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### **Canadian Securities Administrators Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms – Request for Comments**

The *Canadian Society of Corporate Secretaries* (“CSCS”) engages with Canadian securities regulators to ensure our members’ interests are represented.

The effectiveness of Canada’s shareholder voting system is an important issue for those of our members who are from listed issuers or provide services to them. CSCS and our members have been vocal advocates for simplification of the proxy voting system. We developed and published a *White Paper* that made recommendations to address one of the corporate law issues in regard to the proxy voting system. We also provided extensive pre-release commentary on the report entitled *The Quality of the Shareholder Vote in Canada* released by Davies, Ward, Phillips and Vineberg in October 2010.

More recently CSCS took the initiative in October 2011 of convening the inaugural *Shareholder Democracy Summit* in Toronto. The purpose of the Summit was to bring together the key organizations that play a role, or that have a stake, in proxy voting in the Canadian capital markets. The two-day conference focused on the state of proxy and share voting in Canada.

The Summit confirmed that there is a consensus among key Canadian stakeholders that the current shareholder voting processes are flawed, and that there may be an opportunity to undertake fundamental reform.

The Inaugural Report that we published following the Summit provides a detailed report of the proceedings and is available to be downloaded from the CSCS website by [clicking here](#). If the link is not active in this document you may access the Inaugural Report at the following URLs:

<http://www.cscs.org/Resources/Documents/summit/Summit%20Repor.pdf>  
<http://tinyurl.com/7ywgxw6>

As a direct result of that initiative CSCS is currently proposing to key stakeholders a five-year, full-time facilitation program whose purpose is to bring about a comprehensive reform of all processes in which Canadian shareholders vote their shares.

We thank the CSA for leading the exploration of the critical processes that underpin the integrity of shareholder democracy in Canada, and for this opportunity to share our comments on shareholder democracy issues including the important role played by proxy advisory firms.

### **Response to the request for comments**

Before responding to the CSA's specific requests for comments, it is important to address concerns that in our view underlie all aspects of shareholder democracy.

One of the concerns expressed in the Consultation Paper that may ultimately temper the CSA's position on whether, and if so, how, to approach the regulation of proxy advisory firms is that the existing processes are manifested in a commercial enterprise among the proxy advisory firms and their clients.

At some point the public interest must transcend the commercial interests of market participants. That is what market regulation is all about, and that is why the CSA are examining the practices of proxy advisory firms.

Corporations make up roughly half of the world's largest economies. In this way, decisions made by corporations have a significant impact on the way we live our lives, and in particular the fate of our savings. Society therefore has a tremendous stake in the quality of corporate management.

This reality, and the prominent failures that have cost us so dearly in recent years, justify the current focus on the importance of good corporate governance practices.

The early focus was on the conduct of boards of directors and their role in managing or overseeing the management of corporate business. More recently, the role played by shareholders in selecting, retaining and replacing directors has also entered the spotlight.

If in the past the role of shareholders in the equation for the governance of public corporations was the object of benign neglect, this is certainly no longer the case, and can no longer be the case. There is an intention among regulators and large shareholders to use the shareholder's franchise to promote and sustain good governance, and to deal effectively with poor governance.

This justifies focusing sharply on the processes that attend shareholder voting. These processes have suffered neglect. We hasten to add that no one is responsible for that neglect. The CSA in particular have devoted substantial efforts for a long time now to improve the quality of shareholder voting. The reality however is that the processes are complex and go beyond the confines of securities regulation. The time is right for all stakeholders to examine those processes and work vigorously to ensure that they deliver trustworthy and timely results.

Proxy advisory firms play a very important role in the way institutional shareholders vote their shares. They provide essential services in terms of policy development, analysis of particular items of business on meeting agendas, and the logistics that gather voting intentions and deliver votes.

The importance of that role in the modern social context makes the integrity of the process administered by proxy advisers a matter of public interest, and therefore causes aspects of it to rise above private commercial interests.

