

**Canadian Coalition for
GOOD GOVERNANCE**
THE VOICE OF THE SHAREHOLDER

September 19, 2012

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

C/O: Anne-Marie Beaudoin
Corporate Secretary
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John Stevenson, Secretary
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Dear Sir/Madame:

**Re: CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory
Firms**

We have reviewed CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms (the "Consultation Paper") and we thank you for the opportunity to provide our comments.

Representing the interests of institutional shareholders, CCGG promotes good governance practices in Canadian public companies to best align the interests of boards and management with those of their shareholders. We also seek to improve Canada's regulatory framework to strengthen the efficiency and effectiveness of the Canadian capital markets. CCGG Members collectively manage almost \$2 trillion of savings on behalf of most Canadians. A list of our members is attached to this submission¹.

GENERAL

CCGG agrees that the Consultation Paper accurately summarizes concerns that have been expressed by some market participants regarding the role of proxy advisors. We do not believe, however, that those concerns justify a regulatory response. CCGG believes that much of the criticism relating to proxy advisors stems from a misunderstanding of the services they provide and/or the use to which those services are put by their clients² and regulation would not add any meaningful benefit. Moreover, since there are only a small number of competitors in the industry and therefore limited choice of proxy advisors, we are concerned that regulation will serve as a barrier to entry for any new proxy advisory firm.

As noted in the Consultation Paper, it is important to be mindful of the fact that proxy advisors play an important role in assisting institutional investors, which are themselves regulated under various types of legislation, to fulfil their fiduciary obligations to their clients. A large institutional investor may own portfolio securities of thousands of companies across global markets, making it very difficult to assess and vote on all matters put to shareholders without having access to the market-specific research information provided by proxy advisors. However, the fact that institutional investors use the services of proxy advisors should not lead to the conclusion that such investors delegate their voting decisions entirely to proxy advisors. CCGG Members recognize the importance of the shareholder vote. In CCGG's *Principles for Governance Monitoring, Voting and Shareholder Engagement*³ CCGG Members endorse best practices regarding shareholder voting and the oversight of governance practices for companies in which they are invested. Those Principles specifically provide that "if an institutional investor uses outside service providers to assist it in arriving at its voting decisions, the institutional investor should assess the advice it receives rather than automatically following it". If an institutional investor inappropriately delegated its vote to a proxy advisor, then the fault would lie with the investor, not the proxy advisor.

¹ Please note that to avoid any appearance of a conflict of interest as a result of its ownership of Glass Lewis, our member, Ontario Teachers' Pension Plan, did not participate in the preparation or approval of this submission.

² For a more detailed discussion of the misconceptions regarding proxy advisors, we refer you to an article by Stephen Davis & Jon Lukomnik entitled "Three Myths about ISS" appearing in Compliance Week, August 9, 2011.

³ This document is an update of the 2005 *Statement of Principles Regarding Member Activism* referred to in the Consultation Paper and is available at www.ccg.ca.

ISSUES RAISED

Potential Conflicts of Interest

In CCGG's view, the potential for conflicts of interest within some proxy advisors and the general perception that those conflicts are not appropriately identified or managed is the most significant issue that has been raised by market participants. Although we agree that as a matter of best practice it would be appropriate for proxy advisors to have policies and procedures designed to identify and manage any conflicts of interest that arise in connection with the issuance of a vote recommendation, as well as policies to deal with employee and ownership conflicts, we understand that because of market forces proxy advisors already have such policies in place and disclose them publicly. Accordingly, we do not think that regulation in this regard would add substantively more value.

With respect to the proposed requirement for proxy advisory firms to "separate" their proxy advisory services from their consulting services we note that, as far as we are aware, the only proxy advisory firm which provides both types of services (i.e., ISS) already offers those services through separate corporate entities.

We do not think that companies should be required to disclose in their proxy circular the fact that they have engaged a proxy advisor to provide consulting services. ISS states that one of the key goals of its "firewall" put in place to manage potential conflicts of interest is to ensure that its research team does not know the identity of its consulting clients⁴. Requiring issuers to disclose those consulting contracts would undermine those efforts. Moreover, ISS's investor clients can contact ISS' Legal and Compliance Departments to obtain information about an issuer's use of ISS's consulting services, including the amount of compensation its consulting business will receive from an issuer⁵, thus allowing institutional investors to assess the impact of any potential conflicts.

