is a necessary condition, there is a low threshold for this legitimacy. Persistence is categorized as a sub-attribute of urgency in Gifford's framework. Both corporations interviewed claimed that the time dimension of urgency was not a crucial factor, as they did not feel significant pressure to adopt SoP within a given time period. The review of shareholder proposals also confirm that persistence is effective; most proposals were filed twice before being adopted and the frequency of proposals filed on the issue increased significantly since 2005. Urgency as a driver of engagement is inconsistent with what Hebb et al (2010) find in their study of investors, where legitimacy is dominant. "None of the three cases under investigation pointed to the attribute of urgency as a driver of successful engagements nor was the lack of urgency discussed as the cause of unsuccessful engagements" (Hebb et al, 2010, pp.38). More research and interviews are required to confirm this result, but this suggests that public policy should seek to provide shareholders with multiple opportunities to engage. For example, instead of waiting for AGMs to submit a proposal, policy changes could enable shareholders to submit proposals more frequently. Further, more explicit policy requiring engagement with shareholders on a regular basis, with guidance and supervision to ensure it is meaningful engagement could leverage the persistence and legitimacy of engagers. This must be balanced with the need to protect management from excessive shareholder intervention that has the potential to negatively affect the performance of the company.

Investors and corporations agreed that power was the least successful factor of the three. Both recognized the harmful effects that drawing negative media attention and divestment campaigns have for share value, firm profits and their overall relationship. Although SHARE filed proposals when they were not happy with the response to the letters they sent out regarding SoP, this action was not intended as a means of power, but rather a way to bring more attention to the issue and continue to engage in dialogue. The lack of preference for power is confirmed in analysis of share proposals, where aggressive, threatening language does not correspond with success, and as a strategy has decreased drastically over the past five years.

Therefore, public policy that aims to increase shareholder power over corporations is not an effective means and should be avoided in favour of legitimacy and urgency enhancing measures. The challenge lies in controlling how shareholders choose to use policy instruments extended to them. Legitimacy and urgency enhancing policy measures could be used as an opportunity by some 'special interest' shareholders and translated into power enhancing mechanisms. Policymakers must consider options for preventing capture of these policies, by perhaps also enhancing management rights to reject proposals and engagement on issues that are deemed discriminatory and harmful to society or can be proven to interfere with effective management. Overall, this requires a greater supervisory role to manage more complex situations that may arise.

Analysis comparing the results for 2008 and 2009 pay and performance in this study find a shift in some adopters away from poor performance links. Also, in 2009 more adopters congregate around quadrants one and three, representing effective pay for performance linkages. Engagement efforts of SHARE (Meritas) may be a significant factor explaining this change. However interviews suggest that although shareholders did play an important role in bringing the issue to the table, other actors and events also contributed to the decision to adopt. In the wake of the most recent financial crisis, a higher proportion of proposals related to executive compensation are filed. The media attention in the US to executive compensation has permeated the border, and there is increasing international attention to the issue (FSB, G20. BASEL III). Both investors and corporations claim that it is too early to observe any impacts of the SoP engagement. However, it is clear from the data that SoP adopters are more likely to have stronger pay for performance links and more research should focus on this in the future once more issuers have held the votes.

Although it is too early to draw any conclusive evidence about the impact of corporate engagement in the case of the advisory vote on executive compensation, this paper has identified synergies generated by cooperation between state and shareholders. Determining whether SoP should be legislated in Canada requires careful consideration for the policy context in which it is introduced. Canada is moving towards principles based regulation, and away from regulation centered on rules. This presents an opportunity for increasing leverage between shareholders and the state in monitoring corporate behaviour. However, it is important that PBR include sufficient guidance and support for both shareholders and corporations, as expressed in the interviews. Many institutional investors are still hesitant to incorporate ESG factors into their decision-making as a result of unclear policy position on the issue. Further, corporations are left to draft their own policies (such as SoP) in absence of official policy guidance and have expressed concerns about this. Canada is recognized as a corporate governance leader on indices such as Governance Metrics International, and has been recognized internationally for its prudential regulation of the financial sector (OSFI, 2009). As a result, some argue that Canada does not require increased shareholder rights.

