Institute for governance
of private and public organizations

Submission of IGOPP to the Canadian Securities Administrators in reply to the Request for Comment on the Proposed National Policy 25-201

Guidance for Proxy Advisory Firms

Institute for Governance (IGOPP)
Montréal, Québec

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Toward Value-Creating Governance™

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Acknowledgement

The board of the Institute for Governance (IGOPP) has formally approved this comment in reply to the CSA Notice and Request for Comment: Proposed National Policy 25-201 Guidance for Proxy Advisory Firms.

Mr. Louis Morisset, President and CEO of the Autorité des marchés financiers du Québec abstained because of the regulatory role of the Autorité.

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INTRODUCTION

IGOPP has issued in 2013 a policy position on the role of proxy advisors titled *The Troubling Case of Proxy Advisors: Some policy recommendations*. This submission draws largely from that policy paper and, hence, it is attached as an appendix.

The proposals of the CSA to raise somewhat the level of disclosure requested from proxy advisors is commendable but clearly not sufficient. **Normative** measures are required to ensure appropriate supervision of the activities of proxy advisors, given their significant influence on corporate governance and their role in the processes of acquisitions and proxy battles.

Numerous issues are identified in the Proposed National Policy 25-201. We intend to respond by addressing the specific questions contained in the CSA Notice and Request for Comment.

QUESTION #1

Do you agree with the recommended practices for proxy advisory firms? Please explain.

To respond to this question, we shall review the various subject-matters included in the Proposed National Policy.

CONFLICTS OF INTEREST

The measures proposed in sections 2.1(3) to 2.1(7) appear to us to be insufficient to eliminate actual or potential conflicts of interests which may stem from a situation described in 2.1(2). Thus, the assertion proposed in section 2.1(1) of the Proposed National Policy, which reads as follows:

"Effective identification, management and mitigation of actual or potential conflicts of interest are essential in ensuring the ability of the proxy advisory firm to offer independent and objective services to a client."

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Should rather be worded as follows:

"It is essential to **prevent** actual or potential conflicts of interests so the proxy advisor firm is able to provide independent and objective services to its clients".

The implementation of firewalls and "Chinese walls" to ensure that no communications seep from one unit to the other has given poor results in other industries where such firewalls were deemed to be in place. It is a dubious practice, as was shown for credit rating agencies, to allow an organization to run two entities under the same corporate roof:: one selling services to corporations which can be helped or hurt by the "independent advice" sold to investors by the other entity.

For instance, the movement of staff between the two units, a normal practice in all corporations, becomes a problem in this case.

Calling for "setting and preserving a culture of compliance respecting conflicts of interest" in proxy advisor firms may be a form of wishful thinking. The establishment of policies and procedures, internal controls or a formal code of conduct cannot guarantee a leak-proof barrier between the business units involved. Ideally, proxy advisory firms should be adopting policies, or be forced to adopt policies such as were imposed on auditing firms, which now are prohibited from offering management-consulting services to corporations they audit.

Furthermore, a similar prohibition has been put in place for rating agencies.

Part 240 – General rules and regulations, Securities Exchange Act of 1934; Section 17g-5 states :

> *"(c) Prohibited conflicts. A nationally recognized statistical rating organization is prohibited from having the following conflicts of interest relating to the issuance or maintenance of a credit rating as a credit rating agency :...*
>
> *(5) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to an obligor or security where the nationally recognized statistical rating organization or a person associated with the nationally recognized statistical organization **made recommendations** to the obligor or the issuer, underwriter, or sponsor of the*

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security ***about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security****"(Emphasis added)*

Thus, we recommend:

- ***Canadian regulators should prohibit proxy advisory firms from offering their corporate services to corporations about which they issue proxy voting recommendations to their institutional clients***

TRANSPARENCY AND ACCURACY OF VOTE RECOMMENDATIONS

According to Section 2.2(1), "[i]t is important for market participants to understand how proxy advisory firms arrive at a specific vote recommendation and to assess the quality of the research and analysis behind such a recommendation."

