CCGG PUBLICATION
DUAL CLASS SHARE POLICY
SEPTEMBER 2013

Canadian Coalition for GOOD GOVERNANCE
THE VOICE OF THE SHAREHOLDER

Introduction

In October 2011 the Canadian Coalition for Good Governance ("CCGG") issued its *Governance Differences of Equity Controlled Corporations* policy and at that time indicated we also would prepare guidelines for companies which had dual class shares ("DCS") (i.e., multiple voting shares ("MV Shares") and subordinate voting shares ("SV Shares")). This publication sets out CCGG's current views on DCS companies.[1]

Background

The manner in which DCS companies are regulated in Canada today results from rules adopted by the Canadian Securities Administrators ("CSA") in the early 1980s and by the Toronto Stock Exchange ("TSX") in 1987 after years of hearings and debate.[2] No material changes to these rules have been made in 25 years. Since then, however, articles have been published in Canada and abroad discussing the advantages and disadvantages of DCS structures[3] and CCGG members have expressed various views about DCS companies (some of which are set out in published policies of certain of our members).[4] The extract below from a paper published in 2005 by the Economics Division of the Library of Parliament entitled "Dual-Class Share Structures and Best Practices in Corporate Governance"[5] describes the emergence of DCS companies in Canada:

> "Dual-class share structures emerged in [Canadian] companies for a variety of reasons. Historically, Canadian companies issued shares with multiple voting rights to preserve family control while gaining access to capital in public equity markets.

To retain voting control over the firm, the family kept the high-voting stock for themselves and sold the restricted-voting shares to the public. Even today, these structures are common among family businesses that wish to go public, and often represent a transitional phase between private and full public ownership. As the company grows, controlling shareholders may opt to move to more equitable voting structures in a bid to build a larger investor base.

Past restrictions on foreign investment also served to encourage the use of dual-class share structures. For example, the 1967 revision to the *Bank Act* bestowed a 10% voting cap on all chartered banks and capped aggregate foreign ownership at 25%. While some of these restrictions have been lifted, the federal government continues to limit the level of foreign ownership of companies in various regulated sectors, including telecommunications, broadcasting, media and entertainment, and airlines. Even now, companies that use dual-class shares tend to be largely concentrated in these sectors. These companies often justify the continued use of such structures by the need to avoid violating foreign-ownership restrictions, while attracting adequate equity investment from foreigners.

An additional explanation as to why companies that favour dual-class share structures are concentrated in the broadcasting and cable industries relates to the takeover protection conferred by subordinated voting. The existence of a large control block of shares makes it difficult for an investor to mount a hostile takeover of a firm. Since government regulators provide a limited number of broadcast licences, often the only method of obtaining a licence is to take over an existing company. Thus, it is argued that licensed firms have a greater incentive to protect themselves by issuing dual-class shares. Additionally, it is often the case that dominant individuals and families have played a significant role in the foundation and growth of the major cable and media firms in Canada."

CCGG TEAM

Stephen Erlichman
Executive Director
serlichman@ccgg.ca
(416) 847-0524

Catherine McCall
Director of Policy Development
cmccall@ccgg.ca
416-868-3582

Tony D'Onofrio
Director of Board Engagement &
Head of Research
tdonofrio@ccgg.ca
416-363-8253

Ali Abid
Research Associate
aabid@ccgg.ca
416-847-0525

Felicidad (Fely) David
Administrative Coordinator
fdavid@ccgg.ca
416-868-3576

The Case For and Against Dual Class Shares

The following paragraphs summarize some possible advantages and disadvantages of utilizing DCS structures.

