1.1.4 CSA Consultation Paper 25-401 – Potential Regulation of Proxy Advisory Firms

CANADIAN SECURITIES ADMINISTRATORS

CONSULTATION PAPER 25-401:

POTENTIAL REGULATION OF PROXY ADVISORY FIRMS

June 21, 2012

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INTRODUCTION

The purpose of this consultation paper (the Consultation Paper) is 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.

The specific concerns about proxy advisory firms that have been raised by market participants, primarily issuers and their advisors, fall into the following broad categories: (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.

While we acknowledge these concerns, we also recognize that the relationships between proxy advisors and their clients are commercial (i.e., contractual), that there are legitimate reasons why institutional investors make use of the various services provided by proxy advisory firms and that these services are not currently subject to regulatory oversight. However, in the Canadian context, limited information is available about the ways in which institutional investors use the services of proxy advisory firms, the extent of reliance on the services provided by proxy advisory firms and whether institutional investors share any of the concerns identified above. Also, the extent of the impact of the concerns on the integrity of our markets is unclear.

Given these competing factors, the objectives of this consultation are two-fold. First, we would like to obtain information and views about the concerns raised by market participants to further inform our analysis before we conclude if there is a need to regulate proxy advisory firms. While the Consultation Paper discusses our understanding of the concerns raised, we are also soliciting additional feedback from interested market participants on specific questions, which are set out at the end of the Consultation Paper.

The second objective is to outline possible securities regulatory responses to the concerns raised and possible regulatory frameworks to implement these responses, and to request your feedback on such regulatory responses and frameworks. Although we consider a range of possible securities regulatory options in the Consultation Paper, we may decide based on the comments received and the impact of the specific concerns on the integrity of our markets, that other alternatives are preferable or that a securities regulatory response is not warranted.

Part 1 of the Consultation Paper sets out broadly our understanding of the proxy advisory industry, the various services proxy advisory firms provide to their clients and the role these firms and their clients play in our capital markets. Part 2 briefly identifies the nature of the concerns raised by certain market participants. Part 3 describes the Canadian and international regulatory landscape. Part 4 discusses our analysis of the concerns and also possible regulatory responses. In Part 5, we consider securities law frameworks, including existing and new frameworks, that could be used to implement a potential regulatory response should a response be warranted.

We welcome comments or clarifications on any of the concerns raised and the possible responses.

1. BACKGROUND

1.1. Services provided by proxy advisory firms

A firm offering proxy advisory services will review and analyze the matters (either issuer or shareholder proposals) put for a vote at a shareholders' meeting and will make a vote recommendation to its client, usually an institutional investor. The matters for which proxy advisory firms may make a vote recommendation include anything from routine corporate governance matters to highly complex mergers and acquisition (M&A) transactions that involve a voting decision.

A proxy advisory firm's proxy vote recommendations are generally based on whether the issuer complies with the governance practices or standards recommended by the firm for that proxy season. On M&A matters, proxy advisory firms may also review transaction terms and other transaction documents. A firm may also offer custom analysis and vote recommendations to clients based on the voting policy of the client. An institutional investor may instruct the proxy advisor to submit its voting instructions based on the proxy advisor's guidelines or on the institutional investor's own guidelines.

A proxy advisory firm may also offer automatic vote execution services whereby a client's shares are automatically voted in accordance with the firm's recommendations or a custom policy designed by the client. The client has the ability to review and override the recommendations, as well as re-vote, prior to the vote cut-off time.

A firm may assist with the administrative tasks associated with keeping track of the large number of voting decisions. This includes an end-to-end proxy voting platform where a firm receives the clients' proxy ballots, works with custodian banks, executes votes on clients' behalf, maintains vote records and provides comprehensive reporting of the information in the system related to meetings, ballots and accounts.

In addition to providing proxy advisory and voting services to institutional investors, some firms also provide consulting advisory services to issuers on corporate governance matters or attribute governance risk indicators to issuers.

The proxy advisory industry in Canada is dominated by two firms – Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co (Glass Lewis). Both are headquartered in the United States (U.S.).

ISS is a subsidiary of MSCI, Inc. MSCI Inc. is a provider of investment decision support tools, such as indices, portfolio risk and performance analytics, and governance tools, to clients such as large pension plans and boutique hedge funds.

Glass Lewis is a wholly-owned subsidiary of Ontario Teachers' Pension Plan Board (Teachers). Teachers is a single-profession pension plan in Canada and invests the pension fund's assets and administers the pensions of active and retired teachers in Ontario.

In the U.S., it is estimated that ISS has approximately 61% of the market, Glass Lewis approximately 36% and other US proxy advisors have the remaining 3%, based on the aggregate portfolio equity size of each proxy advisors institutional clients.[1] We are not aware of any similar statistics for the Canadian market.

1.2. Role of institutional investors

Proxy advisors play an important role in the capital markets by aggregating information, providing research expertise, setting default voting standards and facilitating investor participation in shareholder meetings.

In terms of Canadian institutional investors and their duty to vote, it is our understanding that institutional investors who hold their interest on behalf of their clients or plan beneficiaries would have a duty to their clients or plan beneficiaries to deal appropriately with the assets they hold on their behalf and that duty will typically require the institutional investor to vote the shares held.[2] Most organizations representing the views of institutional investors emphasize the importance of being an "active investor," generally meaning that institutional investors should vote all of their shares and should do so on an informed basis.[3]

Such engagement by institutional investors has the potential to better align the interests of shareholders and management as institutional investors have sufficient ownership stakes and sophistication to act as motivated representatives of diversified shareholders.

Institutional investors, in making their voting decisions, may use the services of proxy advisory firms in different ways and to varying degrees. In general, it is perceived that larger institutions with sophisticated in-house teams that focus on governance and voting issues may subscribe to the research reports and recommendations of one or more of the proxy advisory firms to further inform their own views, while smaller institutional investors may not have the necessary internal resources to conduct their own research and may choose to rely more heavily on the research and recommendations of proxy advisory firms for voting guidance.[4]

1.3. Growing demand for proxy advisory services

In recent years, the demand for the services provided by proxy advisory firms has grown. A number of factors are contributing to the increase in demand for the services offered by proxy advisory firms including the overall growth in institutional investment in a wide range of diversified issuers and greater pressure on institutional investors to effectively exercise their stewardship responsibilities.

Enhanced continuous disclosure requirements as well as the number and complexity of matters to be voted upon by shareholders at any given meeting have also increased the sheer volume of disclosure documents. These factors, combined

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1 Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control", *Stanford Journal of Law, Business and Finance*, Spring 2009, at pages 12-14.

2 Davies Ward Phillips and Vineberg LLP, *The Quality of the Shareholder Vote in Canada*, October 2011 (Davies Paper), at page 169.

3 Ibid., at page 169. Also, in Canada, the Canadian Coalition for Good Governance deals with this issue in its *Statement of Principles Regarding Member Activism*, February 16, 2005: http://www.ccgg.ca/site/ccgg/assets/pdf/Statement_of_Principles-Member_Activism__Rev._Version_-_Feb_16_2005_.pdf.

4 U.S. Government Accountability Office Report to Congressional Requesters, *Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting*, June 2007 (the GAO Report), at page 16.

with the time constraints imposed by the concentrated proxy season in Canada, have likely resulted in growing institutional investor demand for the analyses and vote recommendation services provided by proxy advisory firms.

With increased demand for proxy advisory services, the perceived influence of such firms' vote recommendations has also risen, leading some to suggest that a recommendation from a proxy advisory firm could make the difference between the success and failure of a corporate proposal.[5]

1.4. Potential or perceived influence of proxy advisory firms

The potential or perceived influence of proxy advisory firms on both institutional and retail investors is a complex issue. As noted, proxy advisors may play an important role, particularly with regards to investors who may not have the expertise to weigh in on particular questions put to shareholders, who do not have the necessary internal resources to carry out their own research or who determine that reliance on external recommendations is an appropriate means of exercising their voting rights in certain circumstances. For other investors, proxy advisory firms provide supplemental information, analysis, and research, which may improve the overall quality of votes.

