January 31, 2020

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Via SEC internet submission form

Dear Sirs/Mesdames:

Re: S7-22-19 Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice

Thank you for the opportunity to provide comments on the proposed amendments referenced above. I am the N. Murray Edwards Chair in Business Law at the University of Calgary in Canada. By international standards, we have a very similar market and regulatory environment to that of the United States. My research interest over the past seven or eight years has been the declining public markets in the United States, Canada and the United Kingdom.

I have published two articles summarizing the empirical research on proxy advisors in peer-reviewed journals over the past five years, and as many as half-a-dozen additional journal articles that touch on the work of proxy advisors in areas as disparate as their attempts to measure the quality of firms' corporate governance and the impact of their executive compensation activities on firm performance.

I approach the problem of public market decline with no preconceived notions, and I have tried to examine all the changes introduced to the public markets over the past three decades. I certainly don't believe proxy advisors are the sole reason public equity markets have become less competitive, but I believe the best evidence is that they are complicit in many of the negative features of public markets most cited by market participants. There is very little third-party evidence I am aware of that suggests their activities and recommendations improve firm performance.

A review of the comments received by the SEC on this matter to date, suggests there is still a real question whether it is appropriate for the SEC to regulate proxy advisors at all. I am therefore attaching one of my papers that addresses this issue.[1] In that paper I make the following the argument:

1. The most commonly provided rationale for securities regulation is that there are significant externalities (positive and negative) that arise out of the production of information by issuers. The dominant problems are an underproduction of information and the production of fraudulent information. In many circumstances it is in the interests of an issuer or its managers, or both, to either reduce the costs of collecting and providing material information, or to provide misleading information to the market. Either of these can lead to a significant mis-pricing of the issuer's securities and so the SEC has both mandated disclosure and punishments for fraudulent disclosure.

[1] Bryce Tingle, "The Agency Cost Case for Regulating Proxy Advisory Firms" (2016) 49:2 UBC L. Rev. 725).

2. The SEC's concern that market participants have the information they require to accurately price the prospects of public companies has often extended to regulating third parties involved with the production of information such as investment banks, audit firms, and credit-rating agencies. There is no principled reason to exclude proxy advisory firms if they adversely impact the quality of information in the market.

3. The market for proxy advice consists only of agents: the investment fund managers who purchase proxy advice and the proxy firms that provide it. The principals in the market for corporate governance information – the individual American beneficiaries of investment funds and the issuers – are absent from the proxy advice market. There is considerable evidence that investment fund managers have few incentives to invest significant time and energy into understanding the corporate governance arrangements of the potentially hundreds of companies they own. Indeed, the very existence of the proxy advisory industry is a testament to this fact. There is little reason to believe that investment fund managers do a better job at evaluating the quality of the corporate governance advice they receive from proxy advisors. Indeed, to evaluate proxy advice, the fund managers would have to do the very work of investigating the governance arrangements of portfolio companies that they seek to avoid by hiring proxy advisory firms.

4. There is significant evidence of failures in the production of information in the proxy advisory market:

> a. There have been studies (for example the one detailed in footnote 32 in the attached paper) finding negative economic consequences arising from the adoption of particular proxy firm guidelines.
>
> b. The development of advisors' voting guidelines appears inadequate and under-resourced. One paper looking at this issue is amusingly titled, "And Then a Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?"[2]
>
> c. The guidelines that are developed do not reflect the best empirical evidence available about the outcomes arising from various governance structures. Very often proxy advisors' guidelines fly in the face of vast bodies of empirical research about the efficacy of a particular structure.
>
> d. There is considerable inconsistency in the recommendations provided by different proxy advisory firms. This also occurs in cases where only one firm can be correct.
>
> e. There is considerable evidence that proxy advisors do not accurately score or rate a firms' corporate governance arrangements.[3] The failures in this area are so large as to cast doubt

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[2] David F Larcker, Allan McCall & Brian Tayan, "And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?" online: (25 February 2013) Stanford Closer Look Series at 2: Stanford Graduate School of Business <www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-31-proxy-firms- voting-recommendations.pdf>

[3] Bryce Tingle, *What is Corporate Governance? Can We Measure it? Can Investment Fiduciaries Rely on it?* (2018) 43 Queen's L. J. 822.

on the entire enterprise of external parties using “best practices” to evaluate governance quality.

f. Proxy advisors’ voting recommendations are often based on rules that are ambiguous or opaque. Besides making it impossible for their investment fund manager clients to evaluate the quality of the rules, this feature of proxy advisors’ work introduces an element of unpredictability in voting recommendations that are frequently referenced by issuers in their submissions to securities regulators.

g. Proxy advisors have small staffs relative to their workload, even when temporary workers hired for the proxy season are factored in. There is a significant mismatch between the complexity of the work that must be done in a short time frame and the junior, temporary analysts employed by the firms.

h. There is abundant evidence that a significant number of mistakes, of many different types, are made in the course of generating proxy voting recommendations.

i. Proxy advisors often do not correct a mistake when it is brought to their attention.

j. The constant addition of new corporate governance practices and refinements to existing practices may be at least partly explained by institutional and economic imperatives at the proxy firms themselves, rather than new developments in corporate governance.

I attach a copy of my paper, which contains some of the research underlying the above arguments.

Sincerely,

Bryce C. Tingle
N. Murray Edwards Chair in Business Law, Faculty of Law, University of Calgary
Director, Financial Markets Regulation Program, School of Public Policy

The final version of this paper can be found in (2016) 49:2 UBC Law Review

THE AGENCY COST CASE FOR REGULATING PROXY ADVISORY FIRMS

Bryce C. Tingle[1]

The current market for proxy advice arises out of an agency problem, but not the one usually assumed. Investment fund managers have relatively few economic incentives to invest effort on corporate governance and so they tend to organize around picking the best stocks and trading those stocks at the optimal time. This creates a market for third party proxy advisors, but both investment managers and proxy firms bear few of the costs of poor governance and operate under incentives to keep proxy advice as inexpensive as possible.

Empirical evidence drawn from the academic studies performed on this market, along with trends revealed by submissions to the SEC and CSA, show significant problems with the content of proxy advice (including mistakes in what produces good corporate governance and frequent errors in voting recommendations) along with problems in the process by which the advice is delivered (including insufficient information for advisors to comply with their own voting guidelines, conflicts of interest, opacity, and an apparent inability to correct errors.)

The case for regulatory intervention in the market for proxy advice can be stated quite simply: (1) there is empirical evidence of significant, repeated informational failures produced by the market for third party proxy voting advice; (2) there is evidence these failures arise systemically as a logical consequence of the conflicts of interest of the agents that make up the market; and (3) there is evidence of significant externalities in the market for proxy advice, suggesting the value of good proxy advice is not captured by the agents that participate in the market and that high-quality advice is therefore underproduced. This is precisely the type of market failure securities regulation is designed to fix. The paper concludes by recommending the modest application of traditional disclosure tools to the market for proxy advice.

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[1] N. Murray Edwards Chair in Business Law, University of Calgary.

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INTRODUCTION

Something has gone wrong in Western public capital markets.[2] They are less attractive to companies already listed on these markets[3] and to companies that would otherwise consider going public.[4] At the same time, Western economies are experiencing an apparent secular decline in dynamism and productivity growth.[5] This has unleashed a flood of blue

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[2] See Bryce C. Tingle, J Ari Pandes & Michael J Robinson, "The IPO Market in Canada: What a Comparison with the United States Tells Us About A Global Problem" (2013) 54:3 Can Bus LJ 321 [Tingle, Pandes & Robinson "IPO Market in Canada"] (discussing proposed causes of the decline in Canadian and US Initial Public Offerings (IPOs) markets).

[3] Jesse M Fried, "Firms Gone Dark" (2009) 76:1 U Chicago L Rev 135 at 135–36 (discussing how and why firms are delisting over the last several years).

[4] Xiaohui Gao, Jay R Ritter & Zhongyan Zhu, "Where Have All the IPOs Gone?" (2013) 48:6 J Financial & Quantitative Analysis 1663 at 1664, 1667–68 (describing a drop in small firms issuing IPOs); Tingle, Pandes & Robinson "IPO Market in Canada", *supra* note 2 ("America is not just generating fewer IPOs domestically, it has become significantly less attractive a market for foreign IPOs" at 330).

