Law of Corporate Management

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Shareholder activism in the Canadian Banking Sector: A Look at Mr. Yves Michaud's Proposals for Reform.

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1.1 Introduction

In 1997, the Quebec Superior Court ruled that a shareholder had a right (subject to statutory restrictions) to force the management of two large Chartered Banks to distribute its proposals for reform in management proxy solicitation materials. This lower court decision was upheld a few months later by the Quebec Court of Appeal.

According to Cambridge Professor Brian R. Cheffins, *Michaud v. National Bank of Canada* may be changing the nature of the relationship between boards of directors and the shareholders they represent and serve. This essay will focus on a very particular element of corporate management in Canada, namely the Boards of Directors of Canada's largest Chartered Banks. It will analyze the recommendations made by Mr. Yves Michaud, a bank shareholder, to the Boards of those Banks, in an effort to understand the dynamic guiding shareholder proposals in the banking industry. As such, the essay does not claim to be of wide application or even a proxy for board-shareholder relations in the broader corporate sector.

Even with such a narrow focus, this paper will endeavor to be useful. The six largest Chartered Banks ("Banks") examined here play a crucial role in Canada's economy as their actions can be felt throughout the entire nation. They are, to borrow terminology from the field of environmental science, "keystone" corporations. The thousands of decisions they make on a daily basis influence the country's economic development and growth. In an era of mega-bank mergers, an inquiry into how they are governed and supervised appears justifiable.

1.2 Michaud's Propositions: A Frame-work for Analysis.

Mr. Yves Michaud, is a retired politician from the Province of Quebec, and has served as a member of the National Assembly for a number of

years in the Parti Québecois majority. A former journalist, he is keenly interested in citizen activism and the pursuit of shareholder democracy. A love of David and Goliath-style confrontations has led him to purchase shares of the Banks and to attempt to assert his rights as a shareholder in their decision-making processes. In recognition of his work, the current Quebec government recently appointed him vice-president of Quebec's Bureau des Services Financiers. The following is an excerpt confirming his appointment to that position:

[Translation] The vice-premier and minister of Economics and Finance of Quebec has announced the appointment of Mr. Yves Michaud to the office of vice-president of the Office of Financial Services, a body whose mission is to oversee investor protection under the powers granted by *the Financial Services and Products Distribution Act*. This Act was enacted on June 19th 1998 by the National Assembly of Quebec and replaces the *Market Intermediaries Act*. Mr. Michaud's mandate will be to act as an advocate for consumers.

Mr. Michaud has used the vehicle of Bank proxy solicitation circulars to disseminate his views on enhanced corporate governance. Following the *Michaud v. National Bank of Canada* decision, Mr. Michaud won the right to print his Propositions in each of the proxy circulars. The Propositions form the backbone of this paper. A three-step approach will be used:

For each Proposition, we will investigate the reasons behind Mr. Michaud's proposal.

We will then contrast these reasons with the opinions of the Banks and their justification for asking the shareholders to vote against Mr. Michaud's proposals.

Finally, a critique of the arguments put forth by both parties (Shareholder and Directors) will then be made, in an attempt to reconcile both sides were possible, and to evaluate the merits of each point of view.

It is hoped that this particular format will highlight the tension that exists between the nominal owners of the Bank and their "elected" representatives, namely the directors and officers.

1.3 Preliminary Matters.

1.3.1 Description of the data.

Only four of the six Banks were chosen for this analysis. The proposals sent in 1998 to the Royal and National Banks are different from those received by the Bank of Nova Scotia, the Toronto-Dominion Bank, the Bank of Montreal and the Canadian Imperial Bank of Commerce. References to Royal and National Banks will be made to supplement some of the arguments made by either side. All four Banks are publicly-traded reporting issuers, and information about their Boards of Directors is readily available. Furthermore, the same Propositions were sent to all four Banks examined here. This affords us with a controlled experiment in that the answers provided by the Banks can then be compared and contrasted for evidence of variation and similarity.

The Bank Proxy Circulars reveal information about the names, positions and years of service of acting directors. It also provides data about executive compensation of the top four executive officers of the Bank. This data is required by the *Securities Act* (*Ontario*), R.S.O. 1990 c. S.5 (as amended) and the Regulations made thereunder. Some information regarding the performance of the Bank stocks in relation to the T.S.E. 300 and other Banks indices is also provided. This data allows us to compare CEO pay with return on equity and test the contention that CEO compensation is tied to shareholder returns. This data will be examined in more detail when we turn our attention to Mr. Michaud's proposition on capping CEO pay.

1.3.2 Some cautionary notes regarding the Michaud proposals.

When Mr. Michaud sent out his propositions for reform to the various Banks, he did not always send all of the same recommendations to each. Mr. Michaud tailored his wish list for each Bank. For example, the proposition requesting that the program extending special preferential loans to senior officers of the bank be terminated, was not sent to the Royal Bank of Canada. That Bank had terminated its program on Dec. 6th 1995. Nine propositions are common to four major banks. They will form the backbone of this paper. This should enable us to preserve the element of comparability.

The Michaud proposals are not meant to be of wide application to all public corporations. They are specific to the financial services industry in Canada, which has its own set of characteristics and attributes. Mr. Michaud began his odyssey as a defender of small retail investors in 1993, "after National Bank swooped down on the remains of the financially troubled General Trustco of Canada Inc. Michaud and a few thousand other holders of $145 million in General Trustco debentures were paid 30 cents on the dollar." He has since devoted his time to safeguard the interests of "épargnants et investisseurs" but mostly to the 'épargants' that is, of depositors and retail shareholders.

Prof. Cheffins' aforementioned article assumes that Michaud's proposals are meant to be of universal application. Clearly they are not, since Mr. Michaud is not interested in overall corporate governance - solely in the accountability of the Boards of large financial institutions in Canada. With these caveats in mind, we can turn to the Michaud Propositions.

2.0 THE MICHAUD PROPOSITIONS

We follow the order in which the nine propositions appear in all of the Proxy Solicitation Circulars sent to Bank shareholders in January of 1998. Mr. Michaud's personal comments will appear in *italics*.

PROPOSITION No.1. Chair of the Board of Directors.

2.1.1 The Proposition:

"It is proposed that the Chairman of the Board be appointed from among the Board members who are not on staff at the Bank."

2.1.2 Mr. Michaud's arguments:

"This proposal is in keeping with the recommendations made by the Pension Investment Association of Canada (PIAC), the Kirby Senate Report on Banking, Trade and Commerce, Fairvest Securities Corporation, the Caisse de dépôt et placement du Quebec, and the Toronto Stock Exchange Committee (Dey Report), whereby the board

of directors must assess the performance of a corporation's senior management with full independence. This is not the case when the president and chief operating officer who also holds the position of chair of the board is required to assess his/her own performance and that of his/her main colleagues. To avoid apparent or actual conflict of interest, "the means for implementing this guideline is for the board to appoint a strong non-executive chair of the board whose principal responsibility is managing the board of directors."

In short, Mr. Michaud, is arguing that a reasonable apprehension of bias exists when the Chair of the Board, whose duty it is to keep an eye on the performance of Management is also the head of the Management team. To press his point, Mr. Michaud relies on the judgment of Justice Rayle of the Quebec Superior Court when she states:

[Translation] Banks are important economic players in Canada's economy. Their leaders exercise unequalled influence. The prestige of the function of chief executive officer may prevent any constructive criticism to emanate from his entourage. The directors who sit on the Board benefit from the prestige of the Bank and of its C.E.O. They are the entourage of the C.E.O. and their re-election to the Board depends on the recommendations made yearly to the C.E.O.

