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Canadian Securities Administrators

Me Anne-Marie Beaudoin
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Ontario Securities Commission
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Submitted by email

Re: Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms

Dear Sir/Madam,

We are pleased to have the opportunity to provide feedback on the CSA Consultation Paper on the proxy advisory industry in Canada.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (EOS), we also respond to consultations on behalf of a number of pension funds and institutional investors from the US, Australia and Canada, as well as across Europe, including BT Pension Scheme Management Limited, BNO Media (Netherlands), VicSuper of Australia and Lothian Pension Fund. (only those clients which have expressly given their support to this response are listed here). We assist these clients, mostly like-minded pension funds with long-term investment horizons, to act as good owners of the assets in which they invest. One way we do so, is by assuming the duties and responsibilities of proxy voting. In all, EOS serves clients with regard to assets worth a total of over C$135 billion (as of 31 December 2011).

As an institutional investor, we vote at over 11,000 general meetings each year on behalf of our clients, including our owner, the British Telecom Pension Scheme. Besides actively engaging with a number of companies, we manage our voting via a partnership with proxy advisory firm Glass Lewis. We are guided by our clients' voting guidelines and have developed best practice regional principles which have themselves been based on local market

standards. While we see a lot of benefit in the vote processing service offered by our advisor, we retain complete authority over voting decisions.

In general, we believe that the proxy voting industry answers a genuine demand among investors who in many cases have to cope with a significant workload concentrated in a comparatively short time period of about four months. This demand has partly to do with the quality of advice provided by the major players on the market, and partly with the convenience in vote processing that proxy advisors offer.

At present, the technicalities of submitting a vote vary widely across jurisdictions, and present investors with a significant amount of paperwork. Employing a proxy advisor can, under certain circumstances, be the only way of ensuring that all votes in all different markets are submitted validly and on time. In our view, it is important to recognise that a large part of proxy advisors' influence stems from this practical consideration. This circumstance, in turn, results from the overall complexity and diversity of voting systems.

The other reason lies in the fact that leading proxy advisors tend to develop their guidelines in cooperation with shareholders and to therefore incorporate what is predominantly seen as best practice globally as well as local corporate governance codes. To a certain extent, their influence upon the corporate governance debate can be considered positive in the sense that the possibility of getting a negative recommendation has served to prompt companies to respond more actively to investor concerns, as expressed through widely-agreed standards.

However, we are concerned that the current structure of the proxy advisor market as well as some widespread investor behaviours could lead to overreliance on proxy advice and create potential for principal-agent conflicts.

Often this occurs because the benefit of good governance flows to the underlying owner of the company (the principal) while the cost of carrying out voting often sits with the fund manager, which as an agent has less incentive to invest in doing the job well. In particular, we are concerned about a lack of resources involved in taking voting decisions.

Even though, in our experience, the influence of proxy advisors cannot be uniformly considered worrying, the incentives of investors and advisors differ sufficiently to create potential for principal-agent conflicts. Due to the popularity of proxy advisory services and especially of "follow the proxy advisor" voting policy, sometimes reinforced by regulatory pressure, in many instances the decision-making process is effectively transferred to a party which does not carry the risk of the voting decision.[1] This is exacerbated by the comparatively

[1] Belinfanti, Tamara, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control,* 14 Stanford journal of Business and Finance,385 2008-2009, p. 407.

high barriers to entry of the market for proxy services and a persistent and high first-mover advantage.[2]

Therefore, it is necessary to introduce mechanisms of enhancing the accountability of proxy advisors, simplifying voting systems to lower entry barriers and incentivising investors towards continuous stewardship of their holdings and meaningful engagement with companies.

We answer the questions below as an institutional investor and from the point of view of whether they would help create these incentives.

Yours sincerely,

Bill Mackenzie
Senior Adviser

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[2] Belinfanti, Tamara, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control,* 14 Stanford journal of Business and Finance,385 2008-2009, p. 408-413.