[5] IMF, *World Economic Outlook: Uneven Growth: Short- and Long-Term Factors*, World Economic and Financial Surveys, (Washington, DC: April 2015) at 111–43 (finding declining private business investment throughout the world); Ryan Decker et al, "The Role of Entrepreneurship in US Job Creation and Economic Dynamism" (2014) 28:3 J Economic Perspectives 3 (discussing declines in US economic dynamism, particularly declining business startup rates and job creation and destruction); Steven J Davis et al, "Business Volatility, Job Destruction, and Unemployment" (2010) 2:2 American Economic J 259 (showing a declining pace of job flows over time); John Haltiwanger, Ian Hathaway & Javier Miranda, "Declining Business Dynamism in the US High-Technology Sector" *Ewing Marion Kauffman Foundation* (February 2014), online: <www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2014/02/declining_business_dynamism_in_us_high_tech_sector.pdf> (summarizing evidence of declining rates of entrepreneurism in the US and finding similar trends in the high-tech sectors); US, Bureau of Labor Statistics of the US Department of Labor, *The Declining Average Size of Establishments: Evidence and Explanations*, (Washington, DC: Monthly Labor Review, March 2012) at 50 (demonstrating the size of startup firms is also declining); Alexander Tabarrok, "Is Entrepreneurship in Decline?" (Paper for The Future of US Economic Growth conference delivered at the Cato Institute, Washington, DC, 4 December 2014) [unpublished, archived at George Mason University], online: <mason.gmu.edu/~atabarro/Is%20Entrepreneurship%20in%20Decline.pdf> (summarizing evidence of a quantifiable decline in economic dynamism); Lawrence H Summers, "US Economic Prospects: Secular Stagnation, Hysteresis, and the Zero

ribbon panels and government reports attempting to determine what has gone wrong with the West's public markets[6] and whether, in their current configuration, they are contributing to the decline in innovation and entrepreneurial vigour.[7] Proxy advisory firms, which advise institutional

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Lower Bound" (2014) 49:2 Business Economics 65 (Palgrave Macmillan) (economic stagnation since the 2008 recession continues); Christine Lagarde, Director of the International Monetary Fund, "The Challenges Facing the Global Economy: New Momentum to Overcome a New Mediocre" (Remarks delivered at the Annual Spring Meetings at Georgetown University, 2 October 2014) at 00h:17m:05s, online: <www.imf.org/external/mmedia/view.aspx?vid=3819798840001> (a lack of both investment and consumption contribute to the low growth); Tyler Cowen, *The Great Stagnation: How America Ate All the Low-Hanging Fruit of Modern History, Got Sick, and Will (Eventually) Feel Better* (New York: Penguin Group 2011) at 1 (economic growth in the US has slowed due to decreased innovation); Robert J Gordon, "The Demise of US Economic Growth: Restatement, Rebuttal, and Reflections" (2014) National Bureau of Economic Research Working Paper No 19895 at 24–26 , online: <www.nber.org/papers/w19895.pdf> (predicting the slow in innovation will not end anytime soon); Robert J Gordon, "Is US Economic Growth Over? Faltering Innovation Confronts the Six Headwinds" (2012) National Bureau of Economic Research Working Paper No 18315 at 1–2, online: <www.nber.org/papers/w18315.pdf> (examining the peak and decline of economic growth in the US).

[6] See e.g. IPO Task Force, "Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth" (20 October 2011) at 1, online: US Securities and Exchange Commission <www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf> (report on how to drive economic growth); US, Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (Cambridge, MA: 30 November 2006), online: <capmktsreg.org/app/uploads/2014/08/Committees-November-2006-Interim-Report.pdf> (report on improving US capital equity markets); US, Committee on Capital Markets Regulation, *The Competitive Position of the US Public Equity Market* (Cambridge, MA: 4 December 2007), online: <capmktsreg.org/app/uploads/2014/12/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf> (report on improving US market competitiveness); US, Chamber of Commerce, *Capital Markets, Corporate Governance, and the Future of the US Economy*, (2006), online: <www.uschamber.com/sites/default/files/legacy/reports/060213capitalmarkets.pdf> (report on risks to US capital markets system).

[7] See, for example, John Kay, "The Kay Review of UK Equity Markets and Long-Term Decision Making" (July 2012), online: UK Department for Business, Innovation and Skills <www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf> (describing how short-termism in public markets has contributed to a decline in growth).

investors how to vote their shares, are the most prominent new feature of how the West governs its public companies, so it is unsurprising that they have been singled out as possibly complicit in these trends.[8]

Several years ago, regulators in Canada[9], Europe[10] and the United States[11] all began separate processes of exploring the role of third party proxy advisors in modern equity markets and whether they ought to be regulated. In Canada and the United States at least, the answer the regulators have come to

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[8] See e.g. Comment letter from Edward S Knight, General Counsel of NASDAQ (8 October 2013) "Re: Petition Related to Proxy Advisory Firms", online: US Securities and Exchange Commission <www.sec.gov/rules/petitions/2013/petn4-666.pdf> ("there is evidence that the [proxy] Firms not only increase the costs of being a public company, but also create disincentives for companies to become public in the first place" at 2).

[9] See *CSA CONSULTATION PAPER 25-401: POTENTIAL REGULATION OF PROXY ADVISORY FIRMS*, OSC, (2012) 35 OSCB 5681 [*CSA CONSULTATION PAPER*].

[10] See EC, European Commission, *GREEN PAPER: The EU Corporate Governance Framework,* (Brussels: COM (2011)) at 64, online: <ec.europa.eu/internal_market/company/modern/corporate-governance-framework_en.htm>; EC, European Commission, *Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement and Directive 2013/34/EU as Regards Certain Elements of the Corporate Governance Statement,* (Brussels: COM (2014)) at 213, online: <eur-lex.europa.eu/resource.html?uri=cellar:59fccf6c-c094-11e3-86f9-01aa75ed71a1.0003.01/DOC_1&format=PDF>; EC, European Securities and Markets Authority, *Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options*, (Paris: 22 March 2012) at 212, online: <www.esma.europa.eu/system/files/2012-212.pdf> [EC, *Proxy Discussion Paper*]; EC, European Securities and Markets Authority, *Final Report: Feedback Statement on the Consultation Regarding the Role of the Proxy Advisory Industry,* (Paris: 19 February 2013) at 84, online: <www.esma.europa.eu/system/files/2013-84.pdf>; The Best Practice Principles for Governance Research Providers Group, "Public Consultation on Best Practice Principles for Governance Research Providers" (28 October 2013), online: <bppgrp.info/wp-content/uploads/2013/11/BPP-Group-Principles-Consultation.pdf>; The Best Practice Principles Group, "Best Practice Principles for Providers of Shareholder Voting Research & Analysis" (March 2014), online: <bppgrp.info/wp-content/uploads/2014/03/BPP-ShareholderVoting-Research-2014.pdf>.

[11] US, SECURITIES AND EXCHANGE COMMISSION, Concept Release 34-62495 "CONCEPT RELEASE ON THE US PROXY SYSTEM" (14 July 2010), online: <https://www.sec.gov/rules/concept/2010/34-62495.pdf>.

apparently is "no."[12] Both the SEC and Canadian Securities Administrators make it clear that there are problems in the way proxy advisors go about their business, but neither country's regulators feel regulation is required or appropriate. The Canadian Securities Administrators proposed response summarizes the situation as follows,

> "[W]e conclude that a policy-based approach providing guidance on recommended practices and disclosure for proxy advisory firms represents a sufficient and meaningful response to address the different perspectives of the respective market participant groups while recognizing the private contractual relationship between proxy advisory firms and their clients."[13]

At least one academic commentator has taken a similar position, arguing regulators should confine themselves to, at most, encouraging the voluntary adoption of certain best practices.[14]

This paper argues the securities commissions in Canada and the United States have made a mistake in not regulating proxy advisors. Properly considered, the need for new rules relating to the proxy industry flows out of the core rationales for securities regulation. Securities regulation is designed to remedy certain kinds of market failures; the day-to-day business of proxy advisors gives rise to precisely these types of market failures.

Part I of this paper reviews the theory behind the regulation of financial markets to set out the usual standard for enacting new securities regulations. Part II discusses the methodology for determining whether the activities of

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[12] *CSA Notice – National Policy 25-201 Guidance for Proxy Advisory Firms,* OSC CSA Notice, (2015) 38 OSCB 4121, online: <www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20150430_25-201-proxy-advisory.pdf> (guidelines not intended to be prescriptive). The only action from the US Securities and Exchange Commission ("SEC") since the Concept Release is *Staff Legal Bulletin* No 20 (IM/CF) *Proxy Voting: Proxy Voting Responsibilities of Investment Advisors and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* (June 30, 2014) (merely commenting on existing legal regime impacting proxy advisors, but proposing no new regulations).