Advantages

- DCS structures allow controlling shareholders which hold the MV Shares, the board of directors and management to focus on the long term success and profitability of the DCS company, thereby permitting long term investment decisions to be made instead of having to satisfy short term financial expectations which can be detrimental to building long term value

- DCS structures encourage entrepreneur-controlled companies to access the public capital markets and thereby provide investors the opportunity to purchase shares in companies that otherwise might not have been available to them

- DCS structures are an effective takeover defence which protects DCS companies from opportunistic acquirers

- DCS structures are helpful in those sectors which still have legislated Canadian ownership or control restrictions

- Some studies show that, over time, companies which have DCS structures outperform companies which do not have DCS structures[6]

Those who are in favour of DCS structures also make the following arguments:

- Our economic and legal system is premised on the principle of freedom of contract. Accordingly, provided there is full, true and plain disclosure of all material aspects of the

DCS structure before an investor purchases SV Shares, there is no reason to disallow the structures

- Good governance and bad governance can be found in all types of corporations, whether or not they have DCS structures. If the issue is how to deal with potential conflicts of interest between a DCS corporation and its controlling shareholders, then that issue can be addressed directly by having independent and unrelated board committees which vet transactions rather than by prohibiting DCS structures generally

- DCS structures, if combined with meaningful equity ownership by the controlling shareholders, can align the interests of controlling shareholders with those of minority shareholders

Disadvantages

- DCS structures confer voting power on the holders of the MV Shares well beyond the economic interest of those holders, thus providing shareholders that take a DCS company public the ability to access public capital (generally at a cost which is less expensive than private capital) and to continue to control the DCS company yet pass off the majority of the financial risk to the public owners of the SV Shares

- DCS structures may result in a non-assertive board of directors in light of the fact that only the holders of MV Shares have the actual ability to elect or replace the board

- DCS structures can entrench poorly performing management, can result in nepotism or cronyism in management succession and can insulate management from accountability for their actions

- Situations have arisen where holders of MV Shares have been able to extract funds and other assets from a DCS company through unreasonable compensation plans or self-dealing

- Situations have arisen where a DCS company's cash flow has been diverted to personal projects championed by the holders of MV Shares which are unrelated to the company's core business and strategy

- Some studies show that, over time, companies which have DCS structures underperform companies which do not have DCS structures[7]

Striking a Balance

In light of the possible advantages and disadvantages of DCS structures described above, it is not surprising that there is not unanimity among CCGG members as to the governance principles which should apply to DCS companies in Canada. Some CCGG members believe that the transparency provided by full, true and plain disclosure of the rights of holders of MV Shares and SV Shares and of the quantum of the economic ownership stake in the DCS company held by the holders of the MV Shares is sufficient to address concerns of alignment, fairness or protection of shareholders without the need for additional rules. Some CCGG members believe that utilizing a robust conduct review and conflicts committee[8] on the boards of DCS companies can go a long way toward alleviating problems associated with DCS structures. However, CCGG's board of directors and a large majority of CCGG's members believe that making disclosure and having a conduct review and conflicts committee is not sufficient; the CCGG board and these members support the best practices principles applicable to DCS companies set out in this document and wish to see these principles applied on a going forward basis to any newly created DCS company.

Notwithstanding that these principles are intended to be applied on a going forward basis to any newly created DCS company, CCGG encourages existing DCS companies[9] (including those grandfathered by the TSX in 1987 and those which have MV Shares and SV Shares in order to comply with legislated Canadian ownership or control restrictions (sometimes legally referred to as "constrained share" corporations)) to take these principles into account if and when appropriate.

CCGG believes it is important to encourage entrepreneurism in Canada and accordingly does not wish to hinder Canadian entrepreneurs from taking their companies public. CCGG 's board of directors and a large majority of CCGG's members believe that the best practice for companies undertaking initial public offerings, however, is to utilize a single class of voting common shares. In those exceptional circumstances when DCS structures will be used for companies undertaking initial public offerings in Canada after the date of this publication, the CCGG board and a large majority of CCGG's members believes that the following principles are balanced and should apply.

CCGG's board of directors and a large majority of CCGG's members also expect the board of a DCS company which undertakes an initial public offering in Canada after the date of this publication and which does not comply with any or all of these principles to explain to shareholders annually in the DCS company's proxy circular (or if the DCS company does not issue a proxy circular because the public owns non-voting common shares, then in another public document which is filed with the securities regulatory authorities) the reasons why it is not appropriate for such principles to apply to the DCS company.

In addition to the best practices principles set out in this document, the principles set out in CCGG's *Governance Differences of Equity Controlled Corporations* policy also apply to DCS companies except to the extent modified herein.

