Institute for governance
of private and public organizations

The Troubling Case of Proxy Advisors:
Some policy recommendations

Policy Paper N°7

Prepared by Professor Yvan Allaire, Ph.D., FRSC
Executive Chair, IGOPP

Adopted by the Board

January 2013

Toward Value-Creating Governance™

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Message of the Chairman

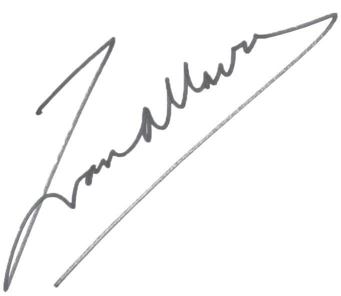
For the seventh time since its creation, our Institute takes a formal position on a significant governance topic. This time, we are making a series of recommendations about the role of proxy advisors and their influence on the governance of public corporations.

These advisers play a significant role by making recommendations to institutional investors on how to vote on various issues submitted to a shareholder vote at the annual meeting of shareholders. The criticisms levied at these advisors by corporate officers and board members have been numerous and scathing. This policy paper examines the situation and makes a number of pertinent recommendations.

I am grateful for the precious contribution of our board members to the contents of this policy position.

The board approved this position in January 2013[1].

We hope that our analysis and recommendations will prove a valuable contribution to the discussion and resolution of a very salient corporate governance issue.



YVAN ALLAIRE, PH.D. (MIT), FRSC
Executive Chair

[1] However, as per the policy of the AMF, Mr. Louis Morisset of the Autorité des marchés financiers abstained.

Executive Summary

The changing times created a business opportunity. As institutional investors and fund managers came to collectively own a large majority of all shares in circulation, their fiduciary obligation, or duty to vote their proxies created a logistical problem.

Proxy advisors, firms specializing in analyzing the information and issuing voting recommendations to their clients, institutional investors and fund managers of all stripes, came about to tap into this market niche.

The outcome was somewhat unexpected. Proxy advisors now stand in a bully pulpit from which to harangue corporate management and boards of directors on all matters of governance and compensation; neither investors, nor investment advisers, they enjoy a franchise to "make recommendations" to investors on how to discharge their fiduciary responsibility as shareholders.

Their influence has grown in spite of repeated criticism of their performance, because investors seemed to find these "advisors" useful in discharging what could be an onerous responsibility. Neither regulated, nor supervised, proxy advisers rely on a business model that makes it virtually impossible for them to handle with care and responsiveness the sheer volume of reports they have to produce in a very short period of time. In the case of ISS, the firm is also vulnerable to conflicts of interests.

Their role in defining what is proper governance, what is an effective board and how should executives be compensated gives them an undue, unhealthy influence on the functioning of private corporations.

Eventually, the chorus of critics got the attention of the securities regulators in the USA, in Canada, in France, which set up consultation processes to determine what, if anything should be done.

The litany of issues raised about proxy advisors is troublesome:

- Lack of transparency as to the process by which they arrive at formulating their recommendations;
- Inaccuracies in their analysis and unresponsiveness to corporate demands for corrections;
- Conflicts of interest, in particular for ISS, by their offering of several services to the same corporations which are the subject of their proxy recommendations;
- More subtle criticisms focus on their definition of «good» governance and the lack of (or very weak) empirical evidence that their kind of governance has any influence on the performance of companies;
- Proxy advisors have a vested interest in raising the bar of «good» governance from year to year to justify their continued employment;

- The influence of proxy advisers on corporate governance makes some, many, boards of directors overly preoccupied with ensuring favorable recommendations from proxy advisers, by taking pre-emptive steps to ensure that their policies on governance and executive pay will not trigger a negative score when fed into the proxy advisers' standardized algorithm;
- Their business model is problematic. Because their clients, institutional investors, collectively own shares in all publicly listed companies, they have to provide «advice» for all these corporations. In Canada, some 1570 companies are listed on the TSX and another 2,200 are listed on the TSX Venture. The financial year of roughly 84% of companies listed on the TSX ends on December 31st. For some 80% of TSX listed companies, there were less than 50 days between the date the Management Information Circular is received by shareholders and the ultimate date for proxy voting. (IGOPP research, 2012). These statistics create a fundamental issue for these service providers and raise basic questions about their business model. How can they cope with this mass of data and come up with fair and thoughtful recommendations for thousands of corporations in a matter of a few weeks in the spring of each year;
- Surprising and puzzling is the role these proxy advisors are now playing in all cases of mergers, acquisitions, proxy contests and all other litigious matters. Proxy advisers offer their opinion on almost all litigious, contentious issues. As these issues often come about as a result of the actions of some activist hedge funds, a proxy advisor's favourable opinion, from ISS particularly, is a highly prized input to the argumentation of activist funds. The potential for conflicts of interest is decupled in these highly charged confrontations with huge sums of money at stakes.

This policy paper makes recommendations to institutional investors as the prime clients of proxy advisors and to securities commissions as the protectors of the integrity of financial markets.

RESPONSIBILITY OF INSTITUTIONAL INVESTORS

Large institutional investors bear a singular responsibility for this state of affairs. They carry the fiduciary responsibility to vote proxies in the interest of their stakeholders, a responsibility they cannot farm out to proxy advisors. Most large institutional investors maintain adamantly that they do not sub-contract this responsibility but merely use proxy advisors as information gatherers and providers of opinions.

Even for that limited role, large institutional investors, as clients of proxy advisory services, should demand that they be given full information on their business model: part-time vs. full-time employees, location of employees, extent of work performed in foreign countries, training of employees, proficiency of the staff, the ways the advisory service copes with the logistics of having to formulate opinions/recommendations on thousands of proposals within a very short time period.