When Mr. Michaud made this first proposal he had to make sure that its substantive content would fall within two parameters: on the one hand, it had to be general enough that it could not be construed as being within the purview of the board of director's managerial discretion, and on the other hand, it had to be specific enough to avoid being considered the promotion of general economic, political, social, religious or other similar causes. To get around this statutory pitfall, Michaud claims that the Boards of the Banks have dismissed the recommendation of separating the functions of Chair and CEO made by the Caisse de dépôt et de placements du Québec, the T.S.E. Dey Report as well as the Kirby Senate Report on Banking, Trade and Commerce; and that as a result, may have compromised the goodwill of the Banks within the institutional investment community.

2.1.3 The Arguments of the Banks.

The Banks oppose Proposition No. 1 for a variety of reasons. Firstly, they believe that Michaud's first proposal would limit their ability to

design a Board capable of adapting to changing business conditions. The Canadian Imperial Bank of Commerce ("C.I.B.C.") adds that it profits from having a Chairman with "a more detailed knowledge of the business and activities of C.I.B.C. and its many global businesses and subsidiaries" and that this would be impossible if its Chairman was not also the Chief Executive Officer. At the Toronto-Dominion Bank ("T.D.") it is felt that Chairmanship appointments are "a function of the circumstances" and that "it is generally in the Bank's best interest to combine the two functions." The Bank of Nova Scotia ("Scotia") uses an argument based on precedent and historical experience. It argues that:

In most of the Bank's 166-year history, the positions of Chairman and CEO have been combined. [...] Virtually all major North American banks are led by Chairmen who also serve as CEO, and most have been very successful at adding value and generating increased returns for shareholders.

Secondly, the Banks also point out that Mr. Michaud's use of the Dey Report is misleading. They point out that the TSE Committee on Corporate Governance recognized that there are other means of facilitating Board independence aside from separating the functions of the Chair from that of the CEO. At the Bank of Montreal ("BMO"), the emphasis is placed on the use made of independent committees of the Board, of lead directors and of external consultants. For example, external consultants are used to advise the independent committee of the Board dealing with executive remuneration. The independence of the Board is guaranteed by the fact that no members of Management are allowed to sit on independent committees of the Board. The *lead* director plays the role that would normally be played by a non-Management Chairman of the general Board.

C.I.B.C. feels that the Proposition is of limited use given that the Bank has in place a Corporate Governance Committee (with no Management members on it) to serve "as a liaison function among the directors, and between the Board and senior management, on corporate matters including an independent assessment of the performance of the CEO."

The same argument is made by Scotia but with the following caveat: recommendations of the independent committees must go to the full Board for approval. This is interesting, given Management's presence at full Board meetings. Yet, Scotia does not categorically oppose the notion of separating the CEO and Chairman position. In fact, Scotia concedes in its reasons, that the Proposition is not completely without

merit on two separate occasions: (i) By stating that: "Scotiabank has occasionally separated the positions on a temporary basis for succession purposes" and (ii) when it writes: "... the Bank nonetheless considers the principle of independence that underlies the recommendation for a separate chair and CEO to be very important".

Finally, some banks argue that current conflict of interest guidelines and procedures for directors and officers are a sufficient guarantee of independence. At T.D. the possibility for outside directors to use independent advisors or to meet without Management being present, is heralded as evidence that sound corporate governance can occur even when the CEO and Chairman of the Board are one and the same person.

2.1.4 Critiques and Commentaries.

In the preceding exchange of views, Mr. Michaud did not have the opportunity to rebut the Bank's arguments. As such, it is difficult to make an informed judgment as to whose argument is most convincing. Nevertheless, a few general observations can be extrapolated from the debate surrounding Proposition No. 1. Mr. Michaud's underlying assumption is that a conflict of interest exists when the person in charge of the watchdog group (Board) happens to be the leader of the supervised group (Management) and also determines who will sit as a member of the watchdog group.

The concern is that non-arm's length structures cannot be in the best interest of the shareholders. Michaud recognizes that the Board should play an important supervisory role over Management and that the appointment of the Chair is a matter of importance to shareholders. If one could draw an analogy between say, French society and a corporation, the election of the President of the Republic (Chairman of the Board) is important to the electorate since it is that person who will be entrusted to defend the interest of the people (shareholders). The Prime Minister (CEO) may wield effective power, but the President retains ultimate control.

The picture that the Banks paint of their Boards is not one in which they are watchdogs of Management. Rather the image is one of a closely-knit team with the CEO/Chair as team captain, working in the best interest of all shareholders, whether they be institutional

investors or retail shareholders like Mr. Michaud. Banks rely on the argument made by Prof. Cheffins:

In a corporation where the directors are deeply committed to the concept of supervision, acting in this fashion will be difficult. The executives will tend to encounter skepticism and criticism rather than receiving the advice, support and encouragement for which they might have hoped. Management will correspondingly become motivated more by the fear of failure than by the prospect of success. This in turn will likely blunt the corporation's competitive edge.

Recognizing that the Banks and Mr. Michaud start from two different conceptions of the role of a Board places us in a better position to understand why their prescriptions differ so widely.

Another argument brought forward by most banks is that when the Chair is also CEO, the Board can benefit from the in-house expertise of the CEO as most CEOs know bank operations extremely well. This being said, Mr. Michaud's proposal is not incongruent with the argument made by the Banks. Nothing in Mr. Michaud's proposal prevents the Banks from having the CEO sit as a director and thus give the Board access to the CEO's expertise.

The question remains: "which conception of the Board should prevail?" Section 157(1) of the *Bank Act* addresses this question by stipulating that the Board manage or supervise the affairs of the Bank. Since it is normally not feasible for directors to manage the Bank's affairs, they should supervise Management and therefore act as a watchdog.

PROPOSITION No. 2. Ineligibility of Suppliers of Services.

2.2.1 The Proposition:

"It is proposed that a person who is "related" to the Bank as a provider of services not be eligible to become a member of the board".

2.2.2 Mr. Michaud's arguments:

Page 24 (articles 5.9 and 5.10) of the report issued by the Toronto Stock Exchange Committee deals with the independence of board

members vis-a-vis management. According to the report, the board should be constituted so that it can bring judgment independent of the particular interest at issue - in all circumstances. An example is "the director who provides services to the company, for example legal or financial services. He or she would generally not be regarded as an unrelated director because the dependence of the advisor/director upon management of the company as a client could, or could be perceived to, interfere with the director's ability to objectively assess the performance of management.

The second proposition is predicated on the same assumption as the first one, namely that conflicts of interest plague a director whose presence on a Board relies to one degree or another on Management's goodwill. For example, if a director is a lawyer at a firm which provides extensive legal services to the Bank, then it is argued that this lawyer will be less likely to criticize Management which is a source of business for his or her own firm. Similarly, if the director is from a major customer of the Bank, it is felt that the close ties that bind the Bank to the customer will limit the ability of that director to criticize Management's actions for fear of jeopardizing the pre-existing business relationship. Michaud's proposal is inspired by the Dey Report's view that the judgment of such a related director could be distorted by such inter-relationships.

His thoughts on this point can be traced back to the Annual Shareholder Meeting of the National Bank, held on March 13th, 1995, in which Mr. Michaud stated:

[Translation] Is it desirable for the chairmanship of the new Conduct Review and Corporate Governance Committee, whose task it is to evaluate the performance of the Bank's top executives, to be given to an important service provider of the National Bank?