Indeed, as we wrote in our policy paper[1], the fundamental problem of proxy advisors resides in their very particular *business model*, which is a tremendously challenging undertaking.

Because their clients, institutional investors, collectively own shares in all publicly listed companies, they have to provide "advice" for all these corporations.

The form 10K of MSCI (the parent of ISS) reports that ISS provides research coverage on over 6,000 U.S.-based companies and over 20,000 non-U.S. companies. Glass Lewis did so for some 16,000 companies! (Latham & Watkins LLP mars 2011).

In 2009, there were more than 20,000 management and shareholder proposals at Russell 3000 companies; and that's before "Say-on-Pay" votes became mandatory! (Source: Investment Company Institute, *Research Perspective 16, no.1*, November 2010).

More than 54% of annual shareholder meetings in the USA were held in April, May or June (Council of Institutional Investors, 2010).

In Canada, some 1,570 companies are listed on the TSX and another 2,200 are listed on the TSX Venture. The financial year of roughly 84% of companies listed on

[1] Allaire, Y. (2013) *The Troubling Case of Proxy Advisors: Some Policy Recommendations*. IGOPP Policy Paper N° 7 – document attached hereto.

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the TSX ends on December 31st. For some 80% of TSX listed companies, there were less than 50 days between the date the Management Information Circular is received by shareholders and the ultimate date for proxy voting (IGOPP research, 2012).

Proxy advisory firms use these statistics to justify their usefulness and promote their services. But these very statistics create a fundamental issue for these service providers and raise basic questions about their business model. ***How can they cope with this mass of data and come up with fair and thoughtful recommendations for thousands of corporations in a matter of a few weeks in the spring of each year?***

They have to resort to one of two measures, or a combination of the two, to achieve this feat, but at a cost in quality and reliability:

1. A standardized grid, a sort of simplified algorithm (often termed a "cookie-cutter" or a "one-size-fits-all" approach), with which corporations are scored for their governance, boards are assessed, compensation is appraised, and shareholder proposals are vetted.
2. The hiring of temporary staff, as well as farming out of the analytical part of the process to low-cost countries, to cope with the avalanche of data in the spring; that coping mechanism raises the issues of competence and training of these part-time employees.

These unavoidable circumstances of the proxy advisor business model make the whole process highly suspect. If only one tenth of companies processed by proxy advisors were to submit that their reports contain errors and inaccuracies and request changes, these proxy advisors would be swamped and unable to cope, as they have admitted forthrightly:

> *"The demands on ISS during proxy season might mean there is no direct response from the firm, but [the president of ISS] assured the participants that the comments received are taken into account as long as the information referenced has been publicly disclosed."*

(Source: Audit Committee Leadership Network in North America View Points: ***A dialogue with Institutional Shareholder Services***, Issue 39 : November 7, 2012).

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Thus, we recommend:

Clients of proxy advisors should insist on divulgation of all pertinent details of the business models used by proxy advisors: part-time vs. full-time employees, location of employees, extent of work performed in foreign countries, training of employees.

Regulators should require that proxy advisors report on their standards of training and experience for their analysts, somewhat akin to what is required of rating agencies at this time.

The SEC has proposed the following standards and rules for credit rating agencies (formally known as Nationally Recognized Statistical Rating Organizations or NRSROs):

> *"Consistent with Section 936 of the Dodd-Frank Act, the proposed rule would require NRSROs to establish standards of training, experience and competence for credit analysts and to :*
>
> > *Consider certain factors when establishing the standards, for example the complexity of the securities that will be rated by the analyst.*
> >
> > *Periodically test its credit analysts on the credit rating procedures and methodologies it uses.*
> >
> > *Require that at least one individual **with three or more years of experience** in performing credit analysis participates in determining a credit rating" (Emphasis added)*

Regulators should insist that proxy advisors show that the employees responsible for the issuing of voting recommendations have an adequate level of experience with actual board functioning and the practical aspects of governance.