As clients of these advisors, they should demand explicit statements of conflicts of interest whenever these advisors are involved in M&A transactions, proxy contests or other litigious matters. They should insist that proxy advisors disclose at the time of their recommendation *whether the advisor has, currently or within the recent past, been engaged by any participant in the relevant M&A transaction or proxy contest, whether any of the interested parties subscribe to the proxy advisory firm's services, and the aggregate fees paid by the interested parties to the proxy advisory firm.*

Finally, institutional investors should state their disagreement with some of the proposed guidelines of proxy advisors. Certainly they should make clear *that they do not consider the ISS proposed guidelines on executive compensation appropriate or useful and that they will not give any weight to voting recommendations based on these metrics*.

Canadian institutional investors should object vigorously to ISS basing some of its «guidelines» on poorly designed studies carried out in the American context.

CANADIAN REGULATORS

The consultation document produced by the Canadian Securities Administrators has provided an excellent summary of the issues as well as some potential remedies. We urge the Canadian regulators to examine the recommendations made in this policy paper as they proceed to set a course forward concerning the proper supervision of proxy advisors.

Indeed, it is a recipe for troubles to co-locate two businesses within the same corporation, one advising institutional investors on how to vote on issues of momentous significance to corporations, the other one advising corporations on how to meet the standards of "good" governance set by proxy advisors. Canadian regulators should certainly *prohibit ISS from offering its corporate services to corporations about which ISS issues proxy voting recommendations to its institutional clients*.

At a minimum, Canadian regulators should demand that ISS provide to its institutional clientele the list of clients of ISS Corporate Services, Inc. for which proxy voting advice is put forth by ISS.

Furthermore, whenever proxy advisors get involved in takeover situations when they are actually advising their clients and the shareholders at large as to the adequacy of the bidder's price for a transaction, regulators should subject them to the regulatory framework applicable to financial advisers and investment bankers offering an "opinion" on the advisability of a transaction.

Finally, Canadian regulators should demand that proxy advisors set standards for the training, expertise and experience of analysts preparing proxy advisors' reports. 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.

Introduction

Once upon a time, individual investors held the majority of shares in publicly listed corporations. Some of them would attend the annual meeting of shareholders; others would appoint management as their proxy to vote their shares; most would not bother to do either. Then, sometime during the 1990s, investment funds and funds of all stripes and colors became collectively the majority shareholders of corporations.

The managers of these funds have a fiduciary responsibility to protect the interest of their clients. In the USA, investment advisors subject to ERISA and/or to the Investment Advisers Act of 1940 have an affirmative *fiduciary* duty to vote all portfolio shares on all matters[1].

Yet, corporate governance has become a growth industry with ever increasing requirements to meet the standards of "good" governance and, thus, many more opportunities for corporations to fail to meet one or the other of the evolving governance norms and guidelines.

As institutional investors and fund managers came to collectively own a large majority of all shares in circulation, the fiduciary obligation, or duty, for fund managers to vote their proxies created a logistical problem.

They had to assess the compliance of large number of corporations with an ever increasing list of principles, rules and canons of good governance in order to cast an informed vote for board members up for election; as well they had to decide how to vote on the mushrooming number of shareholder proposals put forth for the annual meeting of shareholders.

Proxy advisors seemed to offer a partial way out of this quandary.

Smaller investment funds, it is claimed, do not have the means and the resources to carry out their fiduciary duty to vote their proxies. At first blush, this claim is somewhat surprising. These smaller funds hold shares in a very small fraction of the universe of listed corporations. These investment funds have, or claim to have, the resources to carry out the sort of analysis required to back up their decision to invest in a given company, to monitor the performance of that company, and to decide to remain invested or to pull out of the stock! Yet, it is claimed, they do not have the resources to make their own decision on governance matters for these same companies.

In fact, many small investment firms do carry out their own analysis and make their own mind on how to vote on specific shareholder issues.

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[1] However, "…*recently some regulators and commentators have begun to question the validity of this interpretation of an investment adviser's fiduciary duty*". (Latham and Watkins, March 2010). In Canada, institutional investors have a "duty" but not a legal obligation to vote their portfolio shares. "*That duty will typically (but may not always) require 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*". **The Quality of Shareholder Vote in Canada**; Davies Ward Phillips & Vineberg L.P., October 22nd 2010. Were it not for this interpretation of their obligation, fund managers might elect to vote only when substantial issues are at stake and when the value of their investment is in play.

Introduction

Large institutional funds adamantly claim to use the recommendations of proxy advisers merely as one input into their decision process. Of course, that assertion implies that these large institutional investors do have internal resources to review all management and shareholder proposals in order to make up their own mind. As such, proxy advisors would play a limited role of information gathering. One may wish that it be so but the evidence does not quite confirm that view of proxy advisors' limited role, as shown in the next section.

The influence of proxy advisors

Institutional Shareholder Services (ISS), Glass Lewis and a number of smaller firms, have been doing a booming business over the last ten years advising investors on whether to vote against, or withhold their votes for, some or all members of the board; they also advise their clients on whether to vote for or against the various proposals submitted to shareholders in the annual ritual of shareholder meetings.

"Currently, the market is dominated by two providers. ISS, a subsidiary of New York Stock Exchange listed company MSCI, is by far the largest. In 2009, the last year for which market share data is readily available, ISS had more than 61% of the market for proxy advisory services; another report listed ISS as having 1,700 clients in 2010. According to a third study, institutions managing a combined $26 trillion in assets subscribe to ISS's proxy research. The second-largest proxy advisory company is Glass, Lewis & Co. Glass Lewis, a subsidiary of the Ontario Teachers' Pension Plan Board, is reported to serve more than 500 institutional clients collectively managing assets of over $15 trillion. Several other firms in the United States and Europe also provide proxy services, but on a smaller scale." (*Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers, Robyn Bew and Richard Fields, Tapestry Networks/IRCC, June 2012*).