His comments pertained to the appointment of a related director to the Chairmanship of the Conduct Review and Corporate Governance Committee of the Board, the Committee responsible for assessing the remuneration of the Chief Executive Officer.

2.2.3 The Arguments of the Banks.

At the Bank of Montreal, the reasons to oppose Proposition No. 2 are two-fold: a) Management feels that it should not be constrained by

"arbitrary rules" in its hiring practices by self-imposed standards exceeding regulatory requirements; b) Management feels that this concern has already been addressed by current Bank practices.

T.D. uses the same arguments and adds that the *Bank Act* itself "clearly contemplates that directors may provide services to the Bank" and that "specific provisions [of the *Bank Act*] governing this relationship" exist to ensure fairness. In short, T.D. believes that existing statutory provisions satisfy Mr. Michaud's concerns.

C.I.B.C. also uses the term "arbitrary rules" to refer to Proposition No. 2. That Bank further argues that C.I.B.C. is in full compliance with the T.S.E. Guideline requiring that a majority of board members be unaffiliated.

Scotia's response is by far the most thorough and vigorous. It argues that the Bank not only exceeds statutory requirements but that none of its directors could be considered affiliated by virtue of deriving 10% or more of its annual billings from the Bank. In addition to having no affiliated directors, the Bank has established a number of internal policies and measures "to prevent a Director from participating in the review or approval of transactions in which he or she may have an interest."

In general, the Banks believe that having service providers on the Board actually benefits the Bank in that they bring "extensive business and professional experience" to the decision-making table.

2.2.4 Critiques and Commentaries.

A few preliminary observations are in order before commenting on this proposition and the Banks' response to it. Firstly, is the 10% cut-off a meaningful way of deciding who is or is not an affiliated director? If a large law firm derives only say 2% of current billings from its Bank client this may in fact represent millions of dollars in billable hours. Given that such large sums of money could be at stake, is it reasonable to expect any such lawyer-director to voice criticisms over questionable Bank management actions? Could they be said to be unaffiliated?

Secondly, can we say, as the Banks argue, that excluding service providers would limit the pool of qualified director talent to such an

extent as to jeopardize the Bank's competitive position? It would appear that all directors are selected because of their judgment, whether derived from their business or professional background. Yet, specialized knowledge known only to industry-specific participants can always be called upon through the use of outside consultants or qualified experts. All Bank Boards provide for directors to retain experts as the need arises.

The Banks make a forceful argument when they point out that they are complying with statutory duties imposed by the *Bank Act* and that some even go beyond the requirements of the Legislator. Current compliance with TSE and *Bank Act* requirements, though laudable, does not ensure that this will always be the case. Mr. Michaud's proposal, had it been accepted, would have amended the by-laws of the Banks and permanently put to rest the potential for this type of conflict of interest.

PROPOSITION No. 3. Executive Compensation.

2.3.1 The Proposition.

"It is proposed that the overall compensation paid to the highest-ranking bank official, including annual salary, bonuses, incentives, payments under long-term incentive programs and any other form of compensation, not exceed twenty (20) times the average salary, including fringe benefits, earned by bank employees".

2.3.2 Mr. Michaud's Arguments.

"In the executive compensation guidelines it issued in March 1997, the CAISSE DE DEPOT ET PLACEMENT DU QUEBEC, which ranks first among institutional investors in Canada with over $60 billion in assets, recommended that "the Board show moderation and increased restraint, while keeping the corporation competitive" (sic). An international study conducted by Towers Perrin in 1995 gave the following results with respect to the multiple suggested above: Sweden and Japan: 9; Switzerland: 10; Germany: 11; the Netherlands: 12; Belgium and Canada: 13; France: 16; Italy: 17; Australia: 18; U.S.: 24.

In the June 1996 issue of the magazine Affaires Plus, Stephen A. Jarislowsky, who sits on the board of directors of numerous Canadian companies, stated: "(translation) Although it is important for competent staff to be well paid, basic salaries are all too often too high, bonuses are excessive, purchase options outrageous and the loans granted for share purchases ridiculous; not to mention that such loans should carry interest charges." Added Jarislowsky, "excessive compensation is disgraceful and reflects greed more than it does management skills".

Michaud's argument is based on two principles: (a) that compensation should be tied to actual value-added to shareholder wealth, (b) that intra-bank wealth distribution should be equitable and reflect the contribution of all those involved in the process. As an illustration of the first principle, Mr. Michaud uses the case of the compensation granted to the CEO of the National Bank of Canada in 1995. Mr. Michaud compares bank profit and CEO pay levels for both the C.I.B.C. and the National Bank for the year 1995. The figures are as follows:

Table 1: CIBC-National Bank Compensation Tied to Profits. 1995.

Bank	Profits 1995 (a)	CEO Compensation (b)	Ratio of (b)/(a)	What National Bank CEO ought to have received.
C.I.B.C.	$1.02 billion	$1.83 million	0.00179	N/A
National	$245 million	$1.4 million	0.00571	$438 550

A salary of $1.4 million represents an increase of 313% above and beyond what the CEO of National Bank ought to have received had the principle of returns-tied-to-compensation had been applied. This is based on the assumption that the ratio of 0.00179 used in the case of C.I.B.C. is an accurate reflection of the CEO's contribution to overall

profits earned by the Bank. The second principle relating to intra-firm fairness is well exposed by Prof. Cheffins on page 63 of his article when he writes:

Limiting executive pay by way of a fixed multiple scheme does offer some potential advantages. If increases in managerial remuneration far outstrip those enjoyed by rank-and-file employees, this may offend notions of equality the workers have, causing morale to suffer and productivity to drop. All else being equal, lower managerial remuneration means higher net earnings for a corporation. Placing a cap on executive salaries may save a corporation from damaging negative publicity since the mandatory disclosure of executive pay details which takes place under securities laws keeps the issue in the public eye.

This argument is particularly cogent in the case of shareholders like Mr. Michaud given that the impact of bad publicity on corporate image has been shown in other studies to have a significant impact on the price of securities.

2.3.3 Arguments of the Banks.

The Banks are unanimous in pointing out that the generous compensation packages given to top executives are necessary to attract and retain top talent. This echoes an article written in the Financial Post of Toronto, in which a journalist was quoted as saying: "if we start paying executives that way [using Mr. Michaud's multiple approach], then they'd have to leave" and presumably go to the United States where Bank CEOs earn a greater income. The following sample of CEO incomes in the US Banking sector attests to the veracity of the differential between the two nations:

Table 2: Sample of CEO compensation in the US Banking sector. 1996

Bank	CEO Name	Salary & Bonus	Stock option Grants	Total remuneration
Bank of New	J. Carter	$8	$5	$13 918 959

York	Bacot	494 743	424 216	
BankAmerica	David Coulter	$5 677 089	$15 555 119	$21 232 208
BankBoston	Charles Gifford	$3 638 531	$5 779 500	$9 418 031
Bankers Trust New York	Frank Newman	$12 586 300	$1 404 800	$13 991 100
Chase Manhattan Corp.	Walter Shipley	$8 330 834	$3 840 000	$12 170 834
Citicorp	John Reed	$4 090 000	$36 187 500	$40 277 500
J.P. Morgan	Douglas Warner	$5 410 291	$2 162 400	$7 572 691
Hugh McColl	Nationsbank	$4 638 382	$2 739 900	$7 378 282
Averages		$6 608 271	$9 136 679	$15 744 950

The second argument used to discard Proposition No. 3 revolves around a standard bank practice: that of linking remuneration of executives to the Bank's business and financial objectives. The economic argument is in theory quite simple: aligning CEO pay with return on equity results should align the interests of the CEO with those of the shareholders. When the Bank does well and its stock

increases in value, the CEO's personal wealth should follow also increase. If the Bank under-performs, the CEO should be penalized. Wall Street Journal management editor Joann Lublin summarized the argument when she wrote in 1997: "A few years back, chief executive officers began to chant a new mantra: *I should get richer, as long as shareholders get richer*."