Specific request for comment

1. Agreement with concerns identified in the Consultation Paper:

(i) potential conflicts of interest

Yes there are conflicts of interest, both unavoidable and in some cases built into the proxy advisor's business model. An example of the former would be a proxy advisor publishing voting recommendations for a publicly traded financial institution that is also a fund manager and client of the proxy advisor. An example of the latter is illustrated by the ISS business model which provides a fee for service consultancy to corporations on corporate governance issues that form the basis of its proxy advisory service for institutional investors. While "ethical walls" can shield analysts from the specific companies receiving corporate governance advice, there are more general problems that cannot be avoided through the careful structure of ethical walls. For example, when voting policy decisions are made or guidelines are modified by the proxy advisory side of the business, there will always be some concern about how the new policy will affect the company's corporate business. These considerations are real and suggest that compensation systems of firms serving in dual roles should be transparent and can demonstrate that there are no perverse incentives.

(ii) perceived lack of transparency,

Proprietary models used by proxy advisory firms in compensation plan analysis are an example of an opaque strategy that creates the framework for a profitable consulting business, but does not seem to serve the interests of the market as well as a transparent methodology that becomes widely understood and tested. However we do not think transparency of methodology is a significant problem and proxy advisor reports disclose adequately the reasons for their vote recommendations.

(iii) potential inaccuracies and limited engagement with issuers,

The quantity of work compressed into the short proxy season and the short timelines between availability of proxy materials and voting deadlines make engagement with issuers difficult. Sometimes getting the attention of the correct person at an issuer can delay reports for several days. However, allowing an issuer to vet a report is the best way to ensure that factual errors are caught and to ensure the issuer is fairly warned of any recommendations against management. Other structural problems making it difficult to fit in a dialogue with an issuer include custodian-imposed proxy voting deadlines set days ahead of a meeting and the occasional release of proxy materials for complex meetings 21 or fewer days before the meeting.

These factors and the volume of work allow short windows of time to conduct analysis, a mandatory vetting of every report may have the effect of furthering the "one size fits all" policy approach, rather than encourage additional thought and dialogue about a specific issuer's circumstance. We believe that the proxy voting system should better accommodate engagement around proxy issues.

(iv) potentially inappropriate influence on corporate governance practices,

To address issues raised by a proxy advisor, many Canadian issuers have made significant changes to proposals just prior to the proxy deadlines in order to avoid losing a vote. However, the weight of the proxy advisor's recommendation alone is not always enough to motivate issuers to make changes. Clearly market dominance by one proxy advisor is more likely to result in inappropriate influence.

Proxy advisors attempt to set standards that reflect best practices that often differ across the markets they cover. These practices are incorporated into models and peer group comparisons often form the basis for determining "outliers." Comparator groups are generally limited to a particular market and are often grouped according to an industry. In Canada, some multi-national corporations warrant global comparator groups, and some corporations are grouped inappropriately into an industry group driven by their SIC Codes. This formulaic grouping of peer companies sometimes results in an inappropriate peer grouping for an issuer that may be difficult to classify due to diversity or uniqueness of the underlying business. This occasionally results in them becoming an outlier by a measure that may be fairly challenged by an issuer. However such an issuer may be unsuccessful in their bid to overturn a negative vote recommendation based on such an analysis. Given the current pricing of proxy voting research and resulting funds available for hiring analysts, and the intensely seasonal nature of the work, proxy advisors need to adopt such models, even though they acknowledge that they are not perfect for all companies. In such cases, the issuer is forced to go directly to investors, as Cognos did by way of its proxy circular in 2003 (see pages 13 and 14). We note that this type of disclosure is exceptional. In their 2005 proxy circular (page 15), Cognos merely notes that its option plan amendment resulted in an acceptable rate of "SVT" or dilution under the ISS model, thus making clear to the ISS analyst on the other side of the ethical wall, that ISS Corporate Services had been engaged.

(v) the extent of reliance by institutional investors on the advice of such firms

While the top two proxy advisors continue to expand their client bases, large fund managers and pension funds in Canada increasingly are employing the research services of more than one proxy advisor and are performing more independent research to reach their own voting conclusions. However, it is our understanding that such enhanced activity is generally limited to local markets and higher reliance on the advisor is placed with respect to other markets.

To the extent that there is pressure on asset management fees and a bias towards passive asset management or indexing, the influence of proxy advisors could grow as less internal expertise will be employed by asset managers.