[13] *CSA Notice and Request for Comments – Proposed National Policy 25-201, Guidance for Proxy Advisory Firms,* OSC, (2014) 37 OSCB 4339 at 4341, online: Ontario Securities Commission <www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20140424_25-201_rfc-proxy-advisory-firms.pdf>.

[14] George Dent, "A Defense of Proxy Advisors" (2014) 2014 MICHIGAN STATE L REV 1287 at 1328–29.

proxy advisors meet this standard. Part III is a brief introduction to the proxy advisory industry and its influence. Part IV explores how proxy advisors conduct their business in practice, with a focus on the ways agency costs affecting the proxy industry interfere with the production of accurate information. Part V addresses the possible regulatory interventions and proposes the modest application of traditional securities regulatory tools to the proxy advice industry.

I. THE RATIONALE FOR SECURITIES REGULATION

The traditional explanation for governmental intervention in a market is that regulation is necessary because the prices produced by the market fail to reflect externalities or the presence of some public good.[15] As a result of this pricing failure, goods will be produced at sub-optimal levels. In the case of significant externality costs not captured by market pricing, more of an item, or the wrong items, will be produced than would be the case if all the costs of the item in question were reflected in the price. In the case where public goods (a positive externality) are not reflected in prices, too little of the item in question will be produced.[16]

Modern securities regulation has traditionally been justified on the grounds that it addresses two particular types of market failure: the underproduction of information and the production of fraudulent information.[17] (In the context of economic discussions of securities regulation, "fraud" includes negligent misrepresentations as well as intentional attempts to deceive market

[15] See Paul A Samuelson, "THE PURE THEORY OF PUBLIC EXPENDITURE" (1954) 36:4 Rev Economics & Statistics 387 at 388–89; Francis M Bator, "THE ANATOMY OF MARKET FAILURE" (1958) 72:3 Quarterly J Economics 351 at 354, 360, 371; Stephen L Slavin, *Economics*, 6th ed (New York, NY: McGraw-Hill, 2002) at 91.

[16] Philip Black, Estian Calitz & Tjaart Steenekamp, *Public Economics*, 5th ed (Cape Town: OXFORD UNIVERSITY PRESS SOUTHERN AFRICA, 2011) at 46–47.

[17] See Frank Easterbrook & Daniel R Fischel, "Mandatory Disclosure and the Protection of Investors" (1984) 70 Va L Rev 669 at 669 [Easterbrook & Fischel, "Mandatory Disclosure and Protection of Investors"]. See also John C Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System" (1984) 70:4 Va L Rev 717 at 722 [Coffee, "Market Failure"]. But there are academic commentators who argue there is no underproduction of information in securities markets. See Roberta Romano, *The Advantage of Competitive Federalism for Securities Regulation* (Washington, DC: AEI Press, 2002) at 12–62.

participants.)[18] There are obviously significant advantages to investors to having all material information about issuers publicly available.[19] Having this information permits them to accurately price issuers' securities and the relevant risks. However, producing information is costly and companies do not capture all of the benefits of producing this information.[20] For example, some of these benefits are only received by traders in the secondary market, some of these benefits are received by individuals who decide NOT to enter the market for the company's shares. Adverse material information is particularly unlikely to contribute more value to the issuer than the costs of producing it. For these reasons, mandatory disclosure forms the core of securities regulation.[21]

The anti-fraud regime, by imposing duties and penalties on the various corporate actors who might produce materially inaccurate information, is designed to support the mandatory disclosure requirements. The existence of penalties for corporate misrepresentations is based on a recognition that companies may attempt to reduce the costs of information production by reducing the resources dedicated to ensuring the information is accurate and complete, and that corporate managers can reap personal benefits from the mispricing of an issuer's securities or mistakes in the market about the quality of their managerial competence.[22] These are all instances of agency costs: the agent receives benefits as a result of imposing costs on their principal.[23] Thus, the classic structure of a securities regulation is a requirement that an issuer produce particular information (such as the disclosure required for a proxy circular or prospectus)[24] followed by penalties for the issuer and various

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[18] Kimball Dean Parker, "A Historical Approach to Negligent Misrepresentation and Federal Rule of Civil Procedure 9(b)" (2013) 80:3 U Chicago L Rev 1461 at 1462.

[19] Jeff Schwartz, "Fairness, Utility, and Market Risk" (2010) 89 Or L Rev 175 at 200 (advantages include less volatile and more accurate stock prices).

[20] Frank Easterbrook & Daniel R Fischel, *The Economic Structure of Corporate Law* (First Harvard University Press, 1991) at 300.

[21] Easterbrook & Fischel, "Mandatory Disclosure and Protection of Investors", *supra* note 17 at 669; Coffee, "Market Failure", *supra* note 17 at 722.

[22] Ke Wang, *Securities Fraud, 1996-2001: Incentive Pay, Governance, and Class Action Lawsuits*, (El Paso: LFB Scholarly Publishing LLC, 2010) at 1–2.

[23] Michael C Jensen & William H Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3:4 J Financial Economics 305 at 308 [Jensen & Meckling, "Theory of the Firm"].

[24] See *CONTINUOUS DISCLOSURE OBLIGATIONS,* ABSC NI 51-102 (5 April 2015) at 57–66 (proxy circular requirements) [NI 51-102]; *GENERAL PROSPECTUS REQUIREMENTS,* ABSC NI 41-101 (5 April 2015) at 14–15 (prospectus

corporate actors in the event the information is shown to be materially inaccurate.[25]

The most significant development in securities regulation in the past decade has been the intervention of regulators in the corporate governance of issuers to an unprecedented degree following the Enron-era frauds.[26] The development of rules and guidelines relating to audit committees, board independence and governance practices were justified on the grounds that the private benefits arising from the production of inaccurate information by managers and the private costs experienced by directors in monitoring managers, were both too great for the anti-fraud regime to remedy. Traditional regulatory tools were inadequate to ensure the timely production of accurate information about issuers.[27] As well, the Sarbanes-Oxley era regulatory reforms recognized the significant externalities imposed on western countries when securities markets misprice assets and mistake managerial competence. This became an even more dominant theme of the corporate governance regulatory responses to the 2008 financial crisis.[28]

If the regulation of third-party proxy advisors is to be justified, it must be on the grounds that their day-to-day activities contribute to the kinds of market failure securities regulation is designed to remedy. In other words, it is necessary to show that proxy firms routinely underproduce information about

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requirements); *Securities Act*, RSA 2000, c C-44, s 113 (prospectus disclosure requirments).

[25] See e.g. *Securities Act, supra* note 24 at ss 199(1), 203(0.1), 211.03(1)–(4); *Canada Business Corporations Act*, RSC 1985, c C-44, s 149(3)–(4).

[26] Christopher Nicholls, 'The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to Sarbanes-Oxley" in *Canada Steps Up: Maintaining a Competitive Capital Market in Canada: Research Studies* vol 4 (Toronto: Task Force to Modernize Securities Legislation in Canada, 2006) 127; Stephen P Sibold, "Assessing Canada's Regulatory Response to the *Sarbanes-Oxley Act of 2002*: Lessons for Canadian Policy Makers" (2009) 46:3 Alta L Rev 796.

[27] Gerald Vinten, "The Corporate Governance Lessons of Enron" (2002) 4:2 Corporate Governance: Intl J Business in Society 4 at 5–6 (describing flaws in the regulatory system and changes that have since been made).

[28] Stephen M Bainbridge, "Dodd-Frank: Quack Federal Corporate Governance Round II" (2011) 95:5 Minn L Rev 1779 at 1808 [Bainbridge, "Quack Governance II"] (executive compensation high in spite of poor performance); Stephen M Bainbridge, *Corporate Governance After the Financial Crisis* (New York: Oxford University Press, 2012) at 9–10 [Bainbridge, "*Governance After the Financial Crisis*"] (corporate governance failures were at the core of the regulatory responses after the crisis).

corporate governance or that the information they produce is materially inaccurate.