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COMMUNICATIONS WITH CLIENTS, MARKET PARTICIPANTS, THE MEDIA AND THE PUBLIC

Proxy advisers offer their opinion on almost all litigious, contentious issues from hostile takeover attempts to proxy fights and other board challenges. As these issues often come about as a result of the actions of some activist hedge funds, a proxy advisor's favourable opinion, from ISS particularly, is an important and valuable input for an activist fund trying to win its case.

Proxy advisors make recommendations about the price offered in takeovers, and offer their opinion about the validity of the case made by "activist" funds to change a company's strategy, governance or board members. They advise their institutional clients (and all shareholders, as their opinions are widely broadcast in the media) on whether or not to hand in their shares at the proposed price, or to support the "activist" funds' proposals.

Thus, we recommend:

- ***Whenever proxy advisors get involved in takeover situations or proxy contests, their opinion should be accompanied by a declaration informing all parties concerned whether the proxy advisor has, during the previous two years, acted as a consultant for any of the parties involved in the transaction.***

Indeed, Canadian regulators should adopt the suggestion made by Wachtell, Lipton, Rosen and Katz in their submission to the SEC : "*Proxy advisory firms should be required to disclose in their recommendations whether the advisor has, currently or within the recent past, been engaged by any participant in the relevant proxy contest, whether any of the interested parties in a contest subscribe to the proxy advisory firm's services, and the aggregate fees paid by the interested parties to the proxy advisory firm".*

Obviously, if our recommendation on conflicts of interests was adopted, there would be no need for this latter recommendation as proxy advisors would be subject to a general prohibition against acting in this capacity.

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QUESTION #2

Are there any material concerns with proxy advisory firms that are not covered in the Proposed Policy? Please explain.

The Proposed National Policy contains few or no answers to the particular problem raised by issues respecting takeovers or proxy contests, or about what constitutes (in the eyes of the proxy advisor firms) “good” governance or an adequate compensation system.

Proxy advisors stand in a bully pulpit from which they harangue corporate management and boards of directors on all matters of governance and compensation; neither investors, nor investment advisers, they enjoy a franchise to advise investors on how to discharge their duty or fiduciary responsibility as shareholders.

The dominant actor in this business, ISS, also counsels corporations on how to adjust to, and implement, the advice it is giving to institutional investors.

A relevant question in this regard was asked by one of the participants during the roundtable organized by the SEC December 5th 2013[2]:

> “The question really is whether, frankly, ISS which owns no stock should have the power of a $4 trillion voter, and I think that really is sort of the question that these regulatory quirks that we've been talking about have sort of led to. The policies that ISS adopts become de facto standards that everybody has to meet. [...] The voting recommendations are the tip of the iceberg. What happens in the boardroom when everybody says, "Oh, ISS is not going to accept this so we're not going to do it," is the iceberg itself.”

TREVOR NORWITZ, Partner, Wachtell, Lipton, Rosen & Katz

The activities and influence of these proxy advisors must be controlled. Their role in defining what constitutes good governance, what is an effective board and how executives should be compensated is highly questionable. They publish

[2] U.S. Securities and Exchange Commission, Proxy Advisory Firms Roundtable, Thursday, December 5, 2013

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statements on governance with little support from empirical research. They have to face up to the implacable logistics of the yearly proxy process, which they can only do by adopting coping mechanisms that are unsatisfactory and sometimes clearly harmful.

In situations where proxy advisor firms give their opinions concerning a takeover or a proxy contest, or in other disputed contexts, we reiterate the importance of the recommendation made in response to question 1, under the theme "*Communications with clients, market participants, the media and the public*".