Scotia believes that it is in the interest of its shareholders to maintain "market-driven, flexible and performance-linked compensation policies and programs rather than establish arbitrary limits on compensation that would interfere with the Bank's ability to attract and retain talented individuals."

C.I.B.C. adds that compensation should also be tied to asset base under management and the level of returns generated for shareholders. As C.I.B.C. considers itself a global financial institution, it argues that it should be able to recruit its top executives from the global executive labor market. We have already noted that compensation levels are dramatically higher in the United States than in Canada. This would tend to show that the Board of Directors of the Bank has shown tremendous restraint in offering the CEO a comparatively modest compensation package.

The Bank of Montreal rejects Michaud's proposal outright calling it "arbitrary and inflexible" and "inconsistent with market practices." BOM does not support "arbitrary pay caps for executives" as executive pay levels currently "reflect prevailing market practices and vary substantially with the Bank's performance." The Bank emphasizes that a significant component of the CEO's compensation is variable in nature and can only be earned after that executive has met "challenging individual and Bank performance goals which ensure that the shareholders benefit significantly first." This element of risk encourages the CEO to act in the best interest of shareholders, thereby minimizing agency costs and avoiding the application of the Berle and Means hypothesis.

The T.D. Bank does not offer arguments substantially different from its fellow banks. It does however emphasize the use in the compensation setting process, of both independent consultants and of an independent Committee of the Board made up of outsiders. All Banks have a special Committee of the Board to set the compensation levels of top executives and these Committees are exclusively made up of non-Management directors. This procedural safeguard should ensure that pay levels are set in an equitable manner.

2.3.4 Critiques and Commentaries.

2.3.4.1 The debate as it is framed in the Circular….

Mr. Michaud's arguments are two fold: one is moral (i.e. "La rémuneration est une honte!") while the other is made in the interest of shareholders to avoid the application of

s. 143(5)(b) of the *Bank Act*. The Courts, in *Michaud v. National Bank,* have already held that executive compensation matters could fall within the expertise of shareholders; hence the publication of proposition No. 3 in the Management Proxy Circulars. Michaud avoided the application of s. 143(5) (b) by arguing that a failure to take the advice of large institutional investors like the Caisse into account might damage the reputation of the Board within investment circles and increase the cost of raising capital in the future. This second line of argument is consistent with the position taken recently by more active institutional investors. The Caisse de Dépôt et Placement du Québec, for example, has re-iterated in its *Policy and Summary of the Principles Governing the Exercise of Voting Rights* that "the board of directors must show moderation when determining the level of compensation for executive officers and be sensitive to the concerns of the company." However, "moderation" is not defined in any statute, by-law or Bank policy. By relying on a simplistic view of market forces, the Banks feel that what a moderate level is, should be determined by the "market". Obviously, Michaud's proposal, had it been accepted, might have disturbed this compensation arrangement.

The logical link Michaud tried to establish between immoderate compensation and institutional investor annoyance might be difficult to prove especially in light of the most recent empirical work done in the field of institutional investors and shareholder activism. Institutional investors in Canada exert their influence through non-official channels and are known to be particularly camera-shy. These two elements conspire against Mr. Michaud's case in that it makes it hard to substantiate his argument with tangible evidence. As Raymonde Crête and Stéphane Rousseau wrote:

[Translation] The activism of institutional investors is a complex phenomenon which encompasses a multi-faceted reality. It manifests itself through various modes of intervention. Some are more visible than others. They range from a limited surveillance of corporate

activity to an actual active criticism of Management policies. Its scope is difficult to circumscribe given that passivity and activism depend on a range of factors: the special personal relationships developed between the investors and Management, the information released to the public and the publicity made of their interventions. On this point, it should be pointed out that media coverage of investor interventions provides a very biased impression of reality since the media only report the highly public forms of intervention**.[…] In this type of environment, it is difficult to identify active institutional investors and to frame the nature and scope of their interventions.**

2.3.4.2 …and the economic theory that underlies it.

One aspect of the whole Michaud-Bank debate on compensation which is not adequately addressed in the Circular is the underlying **economics of compensation**. The Banks' forcefully argue that it is up to the **market** to determine how much their executives should earn in the final analysis. As was previously pointed out, the Bank of Montreal even highlighted the fact that, if the CEO does not perform, he will suffer a pay cut (i.e. a reduced bonus). The strength of the Banks' argument rests on the assertion that the compensation-determination process is completely objective and market driven.

For each Bank, the process is similar: carefully-chosen performance targets are picked by the Human Resources Committee of the Board. Conflicts of interest are avoided at this stage by making sure that these Committees are staffed with unrelated directors. Use of external consultants is made to further minimize the risk of self-dealing. The Committee then uses bank performance in the market (i.e. TSE stock price) to decide whether or not, the various triggers for compensation will be activated. At all times, it appears that objective criteria are imposed on the CEO and that compensation is truly a reflection of the executive's personal contribution to shareholder wealth. Given the objective nature of the process - the argument goes - the Bank is using moderation in compensating its top officers.

As Professor Eisenberg writes:

In theory, a chief executive's compensation is determined by the board on the recommendation of an independent compensation committee, which in turn acts on the recommendation of an independent personnel department and (often) an independent outside consulting firm, all without the chief executive's participation.

He does, however, point out that ***in practice***:

'[t]he chief executive often has his hand in the pay-setting process almost from the first step.' Personnel executives who don't recommend what the chief executive officer wants may find that their jobs are at risk; consultants who don't recommend what the chief executive wants are (sic) [un]likely to be invited back.

Even if we were to assume that the process described by the Banks functions as it should *in theory*, neo-classical economics does not support the contention made by the Banks that they are paying their CEO a competitive wage.

The Canadian Banking sector is not perfectly competitive. It is highly concentrated and may be characterized as oligopolistic. The 5 largest Chartered Banks under the *Bank Act*, Schedule I account for about 90% of the total assets of Chartered banks. Oligopolistic industries are "generally characterized by some barriers to entry by new firms, so that above-normal profits may be earned by oligopolists in the long run." In Canada, a Charter is required to provide the full gamut of banking services. Also, barriers to the entry of foreign banks has further increased the size of above-normal profits ("rents" as the economists would call them) generated by the Canadian Banks.

According to neo-classical economic theory, oligopolists may still need to compete for workers. That is, being part of a non-perfectly competitive output market does not preclude the Banks from having to behave as perfect competitors in their input markets (i.e. for labor inputs in particular). This explains why the Banks argue that they must compete with other firms for highly qualified workers to staff their Boards. They do so by paying a wage that is high enough relative to the next best alternative, to attract highly qualified individuals (i.e. those with high marginal productivity). However, an optimizing firm (i.e. Bank) would not pay a wage in excess of the worker's (CEO's) marginal contribution to the firm's output valued in dollar terms. That

is, in equilibrium the wage paid to a CEO should not exceed his/her marginal revenue product:

$W = MRP_L$,

where W is the wage paid,

MRP = the marginal revenue product of the CEO.

This can be rewritten $W = MR \bullet MP_L$

where MR = marginal revenue and

MP_L = Marginal product of labor.