II. METHOD

The presence of externalities in the market for proxy advice might seem obvious. Institutional investors and proxy advisory firms are, after all, the only participants in transactions in this market. This leaves out the two constituencies generally regarded as the rightful beneficiaries of capital markets: the companies themselves, and the actual suppliers of capital. (This latter group is comprised of the individuals who place their money with investment fund managers.) The market for proxy advice also does not include the interests of Canada's citizens and employees in fostering productive, competitive, and innovative businesses in this country. Good corporate governance is a public good, and bad corporate governance, if widespread, has demonstrated it can cause significant externalities, even to the extent of economy-wide recessions.[29]

Nevertheless, the presence of parties outside a market, but deeply affected by transactions in that market, is not enough to demonstrate a market failure. There must be empirical evidence of sub-optimal information being supplied in the market. This presents certain methodological difficulties in the case of corporate governance. Market-wide surveys of corporate governance outcomes are notoriously contestable.[30] Problems of endogeneity are

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[29] See Martin Conyon, William Q Judge & Michael Useem, "Corporate Governance and the 2008-09 Financial Crisis" (2011) 19:5 Corporate Governance: An International Review 399 at 400–01 (corporate governance shortcomings were at least contributing factors to the 2008-09 recession); Naveen Kumar & JP Singh, "Global Financial Crisis: Corporate Governance Failures and Lessons" (2013) 4:1 J Finance, Accounting & Management 21 ("[s]everal deficiencies in the corporate governance structure and processes led to the collapse of many financial institutions, and triggering the crisis" at 22); Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis" (2009) 2009:1 OECD J: Financial Market Trends 61 at 63, 65 (corporate governance deficiencies facilitated poor performance in the early 2000s recession).

[30] See e.g. the literature surrounding Bebchuk's Entrenchment Index ("E-Index") found in Lucian A Bebchuk, Alma Cohen & Allen Ferrell, "What Matters in Corporate Governance" (2009) 22:2 Rev Financial Studies 783 (positing a predictive correlation between six corporate governance factors and abnormal returns) where subsequent research has criticized the accuracy of the E-Index. See Dean Diavatopoulos & Andy Fodor, "Does Corporate Governance Matter for Equity Returns?" SSRN Electronic Journal (2 February 2010) at 3–4, online: <papers.ssrn.com/sol3/papers.cfm?abstract_id=1546645> (finding that the E-Index's

particularly acute, for example, when attempting to link a particular proxy voting recommendation to a business outcome.[31] There are too many other factors in a company's internal arrangements, competitive environment and the broader economy that impact corporate performance. This problem is made more acute by the probable delays between a sub-optimal voting recommendation and when the consequences of that recommendation might be become visible in the company's cash flows. Often the chain of causality involves proving a negative: but for a bad voting recommendation, things would have been different. For these reasons there are relatively few convincing empirical studies on the outcomes of proxy advisors' day-to-day voting recommendations.[32]

Thus while some statistically significant empirical studies about the quality of information in the proxy advice market exist, most of the available data is anecdotal. The CSA and SEC requests for comments in relation to the proxy industry generated many letters from issuers, law firms and trade organizations identifying instances of informational failures. This paper argues that what saves these examples from the suspicion we reserve for merely anecdotal data, is the way in which they illustrate and support a

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predictions are inaccurate when looked at during different time periods); Lucien A Bebchuk, Alma Cohen & Charles CY Wang, "Learning and the Disappearing Association Between Governance and Returns" (2013) 108:2 J Financial Economics 323 at 324 (the E-Index is not associated with abnormal returns during the period of 2000-2008); David Larcker & Brian Tayan, *CORPORATE GOVERNANCE MATTERS: A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES* (Upper Saddle River, New Jersey: Pearson Education, 2011) at 453 (no definitive conclusions have been reached about the predictability of an index made up mostly of anti-takeover provisions on future returns); Shane A Johnson, Theodore C Moorman & Sorin Sorescu, "A Reexamination of Corporate Governance and Equity Prices" (2009) 22:11 Rev Financial Studies 4753 ("[w]e…find zero abnormal returns for hedge portfolios defined using Bebchuk['s]…(2004) entrenchment index" at 4755); Sanjai Bhagat & Brian Bolton, "Corporate Governance and Firm Performance" (2008) 14:3 J Corporate Finance 257 ("contrary to claims…none of the governance measures are correlated with future stock market performance" at 258).

[31] Michael R Roberts & Toni M Whited, "Endogeneity in Empirical Corporate Finance" in George Constantinides, Milton Harris & Rene Stultz, eds, *Handbook of the Economics of Finance* vol 2A (Amsterdam: North Holland, 2013) 493 at 501.

[32] Which is not to say there are none, see e.g. David F Larker, Allan L McCall & Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Repricing" (2013) 56:2-3 J Accounting & Economics 146 [Larker, McCall & Ormazabal, "Stock Option Repricing"] (examining the largely negative economic consequences of following proxy advisory firm guidelines for stock option repricing programs).

familiar theme about corporate governance. The dominant paradigm for understanding corporate governance decisions over the last forty years has been agency cost theory.[33] We would normally expect to see agency costs in a market where the only participants are agents and where the monitoring costs of the ultimate economic interest holders are high.[34]

This paper thus proceeds by showing how the available empirical data on the day-to-day functioning of the proxy advice market suggests the presence of market failures generated by well-understood incentives operating on the agents that make up the market. This in turn suggests that the market interactions we cannot see, because they lie outside the anecdotal evidence, conform to the trend. In other words, if the available evidence suggests agency costs are leading to informational failures in the proxy advice market, then it is likely that these failures characterize the market, demonstrating a market failure of the type that securities regulation is designed to remedy.

This method of determining whether there is a need for regulation is the same one used repeatedly over the past decade in relation to other corporate governance interventions by securities regulators. The Sarbanes-Oxley era reforms, for example, were motivated by anecdotal evidence (in the form of the governance failures in companies like Enron, Worldcom, Tyco, Health South, Livent and Hollinger) that conformed to a well-understood implication of agency theory, namely that managers would act in ways to enhance their own well-being at the expense of their shareholder principals.[35]

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[33] See Jensen & Meckling, "Theory of the Firm" *supra* note 23 at 308 (defining agency costs generally). See generally Manohar Singh & Wallace N Davidson III, "Agency Costs, Ownership Structure and Corporate Governance Mechanisms" (2003) 27:5 J Banking & Finance 793 (discussion of agency costs' impact on larger sized firms); Frank H Easterbrook, "Two Agency-Cost Explanations of Dividends" (1984) 74:4 American Economic Rev 650 (discussing agency costs with rgards to dividends); RL Watts & JL Zimmerman, "Agency Problems, Auditing, and the Theory of the Firm: Some Evidence" (1983) 26:3 JL & Econ 613 (discussing origins of independent audits in the context of agency costs); Brandon CL Morris & Brian S Roseman, "Dividends as a Solution to Agency Cost and Opaqueness: Theory and Evidence" (2015) 7:1 International J Economics & Finance 24 (contemplating dividends as a solution to agency costs); Robert H Sitkoff, "An Economic Theory of Fiduciary Law" in Andrew S Gold & Paul B Miller, eds, *Philisophical Foundations of Fiduciary Law* (Oxford: Oxford University Press, 2014) 197 (exploring the problem of agency costs in fiduciary relationships).

[34] See discussion at text accompanying notes 23–25 above.

[35] Pankaj K Jain, Jang-Chul Kim & Zabihollah Rezaee, "The Sarbanes-Oxley Act of 2002 and Market Liquidity" (2008) 43:3 Financial Rev 361 at 363; Pankaj K Jain & Zabihollah Rezaee, "The Sarbanes-Oxley Act of 2002 and Capital Market

The anecdotal data supported the theory, which in turn predicted managerial self-dealing was occurring throughout the market. This is precisely the methodological approach of this paper.

It should be noted in passing that while securities regulation tends to focus on issuers and shareholders, it has often reached out to embrace third parties, like proxy advisory firms, who provide information that affect the market. Investment banks, audit firms and credit-rating agencies are possibly the most prominent examples of these third parties. For example, auditing failures in the post-Enron era supplied evidence that conflicts of interest existed that could be expected to systemically impair the quality of information provided to market participants.[36] Regulatory intervention followed.[37]

Behaviour: Early Evidence" (2010) 23:3 Contemporary Accounting Research 629 at 633–37; Haidan Li, Morton Pincus & Sonja Olhoft Rego, "Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management" (2008) 51:1 JL & Econ 111 at 114-15.

