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**Private & Confidential**
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

**Attention:**

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8

20 August 2012

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

Ladies and Gentlemen:

This letter is submitted on behalf of Mercer (Canada) Limited ("Mercer") in response to the Canadian Securities Administrators' (CSA) request for comment on Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms (issued June 21, 2012 and referred to herein as the "Consultation Paper").

Mercer is a global company that provides human resources and related financial advice, products, and services, including compensation consulting services to corporations, boards of directors, and board human resource and compensation committees. Mercer's Human Capital Executive Rewards business unit provides executive compensation and benefits consulting services to companies around the globe, including major Canadian and US publicly-traded companies. We assist clients in designing and implementing executive and director remuneration programs. We also have extensive experience working with proxy advisory firms and institutional investors. Based on this experience, we appreciate the difficulties issuers have in understanding the advisors' proxy vote recommendation process and the complexities issuers encounter in addressing the advisors' concerns.

Mercer is a wholly-owned subsidiary of Marsh & McLennan Companies, Inc. The comments and recommendations expressed in this letter reflect the views of Mercer and do not necessarily represent the views of Marsh & McLennan Companies, Inc. or its affiliated companies, or those of our clients.

We are aware that our colleagues in Mercer's Investment Consulting business unit have also responded to the CSA's request for comment. Whereas Mercer Investment Consulting has provided comments drawing on their experience as a leading global provider of investment consulting services to Canadian pension plans and other institutional investors, our comments below reflect Mercer's Human Capital Executive Rewards business unit's perspective based on our experience working with issuers.

**General Observations**

We would like to express our overall support for the objectives of the Consultation Paper: to provide a forum for discussion of certain concerns raised about the services provided by proxy advisory firms and their potential impact on Canadian capital markets and to determine if, and how, these concerns should be addressed by Canadian securities regulators.

In light of specific concerns noted by the CSA about proxy advisory firms that have been raised by market participants, primarily issuers and their advisors, we support the CSA's initiative. These concerns include: (i) potential conflicts of interest, (ii) perceived lack of transparency, (iii) potential inaccuracies and limited engagement with issuers, (iv) potential corporate governance implications, and (v) the extent of reliance by institutional investors on the recommendations provided by proxy advisory firms.

We also note there are several aspects of the Consultation Paper that are similar to a Concept Release issued by the US Securities and Exchange Commission (SEC) in 2010, that also sought comments on the extent to which the voting recommendations of proxy advisory firms serve the interests of investors in informed proxy voting, and whether, and if so, how, the SEC should take steps to improve the utility of such recommendations to investors. In particular, the SEC sought comment on whether it should clarify existing regulations or propose additional regulations to address concerns about the existence and disclosure of conflicts of interest on the part of proxy advisory firms, and about the accuracy and transparency of the formulation of their voting. Although the comment period ended in October 2010, and many comments were received, the SEC has not yet taken action on this initiative. We believe the Consultation Paper will help the CSA address similar concerns raised in Canada and possible regulatory responses.

In addition, a consultation paper requesting comments on the proxy advisory industry and possible policy options has been issued by the European Securities and Markets Authority (ESMA). Comments on that paper were due June 25, 2012.

**5.3. Specific request for comment**

We have the following responses to the CSA's specific requests for comments:

**General**

*1. Do you agree, or disagree, with each of the concerns identified in the Consultation Paper, namely: (i) potential conflicts of interest, (ii) perceived lack of transparency, (iii) potential inaccuracies and limited engagement with issuers, (iv) potentially inappropriate influence on corporate governance practices, and (v) the extent of reliance by institutional investors on the advice of such firms? Please explain and, if you disagree, please provide specific reasons for your position.*

We agree with each of the concerns identified in the Consultation Paper, particularly in light of the significant influence of the proxy advisory firms on institutional investor voting and their *de facto* influence on companies in the design of compensation programs and adoption of governance practices, as discussed below.

*2. Are there other material concerns with proxy advisory firms that have not been identified? Please explain.*

We have not identified any additional concerns.