There is a mildly interesting debate as to the extent of their real influence on voting. It is somewhat amusing to watch proxy advisers trying to marshal all evidence «proving» that they are less influential than it appears. Academics are lined up on both sides of the issue of whether proxy advisers influence 20%-30% of the votes (Brossy, 2012; Cai, Garner and Walking, 2009, *inter alia*) or 6%-10% (Choi, Fisch, Kahan, 2010).

However, corporate observers with actual experience of the process note with some dismay the number of proxy votes coming in immediately after the proxy advisers have issued their recommendations. (See, *inter alia*, the submission of IBM to the SEC concept release on the U.S. proxy system, October 15, 2010).

In a 2010 survey by Towers Watson, 59 percent of corporate officers believed that proxy advisors have significant influence on executive-pay decisions at U.S. companies. Similarly, a 2010 study by the Center on Executive Compensation found that 54 percent of companies had changed or adopted a compensation plan or policy in the previous three years primarily to meet the standards of a proxy advisory firm. (Larcker, Miller, and Tayan, 2011) Again, that survey was carried out before a «say-on-pay» vote by shareholders became mandatory for American listed companies in 2011.

Canadian data are less readily available. However, the Canadian consulting firm, Huggesen, which works closely with many Canadian boards of directors on executive compensation issues, reports:

> *Canadian proxy voting outcomes are affected by the voting recommendations of U.S. based proxy advisors in the same way and largely to the same extent as are those in the U.S. The most influential proxy advisor in Canada, namely, ISS (until recently RiskMetrics or "RMG"), is a U.S. based company (as is the second largest, Glass Lewis). Any changes to the operations or business model of proxy advisors resulting from the SEC's review will undoubtedly affect how they carry on business in Canada. For many Canadian issuers who share concerns about proxy advisors, the SEC's review is a welcome development and one that will be followed with keen interest. (Hugessen Consulting Inc. Briefing – August 2010)*

The Tapestry Networks survey, quoted above, conducted on behalf of ISS states:

> *Another avenue of proxy advisers' influence is the degree to which they affect the actions of public company boards and management well before voting season begins. As two commentators put it, "If most directors believe that ISS has power – as their actions indicate – boards may do what they believe ISS wants them to in order to keep their seats, whether or not their belief is justified." Before becoming chancellor of the Delaware Court of Chancery, Leo Strine came to a similar conclusion about the belief in the power of ISS: "Powerful CEOs come on bended knees to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues [facing their companies]."*

Similarly, a recent Conference Board-NASDAQ-Stanford survey of 110 companies found that 72% of respondents reviewed proxy adviser policies or engaged with a proxy adviser to receive feedback on their executive compensation plan, while 70.4% said that their programs were influenced by the proxy advisers or the advisers' policies.

As the chorus of critics of these proxy advisers became louder and more insistent, their role and influence have brought them under the scrutiny of regulators in the USA, Canada, France and the European Union. The SEC and the Canadian Securities Administrators (CSA) have issued excellent papers for consultation purposes (See **Securities and Exchange Commission: Concept release on the U.S. proxy system**, June 2010 and **Canadian Securities Administrators-Consultation Paper 25-401: Potential regulation of proxy advisory firms**, June 21, 2012).

The SEC was deluged with informed comments, telling examples and drastic recommendations for action but, overwhelmed by the implementation of the Dodd-Frank Act, has not taken any action yet. The litany of issues raised about proxy advisors is fairly invariable:

- Lack of transparency as to the process by which they arrive at formulating their recommendations;
- Inaccuracies in their analysis and unresponsiveness to corporate demands for corrections;
- Conflicts of interest, in particular for ISS, by their offering of several services to the same corporations which are the subject of their proxy recommendations;

- More subtle criticisms focus on their definition of «good» governance and the lack of (or very weak) empirical evidence that their kind of governance has any influence on the performance of companies. As a case in point, proxy advisers, ISS in particular, take a strong stand against any measure or arrangement that may act as a hurdle to hostile takeovers: staggered boards, poison pills, supermajority, and of course dual class of shares[2].

  The empirical evidence, though, supporting this stance is often weak or non-existent. For one typical instance, Straska and Waller review all empirical evidence about "*Antitakeover Provisions and Shareholder Wealth*" and conclude that the proxy advisors' generalized opposition to these measures is not supported by their data. (SSRN, July 2012).

  Proxy advisors will even carry out, or have carried out, studies designed to support their position. A recent instance is provided by the IRCC and ISS study on "*Controlled Companies: A Ten-Year Performance and Risk Review*" (October 2012). This poorly designed American study is used by ISS as support for its opposition to dual class of shares in their Canadian guidelines for 2013! See Allaire, Y. "*Notes on a flawed study*" (IGOPP, November 2012) for a critical assessment of that study.

- Then, these proxy consultants have a vested interest in raising the bar of «good» governance from year to year to justify their continued employment. They thus become de facto generators of new governance rules and the arbiters of compliance to their rules. Yet, these new "rules" are not vetted nor subjected to the review process mandatory for any new rule proposed by the regulators.

- The influence of proxy advisers on corporate governance makes some, many, boards of directors overly preoccupied with ensuring favorable recommendations from proxy advisers, taking pre-emptive steps to ensure that their policies on governance and executive pay will not trigger a negative score when fed into the proxy advisers' standardized algorithm. *For example, some such* (proxy adviser) *firms have policies that recommend a vote against a director in the annual director election if during the previous year the director voted in favor of certain corporate actions, leading some boards to ask before approving certain actions, "What are the proxy advisory firms' policies on this action?"* (New York Stock Exchange Commission on Corporate Governance, September 23, 2010).