Principles

1. Electing Directors

Principle:

Holders of MV Shares should be entitled to nominate to the board of the DCS company a number of directors equal to the least of (i) two-thirds of the board, (ii) the number obtained when the board size is multiplied by the percentage of total voting rights held by the MV Shares (rounded up to the nearest whole number), and (iii) if the holders of MV Shares are related to management of the controlled corporation as described in CCGG's *Governance Differences of Equity Controlled Corporations* policy, then one-third of the board.

When a DCS company reports the results of director elections, in addition to disclosing the aggregate voting results the DCS company also should disclose the voting results for the MV Shares and the SV Shares separately.

Note:

In our *Building High Performance Boards* publication, CCGG recommended that two-thirds of the board of every non-controlled corporation should be independent of management.

In our *Governance Differences of Equity Controlled Corporations* policy, CCGG recognized that it would be appropriate for a controlling shareholder which controls a company through its ownership of common shares (and not through MV Shares) to have directors related to it on the board in proportion to the controlling shareholder's ownership of common shares, to a maximum of two-thirds of the board. If the controlling shareholder is related to management of the controlled corporation, however, CCGG recommended that at least two-thirds of the board should be independent of both management of the controlled corporation and the controlling shareholder.

A controlling shareholder which controls the company through MV Shares also should be entitled to have directors on the board in proportion to its voting rights, to a maximum of two-thirds of the board. However, as with a controlling shareholder that controls a company through ownership of common shares, if the holder of MV Shares is related to management of the controlled corporation then at least two-thirds of the board should be independent of both management of the controlled corporation and the controlling shareholder.

In any event, irrespective of which shareholders (i.e., holders of MV Shares or holders of SV Shares) nominate a director, under Canadian corporate law every director owes duties to the corporation rather than to the shareholders that nominated the director (i.e., a director has the duty to consider the interests of all shareholders as well as those other stakeholders recognized by law).

This principle does not require the SV Shares to have a separate class vote in director elections. Each DCS company can determine in its particular circumstances how best to achieve the outcome set out in this principle.

2. <u>Maximum Voting Ratio of MV Shares to SV Shares</u>

Principle:

Any DCS structure which is adopted should require holders of MV Shares to have a meaningful equity ownership stake in the DCS company.

While the import of a “meaningful equity ownership stake” may vary depending on context, a ratio of voting rights of a MV Share to a SV Share of no more than 4 to 1 generally would constitute a “meaningful equity ownership stake”.

Note:

What constitutes a "meaningful equity ownership stake" is not simply an arbitrary computation. A MV Share to SV Share voting ratio of 4 to 1 assures that the holders of all the outstanding MV Shares own 20% of the equity of the DCS company in order to have voting control of the company.[10] CCGG's board of directors and a large majority of CCGG members believe that a 20% equity ownership stake is "meaningful",[11] but also recognize that a lower percentage could be meaningful if the dollar amount of the ownership stake represents a significant economic interest in the DCS company's equity.

3. <u>Non-voting common shares</u>

Principle:

Companies which are reporting issuers should not have non-voting common shares.

Note:

A fundamental right of a common share is the right to vote at a shareholder meeting. By requiring common shares to have a vote, all holders of common shares will be entitled to attend an annual shareholder meeting in order to exercise the fundamental right to vote for directors and to address management and the board once a year.

4. <u>Coattails</u>

Principle:

In order to ensure that owners of SV Shares and owners of MV Shares are treated equally when there is a change of control of a DCS company, all DCS companies which are reporting issuers, even if not listed on the TSX, should have coattails.

The TSX should standardize the form of coattail provisions for TSX listed DCS companies rather than leave the form of coattail to the discretion of the TSX to approve. DCS companies which are reporting issuers, even if not listed on the TSX, should adopt the same standardized coattails.

Note:

The owners of MV Shares and the owners of SV Shares should be treated equally in the event that there is a change of control of the DCS company. The listing requirements of the TSX currently require DCS companies to have coattail provisions in place, the terms of which must be pre-cleared with the TSX.[12] Rather than relying on the TSX's discretion to approve the form of coattail drafted by the DCS company, DCS companies should have standardized coattail provisions in place to protect holders of SV Shares. Furthermore, these standardized coattails should apply to DCS companies which are reporting issuers even if the DCS companies are not listed on the TSX.