*3. Are there specific gaps in the current practices of proxy advisory firms which justify regulatory intervention? Is there a concern that future gaps could be created as a result of new entrants or changes in business or other practices?*

We believe the limited competition in the proxy advisory business will continue and enhances the need for regulation. With two firms – Institutional Shareholder Services (ISS) and Glass Lewis & Co. – dominating proxy advice in Canada, and few likely new entrants to the market, we are concerned that failure to regulate this industry could harm market integrity. With little competition in the industry, it is critical that the proxy advisory firms provide thorough and fair analyses based on accurate information and that their proxy vote recommendation process is transparent and responsive to issuer concerns as well as those of institutional investors.

Also, with the advent of shareholder advisory votes on executive compensation (or say-on-pay policies) in Canada, the influence of the proxy advisory firms is likely to increase. To date, close to 100 Canadian companies have adopted say-on-pay policies, according to Shareholder Association for Research and Education (SHARE). In the US, many institutional investors have deferred to the proxy advisory firms in determining how they should vote on say-on-pay proposals given the substantial increase in the number of proxy votes on ballots each year and the difficulty institutional investors have in evaluating the pay programs of so many issuers. This increase in influence makes it more critical that regulation of proxy advisors be considered, particularly given the shortage of competition in the industry.

In addition, the influence of the proxy advisory firms is likely to continue to increase in light of the move away from plurality voting toward majority voting in director elections in Canada. The Canadian Coalition for Good Governance (CCGG) has recommended companies adopt a majority vote standard for director elections and several companies have adopted a majority standard as a best practice. With majority voting, proxy advisors could further enhance their power by recommending shareholders vote against directors if their concerns are not being addressed. This puts even greater emphasis on ensuring the proxy advisors conduct thorough analyses and reach fair and accurate conclusions.

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

We believe the proxy advisory firms should be regulated to ensure their potential impact on market integrity is not unduly influenced by the conflicts of interest and lack of transparency that exist in the market today. As the Consultation Paper notes, although it is not clear how much influence the proxy advisors have in Canada, it is clear that they have significant influence in the US. The US GAO report notes institutional investors state they do not delegate their fiduciary duties to the proxy advisors and retain the right to override their recommendations. However, in practice in the US, the proxy advisory firms have had substantial influence over shareholder vote results. For example, so far in 2012, 18% of companies where ISS recommended shareholders vote against the say-on-pay proposal failed to receive majority shareholder support. Of issuers receiving a favourable ISS recommendation, less than 1% failed. Also, in 2011 and 2012, say-on-pay vote results for companies that received negative recommendations from ISS were on average about 20% lower than companies that received a favourable ISS recommendation.

Also, the proxy advisors' influence is not limited to vote results. As discussed below, issuers are increasingly making decisions about compensation program design and governance matters in response to proxy advisors' pay and governance policies and guidelines. This could pressure companies to implement plans and programs and adopt practices that are inconsistent with their overall business strategies and policies. We have seen this play out in the equity plan approval area in the US. Issuers feel pressure to adjust their stock compensation plans to pass the ISS or Glass Lewis tests even if those changes may not best suit the issuers' particular circumstances.

**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.*

We believe that a proxy advisory firm may have a conflict of interest if it provides consulting services to issuers on the same matters on which it provides vote recommendations to institutional investor clients. For example, ISS provides analyses and voting recommendations on proxy ballot issues to institutional investors and also provides consulting services to issuers whose proposals they evaluate. We believe this dual role could undermine the ability of ISS to provide "independent" analysis of issuer policies and practices to its institutional investor clients. There is a perception that ISS may treat issuers that pay for consulting services more favourably.

In addition, ISS is a wholly-owned subsidiary of MSCI, which provides risk consulting and investment tools to institutional investors. There is a concern that MSCI may pressure ISS to review MSCI clients more favourably. Glass Lewis's parent firm, the Ontario Teachers' Pension Plan, is the largest single-profession pension plan in Canada and may invest in issuers on which Glass Lewis makes ballot recommendations. The advisory firms state they have policies and procedures in place to mitigate these conflicts, but it is difficult to determine whether these firewalls and compliance programs are effective conflict mitigation measures.

