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Me Anne-Marie Beaudoin
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Dear Mme Beaudoin

Response to CSA Consultation Paper 25-401

LGIM has approximately £382bn of assets under management (as at 31st March 2012) and is one of the UK's largest pension fund equity investors. We welcome the CSA consultation on the Proxy Advisory Industry.

While our approach to investment management includes a relatively high proportion of funds managed for clients who want to passively track an index, our philosophy is to improve the performance of all companies in which we invest. Due to the fact we invest in the global market, we feel it is important that corporate governance standards are upheld in order to protect the integrity of companies and for sustainable long term value creation.

We believe that Proxy Advisors provide an important service to the investment community by helping to reduce costs of analysing voting issues and facilitating voting instructions on their electronic platforms. We also take the view that their influence has grown and become more established in the market which is not going to change in the near future.

With regards to this review, we have not given answers to specific questions but instead highlighted some specific areas and points for consideration. Although we are not in favour of rigid regulation, we feel that the industry should develop standards in line with best practice. A summary of our main views are shown below:

1. **Code of Conduct** – we are supportive of a Code of Conduct which proxy advisors should adhere to but not established by the proxy advisory companies themselves. Similarly to the Financial Reporting Council (FRC) in the UK, an independent body should develop standards and monitor its effectiveness in line with best practice. For example, the Code of Conduct may require a minimum period for a draft report to be sent to issuers for review prior to publication which minimises errors in reports.

2. **Transparency –** the key to proxy advisors working effectively is that there is clear transparency on their procedures for engagement (with companies and investors) and there is meaningful disclosure on conflicts of interest. We are supportive of a 'timeline approach on disclosure' related to engagement with issuers, disclosure in research reports of other services and fees provided to issuers that may impact the independent analysis and public disclosure of their conflicts of interest policy.

3. **Votes connected with financial transactions** – we believe proxy advisors should only provide voting advice on corporate governance related issues and not vote on financial transactions such as M&A or Takeovers. These decisions should be referred to investors for consideration.

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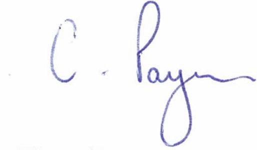
I hope you will find our views to the consultation helpful in formalising a policy to ensure that the operational effectiveness of the Proxy Advisory Industry is maintained and enhanced further for the protection of investors and companies. We are happy to discuss any of the issues highlighted in our submission.

Yours sincerely



Clare Payn
International Corporate Governance Manager

Correlation between proxy advice and investor voting behaviour

Before establishing whether there is a correlation between proxy voting advice and actual voting outcomes, it is important to understand how the advice is formulated and how it is used by investors. The aim of proxy voting advisors is to provide vote recommendations using a policy constructed by their clients on what is believed to be good governance principles. Therefore, the policy itself represents a broad market view on what is considered to be good governance and this is tied to voting recommendations provided by proxy voting advisors. However, a number of issues arise when this policy is not followed after engagement and proxy advisors use their own "judgement" in concluding voting recommendations.

We believe that proxy advisors do have a large and significant influence in voting outcomes at general meetings. Furthermore, as there has been an increase in share ownership by foreign investors and shareholders are diversifying their portfolios, this influence is likely to increase. For example, in the UK, a handful of proxy advisors represent more than 15% of the voting market which is a sizeable amount and could swing the voting outcome on important corporate governance issues. If proxy voting advisors abstain and 'sit on the fence' on voting issues, this will also change the dynamics of voting powers held by investors.

LGIM is supportive of the industry developing standards which proxy advisors have to adhere to on a global basis. More information needs to be collated on the number of shares that are automatically voted in accordance with voting advice from proxy services, the number of investors who have a custom policy and the proportion of investors who subscribe to the service as an information source.

On investment matters such as M&A and Takeovers, these issues should be referred to investors for consideration. Each investor has its own approach to investment (e.g. long only funds, hedge funds etc.) and therefore decisions on such matters should not be outsourced to proxy voting advisors.