Currently, in Canada, the potential influence of proxy advisory firms' recommendations could be significant because, on average, approximately 32% of the shares of TSX-listed issuers are held by institutional investors.[6]

It is expected that a number of factors will contribute to further increase the volume of proxy votes and this growth may be accompanied by greater reliance on the recommendations of proxy advisory firms.[7] However, the extent of reliance by institutional investors on proxy advisory firms is the subject of debate. Some suggest that certain institutional investors view the reliance on proxy advisory firms as a form of insurance against regulatory criticism. In particular, this may be the case in the U.S. to the extent that institutions view the advice given by proxy advisory firms as part of their due diligence process in satisfying their fiduciary duties (for example, see excerpt from the comment letter submitted by the Center[8] to the Securities and Exchange Commission (the SEC)).[9]

In the U.S., some studies suggest that approximately 15-20% of ISS clients have authorized ISS, the largest proxy advisory firm in North America, to automatically vote their proxies however it sees fit.[10]

However, it is our understanding that institutional investors generally follow the corporate governance policies and recommendations of proxy advisory firms because either: (i) they have considered and also agree with such policies and recommendations, or (ii) may not have considered the issue independently, but are prepared to rely on the proxy advisor's policies and recommendations because they believe the proxy advisor's voting guidelines are aligned with their views or guidelines.[11] Any potential influence of proxy advisory firms could be seen as positive to the extent that proxy advisory firms base their recommendations on the corporate governance views and preferences of Canadian institutional investors. From this perspective, the potential influence is not necessarily negative.

It is unclear whether proxy advisory firms' recommendations have any consequential impact on retail investors. The recommendations of proxy advisors with respect to individual matters voted on by an issuer's shareholders may be widely publicized in certain circumstances. For example, issuers and dissident shareholders in contested elections typically issue press releases publicizing proxy advisor recommendations in their favour, and such recommendations are considered significant

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5 Paul H. Edelman and Randall S. Thomas, "Selectica Resets the Trigger on the Poison Pill: Where Should the Delaware Courts Go Next?", Vanderbilt University Law School, Public Law and Legal Theory Working Paper Number 11-20, June 2011, at page 40: "third-party proxy advisors, such as Risk Metrics, can have an effect on institutional investors' voting patterns. Both the court and academic commentary have recognized that the recommendation of a proxy advisor can have a pivotal impact on the outcome of a vote." *See also*, Davies Paper, *supra* note 2, at page 162.

6 Bloomberg data search (January 2012), based on the average percentage of shares held by institutional investors for 1,114 of 1,500 TSX-listed issuers (institutional share ownership information is not available for all issuers).

7 Center on Executive Compensation (Center), *A call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight*, January 2011, at pages 15-19 and page 21.

8 The Center, based in Washington, develops and promotes principled pay and governance practices and advocates compensation policies that serve the best interests of shareholders (Center's website: http://www.execcomp.org/).

9 Center comment letter dated October 25, 2010 to the SEC Concept Release on the U.S. Proxy System published July 14, 2010 (the SEC Concept Release), at page 3: "A primary reason for institutional investor reliance on proxy advisory firms, in the U.S., is a 2003 SEC interpretation that indicated that investment advisors could discharge their duty to vote their proxies and demonstrate that their vote was not a product of a conflict of interest if the vote was made in accordance with a pre-determined policy and based on the recommendations of an independent third party. The advisory firms are considered independent third parties, and if institutional investors rely on the recommendations made by them, the investors are held to have discharged their fiduciary duties to vote in the investors' best interests."

10 Tamara C. Belinfanti, *supra* note 1, at page 15. *See also*, Paul Rose, "The Corporate Governance Industry", *The Journal of Corporation Law*, Summer 2007, at page 103.

11 Davies Paper, *supra* note 2, at page 162.

enough to be reported in the news media. At least one author suggests that retail investors are probably being swayed by the "tsunami of press coverage that often accompanies a formal recommendation by a [proxy advisory] firm".[12]

Anecdotal evidence suggests that some issuers may feel pressured to accept proxy advisory firms' corporate governance policies, regardless of whether the policies are appropriately taking into account key factors and the particular circumstances of the issuers.[13]

1.5. Potential impact of concerns on market integrity

Some market participants cite the potential influence of proxy advisory firms over vote outcomes and the corporate governance of issuers, combined with the possible negative impact of conflicts of interest and lack of transparency concerns that are further described below, as support for greater regulatory oversight in this area. Critics also argue that the possible risk to market integrity could be greater because of limited competition in the proxy advisory industry such that supply and demand market forces may not provide sufficient "checks and balances" on the quality of the recommendations made by a proxy advisory firm.

In our view, it may be appropriate for the Canadian Securities Administrators (CSA) to consider regulating proxy advisors if the above-noted concerns are validated and have a negative impact on the integrity of Canadian capital markets. Accordingly, the purpose of the Consultation Paper is to obtain additional information and assess the validity of concerns about the activities of proxy advisors, the impact on the capital markets, and, if warranted, the need for a securities regulatory response and the appropriate regulatory response.

2. SUMMARY OF CONCERNS

We identify in this section the various concerns raised by certain market participants, primarily issuers and their legal advisers, and the potential impact of these concerns.

Each of these concerns, including our analysis of potential mitigating factors, will be more fully discussed in Part 4.

2.1. Potential conflicts of interest

A conflict of interest may exist if a proxy advisory firm provides vote recommendations to institutional investors on corporate governance matters for which the same firm provided consulting services to the issuer. A proxy advisory firm's independence may also be compromised by conflicts arising in the ownership structure of some proxy advisory firms. Alternatively, an institutional client of a proxy advisory firm could be the proponent of a specific shareholder proposal that could be the subject of a favourable vote recommendation by the firm.

Potential conflicts of interest may compromise the independence of vote recommendations or create a perception that the recommendation is compromised. To the extent that potential conflicts of interest are not properly identified and managed, they could be viewed as having a negative impact on the integrity of the voting process.

2.2 Lack of transparency

It is our understanding that lack of transparency concerns appear to be a combination of both (i) the lack of disclosure about how proxy advisory firms arrive at their vote recommendations and (ii) the lack of public disclosure of the actual report. The concern with lack of transparency is that, without that disclosure, issuers and investors may not be able to question and fully assess the quality of the information and analysis that underlie the vote recommendations, and evaluate their merits. This could have an impact on the integrity of our capital markets. Because the proxy voting report is the product of the commercial relationship between proxy advisory firms and their clients, the report is only provided to subscribers, but the recommendations may be disclosed by subscribers, issuers or other parties to the media for strategic reasons.

2.3 Potential inaccuracies and limited opportunity for issuer engagement

The concern raised by some issuers with respect to apparent inaccuracies in proxy advisors' reports is that such inaccuracies may lead to misinformed decision-making to the extent that institutional investors significantly rely on a potentially flawed analysis underlying a vote recommendation. This concern may be especially acute in the context of complex, controversial voting matters (including M&A transactions) or close vote situations.

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[12] John Mackie, "Failed TMX Bid Puts Spotlight on Proxy Advisory Firms", *Business Law Currents*, June 30, 2011.

[13] Wachtell, Lipton, Rosen & Katz, comment letter dated October 19, 2010 in response to the SEC Concept Release (*supra* note 9)), at page 5. *Report of the New York Stock Exchange Commission on Corporate Governance*, September 23, 2010, at page 23: "Proxy advisory firms seem to develop on an annual basis new policies that constitute best practices for directors or boards, and then use the 'stick' of a recommended 'withhold' vote for directors not following their current notion of best practices." Davies Paper, *supra* note 2, at page 162.

Issuers also feel that the process for engaging with proxy advisory firms in these situations is often unclear. However, whether such inaccuracies in reports are simply differences of opinion amongst issuers and proxy advisory firms or represent misinformed recommendations remains unknown.

2.4. Perceived corporate governance implications

Another concern raised is that proxy advisory firms may have become *de facto* corporate governance standard setters and that, as a result, issuers are compelled to adopt certain "one-size-fits-all" standards which may not be entirely suitable for their specific circumstances. In a 2010 survey conducted by the Center, 54 percent of survey respondents said they had changed or adopted a compensation plan, policy or practice in the past three years primarily to meet the standards of a proxy advisory firm.[14]

As further evidence of the influence of proxy advisors on corporate governance, it is our understanding that some national corporate law firms advise their issuer clients to consult ISS Canadian Proxy Voting Guidelines and the ISS Canadian Governance Policy updates.[15]

We recognize, however, that this influence on corporate governance practices can be beneficial to investors as it may result in the adoption of corporate governance best practices.