Institutional theory can be useful in guiding policymakers with respect to deciding what actions are necessary to regulate corporate behaviour and models to adopt. Policy implications of this research depend on how one views the process of institutional change. If change occurs through voluntary initiatives and informal engagement, then the policy environment is useful for stimulating change indirectly through changing transaction and/or production costs. However, if change is an asymmetrical and an incremental process, where only some industries and shareholders are engaging on specific issues, than the role of the state may be more directly relevant as both a catalyst and driver of the engagement process. Expectations are also important, as equilibrium theory of institutional change suggests. If corporations and shareholders expect that the state will implement a particular regulation or legislation in the future, engagement efforts may be more effective on the particular issue.

Closer investigation on the roles of not only the investors but also corporations in this study suggest that in Canada, the impetus for change derives not only from informal engagement efforts of shareholders, but is also influenced by international trends, investor coalitions and is happening in spite of public policy impetus. But success to date is limited to a specific group of shareholders and corporations.

Conclusion

This case study demonstrates that relying solely on the voluntary action of shareholders to monitor the behaviour of corporations is not a viable policy position. Although representative of society to some degree, there are conflicts of interest between investors' interpretations of fiduciary duties, various shareholder interests and society's interests. Further, as evidence in this paper suggests, engagement does not effectively influence all corporations and not all investors are willing to engage, leaving significant gaps.

However, leaving the regulation and monitoring of corporate behaviour strictly to the state is also an indefensible position. Even in the immediate aftermath of the most recent financial crisis, which turned the system so many have put faith in upside down and inside out, the state proved unable to prevent continued risky behaviour that led to the crisis in the first place. There has been an international movement towards re-regulation, however the path dependent nature of our economic and political choices prohibit a return to an embedded market era

As a result of these limitations, it is imperative that policymakers seek to find a balance between shareholder and state intervention in the market. This paper suggests that synergies are possible. Through leveraging shareholder legitimacy, urgency and to some degree, power, the state can effectively create a mechanism for monitoring the behaviour of corporations, without expending significant resources on monitoring and regulating. On the other side, shareholders are provided with more instruments and avenues to engage with issuers, thereby allowing them to manage their ESG risks more effectively. In addition, leveraging shareholders to monitor corporate behaviour does not necessarily mean increasing the rights of shareholders, as many fear. This study finds that legitimacy and urgency are viewed by investors and corporations as the most important factors of shareholder salience and the state can therefore design policy that leverages these aspects over power.

Over recent years, engagement has garnered more attention in Canada and is recognized as a significant aspect of an institutional investor's responsibilities. Evidence is building to support the assertion that ESG risks are one in the same as 'traditional' risks to both investors and corporations. Because of the plural perspective on the issue, the paper is able to move beyond a one-dimensional understanding of engagement, and address factors of shareholder salience as they interact with both the corporation and the investor. More research should be conducted to investigate the corporate perspective of engagement at different layers of management under varying circumstances, in addition to a host of other actors involved in the engagement process, including policymakers, consultants and investor coalitions. This would provide a more comprehensive understanding of the engagement experience in Canada. Further, this paper suggests that by drawing out institutional theory as a moderating factor, it is possible to explore the engagement not only of a single firm and corporation, but rather, all engagements within a particular jurisdiction and/or cultural groupings. This contributes to a framework in which comparisons between countries and cultures can be made, an area of research deserving of more attention.

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APPENDICES

Figure 1A: CEO Pay Ratio to Average Worker

Country	Ratio of CEO pay to average worker pay
Japan	11:1
Germany	12:1
France	15:1
Italy	20:1
Canada	20:1
South Africa	21:1
Britain	22:1
Hong Kong	41:1
Mexico	47:1
Venezuela	50:1
United States	475:1