Improving corporate voting in a meaningful way necessitates simultaneous macro and micro approaches to the challenge. There are many, many issues intertwined in the voting process. It is isn't possible to address one issue, such as the role of proxy advisory firms, without considering the ramifications of that role in other areas, such as continuous disclosure, dematerialized voting, record dates, and the electronic dissemination and aggregation of information pertaining to voting and shareholder meetings.

It is against that backdrop that CSCS provides comments in response to the CSA Consultation Paper.

### **CSCS Responses to solicited concerns**

#### **General**

1. *Do you agree, or disagree, with each of the concerns identified in the Consultation Paper*

CSCS agrees with each of the concerns identified in the Consultation Paper.

2. *Are there other material concerns with proxy advisory firms that have not been identified?*
3. *Are there specific gaps in the current practices of proxy advisory firms which justify regulatory intervention?*

CSCS believes that the gaps relate primarily to disclosure and to the way that proxy advisory firms engage with issuers. Our responses to specific requests for comments follow below.

4. *Do you believe that the activities of proxy advisory firms should be regulated in some respects and, if so, why and how?*

We agree with the regulatory approach set out in section 5.2.1 of the Consultation Paper. Please see our more detailed response below.

#### **Potential conflicts of interest**

5. *To what extent do you consider proxy advisory firms to: (i) be subject to conflicts of interest in practice, (ii) already have in place appropriate conflict mitigation measures, and (iii) be sufficiently transparent regarding the potential conflicts of interests they may face? If you are of the view that current disclosure by proxy advisory firms regarding potential conflicts of interest is not sufficient, please provide specific examples of such insufficient conflicts of interest disclosure and suggestions as to how such disclosure could be improved.*
6. *If you are of the view that there are conflicts of interest within proxy advisory firms that have not been appropriately mitigated, which of these are the most serious in terms of the potential (negative) impact on development of their voting recommendations and why?*
7. *Should we propose an amendment to NI 51-102 to require reporting issuers to disclose consulting services from proxy advisors in their proxy circular? Or would such disclosure undermine the existing controls and procedures (i.e., "ethical wall") in place which currently may prevent proxy advisory firm research staff who review an issuer's disclosure from being made aware of the identity of their firm's consulting clients?*

CSCS does not believe that the conflicts of interest that may arise as a result of the services provided by proxy advisory firms and those provided to issuers raise concerns that justify regulatory intervention beyond suggesting guidelines for the management conflicts, disclosure of conflicts, and procedures in place to mitigate the conflicts, at most in a 'comply or explain' regulatory framework. To date there has not to our knowledge been a situation that gives rise to significant concerns.

Codes of ethics and internal controls to segregate the potentially conflicting operations are appropriate controls.

CSCS does not see how disclosure concerning the source of advisory services related to the development of governance practices assists investors. The governance practices stand on their own and may be judged against best practices regardless of the sources used to develop them. There is an identity of interest in most cases between the governance practices that proxy advisory firms recommend to their clients and those that it recommends that issuers adopt. The risk would be that proxy advisory firms recommend one thing to their clients, and something completely different to issuers, a situation that is unlikely to arise and that if it were to arise, would tend to kill the issuer consulting business, making the issue go away in the normal course.

The situation with respect to auditors and human resources consultants is different. In that case there are independence issues that may arise from conflicts of interest that are likely to impair the judgment of the consultant charged with rendering an opinion on the quality of financial reporting or the appropriateness of compensation levels. The investing public relies on those opinions. That aspect of public reliance on opinion is not present to the same degree with respect to the services of proxy advisory firms.

### **Perceived lack of transparency**

8. *Could disclosure of underlying methodologies and analysis provide beneficial information to the market or would the commercial costs of doing so be too significant?*

To some degree, proxy advisory firms rely on proprietary methodologies that they do not disclose. CSCS believes that disclosure is important, and does not believe that the cost of doing so could be so significant as to impair the profitability of the services rendered.