[36] See generally John C Coates IV "The Goals and Promise of the Sarbanes-Oxley Act" (2007) 21:1 J Economic Perspectives 91; Joshua Ronen, "Post-Enron Reform: Financial Statement Insurance and GAAP Revisited" (2002-03) 8:1 Stan JL Bus & Fin 39; A Rashad Abdel-khalik, "Reforming Corporate Governance Post-Enron: Shareholders' Board of Trustees and the Auditor" (2002) 21:2 J Accounting & Public Policy 97; Robert Charles Clark, "Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: Morality Tale for Policymakers Too" (2005) Harvard: JOHN M OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS: Discussion Paper No. 525 at 5–10; Sukanya Pillay, "Forcing Canada's Hand? The Effect of the Sarbanes-Oxley Act on Canadian Corporate Governance Reform" (2004) 30:3 Man LJ 285; Robert B Thompson, "Corporate Governance After Enron" (2003) 40:1 Hous L Rev 99 [Robert B Thompson, "Corporate Governance After Enron"]; Janis Sarra, "Rose-Colored Glasses, Opaque Financial Reporting, and Investor Blues: Enron as Con and the Vulnerability of Canadian Corporate Law" (2002) 76:4 St John's L Rev 715; Michael A Perino, "Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002" (2002) 76:4 St John's L Rev 671.

[37] US, Securities and Exchange Commission, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* 33-8810 (20 June 2007); US, Public Company Accounting Oversight Board, *Auditing Standard No 5: An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*, PCAOB Release No 2007-005A (15 November 2015); *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 11-203, 124 Stat 1376 (2010); *CSA Notice 52-313 – Status of Proposed MI 52-111 Reporting on Internal Control over Financial Reporting and Proposed Amended and Interim Findings*, OSC CSA Notice, 29 OSCB 2011 (10 March 2006); *Certification of*

III. THE PROXY ADVISORY INDUSTRY

The proxy advisory industry arises out of an agency problem, although it is not the one frequently cited by the firms themselves. Their reason for existing is found in the separation of ownership and control in modern institutional investors, not modern public corporations.[38] Over the last several decades institutional investors have come to own a growing percentage of Canada's public companies. Intermediary institutions now hold 32% of the shares of TSX-listed issuers[39] and approximately 62% of Canada's 60 largest companies.[40] In the United States institutional investors hold approximately 73% of the thousand largest companies.[41]

While the investment fund is the legal owner of the shares held in its name, the economic interest in those shares actually belongs to the individuals who make up the beneficiaries of the fund. This is the case in every category of institutional investor: pension funds, mutual funds, hedge funds and insurance funds. In practice the individuals managing a fund have very little economic interest in the stock portfolio. The primary motivation for a fund manager is to increase the size of his or her assets under management as that has the most impact on their own remuneration.[42] Fund management

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Annual Filings for Periods Relating to Financial Years Beginning on or After January 1, 2011, OSC NI 52-109F1 (1 January 2011); *Certification of Interim Filings for Periods Relating to Financial Years Beginning on or After January 1, 2011*, OSC NI 52-109F2 (1 January 2011); *Audit Committees*, OSC NI 52-110 (1 January 2011).

[38] Adolf A Berle & Gardiner C Means, *The Modern Corporation and Private Property*, revised ed (New York: Harcourt, Brace & World, 1968) at 128–31 [Berle & Means, *The Modern Corporation*].

[39] *CSA CONSULTATION PAPER*, *supra* note 9 at 5684.

[40] These are the companies in the S&P/TSX 60 Index. Bloomberg Terminal Database, EQS, S&P/TSX 60 <Index> Equity Screening Data: Institutional Investors, retrieved 21 May 2015.

[41] Bryce C. Tingle, "Bad Company! The Assumptions Behind Proxy Advisors' Voting Recommendations" (2014) 37:2 Dal LJ 709 at 715 [Tingle, "Proxy Advisors' Voting Recommendations"].

[42] See Jonathon B Berk & Richard C Green, "Mutual Fund Flows and Performance in Rational Markets" (2004), 112:6 J of Political Economy 1269 (finding fund managers are incentivized to increase the size of their funds until diseconomies of scale risk an outflow of investor funds); Michael K Berkowitz and Yehuda Kotowitz, "Incentives and Efficiency in the Market for Management Services: A Study of Canadian Mutual Funds" (1993), 26:4 Canadian Journal of Economics 850 (discussing the prevalence of asset-based compensation in Canadian funds relative to performance-based compensation); Chengdong Yin, "The Optimal Size of Hedge Funds: Conflicts Between Investors and Fund Managers" (2013) Social Science Research Network http://ssrn.com/abstract=2126689 (finding that the

companies are typically paid a percentage of assets under management and where there are performance incentives involved, increasing the size of the investment fund tends to have a greater impact on the manager's compensation than anything else.

Fund managers grow the size of the portfolios they manage by demonstrating superior returns. This is usually calculated by comparing the returns generated by the manager with the returns generated by competitors or a benchmark such as the TSX Composite Index. To the extent a fund manager can exceed these benchmarks, he or she should expect to see investors reward them with increases in the flow of funds.

This scheme provides very little incentive for fund managers to become involved in the corporate governance of portfolio companies. Any gains generated by these efforts will be shared by all other shareholders of those companies and thus will be fully reflected in the benchmarks. Unsurprisingly, there is considerable evidence that private institutional investors do not tend to get very involved in corporate governance matters.[43] Instead, institutional investors organize themselves around picking the best stocks and trading those stocks at the optimal time. Summarizing his

primary driver of manager compensation is fund size, not performance); Bing Liang & Christopher Schwarz, "Is Pay for Performance Effective? Evidence From the Hedge Fund Industry" (2011) Social Science Research Network http://ssrn.com/abstract=1333230 (finding that increasing assets under management is the primary motivation of hedge fund managers); Jill E Fisch, "Securities Intermediaries and the Separation of Ownership and Control" (2010) 33:4 Seattle UL Rev 877 at 879 (discussing the motivations of fund managers to " match the returns of their benchmark rather than engage in costly activism").

[43] See Bernard S Black, "Shareholder Activism and Corporate Governance in the United States" in Peter Newman, ed, The New Palgrave Dictionary of Economics and the Law (London: Palgrave Macmillan, 1998) 459 at 460 [Black, "Shareholder Activism"]; Stephen J Choi & Jill E Fisch, "On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance" (2008) 61 Vand L Rev 315; John C Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum L Rev 1277 at 1317-28 (money mangers show "limited interest in corporate governance issues ... because the expected gains from most such governance issues are small, deferred, and received by investors, while the costs are potentially large, immediate, and borne by money managers"); Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered" (1993) 93 Columbia L. Rev. 795 (detailing the differing incentives that act on pension fund managers as opposed to private institutional investors such as mutual fund mangers); Tingle, "Proxy Advisors' Voting Recommendations", *supra* note 41 at 715-6.

research on hedge fund involvement with companies, professor Robin Greenwood argues that investment fund managers are not suited to making operating business decisions, and with their short-term focus are unlikely, "to devote time and energy to a [governance-related] task delivering long-term value. After all, there are no guarantees that the effort will pay off, or that other shareholders would recognize the increase in value by paying a higher price per share."[44] Professional investment managers thus present the classic agency problem described by Fama and Jensen as the "separation of decision and risk."[45]

In its letter to the CSA on the subject of proxy advisors, Blackrock Inc., one of the largest investors in the world, advises that while it submits votes at 15,000 shareholder meetings per year in over 90 countries, it employs only 20 corporate governance professionals globally.[46] A theme of most of the letters submitted by institutional investors to the CSA was that it would be difficult for the investor to actively engage in corporate governance activities without the assistance of proxy advisors.[47] The Pension Investment

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[44] Robin Greenwood, "The Hedge Fund as Activist" *HARVARD BUSINESS SCHOOL: WORKING KNOWLEDGE* (22 August 2007), online: <hbswk.hbs.edu/item/5743.html>.

[45] Eugene F Fama & Michael C Jensen, "Separation of Ownership and Control" (1983) 26 JL & Econ 301 at 301.

[46] Comment letter from Robert E Zivnuska, Director, Head of Corporate Governance and Responsible Investment of BlackRock (20 September 2012) "Re: Canadian Securities Administrators Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 1, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120920_25-401_zivnuskar.pdf>.