2.5. Extent of reliance by institutional investors

To date, we have not received any complaints from institutional investors who subscribe for services provided by proxy advisory firms. However, as previously noted, certain market participants are concerned that institutional investors may rely too much on the vote recommendations provided by proxy advisory firms. The extent of reliance can either be complete reliance, which includes an automatic vote in accordance with a proxy advisor's recommendations, or partial reliance, where institutional investors will conduct their own research and include proxy advisors' recommendations as part of their analysis in determining how to vote.

Institutional investors have a duty to their clients to deal appropriately with the assets they hold on their behalf. That duty will compel the institutional investor to vote its shares, whether to protect the long-term value of the investment or to approve or disapprove an action or event that may affect the investment in the short term.[16]

In the Canadian context, limited information is available about institutional investors' reliance on the services provided by proxy advisory firms and whether they have concerns about the activities of proxy advisors but are limited in their options due to the lack of competition in this industry or for other reasons.

In order to obtain additional information from institutional investors on these issues, we pose specific questions at the end of the Consultation Paper.

3. CURRENT REGULATORY LANDSCAPE IN CANADA AND INTERNATIONALLY

3.1. Canada

Currently, in Canada, proxy advisory firms are not subject to formal securities regulatory oversight but their activities have been considered by securities regulators in the past to a limited extent, specifically in the context of our registration and proxy solicitation rules.

In terms of the registration regime, an "adviser" is defined as a person who engages in or holds himself out as engaging in the business of advising another with respect to investment in or the purchase or sale of securities.[17] The activities of a proxy advisory firm as described above do not include advising their clients whether or not to buy or sell securities, but are generally confined to advising their clients on how to exercise voting rights that attach to securities those clients already own.

Notwithstanding this view, it should be noted that in 2003 Fairvest Corporation, now Institutional Shareholder Services Canada Corp. (Canadian subsidiary of ISS), requested and obtained exemptive relief from our adviser registration requirements provided

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14 Center, *supra* note 7, at page 4.

15 For examples, see Stikeman Elliott LLP, *Continuous Disclosure Guide – 2011* (1 March 2011), Canadian Securities Law, www.canadiansecuritieslaw.com/2011/03/articles/continuous-timely-disclosure/continuous-disclosure-guide-2011/, and McCarthy Tétrault LLP, *Management Proxy Circular Disclosure (and related matters) – Aide-mémoire*, www.mccarthy.ca/pubs/Management_Proxy_Circular_Disclosure.pdf, at page 5.

16 Davies Paper, *supra* note 2, at page 169.

17 See the definition of "adviser" in each of our securities acts.

that proposals concerning corporate M&A transactions (i.e., which may lead to a "trade") do not exceed five per cent of proposals in a given year.[18]

In terms of the proxy solicitation regime, National Instrument 51-102 *Continuous Disclosure Obligations* (NI 51-102) contains a definition of "solicit" for the purposes of that rule. The act of providing proxy voting advice may be caught by paragraph (c) of the definition of "solicit", which would suggest that this activity is subject to the proxy solicitation requirements in Part 9 of NI 51-102.

However, to provide greater clarity as to the obligations of proxy advisory firms, proxy voting advice is carved out of the definition of "solicit" if it is communicated to clients (securityholders) in the ordinary course of business and not on behalf of any person soliciting proxies. In these circumstances, proxy voting advice is not subject to the proxy solicitation informational requirements in NI 51-102.

The relevant sections of the definition are as follows:

> "solicit", in connection with a proxy, includes . . .
>
> (c) sending a form of proxy or other communication to a securityholder under circumstances that to a reasonable person will likely result in the giving, withholding or revocation of a proxy . . .
>
> but does not include . . .
>
> (k) communicating, other than a solicitation by or on behalf of the management of the reporting issuer, to securityholders in the following circumstances . . .
>
> (iii) as clients, by a person who gives financial, corporate governance or proxy voting advice in the ordinary course of business and concerns proxy voting advice if:
>
> (A) the person discloses to the securityholder any significant relationship with the reporting issuer and any of its affiliates or with a securityholder who has submitted a matter to the reporting issuer that the securityholder intends to raise at the meeting of securityholders and any material interests the person has in relation to a matter on which advice is given;
>
> (B) the person receives any special commission or remuneration for giving the proxy voting advice only from the securityholder or securityholders receiving the advice; and
>
> (C) the proxy voting advice is not given on behalf of any person soliciting proxies or on behalf of a nominee for election as a director;

Equivalent provisions are found in the definition of "solicit" in section 147 of the *Canada Business Corporations Act* (paragraph (b) (vii) of such definition) and section 68 of the *Canada Business Corporations Regulations*.

As discussed more fully in Part 5, we continue to be of the view that neither of these regimes is an appropriate regulatory framework for any potential regulation of proxy advisory firms.

3.2. United States

As mentioned above, ISS and Glass Lewis are headquartered in the U.S. It is our understanding that, in addition to ISS and Glass Lewis, the proxy advisory industry in the U.S. is comprised of two other major firms: Marco Consulting Group and Egan-Jones Proxy Services. Of these four proxy advisory firms, two firms, ISS and Marco Consulting Group, have registered with the SEC as "investment advisers" under The *Investment Advisers Act of 1940* (*Advisers Act*) using the pension consultant exemption described below.[19] As a result, these firms have to make certain specific disclosures, including information about arrangements that the adviser has that involve certain conflicts of interest with its advisory client and are required to adopt, implement, and annually review an internal compliance program consisting of written policies and procedures that are reasonably designed to prevent the adviser or its supervised persons from violating the *Advisers Act*.[20]

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[18] At the time, Fairvest Corporation requested the relief because it sometimes provided proxy voting advice on corporate transactions such as amalgamations, mergers and other types of reorganizations that may influence the decision to invest in or the buy or sell securities. These transactions represented a small proportion of the proposals on which it provided proxy voting advice.

[19] SEC Concept Release, *supra* note 9, at page 109. A person is an "investment adviser" under the *Advisers Act* in the U.S. if the person, for compensation, engages in the business of providing advice to others as to the value of securities, whether to invest in, purchase, or sell securities, or issues reports or analyses concerning securities.

[20] Ibid., at page 113.

In terms of how proxy advisory firms are currently regulated under U.S. federal securities law, the SEC described its current regime in the concept release identified in section 3.3 hereafter. Depending on their activities, proxy advisory firms may be subject to federal securities laws in at least two respects. The SEC described the current federal regulation of proxy advisors in the U.S. as follows:

> First, because of the breadth of the definition of "solicitation," proxy advisory firms may be subject to our proxy rules because they provide recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy. As a general matter, the furnishing of proxy voting advice constitutes a "solicitation" . . . however, we adopted Exchange Act Rule 14a-2(b) (3) to exempt the furnishing of proxy voting advice by any advisor to any other person with whom the advisor has a business relationship from the informational and filing requirements of the federal proxy rules, provided certain conditions are met. . . .
>
> Even if exempt from the informational and filing requirements of the federal proxy rules, the furnishing of proxy voting advice remains subject to the prohibition on false and misleading statements in Rule 14a-9.
>
> Second, when proxy advisory firms provide certain services, they meet the definition of investment adviser under the Advisers Act and thus are subject to regulation under that Act. . . . proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities. [21]

Proxy advisory firms may have to register with the SEC as investment advisers. The SEC noted that:

> Whether a particular investment adviser is required to register with the Commission depends on several factors. Investment advisers are generally prohibited from registering with the Commission if they have less than $25 million in assets under management. Proxy advisory firms are unlikely to have sufficient assets under management to register with the Commission because they typically do not manage client assets. Proxy advisory firms may nonetheless be eligible to register because they qualify for one of the exemptions from the registration prohibition under Rule 203A-2 under the Advisers Act. In particular, some proxy advisory firms may be able to rely on the exemption for "pension consultants" if they have pension plan clients with an aggregate minimum value of $50 million.[22]

3.3. International Regulatory Initiatives

Various international regulatory agencies have also been looking at the role and potential regulation of proxy advisory firms.

In the U.S., the SEC undertook a public consultative process through the publication in July 2010 of the SEC Concept Release to assess the extent of the regulatory concerns and the potential policy options to address them but did not propose any particular regulatory framework.