Investor responsibilities

As an institutional investor, we have a fiduciary duty to clients to exercise their voting rights responsibly. The right to vote is a basic privilege of share ownership and is important given the division of control between the owners of a firm (shareholders) and the agents appointed to run the Company in their interests (directors).

In addition, voting is a fundamental tool used by investors to signal support or discomfort towards management actions. This mechanism is one of the valuable methods of promoting good corporate governance in the marketplace and therefore it is vital that shareholders take the opportunity to exercise their voting rights responsibly.

We do not believe that the use of proxy voting advisors encourages a risk of shifting the investor responsibility. It is important to understand how investors use proxy-voting advisors before making this assumption. At LGIM, we use the research of proxy voting advisors to support our own internal processes rather than use it as a replacement. They supplement our stewardship activities as an information source.

However, it is important to note that not all investors have the same in-house expertise and are structured differently. In addition, for asset owners, using proxy voting advisors is a practical way of implementing votes across a diversified portfolio managed by different investment managers.

Currently in the UK, the FRC are reviewing the Stewardship Code, which includes investors disclosing the use of proxy voting services. LGIM is supportive of this provision as it provides more transparency on how investors utilise these services. This should also be extended globally to provide consistency across different markets and companies can see how investors utilise the services of proxy advisors.

Conflicts of interest

Due to the different services that proxy voting advisors provide, conflicts arise which may impact the quality of their work. The two main areas of conflict are when:

(a) Proxy voting advisors provide consultancy work to issuers; and
(b) Proxy voting advisors provide recommendations which are not in line with their policy as a result of dialogue with issuers

In order to mitigate these risks, we believe that there should be improvements in the transparency level of the conflicts of interest proxy voting advisors have when providing their services. This should be made public and reviewed annually.

For example, we believe that proxy voting advisors should include in their research reports whether they provide any other services to the issuer and whether this may impede on their judgement to carry out an independent analysis. This is similar to broker research on buying/selling recommendations which also disclose whether they provide any corporate broking services for the company in question.

The conflicts of interest policy should also be disclosed in their voting policy and the Company's own internal auditors should check that there are sufficient procedures in place to minimise conflicts. This may include disclosures on how the structure of fees is paid and whether the amount is substantial enough to run the risk on the quality of work provided by proxy advisors.

Voting policies and guidelines

One of the main reasons why investors use the services of proxy voting advisors is because there are limited in-house resources to conduct corporate governance on a wide global scale. Proxy voting advisors often have networks of local governance experts in key markets and better understand the regulatory environment. Therefore, it is more efficient to utilise these services. In addition, the analysts working for proxy voting advisors are more accustomed to local market practice and have better communication with issuers where language may be a barrier. This puts them in a better position to extract information which can be used in the analysis.

In relation to engagement between proxy voting advisors and third parties in the development of voting policies and guidelines, the approach varies depending on the proxy voting advisor. In our experience, when developing the policy, the proxy voting advisor seeks the views of clients before writing the policy. These opinions vary from highlighting trends in the industry and the approach that should be taken in the forthcoming year to specific amendments, which aim to improve the impact of votes cast. The difficulty is that each investor has its own view and stance on particular issues, which is why the ultimate decisions and final voting instruction is left to the investor themselves. Furthermore investors express their views on topics in different ways which makes it difficult for proxy voting advisors to capture every issue.

With regards to engagement between proxy voting advisors and issuers, there is limited transparency on the approach taken. This is particularly significant when the final voting recommendation by the proxy voting advisor differs from its own policy on issues (i.e. a judgement call is made). We believe there should to be more detailed disclosures by proxy voting agencies during engagement with companies and how this has impacted their final decision. We are supportive of a 'timeline' structured approach on disclosure from when proxy advisors engaged with issuers to their final voting recommendation. Furthermore, the research report should clearly lay-out and separate what is factual information disclosed by the Company and where the opinion of the proxy voting advisor is included in the analysis.