5. Collapse of the DCS structure

Principle:

The DCS structure should collapse at an appropriate time (in this document called the "MV Share Termination Date") as determined by the board of the DCS company and, if practicable, as set out in the DCS company's articles, unless a majority of the outstanding SV Shares voting separately as a class approve the continuation of the DCS structure. Any approval by the holders of the SV Shares to continue the DCS structure should remain in effect for five years or such shorter period of time as is approved at the shareholder meeting by majority vote of the outstanding SV Shares voting separately as a class. Prior to the expiry date, another separate class vote of the outstanding SV Shares should be required in order to continue the DCS structure for another period of up to five years and so on thereafter. If the DCS structure is not continued, then all MV Shares outstanding on the MV Share Termination Date should convert automatically into SV Shares on a one-for-one basis.

On an ongoing basis, the board of a DCS company should consider the reasons why a DCS structure was established and whether those reasons remain valid and should explain to shareholders annually in the DCS company's proxy circular (or if the DCS company does not issue a proxy circular because the public owns non-voting common shares, then in another public document which is filed with the securities regulatory authorities) the reasons why the continued existence of the DCS structure is appropriate.

Note:

Because there are many types of DCS companies, it is difficult to have a "one size fits all" definition of MV Share Termination Date. Some DCS companies are controlled by entrepreneur founders or immediate family, some are controlled by private equity groups and some are established to comply with legislated Canadian ownership or control restrictions.

By way of example, if a DCS company is created and taken public by entrepreneur founders, then a DCS structure might be defensible when the founders have a meaningful equity stake in the company and bring a unique contribution to the company which justifies maintaining control that is not proportional to equity ownership. If the founders are no longer actively involved in directing or managing the company, or no longer have a meaningful equity stake in the company, then that rationale for the existence of a DCS structure ceases to exist. In those circumstances, the DCS structure should collapse unless a majority of the outstanding SV Shares vote separately as a class to continue it.

Accordingly, boards of newly created DCS companies, as well as the underwriters and legal advisers assisting newly created DCS companies in future initial public offerings, should consider the following matters when contemplating how to define the MV Share Termination Date in a DCS company's particular circumstances:

1) should the definition tie into the date when the DCS company's founders are no longer directors or senior officers of the company?

2) should the definition tie into the date when the DCS company's founders together with permitted transferees (e.g., a founder, a founder's estate, any corporation that is controlled by a founder and any trust of which a founder is a trustee that has been established for the benefit of a founder and/or one or more members of a founder's immediate family) no longer own, directly or indirectly, at least a specified percentage of the total number of the company's outstanding MV Shares and SV Shares (counted as if such shares were of the same class)?[13]

3) is there a specific outside date when the DCS structure should collapse?[14]

4) should the definition tie into the date when legislated Canadian ownership or control restrictions no longer apply to the DCS company?

6. Monetization of MV Shares

Principle:

A holder of MV Shares should not be allowed to monetize the holder's MV Shares by entering into a derivative transaction.

A holder of MV Shares may sell some or all of the holder's MV Shares, if the holder wishes. Such sold MV Shares should convert automatically into SV Shares on a one-for-one basis unless sold to a permitted transferee (as such term is defined by the particular DCS company).

Note:

Owners of MV Shares already are able to exercise control over a DCS company that is not proportional to their equity interest. If a shareholder with MV Shares is allowed to monetize such holder's economic interest in the MV Shares, then the proportion of control to equity will be further skewed or the equity interest of the holder of the MV Shares may be eliminated entirely. Shareholder control with little or no equity investment can lead to non-alignment of the interests of the controlling shareholder with the interests of the other shareholders.

7. <u>Payments to an owner of MV Shares upon a collapse of the DCS structure</u>

Principle:

No premium should be paid to the owner of MV Shares upon a collapse of the DCS structure.

Note:

Just as owners of MV Shares and SV Shares should be treated equally pursuant to coattail provisions upon a change of control of a DCS company, owners of MV Shares should not be entitled to receive any premium when a DCS structure is collapsed. Accordingly, on the MV Share Termination Date all outstanding MV Shares should convert automatically into SV Shares on a one-for-one basis.