Lack of Transparency

We do not think that this concern has merit and accordingly there should not be regulatory intervention in the area. CCGG's view is that the activities of proxy advisory firms are highly transparent. Their corporate governance guidelines and their approach to governance issues are publicly available on their websites. Contrary to the suggestion in the Consultation Paper, we understand that the guidelines of proxy advisors are developed through a public consultation process which allows all interested market participants, including issuers, to provide comments. The websites of both leading proxy advisory firms contain detailed information as to the process issuers should follow if they wish to provide comments or otherwise engage with the firms.

⁴ See ISS response to ESMA Discussion Paper dated June 21, 2012 at p. 7, available at www.esma.europa.eu.

⁵ See ISS response to Concept Release on the U.S. Proxy System dated October 20, 2010 at p. 10 available at <http://www.sec.gov/comments/s7-14-10/s71410.shtml>.

We do not think that proxy advisory firms should be required to disclose their methodologies and/or analytical models. These are proprietary products that have been developed by proxy advisory firms and are the foundation for the research products they sell to their clients. Those clients are sophisticated institutional investors which are capable of assessing the quality of the analysis and voting recommendations based on the level of detail already included in a research report. In addition, arrangements between proxy advisory firms and their clients are private contractual matters and securities laws do not require the use of proxy advisory firms nor do such laws provide exemptions or relax rules if such firms are utilized (unlike, for example, rating agencies, where short form or shelf prospectuses, or prospectus exemptions, can be utilized if certain approved credit ratings exist). Requiring proxy advisors to publicly disclose their proprietary analytics would fundamentally undermine their business model. Similarly, proxy advisors should not be required to publicly disclose their research reports and voting recommendations. Since research reports are one of the main products proxy advisors sell to their clients, requiring these reports to be publicly distributed would further undermine the proxy advisors' business model and would be a disproportionate regulatory response to the concerns that have been identified.

The Consultation Paper notes that at times two proxy advisors have made different vote recommendations and suggests that additional transparency may be required to allow investors to assess the basis of different recommendations when deciding how to vote. In those circumstances, an institutional investor which is a client of a proxy advisory firm always has the ability to contact that firm and ask for additional information or clarification as may be required. Additional public disclosure would not add value to that process and is unwarranted.

Potential Inaccuracies and Limited Opportunity for Issuer Engagement

We agree that as a matter of best practice, proxy advisory firms should use their best efforts to provide issuers with a draft of their report so that an issuer has an opportunity to correct any material factual inaccuracies prior to it being distributed to investors, particularly when its recommendation relates to certain special, non-routine corporate governance matters being put to the shareholders for a vote (for example, if the recommendation relates to a merger, acquisition, share re-organization or another transaction that will materially affect the rights of shareholders). As a matter of best practice, proxy advisors also should have a clear policy and process to deal with any comments received from issuers during proxy season or at any other time. However, proxy advisory firms should be free to develop policies that best reflect their business model. They should not be required to provide drafts to issuers or provide issuers with a certain minimum amount of time to review a report. For example, we understand that in order to manage the demands of proxy season, ISS provides only draft reports to certain index issuers which in Canada are companies listed on the S&P/TSX Composite Index. We understand that Glass Lewis does not generally provide draft reports to issuers in advance. Clients of proxy advisors are aware of these different approaches and can choose a proxy advisor with those considerations in mind.

CCGG also believes that as a matter of best practice, proxy advisors should issue a correction to previously issued reports if proxy advisors subsequently become aware that reports contain any material factual errors. We believe, however, that proxy advisors appropriately use their discretion to determine what amounts to an "error". We understand that issuers often claim

that reports contain an error when in fact the dispute relates to an issue with the underlying analysis. For example, an issuer may take the position that the chosen peer group is incorrect, when this may be an analytical choice made by the proxy advisor. As another example, we understand that issuers have objected to the reliance on standardized data provided to proxy advisors by Standard & Poor's. As long as a proxy advisor discloses the source of any information obtained from a reputable third party, we do not believe it is reasonable to require them to investigate the reliability of information obtained from that third party.