Proxy advisors have now been granted additional leverage by the "say-on-pay" initiative whereby shareholders get to cast a non-binding vote on executive compensation. The practice has now become mandatory in the USA and is spreading fast all over the developed economies. Having to pass judgment on the appropriateness of executive compensation, a challenging, very complex task, many institutional investors have come to rely on proxy advisors for "guidance".

[2] Up to the shareholder meeting of May 2012, the capital structure of MSCI, the parent company of ISS, was made up of two classes of shares, one with a single vote and the other with *five* votes! It would have been embarrassing indeed to keep that capital structure, given the adamant opposition of ISS to dual class of shares.

With no particular expertise in this field and no genuine experience in the matter, they have become the judges of what is fair compensation for corporate executives. If investors suffer from an overload of information about executive pay at corporations in which they are invested, what about proxy advisors who have to rate all executive compensation programs? They have little choice but to resort to simple check-lists and standardized algorithms.

Here are the guidelines published by ISS for the 2012 *say-on-pay* votes:

> *The revised policy also measures the relative alignment between CEO pay and company total shareholder return (TSR) within the peer group for a one- and three-year period (with a 40 percent emphasis on the one-year period and a 60 percent emphasis on the three-year period), as well as absolute alignment between CEO pay and company TSR over a five-year period. Where this alignment is perceived by ISS to be weak, ISS will consider how a number of factors affect alignment of pay with shareholder interests, such as a company's benchmarking practices, completeness of disclosure and ratio of performance based pay to overall compensation.*

It would be difficult to conjure up a more value destroying way of assessing executive compensation. The notions that management can over-ride the tides of stock market fluctuations, that peer group TSR comparisons offer a valid basis to judge the fairness of any particular company's compensation are grand delusions. God forbids that, under the pressure of proxy advisers, boards of directors would come to set compensation in line with such metrics.

Our Institute has issued a policy paper on executive compensation in March 2012 which takes a position diametrically different than what is proposed by ISS:

> *"Compensation should be linked to quantitative* ***and qualitative*** *indicators which drive the economic performance of the company, which measure* ***the long-term value of the company****; every company is somewhat different in this respect and cookie-cutter programs will not do the job; quantitative indicators should not be stock-price related but of the sort that do measure the long-term health of the company, such as Return on invested capital (ROIC) and Economic value added (EVA); they should not be highly volatile and easily manipulated; qualitative performance should be linked to the more subtle character of an organization, its ethics, the sense of belonging and fairness felt by most members of the organization.*
>
> *The competence of management at factoring in its operations the concerns of society at large and the expectations of key constituencies should be reflected in the compensation system of corporate leaders. The success and survival of the corporation hinges on first rate performance on this score."*
>
> (***Pay for Value: Cutting the Gordian knot of Executive Compensation***
> © Yvan Allaire for the Working Group on Compensation of IGOPP, March 2012)

A recent study on this issue concludes:

> *First, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes. Second, a significant number of firms change their compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms apparently in an effort to avoid a negative recommendation. Third, the stock market reaction to these compensation program changes is statistically negative.*
>
> (***The Economic Consequences of Proxy Advisor: Say-on-Pay Voting Policies***
> by Larcker, McCall, Ormazabal, SSRN #2101453, July 5, 2012)

A more useful and pertinent approach would be for proxy advisors to provide information and various metrics on executive pay *without formulating a voting recommendation* but letting their clients judge the relevance of this information for their own decision-making.

RECOMMENDATION I

Large institutional investors, to the extent that they share the views on compensation defended by IGOPP and others, should make it clear to corporations and to proxy advisors that they do not consider their guidelines on executive compensation appropriate or useful and that they will not give any weight to voting recommendations based on these metrics. *However, the information provided by proxy advisers may be used in arriving at their own call on how to vote. There's a key role here for the Canadian Coalition for Good Governance. It has the credibility and the legitimacy to counter the influence of proxy advisors on executive compensation.*

The consultation processes of the SEC and the CSA have produced an abundance of comments and suggestions on how to deal with these issues. Several make good sense and would indeed improve matters measurably. Many suggestions are aimed at improving the time frame for corporate issuers to correct errors or misstatements of information as well as responsiveness to counter-argument about the recommendations formulated by proxy advisors. These suggestions, though sensible, do not take into account the business model of these proxy advisors. Indeed, it seems to us that there are three fundamental issues with the proxy adviser system which must be addressed urgently:

- **1. Their business model;**
- **2. Their ownership structure;**
- **3. Their involvement in M&A and other litigious transactions.**

Their business model

Proxy advisers face a tremendous challenge. Because their clients, institutional investors, collectively own shares in all publicly listed companies, they have to provide "advice" for all these corporations.

The form 10K of MSCI (the parent of ISS) reports that ISS provides research coverage on over ***6,000*** U.S.-based companies and over ***20,000*** non-U.S. companies. Glass Lewis did so for some ***16,000*** companies! (Latham & Watkins, L.P., March 2011).

In 2009, there were more than 20,000 management and shareholder proposals at Russell 3000 companies; and that's before "Say-on-Pay" votes became mandatory!
(Source: Investment Company Institute, *Research Perspective 16, no.1*, November 2010).

More than 54% of annual shareholder meetings in the USA were held in April, May or June (Council of Institutional Investors, 2010).

In Canada, some 1570 companies are listed on the TSX and another 2,200 are listed on the TSX Venture. The financial year of roughly 84% of companies listed on the TSX ends on December 31st. For some 80% of TSX listed companies, there were less than 50 days between the date the Management Information Circular is received by shareholders and the ultimate date for proxy voting. (IGOPP research, 2012).

