Hermes Equity Ownership Services

Hermes Equity
Ownership Services Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

Tel: +44 (0)20 7702 0888
Fax: +44 (0)20 7702 9452

www.hermes.co.uk

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON
M5H 3S8
Fax: 416-593-2318

Email: jstevenson@osc.gov.on.ca

March 31, 2011

Dear Mr. Stevenson,

Re: OSC Staff Notice 54-701: Regulatory Developments regarding Shareholder Democracy Issues

Improving shareholder democracy is central to stockmarkets making themselves attractive to investors by fostering effective dialogue between companies and their shareholders. We welcome this opportunity to review and comment on the important issues outlined in this Staff Notice.

By way of background, Hermes is one of the largest asset managers in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including the BT Pension Scheme, the BBC Pension Trust, The National Pension Reserve Fund of Ireland, the Lothian Pension Fund, PNO Media (Netherlands), Canada's Public Sector Pensions Investment Board, HESTA Super Fund and VicSuper of Australia (only those clients which have expressly given their support to this response are listed here).

Shareholder Democracy Issues

1. Slate voting and majority voting for uncontested director elections

Slate voting refers to a voting practice by which shareholders are able only to vote in respect of an entire slate of director nominees presented by management. Slate voting is in contrast to individual director voting, where shareholders are able to vote in respect of individual director nominees. Ontario securities legislation does not currently prohibit or restrict slate voting at shareholder meetings, through proxy requirements or otherwise. The dominant voting standard in Ontario and Canada is plurality voting, which permits directors to be elected without receiving a majority of votes in their favour.

We are pleased that the Ontario Securities Commission ("OSC") is weighing the merits of reforms to securities law which would facilitate individual director voting and majority voting for director elections of reporting issuers.

Majority Voting

A majority voting standard to elect directors is fundamentally important to investors and is the cornerstone of shareholder democracy. The plurality standard currently used in Canada does not empower shareholders to vote by proxy "for" or "against" directors. Their only right is to vote "for" them, or "withhold" their vote. In the absence of a proxy contest, the "withhold" vote does not bind the board to take any action, even if shareholders overwhelmingly elect to withhold votes from a particular director or slate.

We recognize that most Canadian boards are well run and have been willing to demonstrate accountability by voluntarily adopting a majority vote requirement for director elections. We also believe that most directors serving on these boards, before the adoption of a majority voting policy, would have resigned in the event that a majority of votes were withheld from their election. So the companies that already seem to be the most accountable to shareholders are the ones that have adopted majority voting.

However, many Canadian companies continue to cling to the plurality standard. In fact, almost half of the S&P/TSX Composite Index companies have not moved away from plurality voting, despite the fact that the majority voting campaign has been ongoing since 2004 in Canada. There are many examples from the United States and Canada where a majority of votes were withheld from a director and yet the director did not leave the board. A system that respects basic shareholder democracy should not allow such a result.

For North American corporations, it has been our belief that majority voting in the form of a resignation policy (for example, the Canadian Coalition for Good Governance (CCGG) model majority voting policy) is a reasonable point of departure from a plurality election system. Such a policy fits within existing corporate and securities law and gives the board some leeway to defer a resignation triggered by withhold votes in the extraordinary circumstance where the loss of that director would create a gap in the skills matrix and compromise the functioning of the board. Consequently, such a policy gives some power to shareholders while providing some comfort to directors that the board will not be vulnerable due to the unanticipated loss of key members (and skills). Consequently, we have supported this approach and recommend that the OSC consider, at a minimum, this approach to majority voting as the minimum regulatory standard. We caution that the OSC would have to closely monitor the application of such a majority voting rule to ensure that companies are not disenfranchising shareholders by abusing "holdover" provisions like the one set out in the CCGG model majority vote policy. However, shareholder meetings where an actual majority of votes are withheld from a director will most likely continue to be very rare occurrences in Canada.

Ultimately, we believe that a true majority vote standard is the right model for Canada. Since shareholders have sole responsibility to elect directors, it is reasonable that in the event that, at a shareholder meeting, a majority of the shares represented at the meeting do not support a particular director, that individual should cease to be a director at that time without exception. This is a true majority vote standard. Reinforcing this, the form of proxy should

reflect the choices of “for” and “against” with boxes for each choice clearly placed by the name of each director nominee.

However, we recognize that the implementation of a true majority vote standard would require amending provincial securities laws as well as corporate laws, which would take some time. Further, with a true majority vote standard come legitimate concerns over the possibility of a negative vote and failed board. Solutions based on a holdover of defeated directors are less than ideal. For true majority voting to operate and minimize the problem of failed or compromised boards, we recognize that certain practices must evolve. For example:

- The role of investor relations will need to expand to ensure that, well in advance of the printing of proxy materials and on an ongoing basis, the board is aware of any weak support for any incumbent or nominee director(s) so it can make contingency plans.

- Directors need to better understand the voting guidelines of their key investors.

- Placement agencies and organizations like the Institute of Corporate Directors as well as institutional investors will need to step up their activities to ensure that a larger pool of potential directors with diverse skills is identified.