In other words, W is the optimal wage payable to a CEO of the Bank in a competitive market for CEO labor. The Bank claims to be following this approach in determining CEO pay. However, this approach has been the subject of much criticism. The economist Richard Lester wrote in 1946 that the information and computational requirements necessary to determine W far exceed the computational ability of most employers. Prof. Kaufman notes that "the difficulties of measuring the marginal product in large-scale organizations with highly interdependent production processes preclude the use of marginal calculations". It is difficult to determine the individual contribution of a particular employee to the overall performance of the firm, especially when said firm is large and has a complex system of organization. This would seem to fit the description of most large Banks, with their layers upon layers of vice-presidents and middle managers.

Neo-classical economic theory [which the Banks use to justify the tying of CEO compensation to performance] goes even further, in that it asserts that firms which are oligopolistic in their output markets may not pay wages equivalent to the employee's marginal revenue product even if there was a perfect ability to monitor productivity. Economic rent coupled with the agency cost imposed by the separation of control from ownership, creates an incentive for Bank management to set a CEO wage **greater** than his/her marginal product of labor. Gunderson and Riddell explain this phenomenon:

...firms in an oligopoly typically earn above-normal profits that are not competed away by new entrants. Workers may succeed in capturing some of these "economic rents" - especially if the firm's management is satisfied with less than maximum possible profit, perhaps because of

a separation of ownership and control. In these circumstances, workers benefit from a less cost-conscious management, and shareholders earn a lower return than they would if the firm paid the market wage, ***albeit still a greater return than is available in competitive industries***. …oligopolists, like monopolists, are often large firms and they may pay ***above-market wages*** for reasons relating to their size.

To summarize this subsection of the paper, it does appear that a number of factors conspire against the scientific market valuation of a CEO's contribution to shareholder wealth. For the reasons listed above, current Bank techniques used to set executive compensation need to be reexamined.

PROPOSITION No. 4. Loan programs for executives.

2.4.1 The Proposition.

"It is proposed that the loan program for directors, executive officers and senior officers, other than under securities purchase programs, be terminated on December 31, 1998".

2.4.2 Mr. Michaud's Arguments.

"This type of program includes loans at one-third or one-half of the prime lending rate, depending on the institution in question, for the purchase of residential properties or personal borrowings. This practice, which benefits executive officers who are already amply compensated under other programs, is clearly abusive. Royal Bank of Canada terminated its program on December 6, 1995. Since the comparison market is often invoked with respect to the compensation of bank officers to justify exorbitant salaries, and given the step taken by the country's largest bank, the other banking institutions might be expected to follow suit".

Mr. Michaud, has on other occasions pointed out that the Boards of the Banks often try to assimilate the loans program offered to all bank employees with the special loans program set up for executives. This,

in his mind, is a shrewd way of framing his proposition as being unfair on unreasonable. Michaud's proposition is in fact restricted to directors, executive officers and senior officers.

The underlying argument behind Proposition No. 4 is the same as that found in Proposition No. 3, namely that executives are already well compensated by the Bank and that there is no need for "extra perks" like interest-free loans.

2.4.3 The Arguments of the Banks.

The 4 Banks that received Proposition No. 4 all concur in pointing out the following facts: (a) directors are not eligible for the preferential loans program, (b) the program is currently not restricted to top management but has been made available to all Bank employees, (c) this type of inducement is necessary to retain top talent and forms part of the overall compensation package. Royal Bank of Canada terminated its own program on Dec. 6th 1995. [Note however that it still appears in the Bank's Proxy Circular as a "grand-fathered plan"].

2.4.4 Critiques and Commentaries

This proposition is an offshoot of the previous one, in that it is based on a view that given current compensation levels, the money of the shareholders should not be spent on trivial matters that do little to improve shareholder wealth. The view of the bank is that this extra compensation helps to retain competent staff. This is not borne out in the facts, as Royal reports no loss of top talent due to the termination of the Loans plan. In fact, Royal is the largest (and arguably one of the most profitable) bank in Canada as shown by Table 3.

Table 3. Shareholder Returns in 1997 on $100 invested in 1992.

Bank Name	*Result*	*Variation from group average. & Rank [x]*
Royal Bank of Canada	$380.00	+$44.77 [1]

C.I.B.C.	$349.75	+$14.52 [2]
Toronto-Dominion Bank	$343.00	+$7.77 [3]
Bank of Montreal	$319.47	-$15.76 [4]
Bank of Nova Scotia	$318.13	-$17.10 [5]
National Bank of Canada	$301.04	-$34.19 [6]
Average	$335.23	

Furthermore, CEO compensation, to take an example, is not even tied to this very simple and objective criteria. When we compare CEO compensation packages with shareholder results, we find that even when a bank under-performs in relation to the average banking group performance, the compensation still increases. The compensation packages of Bank CEOs is compared with the data from Table 3 in this next table.

Table 4: CEO compensation (1997) in relation to Bank Performance.

Bank Name	*CEO Compensation Package*	*Compensation variance*	*Stock variance & Rank [x]*	*Anomalies*
Royal Bank of Canada	$3, 172, 704.00	+84, 622.5	+$44.77 [1]	
C.I.B.C.	$2, 654, 743.00	+366, 661.5	+$14.52 [2]	

Toronto-Dominion Bank	$1, 858, 802.00	-429, 279.5	+$7.77 [3]	X
Bank of Montreal	$2, 314, 819.00	+26, 737.5	-$15.76 [4]	X
Bank of Nova Scotia	$2, 554, 016.00	+265, 934.5	-$17.10 [5]	X
National Bank of Canada	$1, 173, 405.00	-1, 114, 676.5	-$34.19 [6]	
Average	$2, 288, 081.50	N/A	N/A	N/A

Table 4 reveals that the CEO of the Toronto-Dominion Bank, while earning a lot less ($429, 000 less) than the average of his peers, was at the helm of a Bank which outperformed the average bank group. The CEOs of BOM and Scotia are in the opposite category: they earned more than the group average while their respective banks under-performed vis-à-vis the Bank Comparison Group average.

Incidentally, with the above figures, we can approximate which Bank earned the biggest return for the money invested in its CEO. By dividing CEO Pay in 1997 by stock price in 1997 we obtain the cost to Shareholders of generating $1 of stock appreciation. The lower the ratio, the better the performance of the CEO. Table 5 provides us with those details:

Table 5: CEO efficiency in 1997.

Bank Name	*CEO Compensation Package*	*Stock index1997 (100=1992)*	*Pay/Results Ratio*	*Rank of efficiency*
Royal	$3, 172,	380.00	$8349.22	6

Bank of Canada	704.00			
C.I.B.C.	$2, 654, 743.00	349.75	$7590.40	4
Toronto-Dominion Bank	$1, 858, 802.00	343.00	$5419.24	2
Bank of Montreal	$2, 314, 819.00	319.47	$7245.81	3
Bank of Nova Scotia	$2, 554, 016.00	318.13	$8028.21	5
National Bank of Canada	$1, 173, 405.00	301.04	$3897.83	1
Average	$2, 288, 081.50	335.23	$6825.40	

This table illustrates the fact that although Royal Bank outperformed its competitors in terms of stock appreciation, it had to pay its CEO the largest sum of money. National Bank paid its CEO the least but generated a good stock price appreciation in return (far above the TSE 300). Again, it is the shareholders of Toronto-Dominion Bank that received the greatest benefits for their expenditures on CEO compensation.