Similarly, we do not think that proxy advisors should be required to address issuer comments in their reports. Institutional investors engage proxy advisors to obtain the benefit of their research and analysis, not to provide a forum for issuers' responses. Issuers are free to comment publicly if they disagree with the analysis prepared by a proxy advisor or issuers could post to their websites commentary or corrections relating to a report from a proxy advisor. Issuers could also reach out to their shareholders to engage in a discussion of their corporate governance practices and any disagreement they might have with the analysis prepared by a proxy advisor.

Finally, it is important to bear in mind that if the reports of proxy advisors routinely contained material errors of fact, poor analysis or unsupported recommendations, it is unlikely their services would continue to be retained by sophisticated institutional investors. In this way, market forces may provide the most effective regulation of the quality of services provided by proxy advisors.

Development of Corporate Governance Standards

CCGG believes that this issue, more than any other, is based on a misunderstanding of the role played by proxy advisors. Critics of proxy advisors state that many shareholder votes are cast in accordance with the recommendation of a proxy advisor and they conclude that one or more of the proxy advisors are "controlling" the shareholder vote and becoming the *de facto* standard setters in corporate governance matters. The Consultation Paper also suggests that issuers may be changing their practices to conform to the policies of proxy advisors.

This criticism fails to take into account that the governance policies of proxy advisors are developed and updated each year in consultation with institutional investors and other market participants⁶. Moreover, proxy advisors also apply customized policies developed by institutional investors and some proxy advisors allow institutional investors to choose from several "specialty" guidelines (for example, faith-based guidelines or guidelines for socially responsible investors). We understand that ISS, the largest proxy advisor, applies over 400 custom policies and estimates that the majority of shares voted by ISS clients fall under custom policies provided to ISS by institutional investors.⁷

⁶ As noted earlier, although the Consultation Paper asks whether it is sufficient for proxy advisors to develop their voting policies and guidelines by soliciting comments from their clients, it is our understanding that proxy advisors encourage and receive comments from all market participants. For example, when developing its corporate governance guidelines, ISS issues a public call for comments from all market participants, including issuers.

⁷ See ISS response to ESMA Discussion Paper, *supra*, at p. 2.

In light of the above, rather than regarding proxy advisors as the corporate governance “standard-setters” we think it is more accurate to regard them as reflecting the corporate governance standards of their institutional investor clients. Accordingly, to the extent that issuers are changing their practices to conform to the policies of proxy advisors and those policies reflect the principles of good governance supported by institutional investors, then it is a positive development that will lead to improved governance in Canadian public companies.

Moreover, CCGG believes that concerns about proxy advisors “controlling” the shareholder vote stem at least in part from a failure to distinguish between causation and correlation. In this regard, we refer you to a paper authored by Stephen Choi et al⁸ which discusses the various factors which may cause shareholders to vote in accordance with the recommendations of proxy advisors (correlation) short of blindly following the recommendations of proxy advisors (causation). Those factors include the following:

- institutional investors may choose a proxy advisor based on the fact that it agrees with the proxy advisors’ previously published governance guidelines or one of its specialty guidelines;
- institutional investors have considerable input into the development of those guidelines; and
- there may be substantial agreement among investors regarding governance best practices.

The paper concludes that it is likely a recommendation from ISS causes a shift in 6-10% of the shareholder vote but notes that “ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences.”⁹

CCGG agrees that as a matter of best practice, proxy advisors should implement fair and transparent procedures for developing corporate governance policies (to the extent they have not already done so) which would give all market participants information on how they can provide comments as part of that process.

Reliance by Institutional Investors/Specific Questions for Institutional Investors

Although we cannot speak to the practices of our individual Members, we believe that institutional investors which use the services of proxy advisors can retain the right to vote their shares contrary to the recommendation of their proxy advisor. Similarly, if institutional investors disagree with a particular part of their proxy advisor’s guidelines, they can ensure that their own guidelines are applied on a particular issue. As detailed above, we also are generally aware that the guidelines of proxy advisors are developed in consultation with their institutional investor clients. We are confident that if an existing or proposed policy did not reflect the views of a significant number of a proxy advisor’s institutional investor clients, those

⁸ Choi, Fisch, Kahan, “The Power of Proxy Advisors: Myth or Reality” (2010) 59 Emory Law Journal 869.