Also, the seasonality of proxy voting will continue to be a factor supporting varying degrees of reliance on proxy advisors by nearly all fund managers.

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

We noted above the potential problems arising from compensation policies at proxy advisors with business models that include corporate consulting on proxy and governance issues. We believe that if proxy advisors continue to operate in this way, variable pay of a proxy advisor's employees or executives should be appropriately linked to either the profitability of the institutional advisory business or the corporate advisory business, but not both.

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

We are concerned about the depth of expertise among analysts at proxy advisors. With virtually all takeovers now completed as plans of arrangement, more recommendations are being given by proxy advisors on these complex corporate transactions. While sophisticated fund managers with their own research capability may and often do ignore the recommendation of a proxy advisor on such transactions, issuers increasingly utilize the press to publicize supportive recommendations of proxy advisors. As this may influence the actions of retail investors, we note this as a potential gap. We also have concerns about proxy

advisors also providing fee-based consulting to issuers on proxy issues and corporate governance. These concerns are noted below.

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

We believe that proxy advisors which also provide fee-based consulting to issuers on proxy and governance matters represent problems that are not well understood by their clients and thus do not receive enough scrutiny. We believe that the profitability of corporate consulting can give a competitive advantage to a firm by allowing lower pricing of proxy research and voting services compared to a proxy advisor operating without this conflict. Leveraging institutional investor influence to charge fees to issuers contributes to market dominance by an advisor that has a less attractive business model. We believe that a conflict-free business model is preferable for a proxy advisor and are concerned with this as a barrier to entry for new proxy advisory firms. At a minimum, we believe the regulator should examine the compensation systems employed by proxy advisors with corporate consulting businesses to ensure incentives are appropriately aligned.

Potential conflicts of interest
5. To what extent do you consider proxy advisory firms to:
(i) be subject to conflicts of interest in practice:

For most advisors, conflicts arise from time to time, but are isolated to specific proxies or situations. In the case of fee-based corporate consulting, it is inherent in the business model.

(ii) already have in place appropriate conflict mitigation measures:

Appropriate internal measures, including concealing the proxy advisor's consulting client's identity from the proxy analyst, have been implemented. However, it is difficult for the proxy advisor to enforce a non-disclosure agreement entered into with their corporate advisory clients. A clear example of this is contained in the 2003 and 2005 Cognos Inc. proxy circulars, where the company plainly discloses (2003, p. 13 - 14) or infers (2005, p. 15) that it retained ISS corporate consulting services.

(iii) be sufficiently transparent regarding the potential conflicts of interests they may face?

Generally, proxy advisors have been thorough in disclosing where conflicts may occur in their proxy research, or by other means if it is not possible to do so in the body of the report. It is hard to know how individual analysts, in practice, deal with these conflicts.

In the case of disclosing the identities of corporate consulting clients, the information is available if one takes steps to obtain it. Although this could be improved from an institutional investor client perspective, such disclosure could compromise the ethical wall. We believe it is preferable to operate without such conflicts in the business model.

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?

As noted above, we have a concern with conflicts that are built into the business model, specifically fee-based corporate consulting on proxy and governance issues by proxy advisors. We believe that the development of such corporate services requires the use of very structured models to ensure consistency and reduce interpretation. This limits the amount of case by case analysis that can be applied by an analyst in preparing a vote recommendation, leading to a one-size-fits-all approach, which may be detrimental to some issuers in some

circumstances. We noted above our concern about the potential effect in the development of voting policies and guidelines.

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 firms consulting clients?

Disclosure of consulting clients should be clear, but done in a manner that maintains the ethical wall. However, we believe that engagement is a necessary extension of the corporate governance process, not a fee-based consulting opportunity. To the extent that proxy advisors are representing shareholder interests, they should not be consulting with issuers on proxy matters for a fee.

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?

Such disclosure may clarify some opaque models, but we do not believe that there will be much benefit to the market.

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

Under the current system, despite the constraints of proxy advisors, issuers should be able to dialogue directly with them and with investor clients of the proxy advisor, if there are concerns about a proxy advisor's recommendation. Proxy advisors should readily fulfil issuer requests to obtain copies of proxy analysis coverage of their meetings.

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?