The link between compensation and performance, the Bank's main argument to retain their Executive Pay Program, has not been demonstrated. Professor Main writes in the *Journal of Labor Economics* that there is disagreement among economists as to whether or not commitment by employees and compensation levels can be correlated in a statistically significant manner. Again, empirical data from the field of economics would tend to call the Banks' reasoning into question. At the very least the Banks ought to have made a more convincing case instead of dismissing Mr. Michaud's proposition out of hand.

PROPOSITION No. 5. Proposals under Section 189 and 168 of *the Act respecting banks and banking.*

2.5.1 The Proposition

It is proposed that recommendation no. 12, which was issued by the Caisse de dépôt et placement du Quebec in March 1997 and stipulates that the proxy addressed to the shareholders should "allow a separate vote for each person proposed" to serve as director, be incorporated in the by-laws of the bank.

2.5.2 Mr. Michaud's Arguments.

Except at the Laurentian Bank, shareholders, whether or not they designate a proxyholder to act on their behalf at the general meeting, can vote directly on the proxy form for the election of directors. However, they can either vote for all the directors proposed by the bank or "abstain". The current proposal is designed to change this practice so that shareholders can vote separately for each director on the proxy form.

According to Michaud, this proposition is at the heart of debate over corporate governance and shareholder rights. The current practice of slate voting is considered a way of imposing the Board's candidates on the shareholders without discussion or analysis. The names of Board candidates are simply read out loud at the annual meeting of shareholders and they then become directors for another year. Shareholders are asked to vote for fiduciaries of their corporation without having even been given a curriculum vitae for each of the candidates.

More importantly, slate voting makes it virtually impossible, in the absence of cumulative voting, for minority shareholders to voice their concerns and attempt to elect a director that will protect their specific interests on the Board. From a political science point of view, slate voting is an extreme form of the "first-past-the-pole" mode of election, a voting system known for its potential to distort electoral representation. According to Justice Rayle of the Quebec Superior Court, the Legislator wanted to protect the inalienable right of shareholders to decide certain issues (adoption of by-laws, election of

directors, election of auditors etc...) and this right should not be contravened by bank policies. Mr. Michaud would prefer being able to vote for or against individual directors and thus show his disapproval of some or all of the candidates presented by the Board.

2.5.3 The Arguments of the Banks.

Scotia already complies with Michaud's proposal. As the Management Proxy Circular states: "If a shareholder does not wish to vote for that slate as a whole, or wishes to vote only for particular Directors, the shareholder can appoint a proxyholder to attend and cast a ballot as instructed."

C.I.B.C.'s objection is based on their belief that collective board decision-making calls for collective appointment to the Board of Directors. As C.I.B.C.'s proxy says:

"CIBC's Board of Directors feels that the current system of voting for all directors as a slate is an accurate reflection of the collective nature of the way the Board deliberates and makes its decisions [...] therefore, when shareholders vote for the election of directors, the Board believes its performance should be judged as a complete entity".

The Bank of Montreal has a Board Governance and Administration Committee to recommend nominees to the Board. This Committee is charged with determining the Board's size and skill mix. Once the Committee has found its prospective directors, it simply proposes them to the shareholders as a slate. The Bank believes that "the present process results in an independent, experienced and dedicated Board of Directors with an appropriate mix of skills." Meanwhile, the T.D. Bank does not elaborate on its objections to Proposition No. 5. In essence, it states that its directors are "well positioned to assess the skills, qualifications and appropriateness of the list of nominee directors presented".

2.5.4 Critiques and Commentaries.

The idea of voting for individual directors instead of a slate is possible - as demonstrated by the example of Scotia. The addition of brief

biographies for Board candidates might be a step forward in increasing transparency without incurring substantial administrative costs. However, a weakness emerges when advocating for greater shareholder participation in the context of widely-held corporations such as Banks. How does one ensure adequate shareholder participation without incurring prohibitively high transaction costs? Let us assume for example that the Bank of Osgoode (a fictitious entity) has 100 shareholders. All 100 decide to attend the annual meeting of the shareholders. Each shareholder has 5 propositions to make. This alone amounts to 500 propositions. For each proposition, the Board must explain whether or not it supports the proposition. If an average of one page is required to print 2 resolutions, the appendix to the management proxy circular alone would have to be 250 pages long! This does not take into account the fact that for each proposal, a discussion of 15 minutes minimum per resolution would have to be allowed. The Bank would need to reserve the Conference room for a minimum of 125 hours [5.2 days!], just to get through the propositions, and would still have to elect its directors, appoint its auditors and carry on its other items of business. Clearly, the degree of shareholder participation must be balanced with the efficient execution of business imperatives.

PROPOSITION No. 6. Number of Directors.

2.6.1 The Proposition.

It is proposed that the number of directors of the bank be fixed at twenty-four (24).

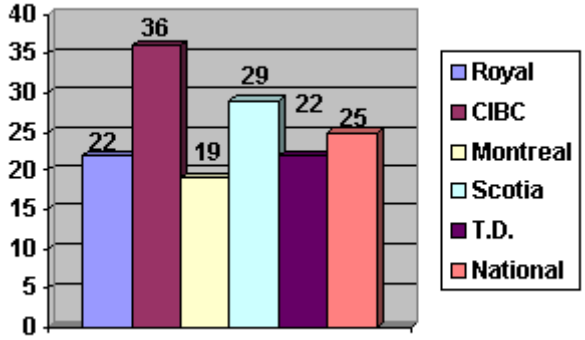
2.6.2 Mr. Michaud's Arguments

This proposal must be adopted in order to apply the cumulative voting provisions of subsection 168(1)(a) of the Bank Act, which stipulates that "there shall be a stated number of directors fixed by by-law and not a minimum and maximum number of directors". The number "24" is based on the Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada (1994; page 31, 5.41): "The effectiveness of a board of this size has been debated within the

Committee. There is a general view within the Committee that as the number of directors on a board increases beyond a particular threshold (approximately 20), the effectiveness of the board decreases. The public wonders how any group of 30 individuals functioning within time constraints can make effective decisions" (sic).

Mr. Michaud's choice of 24 directors is a form of approximation. The Dey Report has questioned the efficiency of a Board with 30 members and also concludes that efficiency declines past a threshold of 20 members. Allowing for the fact that Banks have traditionally had very large Boards, Mr. Michaud ventured to set the maximum at 24 directors. Current Board membership in 1998 is represented in Diagram 1.

Diagram 1: Number of Directors at the Big Six (1998).



In Diagram 1, we find that half of the Banks already comply with the spirit of Proposition No. 6, and National Bank is almost there with 25 directors. The underlying reason behind a smaller Board is quality of participation: a desire to avoid bureaucratic decision-making.

2.6.3 The Arguments of the Banks

All Banks argue that they should be given the flexibility to adjust the size of the

Board to changing business conditions. Flexibility is of particular importance for those financial institutions planning on expanding activities outside of Canada. The Bank of Montreal has a lapidary

introduction to its reasons for opposing the Proposition: "There is no inherent benefit in fixing the number of directors." T.D., for its part, mentions that the Dey Report, which Mr. Michaud uses a great deal, also states: "we do not think there is any one number [of directors] that suits all circumstances. Each board must be constituted to deal effectively with the circumstances of the corporation."

2.6.4 Critiques and Commentaries

If Mr. Michaud deserves criticism for poorly drafting a resolution it would have to be for Proposition No. 6. Sui generis, the proposition is ambiguous. Does Mr. Michaud mean to say that Boards can only have 24 members or is 24 an upper limit? The Bank of Montreal understood it to be the former and strenuously argued against it, given that the BOM Board only has 18 directors and should not expand to 24.