Some quantitative models have fallen short of expectations, or have been relied upon beyond the point where they were designed to yield meaningful results. A prominent example is the 'value at risk' model that some feel exacerbated risks that the model was meant to measure and mitigate when it was applied to mortgage-backed derivatives.

This is an area where disclosure and academic review can shed useful light on the appropriateness of methodologies and analytical tools.

The risk to the investing public is that the undisclosed 'black box' in the proxy advisory firm's toolbox yields inappropriate results, leading to flawed recommendations.

It may not be necessary to compel disclosure of proprietary methodologies as long as the results are monitored in some way in order to identify whether there are flawed methodologies at work. Requiring that the comments of issuers who disagree with the voting recommendation be disclosed as part of the recommendation and be disseminated to the clients' addresses a part of the concern. Requiring that those contested recommendations be filed with the regulator would provide an opportunity to conduct a review that might determine whether there are consistent flaws in a given proprietary methodology.

### **Issuer engagement**

9. *To what extent could there be an improvement in the dialogue with issuers during the vote recommendation process?*
10. *During proxy season, is it appropriate for a proxy advisory firm to engage with issuers in all circumstances or are there legitimate business and policy reasons why it should not be required to do so? Are there certain special types of situations where it is more important that issuers are able to engage with proxy advisory firms?*

11. *If a proxy advisory firm, as a matter of policy, believes that there are certain circumstances where it is not appropriate for it to give issuers an opportunity to review its reports, would it be sufficient to only require in these circumstances that the underlying rationale for such policy be disclosed? Please explain. Or, alternatively should proxy advisory firms be required to provide issuers with an opportunity to review their reports in all circumstances?*
12. *Should we prescribe the details of the processes that proxy advisory firms implement to engage with issuers? If so, what do you suggest the requirements should be?*

CSCS believes that proxy advisory firms ought to engage with issuers in all cases to allow issuers to review and comment on their voting recommendations.

In all cases issuers ought to be given a meaningful opportunity to comment on a proposed voting recommendation before it is sent to the firm's clients. In the event that the issuer takes issue with the recommendation and the firm declines to amend its recommendation, the issuer's comment on the recommendation should form part of the recommendation and be provided to the firm's clients. In this way the client will have the benefit of the alternative perspective offered by the issuer resulting in better and more balanced information for the client.

It is likely that flawed voting recommendations stem in some measure from the volume of work that the proxy advisory firms are called upon to do.

Some types of information that are required to permit analysis to be carried out presently require substantial effort simply to identify and aggregate information. This is as true for professional decision support service providers as it is for retail shareholders. To the extent that the CSA place special importance on the implementation of XBRL for all types of continuous disclosure information (for instance executive compensation, director compensation, attendance, and seniority to name a few) the effort presently expended on gathering XBRL-amenable information might be devoted to other analytical tasks and this might militate in favour of improved accuracy.

Measures such as these would substantially improve the issuer engagement process by reducing the incidence of flawed recommendations and by serving to address in a fair and balanced way those that remain.

### **Potentially inappropriate influence on corporate governance practices**

13. *To what extent should there be a more fair and transparent dialogue between proxy advisors and market participants on the development of voting policies and guidelines? Is it sufficient for proxy advisors to address governance matters by soliciting comments from their clients?*

CSCS feels that as long as the voting policies and guidelines are made accessible by means of publication, the process of developing the policies and guidelines is a matter that may appropriately be left to the proxy advisory firm and their clients.

### **Proposed regulatory responses and framework(s)**

14. *Do you think a securities regulatory response is warranted in connection with each of the concerns identified above? Please explain why or why not.*
15. *Do you agree with the suggested securities regulatory responses to each of the concerns raised? If not, what alternatives would you suggest?*
16. *Do you agree or disagree with the requirements and disclosure framework set out in section 5.2.1 to address the concerns identified? If not, please indicate why. Would you prefer instead one of the other suggested securities regulatory frameworks identified above? If so, please indicate why. Do you agree or disagree with our analysis of these frameworks? Do you have suggestions for an alternative regulatory framework?*

17. *Are you of the view that we should prescribe requirements in addition to or instead of those identified above for proxy advisory firms?*

CSCS agrees that a regulatory response is justified and agrees as well with the disclosure framework set out in section 5.2.1 of the Consultation Paper.