Source: CEO Pay Rates, Foreign VS US, Management, 2005 Kroll, Mark

Figure 1B: Comparison of International CEO Compensation

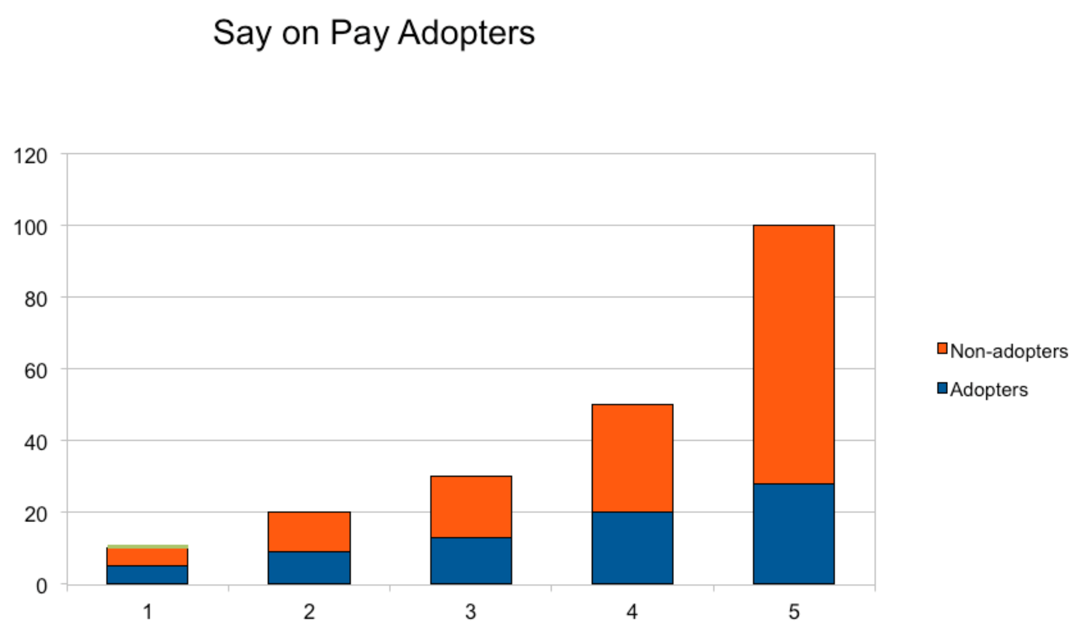
International Comparison of CEO Pay

Country Average CEO Pay % change 1988 Foreign CEO to 2003 pay relative to U.S. (U.S.=100)

	1988	2003	%change (adjusted)
Japan	$437,655	$456,937	-4%
Belgium	$361,591	$697,030	93
France	$381,015	$735,363	93
Sweden	$221,138	$700,290	217
Netherlands	$373,545	$675,062	81
New Zealand		$449,414	20
Switzerland	$481,125	$1,190,567	147
Germany	$388,486	$954,726	146
Spain	$331,708	$620,080	87
Australia	$170,336	$694,638	308
Italy	$322,743	$841,520	161
Canada	$398,946	$889,898	123
UK	$427,335	$830,223	94
United States	$759,043	$2,249,080	196
Non-U.S. avg.	*$360,969*	*$748,904*	*129*

Source: Economic Policy Institute, State of Working America 2004/2005, Ithaca, NY: Cornell University Press.

Figure 2: Largest 100 Canadian Corporations



Source: Globe and Mail Executive Compensation of Canada's Largest Corporations, 2009

Figure 3 : Resolutions filed on Executive Compensation

Year	Aggressive Language	Reference to other jurisdictions	Domestic Regulation	SH rights/value	Academic reports	Appeal to Reputation	Exec Comp as %of all Resolutions
2005	0.00%	0.00%	0.00%	100.00%	100.00%	0.00%	10.00%
2006	79.00%	7.00%	71.00%	93.00%	14.00%	21.00%	33.00%
2007	42.00%	0.00%	55.00%	92.00%	26.00%	47.00%	40.00%
2008	50.00%	38.00%	100.00%	100.00%	88.00%	24.00%	24.00%
2009	0.00%	60.00%	89.00%	100.00%	100.00%	0.00%	35.00%
2010	0.00%	95.00%	64.00%	95.00%	91.00%	0.00%	50.00%