In my opinion, this proposal is of limited use. Firstly, banks themselves have begun to bring the size of their Boards in line with the rest of the economy. The Scotia Board for example, has already begun to reduce the maximum number of directors from 40 to 35. Secondly, this is probably one area of corporate governance where the impetus for improvements will come from the directors themselves. In agreement with the Banks, I would argue that 24 is arbitrary and counter-productive.

PROPOSITION No. 7. Cumulative voting for directors.

2.7.1 The Proposition:

It is proposed under Section 168 of the Bank Act that by-laws call for CUMULATIVE VOTING in the election of directors.

2.7.2 Mr. Michaud's Arguments.

Under the procedure of cumulative voting provided for and explained in Section 168 of the Bank Act, minority shareholders can be permitted

to take part in the election of directors. This provision of the Act allows a maximum of 1 or 2 candidates other than those chosen by the bank to become directors. With cumulative voting, the law tempers practices that are contrary to the principles of corporate governance, such as the proposal of a slate of candidates by the CEO or the board, which foster cronyism through co-opting and patronage, and are likely to create boards that simply rubber-stamp management decisions.

Once again, Mr. Michaud uses this proposition to strike at the heart of a democratic shareholder principle: cumulative voting. Section 168 of the *Bank Act* provides for cumulative voting if the Bank so chooses. This proposition is related to Proposition 5 in that the goal of Mr. Michaud is to avoid a complete `slate appointment' of directors by electing one or two non-Management directors to the Board. Michaud feels that slate appointments leads to the creation of an old boys' network where critical assessments of Management are frowned upon.

2.7.3 The Arguments of the Banks

The C.I.B.C. considers that cumulative voting would "permit the election of a

Director by relatively small groups of stockholders." and that such a director might "regard himself or herself as representing only the special interests of the particular group responsible for such director's election." This would introduce the possibility of dissent within the Board and destroy the climate of team-work and good camaraderie enjoyed by the Board. Furthermore, the Bank does not think it is proper for a director not to act in the best interests of <u>all</u> shareholders.

The Bank of Montreal echoes this sentiment when it writes: "It is important that all directors represent the interests of all shareholders on an equal basis rather than the special interests of any particular group of individuals." It also points out that shareholders of Schedule I banks are not permitted to own more than 10% of a class of bank shares, thus rendering cumulative voting pointless. Minority board representation is portrayed by the BOM as potentially "disruptive and detrimental to the effective functioning of the Board." The same argument is also made by T. D. and Scotia.

2.7.4 Critiques and Commentaries.

If the Legislator provided for the possibility of cumulative voting in section 168 of the *Bank Act* it would appear to be presumptuous on the part of the Banks to argue that such a voting arrangement has detrimental effects on sound corporate governance. That being said, an even more questionable argument is the one put forward by the Banks which claims that having a voice of dissent on the Board makes it difficult for the Directors to work well. The Banks maintain that directors work for the benefit of all shareholders, regardless of who was responsible for their appointment to the Board.

As was pointed out in 2.1.4, we can draw a parallel between an elected government and a Board of directors. Shareholders (citizens) are voters in the political space created by a Corporation, and the Board represents the majority views of the shareholders. Most decisions are made by directors (Members of Parliament), but important decisions such as an amalgamation (i.e. separation in Quebec) require the approval of the shareholders. The Parliamentary Model allows for an Official Opposition to question the views of Government. This begs the question: Why would a Board of directors not allow for the voicing of different views? Why have voting requirements as part of the corporation's by-laws, if, as the Banks all argue, only a Board without dissenting opinions can work properly?

It is conceivable that Bank Boards with no dissenting directors have certain undeniable advantages: quicker meetings and friendly relations with Management. However, those must be measured against the potential disadvantages outlined by Mr. Michaud: possibility of oppression of minority views, rubber stamp atmosphere, group-think, etc. In short, the argument of the banks is unconvincing.

PROPOSITION No. 8. Procedural Code for Shareholder Meetings.

2.8.1 The Proposition.

(The Shareholder proposes) Adopting a code of procedure for general meetings of shareholders.

2.8.2 Mr. Michaud's Arguments.

In Michaud v. National Bank of Canada and Royal Bank of Canada (Jurisprudence Express, 96-245, Quebec Superior Court), a decision that was sustained on appeal, the Court concluded "(translation) that the legislator wanted the annual meeting to be for the shareholders and not for the executives or directors". Shareholders are therefore not subject to arbitrary decisions made by the chair of a meeting, and their comments and proposals should be given proper attention. A code of procedure should give shareholders reasonable time (seven to ten minutes) to discuss each proposal being submitted, and should allow sufficient time (five minutes) for anyone to state his/her objections. As well, annual meetings should not be adjourned until all questions from shareholders have been heard and discussed.

Mr. Michaud's explanation is fairly straightforward. Again, one can trace this proposition to a desire to turn shareholder meetings into a forum for shareholder involvement and empowerment.

2.8.3 The Arguments of the Banks.

The C.I.B.C. was not impressed by the idea of having a code of procedure for its annual meetings of shareholders. That Bank describes the proposition as "unnecessary, inappropriate, [...] unduly restrictive and inflexible". The impressive track record of the Bank with its current reliance on common law principles is also emphasized. C.I.B.C. asserts that it has never been the subject of any complaints by shareholders denied the right to ask questions or speak on shareholder proposals.

T.D.'s argument is one based on the need for flexibility. The Chairman of the Board needs the ability to adjust meeting proceedings to the changing circumstances facing the shareholders at a given time. It is also argued that a code of procedure would give `special interest groups' a chance to usurp "the business of the meeting for purposes other than the fair conduct of business at the meeting." Obviously, such conduct on the part of interest groups would be contrary to the best interests of the shareholders of the Bank.

The Bank of Nova Scotia's argument is almost identical to that made by T.D. with respect to the need for flexibility. However, it does not make the claim that special interest groups are a potential threat to the conduct of shareholder meetings. Finally, the Bank of Montreal uses the reasons found in the C.I.B.C. proxy as well as in Scotia's and T.D.'s.

2.8.4 Critiques and Commentaries.

On the surface, this debate appears to be between the common law tradition of flexibility versus codified procedure. The Banks argue that the Chairman (the judge) knows best and should have the right to guide the proceedings without the shackles of procedure to hamper his or her discretion. Michaud's view is rooted in his conception of shareholder meetings as the final decision-making body of the Bank. Underneath this debate is the real issue of control and power: should a special interest group have the right to use the Bank's own by-laws to impede the smooth operation of shareholder meetings? Should the Bank give anyone (like Mr. Michaud with a few share certificates) the right to tell the Chairman: "I'm sorry sir but let me finish, I still have 2 minutes left…"? The Banks have implicitly answered in the negative.

Our task is to weigh the costs and benefits of such a proposal and see if it would further the interests of the Bank and its shareholders. As was pointed out in 2.5.4 a highly active and vocal shareholder community could overwhelm the managerial capacity of a Bank by the sheer time-constraints it might impose on the Bank. This does not imply that Mr. Michaud's intentions are (or were) to disrupt the business at hand to gain publicity. One may however call into question the way shareholder meetings as they are presently structured in widely-held corporations given the potential for high inefficiencies.

PROPOSITION No. 9. Non-Banking Ombudsman.

2.9.1 The Proposition

It is proposed that the position of Ombudsman be held by a person who is not or has not been a bank employee.

