

September 21, 2012

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New Brunswick Securities Commission
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Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

c/o

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Dear Sirs/Mesdames:

Re: CSA Consultation Paper 25-401: Comment Letter

On June 21, 2012, the Canadian Securities Administrators (the “CSA”) published *CSA Consultation Paper - Potential Regulation of Proxy Advisory Firms* (the “**Consultation Paper**”). We are pleased to submit this letter in response to the CSA's request for comment, and would like to thank the CSA for providing the opportunity to respond to these potential areas of reform.

We support the CSA's initiative to investigate the potential regulation of proxy advisory firms. Davis LLP is a leading full-service law firm, providing comprehensive legal services from offices across Canada and in Japan. We submit that:

- Proxy advisory firms should be regulated.
- Any new regulatory requirements would be best addressed through a new national instrument, and not through the application of other existing regulatory schemes.
- Appropriate regulatory interventions should include requiring internal policies and procedures to minimize conflicts and the disclosure of actual conflicts of interest.
- Increased transparency in proxy advisory firms' policies that manage conflicts of interest is necessary to improve market oversight of proxy advisory firms.
- Prohibition of serious conflicts of interest, such as where the proxy advisory firm provides both corporate advisory services and corporate governance ratings regarding the same issuers, is essential to maintaining issuers' and investors' confidence in the integrity of the advisory firm.
- Greater transparency as to how voting recommendations are produced is required to improve the factual accuracy of the data on which proxy advisory firms rely.
- Identifying the persons involved in preparing proxy advisory reports and disclosing their qualifications in these reports would enhance credibility and confidence, in both the recommendations and the advisory firm.
- Issuers that are being rated by a proxy advisory firm should be given a meaningful opportunity to address perceived omissions and errors and include their concerns in proxy advisory reports (e.g. a process for dialogue with issuers, similar to that proposed by the French Autorité des marchés financiers (the "**FAMF**"), could be adopted.)

Background

Demand for proxy advisory services has grown in recent years due in part to greater pressures on institutional investors to exercise their stewardship responsibilities. Enhanced continuous disclosure requirements and the increasing complexity of matters to be voted upon by shareholders have helped expand the influence of proxy advisory firms on corporate governance practices. The volume of proxy votes is expected to grow in the foreseeable future - greater reliance can be expected to be placed on the recommendations of these firms. We believe that proxy advisory firms should be appropriately regulated so as to promote and maintain confidence in capital markets through proper disclosure and increased transparency.

Some of our clients have expressed concern over the limited visibility of the affairs and decision-making processes of proxy advisory firms. Some of our clients have also suggested that any regulatory framework should not be overly burdensome to market participants, including issuers, and should not impede market efficiency.

In our opinion, a new standalone national instrument, tailored specifically to the regulation of proxy advisory firms, is an appropriate regulatory response. It is also our opinion that any new regulatory requirements would be best addressed through this new instrument and not through the application or modification of other existing regulatory schemes. In this regard, we agree with the reasoning and conclusions set out in Part 5 of the Consultation Paper, “Potential Securities Regulatory Frameworks”.

We offer the following comments on some of the specific questions raised in the Consultation Paper:

Conflicts of Interest:

Q5: 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.

The CSA states in the Consultation Paper that the proxy advisory firm industry in Canada is dominated by Institutional Shareholder Services Inc. (“ISS”) and Glass, Lewis & Co (“Glass Lewis”), a wholly-owned subsidiary of the Ontario Teachers' Pension Plan. Both firms are headquartered in the United States.

Limited information is available as to the nature and extent of conflicts of interest in these firms' Canadian and US operations. Comments on the Securities and Exchange Commission's *Concept Release on the U.S. Proxy System published July 14, 2010* (the “**Concept Release**”) suggest that conflicts have arisen in the United States where advisors employed by proxy advisory firms have had dealings with issuers involved in proxy contests.¹ The CSA notes in the Consultation Paper that conflicts of interest may arise where an institutional client of a proxy advisory firm is a proponent of a specific shareholder proposal that is being rated, or where the proxy advisory firm rates issuers in which the proxy advisory firm's parent corporation has an interest.

¹ Letter from Wachtell, Lipton, Rosen & Katz (October 19, 2011) “Re: Comments on Release No 34-62495; IA-3052; IC-29340; File No. S7-14-10”, at page 8.

The CSA also states in the Consultation Paper that conflicts may arise where a proxy advisory firm provides voting recommendations on the same issuers to which it provides corporate advisory services. We understand that ISS is unique among proxy advisory firms in that it provides both corporate advisory services and corporate governance ratings regarding the same issuers. We further understand that some issuers have reported being solicited by the corporate governance branches of ISS to improve their ratings.²

We note that the websites of both ISS and Glass Lewis disclose the firms' conflicts of interest policies. Disclaimers, and links to these policies, are provided at the end of their reports. However, this disclosure is framed in general terms and does not divulge specific conflicts in which the firms are involved. Ethical walls without market oversight are unlikely to be an effective method of preventing conflicts of interest. They permit proxy advisory firms to be essentially "self-regulated".³ Increased transparency into advisory firms' policies that mitigate and address conflicts, including minimizing employee and ownership conflicts, the disclosure of specific conflicts of interest, and disclosure of the remuneration received by the proxy advisory firm for the consulting services, is necessary to (i) give consumers of proxy advisory services meaningful choice when selecting their advisors, and (ii) promote the general integrity of capital markets.

