Jane Ambachtsheer
Partner

161 Bay Street
P.O. Box 501
Toronto, Ontario M5J 2S5
416 868 2659
Fax 416 868 9634
jane.ambachtsheer@mercer.com
www.mercer.ca

Private & Confidential
British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

Attention:

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

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

20 August 2012

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

Ladies and Gentlemen,

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

We are aware that our colleagues in Mercer's Human Capital Executive Rewards ('Mercer Human Capital') business unit have provided a submission in response to the CSA's request for comment. Whereas Mercer Human Capital has provided comment drawing on their experience providing executive compensation and benefits consulting services to companies, this submission reflects Mercer Investments' perspective based on our conversations and experience working with institutional investors and the issue of proxy voting.

About Us

Mercer's Investment Consulting business is a leading global provider of investment consulting services, and offers customized guidance at every stage of the investment decision, risk management and investment monitoring process. We have been dedicated to meeting the needs of clients for more than 30 years and work with the fiduciaries of pension funds, foundations, sovereign wealth funds and other institutional investors. We advise more than 2,750 clients on assets in excess of US$3.5 trillion globally and employ more than 1,000 staff across 40 countries worldwide. We create value through our commitment to thought leadership; world-class, independent research; and experienced consultants.

In Canada, Mercer is the leading provider of investment consulting services, with more than 750 clients. Mercer has a long and extensive involvement in the theory and practice of corporate governance in Canada, providing research and advisory services related to proxy voting and the incorporation of environmental, social and governance issues into investment decision making ('Responsible Investment'). Mercer has provided advice on governance and responsible investment to more than one hundred national pension plans, plan sponsors, sovereign wealth funds, foundations and endowments and other significant institutional investors around the world.

Mercer's Recent Australian Study on Proxy Voting

Mercer completed a landmark study in 2011 on the matters raised in this consultation paper. The study[1] was commissioned by the Australian Institute of Company Directors and was titled *Institutional Share Voting and Engagement Exploring the Links Between Directors, Institutional Shareholders and Proxy Advisers.*[2] This report is specifically referenced here – it is also appended to (and forms part of) this submission – as it substantiates and informs the key recommendations and views that are contained in paragraphs below.

[1] Participants in the study included company directors of ASX 200 companies including top 20 companies, fund managers, super funds and investor relations, and conducted in-depth interviews with a further 50 share voting industry participants such as company directors, proxy advisers, superannuation funds, fund managers, custodians and industry associations.

[2] http://www.companydirectors.com.au/Director-Resource-Centre/Research-reports/~/media/Resources/Director%20Resource%20Centre/Research/AICD%20%20ISVotingWeb_FINAL.ashx

Comments on the Regulation of Proxy Advisers – Concepts and Principles

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

Specific concerns noted by the CSA[3] include: (i) potential conflicts of interest, (ii) perceived lack of transparency, (iii) potential inaccuracies and limited engagement with issuers, (iv) potential corporate governance implications, and (v) the extent of reliance by institutional investors on the recommendations provided by proxy advisory firms. This submission focuses mainly on the final point.

While Mercer shares many of the concerns that are the subject of the consultation paper, we believe these concerns may not necessarily be solved through regulation. It is our view that regulation of the kind canvassed in the consultation paper will not address the core reasons for deficiencies in the share voting process and may in fact exacerbate existing problems (for example, by raising entry barriers to the market and limiting the potential for future competition).

It should be noted, however, that we do support one potential tightening of the regulatory framework as relates to increased disclosure of conflict of interest. While we did not find evidence of conflict of interest and related poor disclosure in Mercer's recent research on the Australian proxy voting process (although the research did not focus on the US / Canadian markets), it would be difficult to argue against increased disclosure provisions as outlined in the discussion paper. We therefore support an amendment to NI 51-102 "to require reporting issuers to disclose consulting services from proxy advisers".

How influential are proxy advisory firms?

[3] In this submission we would like to flag what we regard as a 'sleeper issue', and this is the reliance on proxy advisers by foreign institutional investors. These investors (where they do not use investment managers to vote on their behalf) may be necessarily much more reliant on proxy advisory firms. We offer no further comment on this subject in this submission, except to say that this is an issue that should be further analyzed and researched.

Mercer's view is that proxy advisers clearly are influential. How influential? This matter is not straightforward and quantitative estimates vary greatly.[4] However, much of the discussion seems to be beside the point. The question is not whether they are influential – as one of our interviewees for the Australian study succinctly put it "Yes of course they are influential. We wouldn't pay them otherwise, nor would the market pay them…but that doesn't mean we don't make our own decisions…"[5] The better question is whether that influence is 'improper' in some way – which is a persistent theme in the commentary on proxy advisers and a central part of the rationale for the regulation of proxy advisers. On this topic, we offer the following passage from our Australian study.

The key point is how proxy advice is used by institutional investors:

- *As an input – The view here is that institutional investors use proxy advisory firms as an aid to decision making. Investors have outsourced some of the work (collection of company information, assessment according to guidelines) because it is efficient to do so. As one interviewee put it, institutional investors have every right to avail themselves of the cost efficiencies of outsourcing. The key point is that the institutional investor is the party that actively makes the decision; the proxy advisory firm is simply an input to that decision.*
- *As a decision maker – The view that emerged as a strong theme with Australian company directors and with some institutional investors (to a far lesser degree than with directors) is that institutional investors have outsourced decision making to proxy advisory firms, and that they have done so because they do not want to bear the cost of making the decision themselves. It is said this occurs when institutional investors simply accept or rubber-stamp the recommendations of proxy advisory firms. This is regarded as both improper (a failure of duty) and as damaging to Australian companies because it imposes a "tick-the-box" or "one-size-fits-all" mentality.*