2.9.2 Mr. Michaud's Arguments.

As in matters of law, justice must not only be rendered, but must also be perceived to be rendered. This elementary principle is designed to ensure that there is no appearance of conflict of interest between the person who makes the decision and the person who is the focus of the decision. Appointing a bank employee or retiree to the position of Ombudsman might create a climate of mistrust in light of the close relations that could exist between the Ombudsman and his/her current or former employer.

2.9.3 The Arguments of the Banks

All four Banks argue that for a Bank Ombudsman to be efficient he or she must have intricate knowledge of bank procedures and personnel. This familiarity with Bank operations ensures speedy resolution of problems and thus contributes to better client relations. The Banks also point out that a fair and impartial appeal process exists. Clients unhappy with the Bank's ombudsman can always take their case to the Canadian Banking Ombudsman, an independent officer who is not and has never been a bank employee.

2.9.4 Critiques and Commentaries.

The arguments of the Banks are partially contradictory and of limited persuasive value. Firstly, the Banks assert unconvincingly that intricate knowledge of bank activities is necessary in order to achieve a prompt resolution of cases. Nothing prevents the ombudsman from working with an experienced Bank assistant. This assistant would have the knowledge required to access key documents or personnel in a timely fashion but could not be said to be in a potential conflict of interest as an Ombudsman. Furthermore, the reference to the Canadian Banking Ombudsman as a satisfactory solution to the Bank's ombudsman is surprising and somewhat contradictory. On the one hand, the Banks argue that the Canadian Banking Ombudsman is not related to the Banks and can perform his or her Ombudsman duties well. On the other hand, then argues that the Banks' own Ombudsmen need to have long years of service to discharge their duties adequately. It is

unclear how much importance should be attributed to the long years of service!

Because Ombudsmen traditionally perform adjudicative functions, and therefore ought to be devoid of bias, Mr. Michaud's recommendation appears to be sound. Furthermore, if one were to provide such an outside Ombudsman with a veteran of the Bank to second him or her, the Bank's argument would lose much of its appeal.

3.0 Conclusions

3.1 Explaining Bank Shareholders' lack of interest in Michaud's Proposals.

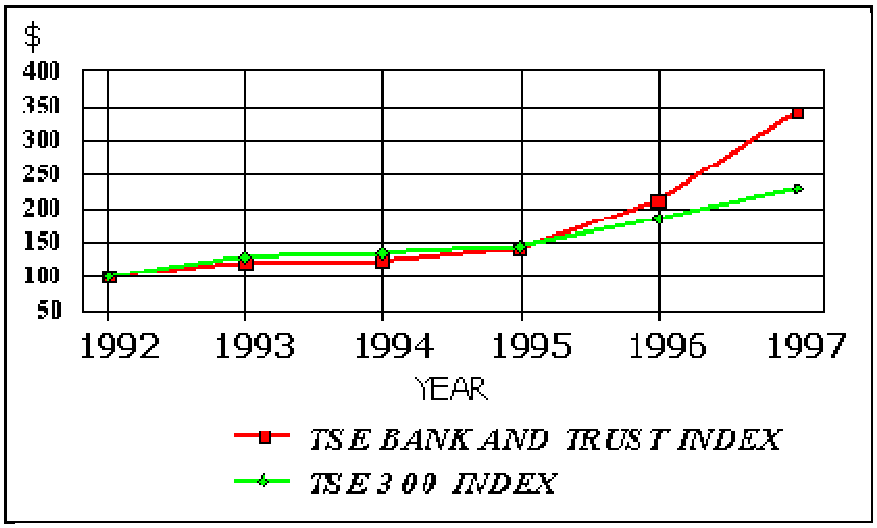
Every single one of Mr. Michaud's propositions was soundly defeated at the various annual meetings of shareholders. Assuming that shareholders are rational actors capable of assessing the soundness of Mr. Michaud's proposals, we are left with the question: why such a lack of enthusiasm? Votes of support ranged from a low of 5% to a high of 27%. The more favorable results tend to prove that certain shareholders actually considered Mr. Michaud's arguments worthy of implementation, and that he is not just a radical ***bank basher***.

This still does not explain the general lack of support for what might appear to be sound measures to improve corporate governance. After all, Mr. Michaud did not re-invent the wheel and was inspired in many instances by the T.S.E. Dey Report or by recommendations of the Caisse de dépôt et placement du Québec, the largest institutional investor in Canada.

The obvious answer lies with economic theory and was already alluded to in section 2.3.4.2. Banks are oligopolies that derive economic rents. These rents are shared among the managers of the Bank and its shareholders. Shareholders may not be pleased with the allocation of the rents (i.e. may think that the CEO and senior officers are paid too much for the amount of wealth they truly add to the Bank) **but will normally refrain from protesting as long as they earn on average a higher return with a bank stock than elsewhere in the market.** On average, the Banks have consistently outperformed

the competitive market in terms of Return on Equity as can be seen from Diagram 2.

Diagram 2: Five-year Total Return on $100 Investment (1992-1997)



This calculated apathy results in a lack of support for reforms and by an unwillingness to apply the Bay Street Rule [that is, selling under-performing stocks]. The conclusion one can draw from economic theory is that were banks to consistently under-perform vis-à-vis the rest of the market, Mr. Michaud's proposals might have met with greater support.

3.2 Can shareholder democracy survive in widely-held corporations?

Michaud believes that the shareholder meeting is intended mainly for shareholders and that as a group, shareholders are the ultimate decision-making body of the corporation. This view is substantially entrenched in the concept of *unanimous shareholder agreement* found in the *Business Corporations Act (Ontario)* and the *Business Corporations Act (Canada)*. However, the *Bank Act* does not allow for that much shareholder control over Bank activities. For example, the words "unanimous shareholder agreement", "pooling agreements" are

absent from the *Bank Act*. This anomaly may in part be due to the division of powers in the Canadian federation.

It would seem that shareholder democracy has, by virtue of the *Bank Act*, a fairly bleak future. To make matters worse, some commentators such as Prof. Brian Cheffins have argued that even if Mr. Michaud's Propositions had carried the day in early 1998, there is doubt as to whether or not they would have been binding on the Bank. Prof. Cheffins writes:

In all likelihood, they would not have been. It is noteworthy in this respect that in the United States proposals dealing with the composition of the board are treated as being merely advisory [...] Also significant is that the directors have the power to choose the chair of the Board [...] and to set managerial remuneration.

3.3 Final Remarks

This paper set out to examine the rationale behind the Michaud Propositions and the possible objections Banks may have to their implementation. This exercise has revealed a number of areas for further study, of which two deserve some special mention:

How can shareholders participate actively in the activities of widely-held corporations without taxing the managerial capacity of the Banks to accommodate their participation?

Did shareholders fail to support Michaud because they fundamentally disagreed with him or because the cost of intervention was greater than the benefits derived from the proposed reforms?

One would hope that Mr. Michaud did not go to Court in vain. However, it does appear that until Banks stop deriving economic rents from their oligopolistic position, the incentive for greater scrutiny into corporate management affairs will be minimal and that shareholders will continue to place their faith in the Directors of the Banks.

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Appendices

Judgment of Justice Rayle, Quebec Superior Court in *Michaud v. National Bank*

Proxy Circular for Royal Bank of Canada

Proxy Circular for Bank of Montreal

Proxy Circular for Toronto-Dominion Bank

Proxy Circular for Bank of Nova Scotia

Proxy Circular for National Bank of Canada

NOTE: To obtain CIBC's Proxy Circular dated Jan. 22nd 1998 call Paul Fisher Corporate Secretary's Division , Corporate Governance Group (416) 980-3096 Email: paul.fisher@cibc.com