[1] The definitions of "controlled corporation", "controlling shareholder", "independent director", "related" and "related director" used in this publication are the same as the definitions of those terms in CCGG'S *Governance Differences of Equity Controlled Corporations* policy.

[2] The history of dual class shares in Canada is described by Stephanie Ben-Isha and Poonam Puri in "Dual Class Shares in Canada: An Historical Analysis" (2006) 29 Dal LJ 117 and, in particular, the hearings and actions taken by the CSA and TSX are described on pages 145-154. Ontario Securities Commission Rule 56-501 and Part VI.H of the TSX Company Manual are the current rules which apply to DCS companies.

[3] Many academic and non-academic articles have appeared over the years. The DCS policy of the Caisse de dépôt et placement du Québec, for example, is modelled largely upon the recommendations in the article by Professor Yvan Allaire entitled "Dual-class share structures in Canada: Some modest proposals" published in November 2006 by The Institute for Governance of Private and Public Organizations.

[4] For example, British Columbia Investment Management Corporation, Ontario Teachers' Pension Plan, Ontario Municipal Employees' Retirement System, Canada Pension Plan Investment Board, the Caisse de dépôt et placement du Québec and Blackrock Canada all have published policies with respect to DCS structures.

[5] Ottawa: Parliamentary Information and Research Service, 2005.

[6] In June 2013 Antonio Spizzirri and Matt Fulbrook of the Clarkson Centre for Board Effectiveness at the Rotman School of Management University of Toronto published "The Impact of Family Control on the Share Price Performance of Large Canadian Publicly-Listed Firms (1998-2012)", which studied the performance of 23 TSX listed family controlled companies (collectively referred to as the "CFFI") of which 18 had DCS structures. The study states: "Looking at the CFFI, firms with a voting imbalance [i.e., DCS structures] outperformed Non-Family firms over 15 years with 8.8% CAGR and 6.1% CAGR respectively. Furthermore, we found that CFFI firms with a voting imbalance also outperform CFFI firms with balanced voting control, which had an average 15-year CAGR of 5.1%".

[7] The 1996 report by Burgundy Asset Management Ltd. entitled "Second Class Owners" (www.burgundyasset.com/data/newsletter/1996_09_Second_Class_Owners.pdf) appears to be the most cited Canadian study on point. Burgundy's Richard Rooney made the following statement in 2007 in reference to this study:

> "We did a vast amount of number crunching in order to get performance data on [413] Canadian companies [121] with and [292] without these [dual class] share structures for several years prior to 1996. We found a tendency for companies with [dual class share structures] to underperform…"

[8] See for example the Related Party and Conduct Review Committee of the board utilized by Power Corporation of Canada and many of its public subsidiaries. Note also the requirement for Canadian federal insurance companies and banks to have Conduct Review Committees and for Canadian investment funds to have Independent Review Committees.

[9] According to the TSX July 2013 eReview, there are 77 DCS companies (exclusive of investment funds) listed on the TSX.

[10] See Allaire, supra note 3, at pages 23-24.

[11] A 20% test also is used for other purposes in Canada, including as the threshold for takeover bids under securities laws and as a factor considered for the equity method of consolidation of affiliates under accounting rules.

[12] TSX Company Manual section 624(l).

[13] In its annual information form for the year ended April 28, 2013, Alimentation Couche-Tard sets out the following circumstances in which each SV Share shall automatically convert into one MV Share:

> "Upon the earliest to occur of:
>
> (i) the day upon which all of the Majority Holders (defined in the Articles of the Corporation as being Messrs. Alain Bouchard, Richard Fortin, Réal Plourde and Jacques D'Amours) will have reached the age of 65, or
> (ii) the day when the Majority Holders hold, directly or indirectly, collectively less than 50% of the voting rights attaching to all outstanding voting shares of the Corporation,
>
> each Subordinate Voting Share shall be automatically converted into one fully paid and non-assessable Multiple Voting Share."

[14] At least one Canadian DCS company, Gluskin Sheff & Associates Inc., has a specific outside date (in that case, May 26, 2016, which is 10 years after the company went public) as one of the events in its definition of MV Share Termination Date which will result in the collapse of the DCS structure.