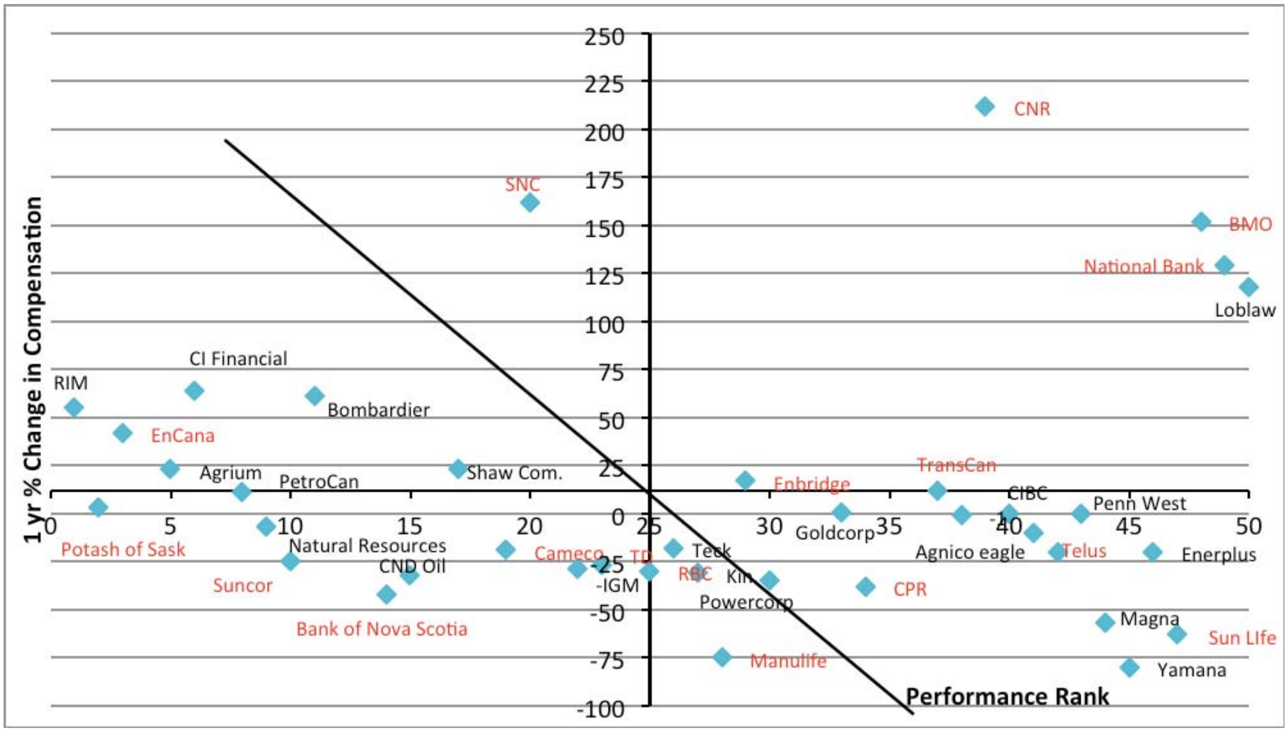
Source: SHARE Resolution database 2005-2010

Figure 4: First Say on Pay Vote Results in Canada

Company	Year First Proposal Filed	Adoption of Ex. Vote	2010 Voting results (In Favour of Compensation)
BMO	2008	2009	89.20%
CIBC	2008	2009	93.00%
RBC	2008	2009	92.00%
Toronto Dominion	2008	2009	94.00%
Bank of Nova Scotia	2008	2009	96.80%
Manulife	2009	2009	87.91%
Agrium	2009	2010	96.50%
Russel	2009	2010	99.20%
National Bank	2008	2009	98.55%
Potash Corporation of Sask.	2009	2010	97.34%
Thomson Reuters	2008	2008	95.26%-82.28%
Barrick Gold	2008	2010	86.30%
Sun Life Financial	2008	2009	92.00%
TMX Group	2009	2010	96.62%

Source: SHARE Annual Engagement Reports, 2008-2010

Figure 5: 2008 Pay for Performance



Source: Investor 500 Performance Indicators and Globe and Mail Executive Compensation 2008

*Diagram shows 1 year % change in CEO incentive compensation and company performance- this omits the possibility that CEOs have decided to voluntarily forego mid and long term incentive awards in 2009. In this case, CEO pay in 2010 would not be a meaningful metric against 1 year change in performance.

Figure 6: 2009 Pay for Performance