Proxy advisory firms use these statistics to justify their usefulness and promote their services. But these very statistics create a fundamental issue for these service providers and raise basic questions about their business model. How can they cope with this mass of data and come up with fair and thoughtful recommendations for thousands of corporations in a matter of a few weeks in the spring of each year.

Only by one of two measures, or a combination of the two, can they accomplish this feat and these will not produce thoughtful and calibrated recommendations:

1. A standardized grid, a sort of simplified algorithm (often termed a «cookie-cutter» or a «one-size-fits-all» approach), with which corporations are scored for their governance, boards are assessed, compensation is appraised, and shareholder proposals are vetted. Certainly the guidelines of ISS for their assessment of executive compensation described earlier provide a striking example of that process.

2. The hiring of temporary staff, as well as farming out of the analytical part of the process to low-cost countries, to cope with the avalanche of data in the spring; that coping mechanism raises the issues of competence and training of these part-time employees.

This state of affairs, undeniable and unavoidable, makes the whole business of proxy advisers highly suspect. If only one tenth of companies processed by proxy advisors were to submit that errors and inaccuracies have flawed their report and to request changes, these proxy advisors would be unable to cope, as they have admitted forthrightly:

> *"The demands on ISS during proxy season might mean there is no direct response from the firm, but [the president of ISS] assured the participants that the comments received are taken into account as long as the information referenced has been publicly disclosed."*
>
> (Source: Audit Committee Leadership Network in North America View Points: ***A dialogue with Institutional Shareholder Services***, Issue 39: November 7, 2012).

Power Corp. observed quite correctly in its submission to the CSA consultation process:

> *"It is unacceptable for a proxy advisor to cite resource constraints as a reason for not engaging with an issuer — in such situations, the proxy advisor should refrain from issuing an advisory report.*
>
> *Directors have duties to act with a view to the best interest of the corporation and to exercise the care, diligence and skill and to devote sufficient time when contemplating matters submitted to the shareholders' vote.* ***Therefore, if a proxy advisor is to recommend against a matter put forward by the board, it should also be required to allocate sufficient, qualified resources to analyse the matter.*** *(Power Corp. submission to the CSA consultation process, September* 10th, 2012; emphasis added).

RECOMMENDATION II

Clients of proxy advisors should insist on divulgation of all pertinent details of the business models used by proxy advisors*: part-time vs. full-time employees, location of employees, extent of work performed in foreign countries, training of employees.*

RECOMMENDATION III

Regulators should require that proxy advisors report on their standards of training and experience for their analysts*, somewhat akin to what is required of rating agencies at this time:*

The SEC has proposed and adopted the following standards and rules for rating agencies (formally known as Nationally Recognized Statistical Rating Organizations or NRSROs):

> *"Consistent with Section 936 of the Dodd-Frank Act, the proposed rule would require NRSROs to establish standards of training, experience and competence for credit analysts and to:*
>
> > *Consider certain factors when establishing the standards, for example the complexity of the securities that will be rated by the analyst.*
> >
> > *Periodically test its credit analysts on the credit rating procedures and methodologies it uses.*
> >
> > *Require that at least one individual* ***with three or more years of experience*** *in performing credit analysis participates in determining a credit rating."* (Emphasis added)"

The Ownership Structure

One might have reasonably expected that these advisory firms would have remained private, professional organizations, owned by partners fully accountable for the quality of services offered and very vigilant about potential conflicts of interest, somewhat akin to firms of auditors, *post Anderson debacle and the Enron fiasco*.

It is useful to be reminded how these accounting firms swore at the time that their consulting services to the same firms they were auditing were in no way a source of conflict of interest, that impenetrable "Chinese walls" separated consulting services from auditing services! Such statements failed to persuade regulators. Auditing firms had to stop offering management consulting services to the same firms they were auditing.

But it is not so, certainly for ISS. The firm was bought in 2006 by Risk Metrics, a corporation offering all kinds of consulting services to the same companies about which ISS gets to give advice to institutional investors. Then, in 2008, Risk Metrics became a publicly listed company. In 2010 Risk Metrics itself was bought by stock-market listed MSCI, a firm offering multiple services to institutional investors.

The well documented pressures of financial markets to deliver ever growing earnings per share (EPS) translate into internal pressures on management to meet financial market expectations. It is one of the crucial mistakes of our financial age *to allow market sentinels become themselves publicly listed*. It has happened with stock exchanges worldwide; it happened with rating agency Moody's. But here's how Eric Kolchinsky, manager in charge of CDO ratings at Moody's, describes for the Financial Crisis Inquiry Commission the change in culture and values at Moody's after it became a publicly listed corporation:

> *However, by 2007, the culture at Moody's changed dramatically. It was now a major public company with revenues of over $2 billion. It had been one of the best equity performers in the S&P 500.*
>
> *Managers received a significant portion of their compensation in restricted stock and options. … the rating agencies faced the age old and pedestrian conflict between long term product quality and short term profits. They chose the latter. These asymmetric incentives caused a shift of the culture at Moody's from one resembling a university academic department to one which values revenue at all costs.*

Why would a proxy advisory division of a publicly listed corporation be immune to these kinds of pressures for performance? Let's be clear: ISS Corporate Services Inc. (ICS), a subsidiary of ISS, offers *"corporate governance and executive compensation benchmarking and analytical tools and advisory services* ***to corporate issuers*** *and professional services firms"* (ISS web site, emphasis added).