The SEC Concept Release related to various aspects of the U.S. proxy system and included a section on proxy advisory firms.

The SEC Concept Release described the concerns expressed by market participants on the lack of accuracy and transparency with respect to recommendations provided by proxy advisory firms. Also identified were the perceived conflicts of interest resulting from proxy advisory firms providing both proxy vote recommendations to institutional investors and consulting services to issuers seeking assistance with proposals put to shareholders or with improving their corporate governance ratings.

We reviewed the comments received by the SEC on proxy advisory firms as part of our analysis of the concerns identified by market participants. The commenters who responded included issuers, institutional investors, law firms, academics, the proxy advisory firms and industry associations.

Based on our review of these comments, we observed certain high-level themes, which are summarized here as follows:

- There is a general agreement among commenters that proxy advisory services have an impact on the proxy voting process and that proxy advisory firms influence voting outcomes and corporate behaviour. However, institutional investors view the influence on voting outcomes as overstated.

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21 Ibid., at pages 107-110. See also Note 19 for the definition of "investment adviser".

22 Ibid., at pages 112-113.

- There is general consensus among commenters that reliance on proxy advisory firms' research and recommendations by institutional shareholders will continue to grow.

- Proxy advisory firms help institutional investors in managing their voting responsibilities. Large institutional investors have their own internal policies and use proxy advisory firms' advice primarily as a source of information, but smaller institutional investors may lack the staff needed to fully evaluate all matters being voted on and may conclude that for cost/benefit reasons that it is appropriate to base their votes largely or entirely on proxy advisory firms' recommendations.

- On the issue of conflicts of interest, some are of the view that the current standard of boilerplate generic disclosure statements is not adequate; there should be clear and full disclosure of the conflicts. Some recommended that conflicts of interest be prohibited. Others recommended that if a proxy advisory firm offers consulting services to public companies, there should be a complete and total separation of the proxy advisory business from the consulting services.

- There is also general consensus that there should be disclosure of methodologies and rationales for a vote recommendation. With increased disclosure of the criteria and processes used to formulate recommendations, investors will be better able to understand and evaluate vote recommendations.

- Almost all issuers expressed the concern that there may be errors in the vote recommendation reports and that they have little recourse to have these corrected by proxy advisory firms. Many suggested that proxy advisory firms should have processes to ensure factual accuracy and reliability of what they publish and include the opportunity for issuers to review and comment.

At the date of this publication, we are not aware of the SEC's timing or regulatory plans in this area. We will continue to monitor U.S. developments in this regard.

In 2009, the New York Stock Exchange Commission on Corporate Governance (CCG) carried out a comprehensive review of corporate governance principles. In its report dated September 23, 2010, the CCG stated in Principle 8 with respect to proxy advisory firms, that it "recognizes the influence that proxy advisory firms have on the market, and believes that such firms should be held to appropriate standards of transparency and accountability."

CCG recommended that:

1. the SEC should engage in a study of the role of proxy advisory firms to determine their potential impact on, among other things, corporate governance and behaviour and consider whether or not further regulation of these firms is appropriate;

2. at a minimum, proxy advisory firms should be required to disclose the policies and methodologies that the firms use to formulate vote recommendations, as well as material conflicts of interest, and to hold themselves to a high degree of care, accuracy and fairness in dealing with both shareholders and companies by adhering to strict codes of conduct; and

proxy advisory firms should be required to disclose the company's response to their analysis and conclusions.[23]

Similar initiatives have been undertaken in Europe. For example:

1. The French Autorité des marches financiers (AMF France) issued *AMF Recommendation No. 2011-06 of 18 March, 2011 on Proxy Advisory Firms*. AMF France recommended standards for proxy advisory firms in order to promote transparency and manage conflicts of interest.

2. The European Commission published for comment on April 5, 2011, the *Green Paper: The EU Corporate Governance Framework*, aimed at assessing the need for improvement of corporate governance in European listed companies.

3. The European Securities and Markets Authority published for comment on March 22, 2012 the *Discussion Paper: An Overview of the Proxy Advisory Industry - Considerations on Possible Policy Options*.

More details regarding these international initiatives can be found in Appendix A.

[23] *Report of the New York Stock Exchange Commission on Corporate Governance*, September 23, 2010, at page 6.

4. ANALYSIS OF CONCERNS RAISED AND POSSIBLE REGULATORY RESPONSES

We identified in Part 2 certain concerns raised by market participants. In this section, we will consider in greater detail whether these concerns raise market integrity issues that require a securities regulatory response. We will also consider the extent to which proxy advisors are voluntarily addressing these concerns without securities regulatory intervention.

Overall, any securities regulatory response should be proportionate to the potential impact of these concerns on market integrity. In examining and analyzing each of the concerns raised and, on the assumption that a securities regulatory response is warranted, we will discuss how a securities regulatory response may address each of these concerns.

We are requesting your feedback on the concerns identified, our analysis of them and our possible responses, as well as any other alternative regulatory response.

4.1. Potential conflicts of interest

A proxy advisory firm may provide advisory services to issuers on corporate governance or executive compensation matters or provide assistance in developing proposals to be submitted for shareholder approval. Some proxy advisers also qualitatively rate issuers' corporate governance policies and provide consulting services on how to improve their corporate governance ratings.[24] As a result, a proxy advisory firm may provide vote recommendations to institutional investors on corporate governance matters for which the same firm provided consulting services to the issuer.

Alternatively, an institutional client of a proxy advisory firm could be the proponent of a specific shareholder proposal that could be the subject of a favourable vote recommendation by the firm.

There may also be conflicts in ownership structure. For example, Glass Lewis is owned by Teachers which engages in public and private equity investing in issuers on whom Glass Lewis makes recommendations.

Current practice seems to be to provide minimal disclosure in the relevant report, sometimes in the form of boilerplate statements that simply note that conflicts may generally exist.[25]

4.1.1. Analysis

It is our understanding that proxy advisory firms have conflicts of interest policies and procedures in place within their organizations.

For example, ISS manages potential conflicts through a combination of the application of their published voting policy guidelines, a compliance program (Code of Ethics that prescribes conduct of employees in carrying out their responsibilities), implementation of a "firewall" to mitigate conflicts around the advisory business, and disclosure. Clients are informed of potential conflicts and each proxy report contains a legend that the issuer may be a client of ISS. Institutional clients may contact ISS' legal department for specific details.[26]

As another example, Glass Lewis provides disclosure on the front page of its reports regarding potential conflicts. When an institutional investor client solicits votes through a shareholder proposal, Glass Lewis discloses that fact on the front page of the report. Glass Lewis also discloses when an investment manager subsidiary of a public company on which it is writing a report subscribes to its research. Furthermore, where Glass Lewis becomes aware through public disclosure that Teachers has a significant, reportable stake in a company it is covering, that fact is disclosed on the front page of the report for that company.[27]

While this suggests that proxy advisory firms do undertake certain preventative measures, it is not clear to what extent all of the information regarding their policies and procedures are publicly available and whether making them publicly available might address the concerns expressed regarding conflicts of interests.

4.1.2. Possible approach

Potential conflicts of interest have traditionally been addressed in securities regulation through prohibition, adoption of policies or procedures that mitigate the conflicts, or disclosure.

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24 ISS publishes "governance risk indicators". See www.issgovernance.com/grid-info.

25 Cornell Law School, comment letter dated October 20, 2010 in response to the SEC Concept Release (*supra* note 9), at page 3. Pension Investment Association of Canada, comment letter dated December 22, 2010 in response to the SEC Concept Release (*supra* note 9), at page 3: "generic disclosure statements are inadequate and proxy advisory firms should make specific disclosure regarding the presence of a potential conflict of interest." *See also*, SEC Concept Release, (*supra* note 9), at page 117.

26 ISS comment letter dated October 20, 2010 in response to the SEC Concept Release (*supra* note 9), at page 8.

27 Glass Lewis comment letter dated October 18, 2010 in response to the SEC Concept Release (*supra* note 9), at page 10.

Prohibition of conflicts of interest would only be appropriate if there is clear evidence of a material negative impact of any potential conflict of interest on market integrity. We do not think outright prohibition of conflicts of interest is necessary or appropriate for proxy advisory firms at this time.

