Institute for governance of private and public organizations

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The Troubling Case of Proxy Advisors

Policy Paper by the Institute for Governance (IGOPP)

Montreal, March 8, 2013 – For a variety of reasons, proxy advisors have come to exert undue influence on the governance of companies listed on the stock markets and to play a troubling role in all contentious situations in which certain shareholders are opposed to the positions of boards of directors. Understandably, these proxy advisors are already subject to close scrutiny by Canadian securities regulatory authorities. The latter should propose an appropriate supervisory framework regarding the issues raised as a result of this relatively recent phenomenon.

Institutional investors, who are these proxy advisors' principal clients, should also be concerned about the quality and reliability of the information provided to them by these advisors. Moreover, when applicable, institutional investors should publicly state their disagreement with certain rules and guidelines on which the proxy advisors' recommendations are based.

These recommendations have been put forward by the Institute for Governance of Private and Public Organizations (IGOPP), in a Policy Paper prepared by its Executive Chair of the Board, Dr. Yvan Allaire, as part of a new study on **The Troubling Case of Proxy Advisors**.

This IGOPP paper raises several thorny issues concerning:

1. The business models used by these advisors so as to be able to produce thousands of reports and recommendations in just a few weeks, in the spring of each year;
2. The ownership structures of these advisory firms, in particular of ISS, the largest of these firms, which combines, in one company, a proxy advisory service and a governance advisory service offered to companies that are themselves the subject of annual reports to investors concerning their governance;
3. The roles of these advisors in merger/acquisition transactions and in proxy contests by activist funds.

The IGOPP has drawn up six recommendations:

1. Institutional investors should voice their disapproval concerning the models used by these proxy advisors to assess the types and amounts of remuneration received by executives;
2. As clients of the proxy advisors, institutional investors should insist on relevant information regarding their business models and the training and expertise of the individuals who analyse the proposals and draw up voting recommendations;
3. The regulatory authorities should require that proxy advisors report on their standards regarding their analysts' training and experience, similarly to what is required of credit rating agencies;

4. The Canadian regulatory authorities should prohibit ISS from offering advisory services concerning governance and remuneration to those companies about which ISS makes recommendations to investors, in the same way that auditing firms are not permitted to offer consulting services to the companies they audit;

5. When proxy advisors intervene in a merger or acquisition transaction and advise the shareholders to accept or refuse a takeover bid, the proxy advisors should be subject to the standards governing conflicts of interest relating to market intermediaries; any recommendation should be accompanied by the disclosure of any business connection, past or present, as an advisor for any of the parties involved in the transaction;

6. In a broader perspective, the securities commissions should require that, during any proxy contest, the advisors must disclose whether they recently have been or currently are retained by one of the participants in the proxy contest in question, or whether one of the interested parties in a proxy contest subscribes to the services of the proxy advisor, as well as the aggregate fees paid by the interested party to the proxy advisor over the last two years.

The IGOPP paper concludes: "All in all, the business of proxy advisors, though seemingly filling a need, brings forth a host of issues, which, if they are not dealt with vigorously and effectively, may well result in a warped system of governance and a serious failure of accountability."

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The IGOPP's policy paper is available at www.igopp.org

Created in September 2005, the Institute for Governance of Private and Public Organizations (IGOPP) is a joint initiative of HEC Montréal and Concordia University (The John Molson School of Business). The Institute is committed to promoting strong, practical, state-of-the-art governance practices for all types of organizations. IGOPP pursues this objective through four distinct sets of initiatives:

1. Taking public policy positions on key issues of governance,
2. Carrying out or subsidizing relevant research,
3. Offering well targeted training and education programs,
4. Diffusing broadly widely information and knowledge about governance matters.

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