- Institutional investors will need to be more involved in the director identification process and be willing to dialogue with issuers seeking to understand the position of shareholders with respect their board.

- In deciding how to vote their proxies and specifically, before voting against a director, institutional investors must be willing to dig deeper to understand that a problem actually exists when a voting guideline is contravened.

- Like institutional investors, the proxy advisory and voting service providers need to dig beyond the simple application of a policy to back their recommendations as well.

- The proxy voting and advisory industry needs to evolve so it is less dominated by one or even two key players.

With the adoption of majority voting policies by Canadian corporations and other advances in corporate governance, we have seen progress in the areas noted above. We believe that the implementation of a true majority voting standard in Canada will serve to drive further improvements and that the CSA should review the provisions of the Securities Act and make amendments as needed to support true majority voting. In addition, we believe that the OSC and CSA should set out a requirement that reporting issuers adopt a director resignation policy like the CCGG model.

Slate Voting

Although many have abandoned the practice, there continue to be a significant number of companies that present their directors as a slate and require shareholders to vote for all or none of them, a practice commonly referred to as “slate voting”. Slate voting does not allow shareholders to hold individual directors accountable and is particularly inappropriate once a majority voting standard is implemented. Slate voting should be abolished so that shareholders can cast their votes in respect of each individual director.

The form of proxy, whether paper or electronic, should be standardized so that box is provided for each vote option beside the name of every director.

Reporting of Vote Results

Current CSA requirements for reporting vote results do not go far enough to provide meaningful and complete voting information to shareholders. Specifically, when a vote is conducted by a show of hands, the issuer is merely required to report whether the resolution passed or failed. However, we are aware of situations where a substantial percentage of votes cast by proxy were marked “withhold”, but the vote report filed showed the motion only as carried by show of hands. This does little to build confidence in the proxy voting system. The scrutineer’s report tabulating votes by proxy is always available and should be filed in the company’s vote report. We note that a number of countries are now actively discouraging companies from using voting by a show of hands, and encouraging every vote to be carried out by poll. We believe that this move is appropriate and reflects modern circumstances better than the antiquated show of hands model.

We monitor vote results at portfolio companies very closely. They reflect the views of shareholders on matters of corporate governance, which is important information. For example, shareholders may want to give closer scrutiny to a director who received more withhold votes. The information is also valuable to shareholders for the purpose of identifying trends, evaluating proxy voting policies or possibly even helping determine that their own votes were tabulated.

2. Mandated shareholder advisory votes on executive compensation

We are pleased with new disclosure rules the OSC and other securities regulators have implemented to improve executive compensation disclosure so that it provides shareholders with meaningful information to allow shareholders to get a better understanding of how executives are rewarded. There continue to be gaps, some resulting from the use of sensitive performance metrics that are not disclosed for competitive reasons. Others are due to poor explanations or complexity, making it difficult for shareholders to fully comprehend the compensation structure.

These gaps are best filled through shareholder engagement with the compensation committee of the issuer’s board. Other issues of concern relating to executive compensation are also best discussed with the compensation committee. Securities laws should facilitate a constructive dialogue between shareholders and directors. Implementing shareholder advisory votes on executive compensation (Say-on-Pay) is one way to encourage this dialogue.

The real value of say on pay is that it leads to more dialogue between shareholders and directors, specifically, the compensation committee of the board. We encourage the OSC to further investigate Say on Pay and other ideas or methods that facilitate direct communication between shareholders and directors.

3. Effectiveness of proxy voting system

We are encouraged that the OSC is looking at the proxy voting system generally and with a view to determine whether there is a need for additional reforms and to what extent securities law should address these reforms.

We acknowledge that there are problems inherent in the proxy system that are complex and beyond the scope of the CSA. Because the proxy voting system is an international network, prescriptive rules may create problems as changes to the proxy system made in other markets may require a quick response here in Canada, so there is need for a flexible regulatory regime. However, we believe that improvements can be made by securities regulators in the following areas:

- Elimination of any barriers to communication between shareholders which are not seeking control of a company but want to discuss proxy or long-term issues.

- End to end vote confirmation should be provided to shareholders, at least for electronic voting within Canada. Electronic voting protocols and systems that provide for such messaging are in place and in use in other markets. Regulatory pressure is needed to get all the players to build the necessary systems to facilitate such vote confirmation, domestically and globally.

- Ways to improve accuracy of voting in an opaque system. This could be in the form of a periodic or random audit of a specific meeting to determine the quality of processing by the various parties. Such audit could be done by a third party or by the OSC. The OSC should be able to levy significant fines against participants who have failed to process votes as directed by each beneficial shareholder.

Next steps

We are very interested to see what comes out of this review process and we take this opportunity to express our interest in participating in any future consultations with stakeholders on these matters. We are of the view that the matters outlined in the *Staff Notice 54-701 – Regulatory Developments Regarding Shareholder Democracy Issues* are of national interest and we would urge the OSC to develop a joint position with other Canadian securities commissions on these important questions. Other commissions can bring insightful comments which could benefit all market participants.

Sincerely yours,

William Mackenzie
Senior Advisor