We considered the conflict of interest requirements of research analysts when publishing reports or making recommendations with respect to the purchase or sale of securities. There are minimum procedural requirements set out in IIROC (Investment Industry Regulatory Organisation of Canada) Dealer Member Rule 3400[28] for research analysts that operate within an investment dealer. We could consider the relevance of these provisions in developing any potential regulation of proxy advisory firms although we recognize that research analysts have a more direct link to our mandate of protecting investors and market efficiency.

An appropriate response to the concerns raised could be to require proxy advisory firms to identify and control conflicts of interest through adequate organizational structures. Some such structures may already be in place but currently are not fully transparent to other market participants since there are no specific regulatory requirements for proxy advisory firms to disclose such structures.

To the extent that market participants agree that a securities regulatory response is warranted to address potential conflicts of interests at proxy advisory firms, we are requesting your feedback on whether we should require proxy advisory firms to develop, implement and disclose conflicts of interest policies and procedures to manage potential conflicts of interest.

In particular, we request your feedback on the following possible requirements:

1. proxy advisory firms should separate their proxy voting services from the advisory or consulting services;

2. proxy advisory firms should have policies and procedures designed to identify and manage any conflicts of interest that arise in connection with the issuance of a vote recommendation; a firm should have policies to deal with employee conflicts and ownership conflicts;

3. proxy advisory firms should disclose the procedures in place to mitigate or address conflicts; disclosure of the specific conflict in the report to their clients may also be required; and

4. proxy advisory firms should review the effectiveness of such policies and procedures on a regular basis.

The conflicts of interest policies and procedures would be disclosed on the proxy advisors' websites.

4.2. Lack of transparency

Proxy advisory firms' recommendations and how they generate their vote recommendations are not in the public domain because subscription arrangements with clients are private contractual matters. Proxy advisory firms issue reports on a subscription basis to their institutional investor clients and we understand that issuers may also subscribe. For other (non-subscribing) investors, information regarding such recommendations comes in summary form from issuers, bidders or targets, typically in press releases.

Ordinarily, vote recommendation reports are not publicly available and, given the commercial nature of the relationship between proxy advisory firms and their clients, there may be valid business reasons for not making them publicly available.

Even if the recommendation is available publicly, the underlying analysis is not disclosed. While in some cases the analysis may be straightforward application of the proxy advisor's policies, there may be cases which are more nuanced and complex.

4.2.1. Analysis

It is our understanding that proxy advisory firms' vote recommendations are generally based on the application of predefined methodologies and are based on publicly available information. We also understand that there can be some subjective analyst review and there are internal procedures for reviewing the reports before they are finalized.

A concern may exist with the absence of information about how proxy advisors arrived at their recommendation to the extent that issuers and investors cannot assess the quality of the data and analysis that inform the recommendation, and evaluate its merits.

We are considering whether disclosure of the methodologies, analytical models and assumptions used in arriving at a vote recommendation would allow the market to evaluate and judge the rationale for the recommendation or determine why a proxy

[28] http://iiroc.knotia.ca/Knowledge/View/Document.cfm?Ktype=445&linkType=toc&dbID=281205341&tocID=842.

advisor has made a particular recommendation. Disclosure of significant public informational sources used in determining a recommendation may also be helpful.

The additional disclosure may improve the quality and credibility of vote recommendations. An example of the merits of disclosure of the analysis is where various proxy advisory firms make a different vote recommendation for the same matter put to a vote at a shareholders' meeting. Without sufficient details of the underlying analysis, the client cannot make an informed assessment of the different recommendations (for the same matter) in deciding how to vote.

However, we also question whether disclosure of methodologies and analytical models is necessary or appropriate given the commercially sensitive and proprietary nature of not only this information but even the process undertaken by proxy advisory firms to generate their vote recommendations. We would welcome views as to whether the market could benefit from improved transparency in this area or whether the risks in doing so are too significant to justify any intervention.

4.2.2. Possible approach

Given that the vote recommendation itself is essentially a product for which clients have paid subscription fees to obtain, it may not be appropriate to require the reports to be publicly disclosed.

To the extent that a securities regulatory response is warranted to address concerns surrounding lack of transparency, we request your feedback on whether disclosure of the analysis concerning a vote recommendation that enables an investor to assess the basis for a vote recommendation could be appropriate. We would consider requiring that proxy advisory firms disclose the internal procedures, guidelines, standards, methodologies, assumptions and sources of information supporting their vote recommendations. Data gathering procedures to ensure the accuracy of information could also be disclosed.

In determining whether to require the above disclosure, we will have to consider the appropriateness of requiring disclosure if the information is confidential, proprietary or cannot be disclosed for valid business purposes.

4.3. Potential inaccuracies and limited opportunity for issuer engagement

We obtained anecdotal information from our informal discussions with issuers (in addition to comment letters submitted to the SEC) about concerns with inaccuracies in the underlying data used to arrive at a recommendation.[29] Issuers have also complained that, even if those matters were raised, proxy advisory firms did not correct factual inaccuracies once they were made aware of them. A 2010 survey carried out by the Center in the U.S. seems to support this information: "of those responding, 53 percent said that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs in 2009 or 2010."[30]

In the Center's view, "the implications of these inaccuracies are alarming. ISS has historically recommended voting against between 30 and 40 percent of all stock plans it reviews. It follows that if the Center data is representative of large companies generally, then proxy advisory firms are negatively impacting the compensation programs at a meaningful number of companies because of institutional investors' reliance on the data."[31]

Some issuers have also complained of the limited time they are given to provide comments on a proxy advisory firm's preliminary report. They noted that the firm's final report often did not incorporate all of their comments and some reports contained mistakes.[32]

4.3.1. Analysis

ISS and Glass Lewis each have different approaches to engaging with issuers on matters proposed to be voted upon at shareholders' meetings.

ISS distributes its report and recommendations to the issuer in advance of releasing them and gives the issuer an opportunity to vet the report for factual content. Glass Lewis does not meet with issuers once the proxy materials have been sent out, because it believes it is more appropriate to restrict its analysis and recommendations to the issuer's public disclosure. Exceptions are made in the case of contested meetings, certain major transactions or other unique circumstances, where Glass Lewis will meet

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29 Kinross Gold Corporation comment letter dated October 20, 2010 in response to the SEC Concept Release (*supra* note 9), at pages 1-3. See also *Shareholder Democracy Summit Inaugural Report*, October 24-25, 2011, at page 28.

30 Center, *supra* note 7, at page 10.

31 Ibid., at page 10.

32 Ibid., at pages 55-57. The Center attributes the inaccuracies to the following: (1) workload pressures caused by the tremendous growth in the proxy advisory industry; (2) the increased length of proxy disclosures and short turnaround time for analyses; and (3) inadequate quality controls at the proxy advisory firms as proxy advisory firms seek to reduce costs by outsourcing data collection and analysis to low labour-cost countries.

with the issuer and dissidents on a call with some of its clients. It does not provide issuers with an opportunity to comment on its report and recommendations before it is released.[33]

Both ISS and Glass Lewis have recently announced new processes to facilitate engagement with investors and issuers.[34]

Nonetheless, issuers continue to be concerned with inaccuracies in proxy advisor reports as they may lead to misinformed decision-making, especially in the context of complex, controversial voting matters (including M&A transactions) or close votes and that the process for engaging with proxy advisory firms in these situations is often not clear. If these concerns are valid and result in material inaccuracies, that could support a proposal for proxy advisory firms to have a process to address issuer comments on vote recommendations and the underlying analysis.

However, it is not clear to us whether such inaccuracies may simply be differences of opinion or analysis rather than misinformed recommendations by proxy advisory firms that pose risks to market integrity and, ultimately, whether actual voting outcomes were negatively affected in these situations. Accordingly, we are soliciting feedback in this regard.

4.3.2. Possible approach

To the extent that a securities regulatory response is warranted to address these concerns, we request feedback on whether to require that proxy advisory firms have a policy to deal with issuer comments on vote recommendations and the underlying analysis. In particular, the policy would specify the process for issuer engagement, and require that proxy advisors publicly disclose this process.

To inform our analysis on this issue, we are requesting your feedback on whether, if we require proxy advisory firms to have a process for issuer engagement, we should also prescribe the terms of the process by which proxy advisors engage with issuers (for example, by setting specific timelines for which issuers must be given an opportunity to review a draft vote recommendation).