We believe that prohibition of conflicts of interest may be required in some instances. Disclosure alone may not be effective where the proxy advisory industry is controlled by a small number of firms. In a limited market, disclosure does not promote meaningful choice for consumers of proxy advisory services who would seek to avoid conflicts of interest. Regulation that focuses solely on disclosure places the onus on consumers, and not proxy advisory firms themselves, to avoid conflicts.⁴

Recommendation Metrics:

Q8: Could disclosure of underlying methodologies and analysis provide beneficial information to the market or would the commercial costs of doing so be too significant?

Issuers have expressed concern that proxy advisory firms have become *de facto* corporate governance standard-setters -- especially given the lack of transparency with regard to the way proxy advisory firms establish their guidelines and formulate their recommendations, and the reliance that may be placed on them by investors. Proxy advisory firms set more stringent governance standards for issuers than those established by securities regulations and stock

² Monica Langley, "Want to Lift Your Company's Ranking on Corporate Governance? Buy the Test," *Wall Street Journal* (June 6, 2003) online: <<http://online.wsj.com/article/SB105485006531971100.html>>.

³ Tamara Belfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control" (2009) Vol 14:2 *Stan JL Bus & Fin* at pages 37-38.

⁴ Letter from Tamara Belfanti (October 20, 2010), "Re: Comments on Concept Release on the U.S. Proxy System; File No. S7-14-10" at page 4.

exchange policies. As a practical matter, issuers are often forced to follow the corporate governance guidelines set by proxy advisory firms, even if such guidelines may not necessarily fit within the broader strategic objectives of the issuer. Improved transparency as to how advisory firms set their voting standards will assist investors and other market participants in better assessing the reasonableness of proxy advisory firms' guidelines and recommendations.

ISS and Glass Lewis describe the methods by which they arrive at their voting recommendations on their websites, but it is unclear how these recommendations are implemented.⁵ Analysis indicates that ISS ratings "have either limited or no success in predicting firm performance or other outcomes of interest to shareholders."⁶ Despite their reliance on similar criteria, there can be significant discrepancies among proxy advisory firms' commercial corporate governance ratings when they rate an issuer. These divergences suggest that there may be measurement errors in the data relied on by the firms.⁷ Furthermore, we understand that the reports prepared by proxy advisory firms generally do not disclose the data relied on to produce a recommendation.

In addition to the foregoing, we believe that clear and prominent identification of both the persons responsible for preparing reports and their qualifications should be required. Among other things, we think that this would help enhance accountability, responsibility and transparency. We note, by way of comparison, that the reports that are typically produced by Canadian investment bank research analysts tend to give prominent play to the both the identities and the qualifications of the author/analysts (and certainly the investment bank research analysts are performing a substantially similar task as the proxy advisory firms when, for example, they make recommendations on M&A transactions). In contrast, the reports of proxy advisory firms tend not to give such prominent play to the identities and qualifications of the persons preparing such reports. At Canadian investment banks, their leading research analysts are often considered "stars" whose names are well-known in the investment community (for example, the financial press will take note when such analysts switch firms) and who play a role in the overall marketing of those firms' services, whereas the people producing reports for the proxy advisory firms are comparatively unknown. We think it is interesting to consider the reasons for this difference. Is it because the investment banks are operating in a more vigorous competitive environment, and therefore feel more of a need to promote and highlight the qualifications of the individuals who carry out their research?

⁵ Tamara Belfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control" (2009) Vol 14:2 Stan JL Bus & Fin at page 36.

⁶ Robert M Daines, Ian D Gow and David F Larcker, "Rating the ratings: How good are commercial governance ratings?" (2010) 98:439 Journal of Financial Economics, at page 460.

⁷ Robert M Daines, Ian D Gow and David F Larcker, "Rating the ratings: How good are commercial governance ratings?" (2010) 98:439 Journal of Financial Economics, at page 461.

Issuer Engagement:**Q9: To what extent could there be an improvement in the dialogue with issuers during the vote recommendation process?**

Comments on the Concept Release suggest that several American issuers have felt that some proxy voting recommendations rely on erroneous information that is not corrected when requested. Conservative estimates indicate that voting recommendations by ISS alone may influence 6% to 10% of the votes of the median company in the United States.⁸ Further information is required as to the significance of ISS and other proxy advisory firms' influence on voting in Canada. Given the potentially significant impact that proxy voting advice may have on issuers, we believe that issuers that are being rated should be given a meaningful opportunity to address perceived omissions and errors and to have their concerns included and addressed in proxy advisory reports.

The CSA notes in the Consultation Paper that the FAMF has recommended that proxy advisory firms submit drafts of their reports to issuers prior to their distribution. The FAMF has also recommended that:

- the issuer be provided at least 24 hours to submit any feedback or comments to customers,
- the proxy advisor include the company's comments on the voting recommendations in the analysis report that it submits to the investors,
- the proxy advisor correct any substantive error found in its analysis report and reported by the company, and ensure that the correction is submitted to the investors as quickly as possible, and
- the proxy advisor publish on its website its adopted rules on communication with companies, particularly rules on submitting the draft analysis report prior to publication.

We support the FAMF's recommendations. However, we suggest that if the CSA proposes regulations similar to those recommended by the FAMF, the suggested 24 hour comment-period should be extended to at least 48 hours, to allow issuers sufficient opportunity to review and respond to the draft report.

⁸ Stephen Choi, Jill Fisch, Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?"(2010) 59:869 Emory LJ at page 906.

Conclusion

We would like to thank the CSA members who participated in the preparation of the Consultation Paper. We also thank the CSA for its consideration of our comments. Should you have any questions regarding the above please contact Stu Morrow (sbmorrow@davis.ca or 604-643-2948) or Don Collie (dcollie@davis.ca or 604-643-6472).

Respectfully submitted,



DAVIS LLP