[47] See e.g. Comment letter from Jason Milne, Manager ESG Policy and Research & Nancy Church, Senior Manager Business Policy and Governance of RBC Global Asset Management (20 September 2012) "CSA Consultation Paper 25-401 - Potential Regulation of Proxy Advisory Firms", online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120920_25-401_milne_church.pdf> ("[g]iven the demands on institutional investors to exercise all votes on all issues, proxy advisory firms today deliver services that are essential to the capital markets, and at a relatively low cost" at 2); Comment letter from Sheila Murray, Executive Vice President, General, Counsel, Secretary of CI Financial (21 September 2012) "RE: CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms", online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120921_25-401_murrays.pdf> ("[w]e understand the important role that Proxy Advisory Firms can play in corporate governance. Many shareholders do not have the time or the tools to make a reasoned decision regarding certain governance matters. Proxy Advisory Firms establish voting policies

Association of Canada reported on their practice of regularly surveying their members: "The survey results over the years have show that…it is essential for a significant portion of our member funds to use the research services provided by proxy advisory firms."[48]

These are the issues that give rise to proxy advisors: the large number of matters that come before an institutional investor in a single proxy season (PSP Investments advised the CSA that 2,900 meetings in its portfolio in one year gave rise to 30,000 resolutions[49]); the limited time available for an institutional investor to perform the necessary research itself (84% of TSX-listed issuers have year ends on December 31 and thus will likely have their shareholder meetings in a brief period between April and June[50]); and the incentives faced by institutional investors to dedicate their limited resources towards investing and trading rather than corporate governance.

Institutional Shareholder Services ("ISS") was formed in 1985 and began providing proxy advisory services to institutional investor clients the following

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and provide recommendations based on a detailed review of proxy circulars" at 2); Comment letter from Doug Pearce, Chief Executive Officer and Chief Investment Officer of British Columbia Investment Management Corporation (23 August 2012) "Re: CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms", online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120823_25-401_pearced.pdf > ("[g]iven this level of voting volume combined with the condensed period that annual general meetings are held…it is essential that we utilize the research provided by proxy voting advisory firms" at 3)

[48] Comment letter from Julie Cays, Chair of Pension Investment Association of Canada (21 September 2012) "Re: Canadian Securities Administrators Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 2, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120921_25-401_caysj.pdf>.

[49] Comment letter from Stéphanie Lachance, Vice President Responisble Investment and Corporate Secretary of PSP Investments (27 August 2012) "RE: Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 2, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120827_25-401_lachances.pdf>.

[50] Yvan Allaire, "The Troubling Case of Proxy Advisors: Some Policy Recommendations" (January 2013) Policy Paper No. 7 at 15, online: Institute of Corporate Directors <www.iasquebec.com/pdf/pp_troublingcaseproxyadvisors_pp7_short.pdf> [Allaire, "Troubling Case of Proxy Advisors"].

year.[51] A subscription entitles institutional clients to receive ISS's voting recommendations. ISS has other businesses, including advising companies on how to improve their governance practices, but its principal business is evaluating the governance of public companies and providing voting recommendations to their subscribers. Each year, ISS (like its competitors) publishes guidelines on how it intends to generate its voting recommendations for the following year (the "ISS Guidelines").[52] Companies and their directors closely scrutinize this document as they make decisions ranging from setting executive compensation to filling board vacancies.

The market for proxy advisory services was relatively quiet until 2003, when the SEC promulgated regulations that require mutual funds to ensure that their voting power is exercised in the "best interest" of beneficiaries.[53] At the same time a rule was adopted requiring mutual funds to disclose the policies and procedures they use to vote their proxies.[54] The rule changes should be understood as originating in the febrile atmosphere following the Enron-era scandals.[55] Institutional shareholder oversight of management had long been regarded as the solution to corporate governance failures, but reformers had

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[51] See information on the history and purpose of ISS at Institutional Shareholder Services, online: ISS <www.issgovernance.com/about>.

[52] See e.g. Institutional Shareholder Services, "2013 Canadian Proxy Voting Guidelines: TSX-Listed Companies" (19 December 2012) at 10–11, online: ISS <www.issgovernance.com/files/2013ISSCanadianTSXGuidelines.pdf> ["ISS Guidelines"].

[53] *Proxy Voting*, 17 CFR § 275.206(4)–(6) (2003); Stephen Choi, Jill Fisch & Marcel Kahan, "Director Elections and the Role of Proxy Advisors" (2009) 82:4 S Cal L Rev 649 at 653–54 [Choi, Fisch & Kahan, "Role of Proxy Advisors"]. The 2003 change followed a similar reform in 1988, when the US Department of Labor announced that ERISA pension fund fiduciaries had a duty to make informed decisions about how they voted the shares in their portfolios. See Bainbridge, *Governance After the Financial Crisis*, *supra* note 28 at 31. See also Comment letter from Alan D Lebowitz, Deputy Assistant Secretary of the Department of Labor to Helmuth Fandl, Chairman of the Retirement Board of Avon Products, ("The Avon Letter") (23 February 1988) (stating that pension fund advisors' fiduciary duties respecting the management of employee benefit plans include how proxies should be voted); US, Department of Labor, Interpretive Bulletin 68 FR 16400 "29 CFR 2509.94-2: INTERPRETIVE BULLETIN RELATING TO WRITTEN STATEMENTS OF INVESTMENT POLICY, INCLUDING PROXY VOTING POLICY OR GUIDELINES" (1 July 2007) at 364–67, online: US Government Publishing Office <www.gpo.gov/fdsys/pkg/CFR-2007-title29-vol9/pdf/CFR-2007-title29-vol9-sec2509-94-2.pdf>.

[54] *Report of Proxy Voting Record*, 17 CFR § 270.30b1–4 (2003).

[55] Robert B Thompson, "Corporate Governance After Enron", *supra* note 36 at 104–06 (outlining SEC rule changes after Enron).

grown frustrated with the failure of money managers to use their considerable power to oversee management.[56] (Many of the Frank-Dodd reforms following the 2008 crisis, such as say-on-pay, were enacted out of the same motives).[57] To satisfy the requirements imposed by the new rules, investment managers began turning to proxy advisory firms. Around the time of the 2003 regulatory changes, the market for voting advice showed all the signs of significant growth. By 2006, ISS could boast that its advice affected the "governance decisions of professional investors controlling…half the value of the world's common stock."[58]

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[56] Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114:7 Yale LJ 1521 at 1565 [Romano, "Quack Corporate Governance"]. For a more detailed overview of the literature, see Stuart L Gillan & Laura T Starks, "A Survey of Shareholder Activism: Motivation and Empirical Evidence" (1998) 2:3 Contemporary Finance Digest 10 (discussion of the development of shareholder activism); Bernard S Black, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 UCLA L Rev 811 (overview of the power of institutional shareholders as activists). Many scholars have discussed the implications of shareholder activism: Bernard S Black, "Shareholder Passivity Reexamined" (1990) 89 Mich L Rev 520 at 567 [Black, "Shareholder Passivity"]; Roberta Romano, "Less is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance" (2001) 18 Yale J on Reg 174 (suggesting shareholder activism has little effect on a firm's performance); John C Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum L Rev 1277; Ernst Maug, "Large Shareholders as Monitors: Is There a Trade-off Between Liquidity and Control?" (1998) 53 The Journal of Finance 65; Anat R Admati, Paul Pfleiderer & Josef Zechner, "Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium" (1994) 102 Journal of Political Economy 1097; NK Chidambaran & Kose John, "Relationship Investing: Large Shareholder Monitoring with Managerial Cooperation" (1998) New York University Working Paper No FIN-98-44, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297123>; Charles Kahn & Andrew Winton, "Ownership Structure, Speculation, and Shareholder Intervention" (1998) 53 The Journal of Finance 99. For a detailed history of the beginnings of institutional shareholder activism, see Robert AG Monks & Nell Minow, *Watching the Watchers: Corporate Governance for the 21st Century* (Cambridge, MA: Blackwell Publishers, 1996).

[57] Bainbridge, "Quack Governance II", *supra* note 28 at 1782-83.

[58] Robert D Hershey Jr, "A Little Industry With a Lot of Sway on Proxy Votes", *New York Times* (18 June 2006), online: The New York Times <www.nytimes.com/2006/06/18/business/yourmoney/18proxy.html?pagewanted=all &_r=0>.