4.4. Development of corporate governance standards

It has been suggested that proxy advisory firms are no longer “independent” experts evaluating a proposal but influence behaviour of the issuer they make recommendations about.

Proxy advisory firms may indirectly act as “standard-setters” and, as such, some have questioned whether they have the necessary expertise to set corporate governance standards and whether their approach to developing such standards is sufficiently thorough and transparent. While a similar role is played by other governance organizations, these entities do not have as direct an (potential) influence over vote outcomes.

On the other hand, to the extent that proxy advisors engage in a valid policy development process, any potential influence they have may benefit investors broadly by encouraging widespread adoption of governance best practices.

4.4.1. Analysis

Because of the growing influence of proxy advisory firms, the impact of their policies and recommendations on Canadian corporate governance practices may be significant. As mentioned above, a number of issuers claim to adopt the policies in an effort to obtain positive vote recommendations from proxy advisory firms.

According to some proxy advisory firms, policies developed are likely to reflect institutional investor clients’ preferences and views as well as the perspectives of other market participants. For example, ISS gives institutional clients an opportunity to provide input and feedback on policy issues every year post proxy season. In addition, ISS analysts communicate with institutional clients during the course of proxy season on a range of issues including those that are highly contentious. Finally, all market policy documents are available on the ISS website for easy access by both institutional investors and the issuer community.[35]

Glass Lewis develops its proxy voting guidelines based on academic studies and client feedback.[36]

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[33] Davies Paper, *supra* note 2, at page 166.

[34] ISS, news release dated March 29, 2012 (www.issgovernance.com/news/). Glass Lewis, news release dated April 12, 2012 (www.glasslewis.com/about-glass-lewis/press-releases/).

[35] Davies Paper, *supra* note 2, at page 164 for a full description of the process.

[36] Ibid., at pages 164-165 for a full description of the process.

4.4.2. Possible approach

Because of the potential impact of the policies recommended by proxy advisory firms on issuers and their operations, it may be advisable that issuers and other market participants be made aware of any corporate governance policy proposed and ultimately adopted by proxy advisory firms that may affect them for purposes of the upcoming proxy season.

To the extent that a securities regulatory response is warranted to address these concerns, we request your feedback on whether proxy advisory firms should implement fair and transparent procedures for developing corporate governance standards. We would suggest that the procedures and standards be publicly disclosed. Public disclosure of the procedures may result in market participants' confidence in the standard-setting function of proxy advisors.

4.5. Reliance by institutional investors

As noted at the outset of the Consultation Paper, it is unclear to what extent institutional investors in Canada rely on the vote recommendations by proxy advisory firms in any given situation and, if such reliance is placed, the reasons why such investors have made this decision.

In the U.S. context, the GAO Report noted that, whether large or small, all of the 31 institutional investors interviewed indicated that they: (i) retain the fiduciary obligation to vote proxies in the best interest of their clients, irrespective of their reliance on proxy advisory firms, (ii) do not delegate this responsibility, and (iii) retain the right to override any proxy advisory firm recommendations, all of which may limit the amount of influence that proxy advisory firms hold.[37] We are not aware of any similar study in Canada.

Furthermore, we note that any potential influence that a recommendation from a proxy advisor wields generally stems from the willingness of institutional investors to follow vote recommendations on the basis that either:

(i) they have considered and also agree with such recommendations, or

(ii) may not have considered the issue independently, but are prepared to rely on the proxy advisor's recommendations because they believe they are aligned with their guidelines.[38]

4.5.1. Analysis

At a recent Canadian shareholder democracy conference, it was noted that for larger shareholders there is a lot of thought that goes into exercising their voting rights. Smaller institutions may be more likely to follow the advice of proxy advisors because there is a large regulatory burden on them to keep up with the information flows.[39]

However, it is our understanding that very limited empirical information exists about how institutional investors in Canada actually use the services of proxy advisory firms and, generally, whether they share any or all of the concerns discussed in the Consultation Paper. We are therefore soliciting feedback on: (i) how institutional investors view their voting obligations, (ii) the extent to which various types of institutional investors rely on the services provided by proxy advisors, and (iii) whether they share any of the concerns described above or if market forces are sufficiently addressing these issues from their perspective.

In this regard, we included at the end of the Consultation Paper specific questions for institutional investors to inform our analysis and views.

5. POTENTIAL SECURITIES REGULATORY FRAMEWORKS

There are good business reasons and capital market benefits for the existence of proxy advisory firms and the services they provide to their clients. They serve a market need and we anticipate increased demand for their services.

Overall, any possible regulatory response to the activities of proxy advisory firms should address the concerns identified above and meet the objective of making these firms more accountable and the process leading to vote recommendations more transparent.

Based on the feedback received and evidence of the impact of the concerns on market integrity, we may determine that a securities regulatory response is warranted to address any or all the concerns raised. Several securities regulatory frameworks can be considered to implement such responses.

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37 GAO Report, *supra* note 4, at pages 16-17.

38 Davies Paper, *supra* note 2, at page 162.

39 *Shareholder Democracy Summit Inaugural Report*, *supra* note 29, at pages 14-15.

This section deals with possible frameworks for imposing securities regulatory obligations on proxy advisory firms. We outline our analysis and assessments regarding each of the potential securities regulatory frameworks that we identified during the course of our review.

A possible securities regulatory framework in this area could consist of either:

1. amendments to existing securities regulatory frameworks; or

2. the creation of a new securities regulatory framework that would apply specifically to the activities of proxy advisory firms.

For reasons further detailed below, we are of the view that amendments to the existing securities regulatory regimes are not appropriate and that any proposed regulatory framework in this area should include the adoption of a new stand alone securities regulatory instrument. If we decide to implement such an instrument, it would require that we obtain the appropriate legislative authority to adopt it.

Once we have determined the need for regulatory intervention and identified the specific concerns that need to be addressed, we would determine what form of regulation may be appropriate. In that context, we will consider a range of alternatives including but not limited to the alternatives mentioned below.

5.1. Potential amendments to existing securities regulatory frameworks

In this section, we review and analyze whether amendments to our existing registration or proxy solicitation regulatory frameworks would be a suitable response to the concerns identified with proxy advisory firms, assuming that a securities regulatory response is actually warranted.

We note that even if we integrate proxy advisory firms into these existing securities regulatory frameworks, amendments to our securities acts would be necessary to regulate proxy advisory firms within these existing frameworks.

5.1.1. Registration as an "adviser"

National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) sets out the requirements for firms and individuals that are in the business of trading in, or advising on, securities, or if they act as an underwriter or manage an investment fund. To determine whether registration is required as a dealer or an adviser, a firm must consider whether its activities amount to trading or advising, and then determine whether it is carrying out those activities as a business.

NI 31-103 provides for categories of registration that serve to specify the types of registrable activity a firm may conduct, and provide specific requirements for each category.

An adviser, as defined in each of the securities acts in Canada, is a person who engages in or holds himself out as engaging in the business of advising another with respect to investment in or the purchase or sale of securities.

5.1.1.1. Analysis and conclusion

In our view, proxy advisory firms are not in the business of advising in the purchase or sale of securities, and therefore, should not be required to register as "advisers" under our securities acts. Although proxy advisory firms provide advice when they make vote recommendations to their clients regarding proposals put to shareholders at shareholders' meetings, this advice is most often not directly with respect to an investment in securities or the purchase or sale of securities.

Moreover, the activities of proxy advisory firms do not fit within the principles underlying the registration regime since these activities have little connection with registration in the traditional sense and are remote from the protection of retail investors.

As our objective would be to regulate proxy advisory firms as market participants and not necessarily to specifically regulate their relationships with clients, the application of the principles of registration would pose a challenge.

An additional difficulty is that the registration requirements and the registrant obligations under NI 31-103 are not tailored to the business of proxy advisory firms.

If we chose to regulate proxy advisory firms as advisers, we would have to consider whether our current fitness requirements for registered advisers based on the principles of proficiency, integrity and solvency are appropriate. Once registered, proxy advisory firms would then be subject to our oversight through our compliance review programme and our enforcement function.

Conclusion

Our registration regulatory framework was not designed to regulate the proxy advisory industry, since proxy advisors do not directly provide investment advice, do not execute trades or manage any client money. If we were to suggest that proxy advisors register as "advisers", we believe that significant amendments would need to be made to the registration framework to accommodate the regulation of proxy advisors. For these reasons, we conclude that the existing registration framework is not appropriate for proxy advisors.