We recommend rules mandating that proxy advisors identify and disclose these potential conflicts to the public, not just in reports issued to paying subscribers. The advisory firms should be required to explain the exact nature of the conflict (e.g., whether the firm has received consulting fees from the issuer), how the firms' conflict of interest policies and procedures are implemented and how the advisor concluded that the policies and procedures are effective tools for managing conflicts. These disclosures should appear prominently on the advisors' websites as well as in an obvious place in their reports to issuers and institutional shareholders.

The advisors' current disclosures are not adequate. For example, both ISS and Glass Lewis discuss their business model and reference their conflict of interest policies and procedures on the final page of their proxy analysis reports. Glass Lewis directs readers to a website for disclosure of their conflict of interest policies and procedures. ISS states in small type:

> This issuer may have purchased self-assessment tools and publications from ISS Corporate Services, Inc. ("ICS"), a wholly-owned subsidiary of Institutional Shareholder Services Inc. ("ISS"), or ICS may have provided advisory or analytical services to the issuer in connection with the proxies described in this report. No employee of ICS played a role in the preparation of this report. If you are an ISS institutional client, you may inquire about any issuer's use of products and services from ICS by emailing disclosure@msci.com.

We recommend that the disclosure be located where it is easily visible to an investor relying on the report and its recommendations and that the disclosure should be transparent so investors understand the exact nature of the conflicts.

*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?*

We believe proxy advisors that sell consulting services to the same issuers whose proxies they review and on which they issue vote recommendations may present conflicts of interest that should be addressed. For example, many issuers feel obligated to pay to engage ISS for consulting services on how to structure their pay programs or present management resolutions in order to receive a favourable vote recommendation from the proxy advisor. It is noteworthy that other proxy advisors, such as Glass Lewis, state that it is against their policy to accept fees from issuers for consulting services since it would constitute a conflict of interest. Even ISS acknowledges the potential for conflicts of interest with this business model and has created "firewalls" to separate the conflicting businesses. Due to a lack of transparency about the nature of the firewalls, it is not clear whether they adequately mitigate these conflicts.

*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?*

We believe this type of disclosure could help shareholders understand how the issuer engaged with the proxy advisory firms to understand their concerns and to explain any changes made in response to those concerns.

**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?*

We believe that disclosure of the proxy advisors' underlying methodologies and analysis would provide issuers and other market participants with useful information about the advisors' procedures and conclusions without undue cost to these firms. For example, the current “black box” approach to the advisors' analyses and vote recommendations makes it difficult for issuers to understand how to respond to the advisors' concerns and those of their institutional investor clients. For example, Glass Lewis does not publish details of its voting guidelines and states its evaluation is conducted on a case-by-case basis. This raises concerns that it may be inconsistent in its application of its voting policies. Also, the lack of transparency makes it difficult for issuers to determine where mistakes have been made in the analyses or where data may be inaccurate. Also, ISS's more formulaic approach raises concerns about using a one-size-fits-all approach to evaluate pay and governance matters that should be considered in light of the issuer's unique business strategy and objectives. However, the lack of transparency is consistent with both methods and makes it difficult for issuers to anticipate how an advisor will advise its clients on ballot measures.

Generally, proxy advisory firms don't disclose how they arrive at their vote recommendations. For example, in examining the relationship between company pay and executive performance, proxy advisors don't disclose the inputs, formulas and weightings used in their models and methodologies. This can make it difficult for issuers as well as institutional investors to evaluate the pros and cons of the models and methodologies to assess the quality of the advisors' recommendations. For instance, although ISS explains the factors considered in determining a company's peer group for pay and performance comparisons, it is not possible for issuers to determine the companies in the peer group with exactness. Issuers may find ISS has chosen peers in a different industry than the company that the issuer does not consider its competitors.

Also, ISS uses its own method for valuing stock options that assumes they are held for the full term. This is different from how they are valued in the Summary Compensation Table and often produces anomalous results. For example, in the US, ISS's use of a non-GAAP valuation method resulted in the over-valuation of the stock options of many issuers and skewed the results of their pay-for-performance tests.