Several new entrants came into the growing market, including Glass, Lewis & Co. ("Glass Lewis"), Egan-Jones and Proxy Governance Inc.[59] There were a series of mergers and acquisitions that left ISS the single largest player in the market, and Glass Lewis, the second largest firm (and a wholly-owned subsidiary of Ontario Teachers' Pension Plan).[60]

The market for proxy advisory services is very lopsided: Glass Lewis and ISS collectively own 97% of the U.S. market[61] and ISS's market share is approximately twice that of Glass Lewis.[62] ISS claims, "over 1,700 institutional clients managing $26 trillion in assets, including 24 of the top 25 mutual funds, 25 of the top 25 asset managers and 17 of the top 25 public pension funds."[63] Similar statistics are not available for Canada, but the market split between the two firms in this country is likely similar.[64]

The market for proxy advice has none of the indicia of competition. Two firms control 97% of the market, there has been little change over a decade in their relative market share, and no new firms of any size have entered the market during that time.[65] "It is almost impossible to set up a proxy advisory firm today," was the conclusion of the president of Proxy Governance, a firm that left the market in 2010.[66] This suggests the market for proxy advice has

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[59] Choi, Fisch & Kahan, "Role of Proxy Advisors", *supra* note 53 at 654.

[60] For more information on Glass Lewis, see online: Glass Lewis <www.glasslewis.com/about-glass-lewis/>.

[61] Tamara C Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control" (2009) 14:2 Stan JL Bus & Fin 384 at 395–97 (of the five proxy firms, ISS controls over 61% of the market and Glass Lewis controls 36%).

[62] *Ibid*.

[63] Robert M Daines, Ian D Gow & David F Larcker, "Rating the Ratings: How Good are Commercial Governance Ratings?" (2012) 98:3 J Financial Economics 439 at 439 [Daines, Gow & Larcker, "Rating the Ratings"].

[64] *CSA CONSULTATION PAPER*, *supra* note 9 at 5683.

[65] US, Government Accountability Office, *Report to Congressional Requesters: CORPORATE SHAREHOLDER MEETINGS: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting* (GAO-07-765) (Washington, DC: 29 June 2007) (ISS's dominant position in the industry serves as a barrier to competition) ["Corporate Shareholder Meetings"].

[66] Barry B Burr, "SEC Round Table Discusses Shift in Who Pays For Proxy Voting Services" *Pensions & Investments* (5 December 2013), online: Pensions & Investments, online: <www.pionline.com>.

the classic oligopoly structure: large barriers to entry and strong network effects.[67]

Academic attempts to measure the direct influence of proxy advisory firms on shareholder voting have generated results on the low end of 6% to 13% of the vote and on the high end: 13.6% to 20.6%.[68] For widely held companies, even the low end of these ranges make proxy firms the most influential constituency at shareholder meetings. Businesses tend to provide higher estimates of the direct control of proxy advisors: they control one-third or more of the vote (the Society of Corporate Secretaries and Governance Professionals)[69], or up to one-half of the vote (the Chairman of 3M and other business leaders.)[70]

Critics of proxy advisory firms point out that direct one-to-one causation is a limited way of looking at the industry's power in any event.[71] Attempts to

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[67] The barriers to entry are easy to see. Since institutional investors hold shares in thousands of companies, a new entrant into the market must immediately have the scale that will enable it to provide voting recommendations for many proposals affecting all of these companies. Larcker, McCall & Ormazabal, "Stock Option Repricing", *supra* note 32 at 150. The network effects arise out of the importance of reputation in this market. "Several firms that subscribe to ISS's services stated they stay with ISS because it is the proxy advisor that they have relied on for many years. This gives no indication that the institutional investors have independently evaluated the proxy advisors; it appears the proxy advisors are flourishing primarily on reputation." Jodi Slaght, "Whatever Happened to the Prudent Man? The Case for Limiting the Influence of Proxy Advisors Through Fiduciary Duty Law" (2012) 9 Rutgers Business L Rev 1 at 12–13 [Slaght, "Whatever Happened to the Prudent Man?"].

[68] See the discussion in Tingle, "Proxy Advisors' Voting Recommendations", *supra* note 41 at 719, and Choi, Fisch & Kahan, "Role of Proxy Advisors", *supra* note 53 at 660ff.

[69] Remark from Susan E Wolf, former Chairman of the Society cited in Center On Executive Compensation, "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight" (January 2011) at 20, online: THE WALL STREET JOURNAL <online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf>

[70] Comment letter from W James McNerney Jr, Chairman of the Board and Chief Executive Officer of 3M (5 December 2003) "Re: File No. S7-19-03 Security Holder Director Nominations", online: US Securities and Exchange Commission <www.sec.gov/rules/proposed/s71903/3m120503.htm>.

[71] James K Glassman & JW Verret, "How to Fix Our Broken Proxy Advisory System" (16 April 2013) at 11, online: Mercatus Center at George Mason University <mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf>;

measure the influence of proxy advisory firms must include the ways their policies influence boardroom behavior. The influence of these firms in the boardroom is considerable, as anyone who has stepped foot in one over the past decade can testify. For example, a recent survey found that over 70% of directors reported that their boards' remuneration decisions were influenced by the proxy firms' guidelines.[72] Boards adopt corporate governance practices simply to satisfy proxy firms even in circumstances where they do not see the value of doing so.[73]

IV. PROXY ADVISOR VOTING RECOMMENDATIONS IN PRACTICE

Concerns expressed by issuers about how proxy advisory firms go about their business in practice tend to fall into six different categories: sub-optimal policies, a lack of transparency, staffing problems, making factual mistakes, providing too little time to respond and conflicts of interest. The common element to all of these failures are agency costs. Sub-optimal outcomes are generated by proxy firms and accepted by institutional shareholders in exactly the same way that a negligent and inattentive management team is ultimately sustained by a disengaged or supine board of directors. Even the best conceived commercial activity runs into problems when put into practice of course, but when it comes to communicating with investors about shareholder voting, proxy advisory firms are not held legally or financially accountable for these failures.

Imposing on proxy firms the requirements for accuracy, comprehensiveness, and timeliness that are imposed on directors and those responsible for dissident proxy circulars would likely render the proxy advising business impossible. But before any less draconian solution can be evaluated, it is necessary to review the evidence on how the Canadian proxy industry works in practice.

David F Larcker, Allan McCall & Gaizka Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms" (2014) Stanford Graduate School of Business Working Paper No 2105 at 14, online: <www.gsb.stanford.edu/faculty-research/working-papers/outsourcing-shareholder-voting-proxy-advisory-firms> [Larcker, McCall & Ormazabal, "Outsourcing to Proxy Firms"].

[72] David F Larcker, Allan L McCall & Brian Tayan, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions", online: (March 2012) The Conference Board: Director Notes at 4: Stanford Graduate School of Business <https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2012-proxy-voting_0.pdf>.

[73] Corporate Shareholder Meetings, *supra* note 65 at 10.

A. THE DEVELOPMENT OF PROXY ADVISOR VOTING POLICIES

Glass Lewis "provides little information to the general public on the development of their voting policies."[74] They also fail to "provide clarifying detail on how general corporate governance concepts and standards are translated into codified policy."[75] ISS is more forthcoming. They rely on an annual policy survey of institutional investors about corporate governance, combined in (unspecified ways) with industry roundtables and feedback from market participants during proxy season.[76]

Examining ISS's more detailed process, however, caused David Larcker, Allan McCall and Brian Tayan to write a paper amusingly entitled "And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?" [77] Their conclusions are elegantly summarized by their title. They point to the extremely small (and declining) number of participants responding to the ISS survey.[78] The apparent lack of interest in corporate governance among the thousands of institutional investors who received the survey – only 97 responded in 2012 – is not surprising given the many incentives money managers have to ignore matters of corporate governance.[79] The composition of respondents is not disclosed by ISS, so it is difficult to see if it is representative of the mainstream, or if it reflects the opinions of a narrower set of activists.[80]

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[74] David F Larcker, Allan McCall & Brian Tayan, "And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?" online: (25 February 2013) Stanford Closer Look Series at 2: Stanford Graduate School of Business <www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-31-proxy-firms-voting-recommendations.pdf> [Larcker, McCall & Tayan, "Miracle Happens!"].

[75] *Ibid.*

[76] See the ISS Annual Policy Development Process, online: ISS <www.issgovernance.com/policy>.

[77] Larcker, McCall & Tayan, "Miracle Happens!", *supra* note 74.

[78] *Ibid* at 2.

[79] See discussion at text accompanying notes 17–25 above.

[80] See Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice* (New York: Oxford University Press, 2008) at 204–205 for a discussion on the difference between pension fund activism (often backed by unions) and that of professional money managers; see also Bainbridge, "Quack Governance II", *supra* note 28 at 36; Romano, "Less is More", *supra* note 56 at 180-1, 226, 230-3 (detailing some of the non-financial motivations of certain types of institutional money managers).