5.1.2. Proxy solicitation requirements

As noted previously, NI 51-102, a rule that generally applies to reporting issuers, excludes from the definition of "solicit" the function of providing proxy voting advice. Specifically, the definition of "solicit" does not include a proxy advisory firm communicating to security holders, as clients, if the communication is in the ordinary course of business, the firm discloses any potential conflicts of interest, the firm receives remuneration only from clients, and the proxy voting advice is not given on behalf of a person soliciting proxies.

5.1.2.1. Analysis and conclusion

If we opted to regulate proxy advisory firms through the existing proxy solicitation framework, we would have to either remove the exception to the definition of "solicit" or add further conditions to that exception.

If we proposed to remove the exception, proxy advisory firms would be required to prepare and send a proxy circular to securityholders as required by Part 9 of NI 51-102. In our view, this is not the right outcome for regulating proxy voting advice.

Alternatively, we could propose additional conditions to the exception. Further conditions, in our view, would only be added if they related to the general business of a proxy advisory firm. We may not be able to add conditions to require proxy advisory firms to implement policies to deal with conflicts of interest or require disclosure of methodologies supporting the vote recommendations of proxy advisory firms without amending our securities acts to obtain rule-making authority to do so.

Conclusion

We do not believe that the activities of proxy advisory firms amount to "soliciting" proxies nor is preparing and sending a proxy circular the proper response to the concerns raised. Our view is supported by the fact that proxy voting advice is not considered as soliciting under our existing proxy solicitation rules, as evidenced by the exception to the definition of "solicit". Proxy solicitation rules should only apply if the person is actually soliciting proxies.

Furthermore, if we chose to regulate proxy advisory firms through the proxy solicitation requirements in NI 51-102, we would be creating a regulatory framework for proxy advisors in a rule that is designed to apply mainly to reporting issuers.

For these reasons, we do not believe that the proxy solicitation regulatory framework contained in NI 51-102 is an appropriate securities regulatory framework for proxy advisors.

5.2. Adoption of a new securities regulatory framework

To the extent that we conclude that a securities regulatory response is warranted, our preferred securities regulatory solution would be the creation of a new stand alone securities regulatory instrument. Such an instrument would require clear legislative authority to regulate proxy advisory firms. This approach would not attempt to compel proxy advisors to comply with requirements of existing regimes that were not designed with them in mind.

Amendments to our securities acts in order to obtain legislative authority to regulate proxy advisory firms will be necessary to implement this securities regulatory framework.

5.2.1. Requirements and disclosure framework

The framework described below could be set out in a rule that would be directed at proxy advisory firms. The rule could spell out the requirements for a proxy advisory firm in the business of "making" vote recommendations on proposals put to a vote at shareholders' meetings of Canadian reporting issuers.

The rule would include our securities regulatory proposals that we consider warranted to respond to conflicts of interest concerns, and increase transparency in the activities of proxy advisory firms.

In summary, possible requirements could be as follows:

1. to mitigate conflicts of interest,

    a. proxy advisory firms would be required to have policies and procedures designed to identify and manage any potential conflicts of interest that arise in connection with the issuance of a vote recommendation. A firm would have policies to deal with employee conflicts and ownership conflicts;

    b. proxy advisory firms would be required to disclose on their website the procedures in place to mitigate or address conflicts. Disclosure of a specific conflict in a vote recommendation report to their clients could also be required; and

    c. proxy advisory firms would separate their proxy voting services from the advisory or consulting services;

2. to increase transparency in the activities of proxy advisory firms,

    d. proxy advisory firms would disclose internal procedures, guidelines, standards, methodologies, assumptions and sources of information supporting vote recommendations;

    e. proxy advisory firms would implement policies that describe their processes to deal fairly with comments from issuers by allowing issuers an opportunity to review the reports and proxy advisory firms to respond to issuers' comments prior to the issuance of the report. The details of the policies would be disclosed on the firms' websites;

    f. proxy advisory firms would disclose on their websites the procedures they implement in developing their voting policy guidelines.

Based on our analysis, this would be the preferred securities regulatory framework for any potential regulation of proxy advisory firms.

5.2.2. Other possible securities frameworks considered

We've also considered the following frameworks and are seeking comments on these alternatives.

Designation framework

Some market participants have indicated that proxy advisory firms should be regulated in a manner similar to the regulation of credit rating organizations.

The securities regulatory framework contemplated for credit rating organizations may be a possible approach to respond to the conflicts of interest and transparency concerns raised regarding proxy advisory firms. In addition, a component of the designation framework would be the oversight function in the form of compliance reviews performed by regulators.

However, we do not believe that there are sufficient similarities to make it necessary to "designate" proxy advisory firms. Unlike credit rating organizations, proxy advisors do not have a formal role recognized in securities legislation; securities rules do not have requirements that rely on the activities of proxy advisory firms.

In our view, and for reasons mentioned above, it is not advisable to impose entry requirements nor appropriate for securities regulators to perform the requisite compliance oversight functions for proxy advisory firms as the role of proxy advisors is different to other entities whose activities are relied upon as part of other securities law requirements.

Certification framework

A certification securities regulatory framework requires an appropriate person to certify compliance with specific requirements in a rule. The rule would have to include requirements that may be similar to those identified above in section 5.2.1. We could then require that proxy advisory firms designate an appropriate organizational representative to certify that they have complied with the requirements.

Alternatively, we could require certification only with regards to certain requirements in the rule. For example, proxy advisory firms could certify that they have controls in place to mitigate conflicts of interest or to ensure accuracy of data used for their recommendations.

We are concerned that this securities regulatory approach may impose unnecessary burdens for proxy advisory firms. In order to provide a valid certification of compliance with the specific requirements, proxy advisory firms could potentially incur significant additional costs.

Comply or explain framework

A comply or explain securities regulatory framework would require proxy advisory firms to comply with specific best practices or guidelines, and to explain, if they have not complied with the practices and guidelines, why not. This framework would require securities regulators to determine what best practices and standards are for the proxy advisory industry (for example, the potential requirements identified above in section 5.2.1). These would be set out in a rule.

This would be a less intrusive and more incremental regulatory approach that would be appropriate if there are not valid reasons for an approach requiring strict compliance with specific rules for proxy advisory firms. However, it would require us to develop the practices and standards appropriate for proxy advisory firms.

Best practices guidance

Another option would be to adopt a policy that would give guidance on best practices for proxy advisory firms. This approach would be similar to a "comply or explain" model to the extent that securities regulators would determine what best practices are for proxy advisory firms. It would be a minimally intrusive form of potential regulation.

However, if the concerns and impact on market integrity are valid and significant, this option may not be sufficient as it would not provide securities regulators with the ability to ensure and enforce compliance as compared to a rule-based approach. Also, similar to the "comply and explain" approach, securities regulators would be required to develop the requisite best practices for proxy advisory firms.

5.3. Specific request for comment

We specifically seek comments in response to the following questions from *all market participants*:

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.

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

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?

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

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?

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?

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?

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?

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?

Additional questions for *institutional investors:*

18. To what extent and in what ways do you rely on the services provided by proxy advisory firms? Please be as specific as possible.

19. How do you view your duty to vote and how do the vote recommendations of proxy advisory firms play a part in your decision-making process?

20. Do institutional investors have the ability to require changes to proxy advisory firms' practices without the need for regulatory intervention?

21. Assuming you share the concerns identified above, do lack of choice/competition or other market factors in the proxy advisory industry limit your ability to address these concerns directly such that regulatory intervention is warranted? Please explain.

22. Given the above-noted concerns regarding the overall quality and lack of transparency underlying the vote recommendations of proxy advisory firms, what measures do you take and, overall, how do you gain assurance that such recommendations are reliable for your voting purposes?

23. Do you view the policy development process and resulting proxy voting guidelines of proxy advisory firms as appropriate and reflective of your governance preferences and views? Would input from issuers further benefit or potentially hinder such process?

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).

Additional questions for *proxy advisory firms*:

28. What are your views with respect to the concerns identified and with any of the possible regulatory approaches to these concerns?

29. In connection with the possible regulatory approaches, do you have concerns about disclosure of confidential or proprietary information? Please explain.

30. What impact could the preferred securities regulatory framework (requirements and disclosure) have on your operations? Please provide details and, where appropriate, propose an alternate approach.