These two ways of looking at proxy advisory firms and the use of proxy advice by institutional investors are significant. If it is accepted that proxy advice is simply an input, then influence is considered acceptable and associated with a broader acceptance of the role of proxy advisers in the share voting landscape. If, however, the proxy advisory firm is regarded as the decision maker, then its influence is considered not to be acceptable, but an abrogation of a fundamental duty. This latter view gives rise to a number of related concerns about proxy advisers, in terms of the adequacy of their training and experience for their jobs, the independence of the advice given

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[4] See the paper by Robin Bew and Richard Fields *Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers* (Tapestry / IRRC, June 2012) – see especially at p.9.
[5] Mercer / AICD report at p.28 – the quote is from an investment manager.

to institutional share owners and whether they should be subject to regulations in the same way as other professionals such as financial advisers and accountants.

There is a consensus among company directors, managed funds and superannuation funds that the "proxy adviser as decision maker" model is undesirable. There is agreement that institutional share owners have a clear duty to make the voting decision themselves (even if they accept advice), and that to outsource decision making to a third party is simply unacceptable. The difference of opinion is about what happens in actual practice. Institutional share owners are strongly of the view that they do retain the voting decision themselves; that the "proxy adviser as an input" model applies. A significant number of company directors are of the view that the "proxy adviser as decision maker" model applies.

This, then, is largely in the realm of perceptions. There is one observation that did not emerge from the interviews or survey, but that comes from our understanding of the voting decision process itself. It is suggested that whether the "input" model applies or not will depend largely on whether there is sufficient resourcing to enable different views to be actively evaluated and considered. It is clear that managed funds (investment managers) usually have the resources to be able to evaluate different sources of information and make a considered decision (whether they actually apply those resources in this way is open to question). Superannuation funds, on the other hand, generally have fewer resources and may not be as well placed to operate the "input" model.

An opportunity: Address the issue of reliance through a focus on Stewardship

On regulation generally, we believe that we should be confident that the proposed regulation is addressing the key challenge or problem. In this case, we feel the issue is not with the nature of the service provider, but how the product is used by the institutional share owner. Proxy advisers play an active and valuable role in intelligent share voting. However, problems could arise where the system is just outsourced to proxy advisers or other third parties. Institutional investors, where this occurs, open themselves to a charge of not fulfilling basic obligations of share ownership.

The key focus, in our view, should therefore be on institutional investors. Specifically, both asset owners and investment managers need to exercise stewardship of the assets that they oversee or manage, and an important part of that is voting the shares that they own, with active thought and care, and also contributing to public policy in connection with the integrity and efficiency of markets.

With specific regard to voting this means actively considering their interests as shareholders – what we would call 'intelligent' share voting. While not a concern directly identified by the

Consultation document, recent years have seen a significant amount of international policy action focused on transparency and empowering shareholders to enforce and improve their role as principals and stewards of capital.

Rather than a single code having evolved, the result has been the development of several country-specific and regional codes.[6] While there is variation within these codes in terms of the substance and intended audience, a common thread is the promotion of principles-based codes that adopt a "comply or explain" approach towards improving stewardship practices. Importantly, these codes all coalesce around the promotion of a public commitment, monitoring, regulator reporting, and disclosure of stewardship activities by institutional investors as a means of ensuring investor responsibility for the promotion of good governance in the companies in which they invest.

While the Canadian market boasts a number pioneers of shareholder engagement, our experience suggests that the broad level of engagement with the proxy and engagement process is relatively low – particularly outside of large, public funds (although we have seen growing focus on this area by some clients in recent years).

For example, while many investment policy documents address the delegation of voting responsibilities to investment managers, regular and informed monitoring of how these responsibilities are discharged is more rare. Regulatory developments which encourage more focus on this area would likely lead to more allocation of time and resource across the institutional investment principal – agent spectrum, and on the development of associated policies, programs, and monitoring processes. More significant shareholder engagement will necessarily function as a 'check' to the level of influence demonstrated by proxy firms.

The Canadian Coalition for Good Governance has published Principles for Governance Monitoring, Voting and Shareholder Engagement. The CCGG Principles were launched in 2010 as an update to an earlier statement in 2005. The CCGG outlines 5 Principles and best practices for shareholder involvement with Canadian companies. The Principles promote enhanced monitoring and engagement by shareholders as part of integrating governance considerations into the investment process and promoting good governance within companies. The Principles were developed by and for CCGG members, which represent a broad and diverse group of Canadian institutional investors.

[6] Stewardship Codes: An Emerging Global Phenomenon. Mercer. 2012.
http://www.mercer.com/referencecontent.htm?idContent=1428860

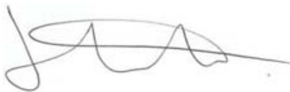
Arguably the Principles have broader applicability, and could be utilised by non-CCGG members and further strengthened by mandating public disclosure detailing the extent to which they comply with the Principles.[7]

In Closing

Stewardship exercised through voting and engagement activities helps the realization of long-term shareholder value. Where companies have inactive or disengaged shareowners, the chances that company management will act in ways that are detrimental to shareholders' interests are greater. Pension plan trustees, and other institutional investors, in complying with their fiduciary (or equivalent) responsibilities, therefore, need to give appropriate and due consideration to these issues as a core part of their deliberations.

We appreciate the opportunity to provide comment on the Consultation Paper. We are prepared to meet and discuss these matters with the CSA at its convenience. Any questions about this letter may be directed to Jane Ambachtsheer (416) 868-2659.

Sincerely,



Jane Ambachtsheer
Partner

[7] This approach is similar to the "comply or explain" approach of the UK Stewardship Code