In addition, proxy advisors that use a formulaic and non-transparent approach to evaluating pay programs and providing vote recommendations make it difficult if not impossible to understand where potential conflicts of interest may exist and how they may affect vote recommendations. Requiring advisors to disclose their methodologies and analyses would not only provide beneficial information to issuers, investors and the market generally but would also shed light on potential conflicts that may compromise the independence of their advice.

**Issuer engagement**

*9. To what extent could there be an improvement in the dialogue with issuers during the vote recommendation process?*

Some of the proxy advisory firms prohibit issuer engagement during the proxy season and vote recommendation process. For example, Glass Lewis has a blackout during the proxy solicitation period during which issuers may not contact the firm with questions about pending proxy proposals. This makes it difficult or impossible for issuers to question the advisor's analysis and conclusions.

We believe the proxy advisors should be required to keep certain channels of communication open throughout the proxy season and vote recommendation process so issuers can address factual errors and questionable vote recommendations. Both Glass Lewis and ISS have created portals through which issuers can report data discrepancies but it is not clear whether they will receive a response from the advisors and whether the errors will be corrected. We recommend that the proxy advisors be required to give issuers an opportunity to review draft reports before voting recommendations are released and that they respond to concerns raised by the issuers.

In the US this past proxy season, a significant number of companies filed supplemental proxy materials questioning the proxy advisors' analyses and conclusions. If issuers had a channel to dialogue with the proxy advisors during this time, it may not have been necessary for them to go directly to shareholders to address their concerns about peer group selection, option valuation and other controversial proxy advisor voting policies.

*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?*

There are legitimate business and policy reasons why proxy advisory firms should not be required to engage with issuers *without limitation* during proxy season. However, we believe there are circumstances in which the advisors should be required to engage with issuers such as where the issuer is questioning the accuracy of the advisor's data and where the advisor is preparing to issue a negative vote recommendation to its institutional shareholder clients.

When proxy advisors refuse to engage with issuers during the proxy season, particularly following a negative vote recommendation, issuers have to go directly to institutional investors to explain why the investors should not follow the proxy advisor's recommendation. This frustrates issuers who want to be able to properly address the data and analysis that led to a negative vote recommendation. And it burdens investors who may feel compelled to reconsider a voting recommendation in light of conflicting information from the issuer.

*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?*

We believe the proxy advisors should be required to allow all issuers to review their reports, but particularly where the proxy advisor is preparing to issue a negative vote recommendation. Given the influence these reports have on institutional investor voting, issuers should have ample opportunity to check the accuracy of the data in the reports and be aware of the report's conclusions and vote recommendations before they are released.

Some proxy advisors allow only large issuers to review their reports in advance of publication and provide a very short time for review. Giving *all* issuers adequate time to review their reports will enable issuers to report errors to the proxy advisor so they can be corrected before the report is released. Issuers often find errors in the data underlying the proxy advisor's conclusions that, if corrected, could alter the advisor's vote recommendation. If an advisor does not correct the errors until after the report is issued, institutional investors may have already submitted their votes.

With limited access to the methodology used and limited understanding of the conclusions drawn, it is difficult for issuers to question the advisors' analyses. Since many institutional investors, particularly smaller ones, rely heavily on the advisors' recommendations, the advisors should have an obligation to ensure their data is correct and conclusions are warranted. For example, ISS does not allow smaller companies to review reports and declines to accept responsibility for their accuracy by including on their reports the following legend:

> While ISS exercised due care in compiling this analysis, it makes no warranty, express or implied, regarding the accuracy, completeness or usefulness of this information and assumes no liability with respect to the consequences of relying on this information for investment or other purposes.

We do not recommend the proxy advisors be required to guarantee the accuracy of the data. However, we suggest the advisors be required to take the following steps to minimize data inaccuracies or misinterpretations and to allow issuers adequate opportunity to respond to concerns raised in advisor reports:

- Set the release date for draft advisor reports at least one week before the final release date to ensure issuers have adequate time to review the draft reports

- Provide issuers with at least a three-day window to confirm that the data in the report is correct and respond to the proxy advisor before the reports are finalized and released to institutional investor clients

- Be receptive to issuer concerns, correct any errors noted by issuers and send a revised report to institutional investor clients

- Include a statement in the final report explaining any disagreements between the issuer and the proxy advisor and allow issuers to respond to or rebut their recommendations and analyses in the final report

- Ensure institutional investors receive timely notification of the corrections and any changes to the advisors' vote recommendations.