We would add, in keeping with our earlier remarks, the importance of XBRL tagging to facilitate data gathering and analysis by all investors and their advisors.

**Additional questions for issuers:**

24. *Overall, what has been your experience with proxy advisory firms? Please be as specific as possible.*
25. *Do you believe that the concerns identified negatively affect voting outcomes at shareholders' meetings? Please provide specific examples of situations where any of the concerns identified above resulted in what you consider to be an inappropriate vote outcome and describe the nature and extent of the harm caused to market integrity.*
26. *To what extent do you adopt the corporate governance standards proposed by proxy advisory firms in your choice of corporate governance policies, even if such standards are not appropriate for your organization? Please provide examples of the types of practices that have been changed due to a proxy advisory firm's guidelines and why such changes were not appropriate or did not improve your organization's overall corporate governance.*
27. *In those instances where you have identified potential inaccuracies in a proxy advisory firm's recommendation, were these material inaccuracies that would have resulted in a change in the proxy advisory firm's vote recommendation? Please provide specific examples of how this situation resulted in an improper vote outcome (i.e., what was the risk to market integrity).*

In preparing its response to the Consultation Paper, CSCS surveyed its members and offers the following anecdotal evidence that CSCS gathered from the survey responses:

- Many of our members report that they are aware of flawed voting recommendations on the part of proxy advisory firms.
- Some members report success in having flawed recommendations corrected, while others report that they were unable to have inaccurate or flawed recommendations corrected.
- The following anecdotes were offered:
  - *"We opted in to ISS's proxy review and received a draft, which outlined that they were going to recommend approval of all meeting items. A few weeks later, one of our major institutional shareholders called us to inform us that they had received ISS's proxy review, and it recommended voting against our say on pay and against 2 directors, based on a supposed "lack of gender" diversity. When we called ISS, they seemed to acknowledge that they had made an error, and revised their recommendation back to the original one. We did NOT receive a copy of that 'second', not draft report, so if our institutional shareholder had not called us, it may very well have resulted in an inappropriate vote outcome."*
  - *"We were informed that a proxy advisory firm recommended against a Stock Option Plan amendment. We succeeded in engaging with the proxy advisor and learned that the peer group that had been used as a benchmark in making the voting recommendation was inappropriate for an analysis of our program because the so-called peers were not in the same sector as us, none were competing for the same talent pool as we do, and were very junior issuers, and not at all comparable in terms of*

*scale, either in revenues or headcount. The proxy advisory firm refused to alter their voting recommendation.*

- A number of our members report that changes were adopted to their governance practices that may not have been in the issuer's best interests as a result of pressure brought to bear by proxy advisory firms.
- The following anecdotes were offered:
  - *"We recently amended our by-laws to address a unique issue, but felt compelled to make other changes to our by-laws to satisfy proxy advisors' expectations (e.g., a change to our quorum requirements). The proxy advisors would have recommended against our by-law amendment, even though it was not controversial, unless we amended our quorum provision at the same time."*
  - *"We took a former CEO (who was independent by regulatory standards and one of the best able to understand and question the company's financials) off of our Audit Committee as the proxy advisory firm deemed him not-independent and issued withhold vote recommendations."*

### **Thank You**

On behalf of our members, we thank the CSA for this opportunity to share our comments on proxy advisory firms.

We also look forward to working closely with the CSA in the context of CSCS' continuing focus on shareholder democracy and we feel certain that through stakeholder engagement, and particularly the facilitation program that CSCS is currently suggesting to stakeholders, working together as issuers, investors, regulators, service providers and industry associations, we will come up with a uniquely Canadian solution that will address the significant issues in the proxy voting system and resolve many of the challenges that presently exist.

### **Contacts**

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Sincerely,



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Canadian Society of Corporate Secretaries