Here's how MSCI, the parent of ISS, describes this risk in its 2012 Form 10K:

> *Through our ISS Corporate Services subsidiary, we provide products and services to corporate clients who use these services to learn about and improve their corporate governance practices. Accordingly, there is a potential conflict of interest between the services we provide to institutional clients and the services, including our Compensation Advisory Services, provided to clients of the ISS Corporate Services subsidiary. For example, when we provide corporate governance services to a corporate client and at the same time provide proxy vote recommendations to institutional clients regarding that corporation's proxy items, there may be a perception that the ISS team providing research to our institutional clients may treat that corporation more favorably due to its use of our services.*
>
> *The conflict management safeguards that we have implemented may not be adequate to manage these potential conflicts of interest, and clients or competitors may question the integrity of our services.*

Of course ISS claims that all steps and measures are taken to protect their organization against conflicts of interest, or more accurately, from the temptation to use the leverage of their proxy advisory role to enhance their consulting revenues. Their web site refers visitors to a letter written by the well-known law firm Sullivan & Cromwell which was mandated to review the measures taken "*to mitigate the potential for conflicts of interest that may arise when ISS Governance Services provides a voting recommendation with respect to an issuer that is a client of ISS Corporate Services, Inc*".

The law firm concludes "*that current protections effectively manage the potential for conflict, and perceived conflict, between ICS and ISS*". Their letter is dated November 29, 2007 when ISS/Risk Metrics was still a *private company* and a much smaller one than it has become since. If Moody's culture and values were changed by becoming a publicly listed company, it behooves ISS to obtain a new comfort letter from Sullivan and Cromwell about the situation in 2012.

Whatever internal and external firewalls put in place to ensure that no communications seeps from one unit to the other, the very real and painful experience in other industries raises doubts about the wisdom of an organization with two units: one selling services to corporations which can be helped or hurt by the "independent advice" sold to investors by the other unit.

The movement of personnel between the two units, a normal practice in all corporations, would be an issue in this case. Yet, it appears that the head of ISS Corporate Services was, prior to this role, "*a senior analyst with ISS' Proxy Advisory Service, responsible for producing analyses and vote recommendations regarding proxy contests, mergers, acquisitions, corporate restructurings, and equity plan proposals*"! (ISS web site)

Glass Lewis is wholly-owned by Ontario Teachers' Pension Plan. OTPP has acquired Glass Lewis from Xinhua Finance in October 2007 after Xinhua Finance had itself acquired Glass Lewis in January of that year. As a clear example that ownership matters, some senior employees of Glass Lewis left the company in May, one of them citing concerns that he was "uncomfortable with and deeply disturbed by the conduct, background, and activities of Glass Lewis's new parent, Xinhua Finance Ltd., its senior management, and its directors". (Gaffen, 2007)

Glass Lewis is adamant however in differentiating itself from ISS. It *does not offer consulting services to public corporations or directors. We are not in the business of advising public companies on their governance structures or conduct, and we refuse to use our position as trusted advisor to institutional investors to win consulting mandates with issuers* (Glass Lewis web site).

While Glass Lewis asserts that it is totally independent from its owner and that the latter has no means of influencing the decisions and recommendations of Glass Lewis, it remains that this form of ownership is not optimal for a proxy advisory firm.

Ideally, proxy advisory firms should be operating with the ownership structure typical of professional organizations, similar to auditing firms for instance. As regulators have been fairly relaxed in letting most other financial market sentinels adopt the corporate form and list their shares on stock markets (viz. stock markets, rating agencies, investment bankers), it is improbable that they would insist that proxy advisors change their ownership structure.

RECOMMENDATION IV

Canadian regulators could and should prohibit ISS from offering its corporate services to corporations about which ISS issues proxy voting recommendations to its institutional clients*, in the same way that auditing firms may not offer consulting services to corporations they audit.*

Furthermore, a similar prohibition has been put in place for rating agencies.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934;
Section 17g-5 states:

> *"(c) Prohibited conflicts. A nationally recognized statistical rating organization is prohibited from having the following conflicts of interest relating to the issuance or maintenance of a credit rating as a credit rating agency:….*
>
> *(5) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to an obligor or security where the nationally recognized statistical rating organization or a person associated with the nationally recognized statistical rating organization* ***made recommendations*** *to the obligor or the issuer, underwriter, or sponsor of the security* ***about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security****;" (Emphasis added)*

At a minimum, Canadian regulators (as well as ISS institutional clients) should demand that ISS provide to its institutional clientele the list of clients of ISS Corporate Services, Inc. for which proxy voting advice is put forth by ISS.

Their involvement in M&A and other litigious transactions

The role of proxy advisors in the yearly, recurring ritual of shareholders voting on various proposals is well documented and their influence ascertained in this paper and many others. The case for their usefulness, though not entirely persuasive, does receive support from institutional investors: the very large number of shareholder proposals, the complex logistics of proxy voting, arcane governance and executive compensation may justify the delegation of factual information gathering and analysis, if not actual voting instruction, to specialized firms.

More surprising and puzzling is the role these proxy advisors are now playing in all cases of mergers, acquisitions, proxy contests and all other litigious matters. Within the ISS proxy advisory services is located what they call *M&A Edge*, which *provides independent, in-depth research analysis that focuses specifically on proposed merger and acquisition deals and proxy contests to inform institutional investors*. (MSCI, 10K, 2012)

For instance, ISS advised institutional investors to vote in favour of the Magna deal with its founder; it urged investors to support the alternate list of CP corporate directors proposed by a Pershing Capital Fund; but it recommended to investors to vote against the takeover of Casey's chain of American convenience stores by Alimentation Couche-Tard!

ISS supported Telus management's proposal to convert its non-voting shares into voting shares (without any premium to the voting shareholders). In this case, the CEO of Telus hailed the recommendation from "*a trusted neutral expert on corporate governance and proxy voting*".

Proxy advisers offer their opinion on almost all litigious, contentious issues. As these issues often come about as a result of the actions of some activist hedge funds, a proxy advisor's favourable opinion, from ISS particularly, is a highly prized input to the argumentation of activist funds.