31. In addition to your responses to the questions posed, we also welcome any additional information and data you can provide to inform our continued review and analysis of the issues identified in the Consultation Paper.

REQUEST FOR COMMENT

The CSA is publishing the Consultation Paper for a 60-day comment period. Please send your comments in writing on or before August 20, 2012. All submissions should refer to "CSA Consultation Paper 25-401". This reference should be included in the subject line if the submission is sent by e-mail. Regardless of whether you are sending your comments by email, you should also send or attach your submissions in an electronic file in Microsoft Word, Windows format.

Please address your submission to the following securities regulators:

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

Please send your comments **only** to the address below. Your comments will be forwarded to the other CSA member jurisdictions.

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Corporate Secretary
Autorité des marchés financiers
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M5H 3S8
Fax: 416-593-2318
e-mail: jstevenson@osc.gov.on.ca

All comments will be posted on the AMF website at www.lautorite.qc.ca and the websites of the other CSA jurisdictions. We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period.

Questions

Please refer your questions to any of:

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June 21, 2012

APPENDIX A

Regulatory Initiatives Internationally

1. France

AMF France issued *AMF Recommendation No. 2011-06 of 18 March, 2011 on Proxy Advisory Firms* (the AMF Recommendation). A recommendation is a proposal to adopt behaviour or comply with a provision that, in AMF France's view, would make it easier to achieve the aims of the standards or general principles under its jurisdiction, without denying that other behaviours or provisions may also be consistent with these standards or principles. Recommendations are not mandatory.

The AMF Recommendation "addresses the issues of establishing and implementing voting policies, issuing voting recommendations, communicating with listed companies, and preventing conflicts of interest."[40] The objective of the AMF Recommendation is to promote transparency and manage conflicts of interest.

Establishing and issuing the voting policy

AMF France recommends that proxy advisory firms publish their general voting policies on their website. AMF France also recommends that the voting policy be established through a transparent process so that the opinions of investors and other market participants can be taken into consideration.

Issuing vote recommendations

AMF France recommends that proxy advisory firms define their methodologies to be used by their staff for their analyses and vote recommendations and publish them on their website.

Proxy advisory firms explain, in their reports, the reasons for the vote recommendations in particular with respect to their published general voting policy.

Communicating with the issuers

AMF France recommends that draft reports be submitted to issuers for review. The issuer would be given at least 24 hours to provide comments. The comments will be included in the report if they are concise and help the investor understand the resolution to be voted on. The final report is sent to issuers at the same time as it is sent to clients.

Proxy advisory firms have to correct any substantive error found in their reports and reported by the issuers.

The policy on communication with issuers would be published on their website.

Preventing conflicts of interest

AMF France recommends that proxy advisory firms define and post on their websites reasonable and appropriate measures to prevent potential conflicts of interest involving the firm, their executive directors and their analysts. Procedures should be specified for conflicts that arise when other activities are involved, for example, advising issuers, providing voting platform, and proxy solicitation.

Measures and procedures are included in a code of ethics or a code of conduct. A compliance officer is designated to ensure compliance with such codes.

Proxy advisors would state in their reports any ties that exist with:

- the issuer;
- a client that is submitting items for the agenda of an issuer on which the proxy advisor is preparing a vote recommendation;
- the persons who directly or indirectly control the issuer.

[40] *AMF Recommendation*, Introduction.

2. European Commission

The European Commission published for comment on April 5, 2011 the *Green Paper: The EU corporate governance framework* (Green Paper) aimed at assessing the need for improvement of corporate governance in European listed companies. The Green Paper highlighted the concerns raised by investors and issuers concerning proxy advisory firms and asked the following questions:

- Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

- Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?[41]

The European Commission published responses to these questions an November 15, 2011. For the first question, the European Commission summarized the responses as follows:

> More than three quarters of respondents who provided an answer to this question agree that EU law should require proxy advisors to be more transparent. Amongst others, respondents mentioned that proxy advisors should be more transparent about the following issues: their methodology for preparing voting advice, voting policies and records, conflicts of interest and the system in place to manage them, whether a code of conduct applies or whether there are internal rules of conduct, applicable procedures for contacting companies when preparing the advice and stewardship policies. A number of respondents believe that in particular the issue of conflicts of interest of proxy advisors should be addressed. Moreover, some respondents are of the view that proxy advisors should be required to register and become supervised entities. It was also mentioned that institutional investors should disclose when they make use of the services of a proxy advisor.[42]

As for the second question, the responses are summarized as follows:

> A small majority of respondents who provided an answer to this question believe that other measures are necessary to address conflicts of interest of proxy advisors. A number of respondents suggested that there should be mandatory separation of services to investors and services to companies, while a few respondents mention that it should be disclosed if proxy advisors also provide services to investee companies. Respondents who provided a negative answer to the question said that the issue could be addressed through self-regulation or codes, or were of the opinion that the issue would be resolved if there were sufficient disclosure on conflicts of interest.[43]

In July 2011, the Department for Business, Innovation and Skills in the UK published the *UK Government Response to the European Commission Green Paper: The EU corporate governance framework*. The UK response to the Green Paper included the views of the Financial Services Authority. The UK's responses to questions 18 and 19 of the Green Paper are:

> Q 18: We understand that ESMA has recently issued a questionnaire to proxy advisors in order to research a possible discussion paper on the role of proxy advisors. The results of this exercise should be awaited before taking any firm decisions. We note that so far the evidence on whether proxy advisory functions pose risks that require a regulatory response is mixed.
>
> Q 19: Unless there is clear evidence that a regulatory response is necessary and justifiable in cost benefits terms, the UK would favour non-regulatory measures, such as an appropriately worded code of conduct against which proxy advisors make disclosure, to address any problems identified in this area.[44]

3. ESMA Discussion Paper

The European Securities and Markets Authority (ESMA) published for comment on March 22, 2012 the Discussion Paper *An Overview of the Proxy Advisory Industry - Considerations on Possible Policy Options* (the ESMA Paper). ESMA did not suggest any formal proposals for policy action related to proxy advisors but rather intends "to gain evidence on the extent to which

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41 European Commission, *Green Paper: The EU corporate governance framework*, April 5, 2011, Questions 18 and 19, at page 15.

42 European Commission, *Feedback Statement: Summary of Responses to the Commission Green Paper on the EU Corporate Governance Framework*, November 15, 2011, at page 14.

43 Ibid., at page 15.

44 Department for Business, Innovation and Skills, *UK Government Response to the European Commission Green Paper: The EU corporate governance framework,* July 2011, at pages 14 and 15.

market failures related to the activities of proxy advisors may exist, the extent to which EU-level intervention might be appropriate, and what ESMA's role might involve."[45]

The ESMA Paper explored the issues that can be seen as factors which potentially influence the accuracy, independence and reliability of the proxy advice given to investors, such as the potential for conflicts of interest. Also considered are the degree of transparency on management of the conflicts of interest, the voting policies and guidelines, dialogue with issuers, vote recommendations and the procedures for elaborating a recommendation report.

ESMA put forth the following policy options that it will consider and on which it seeks input from market participants.[46]

1. No EU-level action at this stage

   This option would reflect that there are different markets within the EU, and that overall, the proxy advisory industry in Europe is still developing. Under this option, it would be up to each Member State (or industry) to develop the appropriate standards they consider necessary.

2. Encouraging Member States and industry to develop standards

   Under this option, there may be some form of informal engagement between the European authorities (ESMA, the European Commission), Member States, and/or industry to develop standards that are appropriately tailored for the European markets, either in the form of national codes developed by Member States or by encouraging proxy advisors to develop their own code of conduct.

3. Quasi-binding EU-level regulatory instruments

   This option would involve developing regulatory instruments, but this would not be in the form of binding legislation. One form would be developing standards on a "comply or explain" basis which would be underpinned by an EU Regulation or Directive. A second possibility would be ESMA guidelines or recommendations.

4. Binding EU-level legislative instruments

   This would involve the introduction of binding EU legislation. This approach might also include additional measures on authorization or registration and supervision by national competent authorities or ESMA.

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45 ESMA, Discussion Paper *An Overview of the Proxy Advisory Industry - Considerations on Possible Policy Options*, March 22, 2012, at page 5.

46 Ibid., at page 5 and pages 34-38.