If the advisor is in agreement with the recommendations of management in the proxy circular, it is clear that engagement is not necessary. If proxy disclosure is unclear or inadequate, it is appropriate for the advisor to engage to obtain more information. If the advisor recommends a vote against a proposal or nominee or in the event of a proxy fight, there should be an avenue for the issuer to initiate dialogue with the proxy advisor, and their shareholders, if deemed necessary by the issuer.

11. If a proxy advisory firm, as a matter of policy, believes that there are certain circumstances where it is not appropriate for it to give issuers an opportunity to review its reports, would it be sufficient to only require in these circumstances that the underlying rationale for such policy be disclosed? Please explain. Or, alternatively should proxy advisory firms be required to provide issuers with an opportunity to review their reports in all circumstances?

Due to the difficulty identifying shareholders in Canada and the reality that some investor clients of advisory firms are not in a position to engage on proxy matters, a report containing a vote recommendation that is published on the advisor's website or distributed to clients should be available to the relevant issuer on request. The advisor should always be willing to dialogue with an issuer who has legitimate concerns about a report.

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?

Other than ensuring the right to obtain a report noted under 11 above, we do not think that there should be any prescriptive steps. It is reasonable that a public company would be aware or be made aware by its advisors that they would be covered by a proxy advisor, and the onus would be on them to be proactive, particularly since there are only two significant proxy advisors in Canada.

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?

It is for the proxy advisor firm to develop its own voting policies and guidelines based on its own independent views. In many cases individual institutional investor clients will specify their own policies which are then executed by the proxy advisor. Given the high profile of proxy advisors, we believe feedback on policies from other market participants is dynamic and influential.

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.

Other than setting some limitations or guidelines for proxy advisors and basic rights for affected participants as noted above and summarized under section 16 below, we do not see the need for extensive regulation.

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

See response under section 16 below.

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?

Due to the international nature of proxy advisor influence, we believe that for this part of the financial industry, a harmonised approach will be more effective than a national one. However, we believe that proxy advisors currently provide disclosure that largely complies with the requirements set out in section 5.2.1. so such regulation would not be onerous.

We believe that issuers should be able to request and acquire copies of published analysis and vote recommendations concerning an upcoming meeting of their shareholders. We believe that companies should have the opportunity to engage with the proxy advisor where a vote recommendation has been made against a proposal, or the proxy advisor if there is a factual error in the report. It is our understanding that proxy advisors do address factual errors by sending timely updates or alerts to clients.

We believe that engagement with issuers on proxy issues is a responsibility of shareholders. To the extent that the right to vote has been outsourced to a proxy advisor, we believe that

engagement with the issuer by the proxy advisor is done on behalf of their investor clients and therefore should not receive a fee from the issuer for doing so.

If corporate services continue to be offered by proxy advisors, we believe that the separation of businesses as contemplated in 5.2.1 also include a requirement that compensation schemes support the independence of these two distinct activities and reinforce the accountability of the proxy advisor to its investor clients.

With respect to mergers and acquisitions and the appropriate depth of research and expertise employed at proxy advisor firms, we do not think that this is something that can be set out in regulations and must ultimately be driven by clients. However, we are concerned about the promotion of proxy advisor recommendations in the press.

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

No

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.

We appreciate the detail of the reports and organization of data into a consistent form, making it possible to quickly identify areas where additional research or reference to the proxy circular is warranted.

We rely on the reports to get a quick snapshot of the quality of reporting and governance practices employed by the issuer.

We investigate vote recommendations against management and formulate our own opinion, which often involves reviewing historical proxy advisor research as well as proxy circulars and other corporate documents as needed.

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?

We believe that we have a duty to vote all proxies in a way that best serves the interests of our clients and pension beneficiaries

We rely heavily on our internal expertise which includes individuals who specialize in specific markets. These individuals understand local market best practices and are familiar with companies that have challenging issues. The proxy advisor essentially provides time-saving tools as well as some valuable insight.

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

Yes

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.

No

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?

We do not rely on the voting recommendations of our proxy advisor. .

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?

We believe that proxy advisors are influential and recognize that their policy development processes incorporate many factors and are subject to many influences. We believe that issuers and their advisors currently do influence policy development at proxy advisors.