Proxy advisors actually make recommendations about the price offered for a takeover. Acting as quasi-investment bankers, they advise their institutional clients (and all shareholders as their "opinion is widely broadcast in the media) whether to hand in their shares, or not, at the proposed price. Here are a few recent examples:

ALIMENTATION COUCHE TARD (ATD) V. CASEY'S

In ISS's report issued September 15, 2010, ISS concluded that "ATD's currently outstanding offer is far from a compelling starting point for negotiations, and does not merit shareholder support for the ATD slate."

With respect to Couche-Tard and its $38.50 per Casey's share cash tender offer, Glass Lewis states, "In our opinion, the Dissident has not proven that the Offer represents the greatest value for shareholders nor has it shown that the incumbent directors should be removed from the board at this time."

KINROSS GOLD V. RED BACK

ERIC REGULY, Globe and Mail, September 09, 2010.

> *"One adviser in particular, Institutional Shareholder Services (ISS), has triggered low-grade panic among Kinross executives. ISS recommended that shareholders reject the Red Back deal. While ISS's call will be followed by fewer than 10 per cent of Kinross's shareholder base, every vote counts when the hurdle rate is 50 per cent plus one vote. It's no exaggeration to say that ISS has the potential to wreck Mr. Burt's dream, maybe his career.*
>
> *ISS is becoming a big name on Wall Street. Its job is to advise institutional shareholders on how to vote their shares in takeovers, mergers, proxy fights and corporate governance matters. Clients of ISS usually follow its advice; indeed, some are required to do so. Too bad, because the Kinross-Red Back deal is one case where ISS appears to have made a bad call…"*
>
> **So who is right, ISS or Kinross?**
>
> ISS is not on the ground in Africa; Kinross is ISS lacks the technical expertise to value the Red Back deposits; Kinross doesn't. ISS does not appear to realize that no gold company is valued on proven and probable preserves alone; Kinross and other miners know those figures are only a fraction of the story. If you think Kinross is run by people who lie about gold deposit potential, then sell your shares and run. If you don't, Kinross deserves the benefit of the doubt on the Red Back deal."

EQUINOX V. LUNDIN

Peter Koven, Financial Post, Mar. 28, 2011

> *"Proxy voting firm Institutional Shareholder Services (ISS) is recommending that Equinox Minerals Ltd.'s shareholders vote in favour of the company's $4.8-billion hostile takeover bid for Lundin Mining Corp.*
>
> *The endorsement is a big boost for Equinox, which was rejected by Lundin's board and is trying to build investor support for the deal.*
>
> *ISS noted that shareholder approval of the Equinox bid "is warranted" based on strategic rationale, "apparently" manageable risks, and lack of corporate governance concerns.*
>
> *In rejecting the bid, Lundin argued that the price is too low and the risk is too high because Equinox plans to take on US$3.2-billion of new debt. Equinox chief executive Craig Williams has maintained that the debt level is manageable."*
>
> *"We are pleased to receive the independent third-party recommendation from ISS," Mr. Williams said."*

As M&A transactions and proxy contests occur only intermittently, one would think that an investor, institutional or not, would take the time and would have the resources to assess the pros and cons of the issue, draw appropriate conclusions and vote in a fiduciary responsible manner.

The influence of proxy advisors should be minimal. But it does not seem to be the case. A well-publicized and positive report by ISS provides invaluable support to the activist fund. It would not be surprising to find that these hedge funds are good reliable clients of the various services offered by ISS. Indeed, 42 of the 50 largest hedge funds are clients of ISS. (Source: IBM submission to the SEC, October 15, 2010).

MSCI is clearly sensitive to the risk posed by the dual role of ISS:

> *The institutional clients of both our Performance and Risk and Governance businesses, particularly hedge funds and more active institutional investors, may have material economic and other interests in the corporations on which ISS provides proxy analyses and ratings or which are the subject of our financial research and analysis products and services. In some cases these institutional clients pay us a significant amount of money for our Performance and Risk products and services and, accordingly, there may be a perception that we might advocate a particular position or provide research that supports a particular conclusion with respect to a corporation in order to satisfy the unique economic or other interests of a particular institutional client. As a result, institutional clients, competitors and other market participants could raise questions about our ability to provide unbiased services, which could harm our reputation.* (MSCI, Form 10K, February 29, 2012)

RECOMMENDATION V

Whenever proxy advisors get involved in takeover situations, they are recommending in effect that their institutional clients sell, or not sell, their shares to a would-be acquirer. In those circumstances, they should be subjected to regulations put in place for financial advisers and investment bankers giving an "opinion" to a board about a merger or acquisition transaction. Any such advice given by proxy advisors should inform all parties concerned as to whether the proxy advisor has acted as consultant in any way for any of the parties involved in the transaction over the last two years.

Of course if recommendation 3 above was implemented, that issue would become moot as proxy advisors would be generally prohibited from acting in this capacity.

RECOMMENDATION VI

In cases of proxy contests and other litigious matters, Canadian regulators should adopt the suggestion made by Wachtell, Lipton, Rosen and Katz in their submission to the SEC: "Proxy advisory firms should be required to disclose in their recommendations whether the advisor has, currently or within the recent past, been engaged by any participant in the relevant proxy contest, whether any of the interested parties in a contest subscribe to the proxy advisory firm's services, and the aggregate fees paid by the interested parties to the proxy advisory firm".

Conclusion

This policy paper has stressed the untenable position in which proxy advisory firms find themselves. Neither regulated, nor supervised, proxy advisers rely on a business model that makes it very difficult, virtually impossible for them to handle with care and responsiveness the sheer volume of reports they have to produce in a very short period of time. In the case of ISS, the firm is also vulnerable to conflicts of interests.