⁹ *Ibid.*, at 906. For a further discussion of the overlap between proxy advisors’ guidelines and the preferences of institutional investors see the submission of the Council of Institutional Investors dated October 14, 2010 in response to the SEC Concept Release, available at www.cii.org/correspondenceArchive2010.

investors would likely be able to convince the proxy advisory firm to change those guidelines without the need for regulatory intervention.

In March and April of 2012 (prior to the issuance of the Consultation Paper) CCGG conducted a short survey of our Members regarding their use of proxy advisors. Thirty-one of our forty-six Members responded to that survey. The survey results reinforce our prior statement that the fact that institutional investors use the services of proxy advisors should not lead to the conclusion that such investors delegate their voting decisions entirely to proxy advisors. In particular, 55% of respondents to the survey indicated that they retain proxy advisors to apply a combination of the investor's own custom guidelines and the proxy advisor's guidelines, 23% of respondents rely solely on their own custom guidelines and only 23% rely on the guidelines developed by proxy advisors.

POTENTIAL SECURITIES REGULATORY FRAMEWORK

As detailed above, we do not think that it is necessary for securities regulators to regulate the services provided by proxy advisors. Those services provide institutional investors with an efficient and cost-effective way to monitor the corporate governance practices of the companies in which they are invested, particularly for investors with significant investments across global markets. We believe that market forces will prove the most effective regulation of the quality of services provided by proxy advisors. Critics of proxy advisory firms who seek to invoke the public interest as a reason for regulating them appear to be doing so based on the misinformation and misconceptions outlined above and accordingly we believe regulation is not justified on that basis.

We would encourage proxy advisory firms to develop a voluntary code of best practices to reflect some of the best practices discussed above, which may provide institutional investors with additional information to assess their proxy advisors. If institutional investors which use proxy advisory firms determine that it would be desirable to change any of those policies or practices, they can use their position as clients to press for those changes without the need for regulatory intervention.

We thank you again for the opportunity to provide you with our comments. If you have any questions regarding the above, please feel free to contact the undersigned at 416.947.4587 or dan.chornous@rbc.com or our Executive Director, Stephen Erlichman, at 416.847.0524 or serlichman@ccgg.ca.

Yours very truly,



Daniel E. Chornous, CFA
Chair of the Board
Canadian Coalition for Good Governance

CCGG MEMBERS

Alberta Investment Management Corporation (AIMCo)
Alberta Teachers' Retirement Fund Board
Aurion Capital Management Inc.
BlackRock Asset Management Canada Limited
BMO Harris Investment Management Inc.
British Columbia Investment Management Corporation (bcIMC)
Burgundy Asset Management Ltd.
Canada Post Corporation Registered Pension Plan
CIBC Global Asset Management
Colleges of Applied Arts and Technology Pension Plan (CAAT)
Connor, Clark & Lunn Investment Management
CPP Investment Board
Franklin Templeton Investments Corp.
GCIC Ltd.
Greystone Managed Investments Inc.
Healthcare of Ontario Pension Plan (HOOPP)
Jarislowsky Fraser Limited
Leith Wheeler Investment Counsel Ltd.
Lincluden Investment Management
Mackenzie Financial Corporation
McGill University Pension Fund
Manulife Asset Management
NAV Canada
New Brunswick Investment Management Corporation (NBIMC)
NEI Investments
Nova Scotia Pension Agency
Ontario Municipal Employees Retirement System (OMERS)
Ontario Pension Board
Ontario Teachers' Pension Plan (Teachers')
OPSEU Pension Trust
Public Sector Pension Investment Board (PSP Investments)
RBC Global Asset Management Inc.
Régimes de retraite de la Société de transport de Montréal
Russell Investments
SEAMARK Asset Management Ltd.
Sionna Investment Managers Inc.
Standard Life Investments Inc.
State Street Global Advisors Ltd. (SSgA)
Sun Life Financial Canada
TD Asset Management Inc.
Teachers' Retirement Allowance Fund
UBS Global Asset Management (Canada) Co.
United Church of Canada
University of Toronto Asset Management Corporation
Workers' Compensation Board - Alberta
York University Pension Plan