These steps will further protect the proxy advisors' institutional investor clients by helping them fulfill their fiduciary duties to their individual investors and enhance the integrity of the proxy voting process.

We appreciate that institutional investors are the primary client base of the proxy advisory firms and that these institutions have fiduciary duties to make informed and rational decisions on behalf of their participating investors. This is reflected in the proxy advisors' efforts to maintain a standardized approach to evaluating proposals and making vote recommendations that is not swayed by issuer input. However, we are concerned that institutional investors may not be getting the best advice if it is compromised by potential conflicts of interest, is based on inaccurate data and lacks a clear understanding of the issuers' unique characteristics and situation. The growing complexity of issues presented for shareholder voting has placed unprecedented demands on institutional investors in exercising their fiduciary duties, which has in turn increased the need for proxy advisor services. Thus, there needs to be effective safeguards to ensure the proxy advisory firms are providing their institutional investor clients with the accurate information and objective analyses.

*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?*

We do not think it would be necessary or appropriate to prescribe the details of the processes that proxy advisory firms implement to engage with issuers because each issuer has different engagement needs to fit its business model. However, we believe it would be appropriate to prescribe minimal requirements that the proxy advisors must follow if approached by an issuer for a dialogue such as to report inaccuracies in the advisors' reports or to discuss a potential negative vote recommendation.

**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?*

We believe the proxy advisors should be required to engage with *all* market participants in the development of their voting policies and guidelines to consider a variety of points of view before finalizing their guidelines. By soliciting comments only from institutional investor clients, the advisors are not considering the concerns of all stakeholders.

We believe the proxy advisors have become *de facto* standard setters for corporate governance best practices and as such should be required to solicit input in developing or revising their voting policies and guidelines from all stakeholders, including institutional investors and issuers. The advisors' one-size-fits-all approach to governance best practices has caused some issuers to adopt governance policies that satisfy the advisors' standards in order to receive a favourable vote recommendation but that may not necessarily have been most suitable to the issuer's unique structure and thus not in the best interest of the company and its shareholders. Although ISS solicits input for its voting guidelines each year, it is not clear how this input contributes to the final policy guidelines since there is little transparency in the policy development process.

**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.*

We believe a limited securities regulatory response is warranted to address the conflicts of interest, transparency and accuracy concerns raised in the Consultation Paper since these have the greatest potential for abuse. Given the significant influence of proxy advisors on the proxy voting process and results, we believe they should be subject to oversight through securities regulation of their processes and disclosure.

*15. Do you agree with the suggested securities regulatory responses to each of the concerns raised? If not, what alternatives would you suggest?*

Requiring registration as advisors might not be appropriate, and legislative action to create a new regulatory system for proxy advisors may not be practical. However, we agree that the framework proposed in 5.2.1 of the Consultation Paper would be an appropriate regulatory response. This system would require proxy advisors to comply with rules established by securities regulators that could address concerns about conflicts of interest, transparency and data accuracy. These rules should be drafted with input from all stakeholders, including issuers, proxy advisors and institutional investors. The rules should accomplish the following:

- Prohibit proxy advisors from charging fees for providing consulting services on the same matters on which they provide vote recommendations or require adequate safeguards to mitigate such conflicts of interest

- Require disclosure of conflicts of interest that arise from their role as advisors to issuers and investors and their ownership structure

MERCER



- Require detailed disclosure of voting guidelines and methodologies for analyzing ballot measures, including pay programs and governance practices

- Mandate periodic securities regulatory review of research reports to monitor accuracy and transparency

*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?*

We agree with this proposed response.

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

We do not have any additional requirements that should be prescribed.

*******

We appreciate the opportunity to comment on the Consultation Paper, and respectfully request that the CSA consider the recommendations set forth in this letter. We are prepared to meet and discuss these matters with the CSA at its convenience. Any questions about this letter may be directed to Lisa Slipp (416) 868-7665.

Respectfully submitted,

L Slipp

Lisa Slipp
Partner