Proxy advisors stand in a bully pulpit from which to harangue corporate management and boards of directors on all matters of governance and compensation; neither investors, nor investment advisers, they enjoy a franchise to advise investors on how to discharge their duty or fiduciary responsibility as shareholders.

The dominant actor in this business, ISS, also counsels corporations on how to adjust to, and implement, the advice it is giving to institutional investors. As part of a stock market listed corporation, ISS must find lucrative ways to leverage its dominant market position.

The power and influence exerted by these proxy advisors must be contained and corralled. Their role in defining what is proper governance, what is an effective board and how should executives be compensated is damaging to the performance of corporations. They publish edicts on governance that have little support in empirical research. They have to face up to the implacable logistics of the yearly proxy process in ways that are bound to produce unsatisfactory results.

RESPONSIBILITY OF INSTITUTIONAL INVESTORS

Large institutional investors bear a singular responsibility for this state of affairs. They bear the fiduciary responsibility to vote proxies in the interest of their stakeholders, a responsibility they cannot farm out to proxy advisors. Most large institutional investors maintain adamantly that they do not sub-contract this responsibility but merely use proxy advisors as information gatherers and providers of opinions.

Even for that limited role, institutional clients should demand much more transparency about the business model of proxy advisors. Large institutional investors, as clients of proxy advisory services, should demand that they be given full information on their business model: part-time vs. full-time employees, location of employees, extent of work performed in foreign countries, training of employees, proficiency of the staff, the ways the advisory service copes with the logistics of having to formulate opinions/recommendations on thousands of proposals within a very short time period.

As clients of these advisors, they must, henceforth, demand explicit statements of conflicts of interest whenever these advisors are involved in M&A transactions, proxy contests or other litigious matters. They should insist that proxy advisors disclose at the time of their recommendation *whether the advisor has, currently or within the recent past, been engaged by any participant in the relevant M&A transaction or proxy contest, whether any of the interested parties subscribe to the proxy advisory firm's services, and the aggregate fees paid by the interested parties to the proxy advisory firm*.

Finally, institutional investors should state their disagreement with some of the proposed guidelines of proxy advisors. Certainly they should make clear *that they do not consider the ISS proposed guidelines on executive compensation appropriate or useful and that they will not give any weight to voting recommendations based on these metrics*. There's a key role here for the Canadian Coalition for Good Governance. It has the credibility and the legitimacy to counter the unhealthy influence of proxy advisors on executive compensation.

Canadian institutional investors should object vigorously to ISS basing some of its «guidelines» on poorly designed studies carried out in the American context.

CANADIAN REGULATORS

The regulators should take a strong stance on some of the issues raised here and by many other commentators. The consultation document produced by the Canadian Securities Administrators has provided an excellent summary of the issues as well as some potential remedies. We urge the Canadian regulators to examine the recommendations made in this policy paper as they proceed to set a course forward concerning the proper supervision of proxy advisors.

Indeed, the co-location of two businesses within the same corporation is a recipe for troubles. Canadian regulators should certainly *prohibit ISS from offering its corporate services to corporations about which ISS issues proxy voting recommendations to its institutional clients*.

At a minimum, Canadian regulators should demand that ISS provide to its institutional clientele the list of clients of ISS Corporate Services, Inc. for which proxy voting advice is put forth by ISS.

Furthermore, whenever proxy advisors get involved **in takeover** situations when they are actually advising their clients and the shareholders at large as to the adequacy of the bidder's price for a transaction, regulators should subject them to the regulatory framework applicable to financial advisers and investment bankers offering an "opinion" on the advisability of a transaction.

Finally, Canadian regulators should demand that proxy advisors set standards for the training, expertise and experience of analysts preparing proxy advisors' reports.

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.

List of recommendations

RECOMMENDATION I

Large institutional investors, to the extent that they share the views on compensation defended by IGOPP and others, should make it clear to corporations and to proxy advisors that they do not consider their guidelines on executive compensation appropriate or useful and that they will not give any weight to voting recommendations based on these metrics.

RECOMMENDATION II

Clients of proxy advisors should insist on divulgation of all pertinent details of the business models used by proxy advisors: part-time vs. full-time employees, location of employees, extent of work performed in foreign countries, training of employees.

RECOMMENDATION III

Regulators should require that proxy advisors report on their standards of training and experience for their analysts.

RECOMMENDATION IV

Canadian regulators could and should prohibit ISS from offering its corporate services to corporations about which ISS issues proxy voting recommendations to its institutional clients, in the same way that auditing firms may not offer consulting services to corporations they audit.

RECOMMENDATION V

Whenever proxy advisors get involved in takeover situations, they are recommending in effect that their institutional clients sell, or not sell, their shares to a would-be acquirer. In those circumstances, they should be subjected to regulations put in place for financial advisers and investment bankers giving an "opinion" to a board about a merger or acquisition transaction. Any such advice given by proxy advisors should inform all parties concerned as to whether the proxy advisor has acted as consultant in any way for any of the parties involved in the transaction over the last two years.

RECOMMENDATION VI

In cases of proxy contests and other litigious matters, Canadian regulators should adopt the suggestion made by Wachtell, Lipton, Rosen and Katz in their submission to the SEC: "Proxy advisory firms should be required to disclose in their recommendations whether the advisor has, currently or within the recent past, been engaged by any participant in the relevant proxy contest, whether any of the interested parties in a contest subscribe to the proxy advisory firm's services, and the aggregate fees paid by the interested parties to the proxy advisory firm".

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List of IGOPP Policy Papers

Dual-class share structures in Canada:
Review and recommendations
2006

Corporate citizenship and the right to vote:
A proposal
2006

The Independence of Board members:
A Quest for Legitimacy
2008

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Pushing for Change
2009

Giving Shareholders a Say on Pay:
A measure leading to better governance?
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