QUESTION #3

Will the Proposed Policy promote meaningful disclosure to the proxy advisory firms' clients, market participants and the public? If not, what additional information should be disclosed?

In section 2.4.2 e) of the Proposed Policy, it is stated that "[w]hen issuing its vote recommendations, we expect proxy advisory firms to also communicate all of the following information to their clients in their reports: [...] where applicable, the nature and outcome of any dialogue or contact with an issuer in the preparation of the vote recommendations".

In our opinion, it would be important to know the deadline given to the issuer to respond, the time required to make a response, if need be, and the proxy advisor firm's explanation if it chooses not to change its opinion (advice) following the exchange with the issuer (in cases where the issuer wanted a change made).

Generally, the nature and outcome of the dialogue or exchanges with the issuer during the development of the recommendations should be explicitly disclosed in the proxy advisor firm's reports.

In any case, the time available to proxy advisors to deliver their thousands of opinions to their clients in a timely manner is so short that this kind of dialogue is virtually impossible. Indeed, that is a large part of the problem with proxy advisors.

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QUESTION #4

We encourage proxy advisory firms to consider designating a person to assist with addressing conflicts of interest. Should we also encourage proxy advisory firms to have a person assist with addressing determination of vote recommendations, development of proxy voting guidelines and communication matters?

As mentioned in the response to Question 1, proxy advisor firms should, at the very least, have to disclose to their clients (and to all interested parties when giving their opinion on acquisitions or proxy fights) any situation of actual or potential conflict of interests; that is, if the regulators choose not to eliminate their possible occurrence.

Proxy advisor firms should provide with their voting recommendations to their institutional clients the list of all the corporate clients to whom they have sold other services.

When a proxy advisor firm issues an opinion about a disputed matter (takeover, proxy contest, etc.), it should divulge which parties, if any, are or have been clients of the proxy advisor.

The proposals of the CSA amount to organizational arrangements that do not go to the heart of the problem.

QUESTION #5

We expect proxy advisory firms to disclose their approach regarding dialogue or contact with issuers when they prepare vote recommendations. Should we also encourage proxy advisory firms to engage with issuers during this process? If so, what should be the objectives and format of such engagement?

We believe that it is in the interest of all parties that there be open communication between proxy advisor firms and issuers, if only to reduce the risk of inaccuracies. Generally, as mentioned in response to Question 3, the nature and outcomes of dialogue or exchanges with an issuer during the development of recommendations should be explicitly disclosed in the proxy advisor firm's reports.

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It would be appropriate for proxy advisor firms to begin discussions with issuers and other parties ***before they adopt any policy or standard on what constitutes "good" governance***. *Proxy advisors should be more sensitive to differences in the context of governance from one country to the next.* For example, Canada differs from the United States in several critical aspects. For instance, Canadian corporations with dual class of shares have almost universally adopted a "coattail" provision whereby the controlling shareholder through a multiple-vote shares, cannot sell its controlling shares at a price that is not offered to the minority shareholders. There is no equivalent provision in the United States.

QUESTION #6

A proxy advisory firm may provide automatic vote services to a client based on the proxy advisory firm's proxy voting guidelines. Should we encourage proxy advisory firms to consider obtaining confirmation that the client has reviewed and agreed with the proxy advisory firm's voting guidelines leading to vote recommendations?

Yes.

If so, should we encourage the proxy advisory firms to consider obtaining such confirmation annually and following any amendments to the proxy advisory firm's proxy voting guidelines?

Yes. We support this proposal which seems to be inspired by the elementary respect that any fund manager should show its clients.

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ABOUT IGOPP

Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business) and the Stephen Jarislowsky Foundation, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

Our Mission

- Strengthen fiduciary governance in the public and private sectors;
- Make organizations evolve from a fiduciary mode of governance to a ***value-creating governance®***;
- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

Our Activities

The Institute's activities focus on the four following areas:

- Policy papers
- Training
- Research
- Knowledge dissemination

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