Voting recommendations

There are 3 main steps to the development of voting recommendations.

Firstly, proxy voting advisors employ primary research methods and state factual information in their reports. The main sources of information are from public disclosures by issuers to the market e.g. annual report and accounts, financial results. This fact finding process is used as evidence in their analysis.

The second step is to go through this information and check against their own policy to see whether there have been any deviations from best practice or good governance principles. Depending on the proxy voting advisor, the analysis may go further and involve dialogue between proxy voting analysts and issuers to provide more evidence.

After all information has been gathered, the proxy voting advisor comes to a final decision on voting recommendations.

We believe that there can be significant improvements in the transparency of step 2 which is a significant part in this process. As highlighted at the end of question 6, there needs to be more detailed disclosures by proxy voting agencies during engagement with companies and how this has impacted their final decision. This is where the accuracy, independence and reliability of voting recommendations may be affected and changed. The lack of sufficient transparency in relation to key aspects of proxy voting advisors methodology, especially on how voting policies and guidelines are applied to produce voting recommendations, is important. As investors, we are not involved with this dialogue and so cannot comment on the quality of communication and how proxy voting advisors engage. We are supportive of a 'timeline' structured approach on disclosure from when proxy advisors engaged with issuers to their final voting recommendation. Furthermore, the research report should clearly lay-out and separate what is factual information disclosed by the Company and where the opinion of the proxy voting advisor is included in the analysis.

We believe that engagement is positive because it reduces the number of factual errors in the proxy voting analysis and makes reports more comprehensive. However, in order for this system to work well, proxy advisors should give issuers sufficient time to review a draft of the report. One of the main problems with this is the seasonality of the proxy voting season and the intense pressure on resources at specific times during the year.

In addition, another important factor to take in to consideration is the training and skill of the analyst. Although there are senior analysts checking work, there may be loopholes in checking the consistency and accuracy of the report. Most of the checking may only be based on grammar and spelling. Not on the facts themselves. Therefore there should be clear transparency and disclosure on the training and background of the analysts employed by proxy voting advisors.

Regulation options

At LGIM, we prefer markets and/or industry to develop standards. We feel this is the most appropriate policy as it does not consist of rigid regulation and recognises the influence of proxy advisors.

It would provide flexibility which is crucial due to the differentiation in the marketplace in terms of the types of investors and differences in the structure of the shareholder register which may impact corporate governance frameworks.

We believe that before formal regulation is imposed, there needs to be a more thorough understanding of the industry which is still evolving. The effects of regulation need to be fully understood before being implemented. There is a danger that increased regulation would place an unnecessary burden on all parties and may have indirect consequences e.g. act as a barrier to entry for other proxy voting agencies. Healthy competition is good and ensures that proxy voting agencies are acting in the best interest of their clients and issuers by providing good quality research and other services.

Alternatively, it is clear that the influence of proxy advisors is growing stronger which needs to be controlled in a manner which does not inhibit their growth. Therefore, doing nothing is not a viable option.

Although we do not believe that there is one size fits all approach, we feel that a Code of Conduct should be developed and monitored by an independent body. Similarly to the Financial Reporting Council (FRC) in the UK, this body should be responsible for setting global standards and seeking to achieve regional consistency on the use of proxy advisors and how they operate without restricting their business.

Additional information

As highlighted previously, LGIM is supportive of encouraging the industry to develop its own self regulating standards at this time. However, it's important to note that proxy advisors themselves should not be monitoring these standards. It is important that an independent body with minimal conflicts but represents the market more broadly takes charge on this issue.

A summary of our key points for consideration is shown below:

1. **Code of Conduct** – we are supportive of a Code of Conduct which proxy advisors should adhere to but not established by the proxy advisory companies themselves. Similarly to the Financial Reporting Council (FRC) in the UK, an independent body should develop standards and monitor its effectiveness in line with best practice. For example, the Code of Conduct may require a minimum period for a draft report to be sent to issuers for review prior to publication which minimises errors in reports.

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