Professor Larcker and his co-authors identify numerous instances of confusing or biased questions in the survey.[81] (These include the use of words like "excessive" and "problematic" which nicely combine both bias and ambiguity.) They then question the absence of information about how survey responses (which are quite general) are turned into concrete voting policies (which must be quite specific).[82] At what precise point, for example, do the number of shares pledged by an executive director for a loan trigger a vote against that executive?

There are also questions about the relationship proxy firms' recommendations bear to the best empirical evidence available about outcomes arising from various governance structures. In general, the ISS Proxy Voting Guidelines reflect the conventional wisdom about corporate governance assumed by academics, regulators and activists[83] – but this conventional wisdom is often unsupported, or contradicted, by empirical research.[84] Examples include the dubious impact of independent directors on

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[81] Larcker, McCall & Tayan, "Miracle Happens!", *supra* note 74 at 2–3.

[82] *Ibid* at 3.

[83] See Stephen J Choi, Jill E Fisch & Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?" (2010) 59:4 Emory LJ 869 ("[w]e found a substantial correlation between proxy advisor recommendations and the factors that academics, policy makers, and the media have identified as important" at 881) [Choi, Fisch & Kahan, "Power of Proxy Advisors"]; see also Romano, "Quack Corporate Governance", *supra* note 56 at 1523–24 (the independent-director requirement and prohibiting accounting firms from providing consulting services were advanced prior to the collapse of Enron by policy entrepreneurs. The Enron collapse put these initiatives on political agendas by providing a "policy window"); Bainbridge, "Quack Governance II", *supra* note 28 at 8 (bubble laws, like SOX, are often enacted after policy entrepreneurs advocate for packaged ideas tending to be critical of markets and corporations); Frederick Tung, "The Puzzle of Independent Directors: New Learning" (2011) 91:3 BUL Rev 1175 ("[i]n our hopes and dreams, then, the independent director offers something of a magic bullet for corporate governance" at 1176, while noting that empirical wisdom had yet to prove this) [Tung, "Puzzle of Independent Directors"]; Sanjai Bhagat & Bernard S Black, "The Uncertain Relationship Between Board Composition and Firm Performance" (1998-99) 54:3 Bus Lawyer 921 ("[m]ost commentators applaud the trend toward greater board independence" at 921, noting examples such as the National Association of Corporate Directors, CalPERS, and the Business Roundtable, while also showing that no empirical evidence suggests independent directors increase firm performance at 922).

[84] See Daines, "Rating the Ratings" *supra*, note 63, (finding that ratings of companies' corporate governance arrangements were uncorrelated with accounting restatements, class-action lawsuits, accounting performance measures, market-to-book ratios, or stock price performance); Patil Gupta et al, "Corporate Governance

corporate performance,[85] the failure of research to demonstrate advantages to separating the CEO and Chairman role,[86] the lack of evidence that multiple

and Firm Value: Evidence from Canadian Capital Markets" (2009) 6 Corp. Ownership and Control J. 293 (finding the Globe & Mail's Board Games measure of corporate governance best practices were unconnected to companies' subsequent market valuation or future operating performance); Sanjai Bhagat et al, "The Promise and Peril of Corporate Governance Indices" (2008) 108 Columbia L. Rev. 1083 (finding a company's adherence to various corporate governance best practices measured by the "G-Index" has an "insignificant" relation to future operating results); John Core, et al. "Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investor Expectations" (2006) 61 J. of Finance 783 (finding companies highly ranked by adherence to the corporate governance practices contained in the G-Index actually underperform lower ranked firms over the study's four year period); David Finegold, et al, "Corporate Boards and Company Performance: Review of Research in Light of Recent Reforms" (2007) 15 Corp. Gov.: An Int'l Review 865 (a meta-analysis of over 100 studies of corporate governance best practices that fails to find any predictable relationship between these practices and business outcomes); Sydney Finkelstein & Ann Mooney, Not the Usual Suspects: How to Use Board Process to Make Boards Better (2003) 17 Academy of Mgmt. Exec., 101 (finding no way to distinguish high and low performing companies on the basis of a panel of corporate governance best practices). See also, Bryce C. Tingle, What Do We Really Know About Corporate Governance Best Practices? A Review of the Empirical Research Since 2000 (forthcoming) (reviewing the research on corporate governance best practices since 2000 and concluding there is little evidence that either separately or together these best practices positively impact firm performance). See also the work done in the UK in relation to the Cadbury governance recommendations (the ancestor of Canada's governance regime), showing that compliance with the Cadbury best practices neither improves performance nor survivorship: Charlie Weir, David Laing & Phillip J McKnight, "Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies" (2002) 29:5–6 J Business Finance & Accounting 579 at 599 (little evidence that Cadbury governance mechanisms correlate to higher performance); Charlie Weir & David Laing, "The Performance Governance Relationship: The Effects of Cadbury Compliance on UK Quoted Companies" (2000) 4:4 J Management & Governance 265 at 265 (complete compliance does not appear to be associated with better performance); Nikos Vafeas & Elena Theodorou, "THE RELATIONSHIP BETWEEN BOARD STRUCTURE AND FIRM PERFORMNACE IN THE UK" (1998) 30:4 British Accounting Rev 313 at 389 (firms that adopt the Cadbury recommendations are no more likely to survive firms that have not). See also the various articles cited *infra* notes 90–92.

[85] See the authorities *infra* notes 94–97.

[86] Ryan Krause & Mathew Semandeni, "CEO-Board Chair Separation: If it Ain't Broke, Don't Fix It", online: (June 2013) The Conference Board: Director Notes at 1 <www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V5N11-

board commitments produce a measurable decline in board performance,[87] the weak or non-existent evidence that corporate anti-takeover defenses adversely impact shareholder wealth,[88] and the suggestion that popular restrictions on executive compensation may actually diminish shareholder value.[89]

In Canada, the role of ISS in Agrium's proxy battle with Jana Partners in the spring of 2013 offers a fascinating example of this, in part because some of the empirical research in question was actually performed by one of the authors of the ISS voting recommendation.[90] While the voting recommendation was in favour of the election of a "hybrid" board consisting of two nominees of Jana Partners and seven incumbent directors,[91] the earlier research performed by its author found that most of the gain in shareholder value that followed a real or threatened proxy contest occurred through the contest period, as the market priced in its expectation of a change. Following the actual installation of a hybrid board, however, performance for those

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13.pdf&type=subsite>; Dan R Dalton et al, "Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance" (1998) 19:3 Strategic Management J 269 at 272.

[87] Adam C Pritchard, Stephen P Ferris & Murali Jagannathan, "Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments" (2003) 58:3 J Finance 1087 at 1088.

[88] Miroslava Straska & H Gregory Waller, "Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature" (2014) 49:4 J Financial & Quantitative Analysis 933 at 941; Miroslava Straska & Gregory Waller, "Do Antitakeover Provisions Harm Shareholders?" (2010) 16:4 J Corporate Finance 487 at 497.

[89] Matt Bloom & George Milkovich, "Relationships Among Risk, Incentive Pay, and Organizational Performance" (1998) 41:3 Academy of Mgmt J. 283; Young Baek & Jose Pagan, "Executive Compensation and Corporate Production Efficiency: A Stochastic Frontier Approach" (2002) 41:1-2 Q. J. of Bus. & Econ. 27; Larcker, McCall & Ormazabal, "Outsourcing to Proxy Firms", *supra* note 71 at 39–40; Larcker, McCall & Ormazabal, "Stock Option Repricing", *supra* note 32 at 165.

[90] Interview of Agrium executives Leslie O'Donoghue and Peter Miller (29 April 2013), who advised that one of the authors, Chris Cernich, of an IRRC study on hybrid boards (see Chris Cernich et al, "Effectiveness of Hybrid Boards", Investor Responsibility Research Center ("IRRC") Institute for Corporate Governance prepared by Proxy Governance Inc (May 2009), online: <irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf> [Chris Cernich, "Hybrid Boards"]) was one of the authors of the ISS recommendations advising Agrium shareholders to elect a Hybrid Board. See ISS Proxy Paper: Agrium Inc (26 March 2013) ["ISS Proxy Paper"]. He is listed as a main contact for the ISS Proxy Paper.

[91] "ISS Proxy Paper", *supra* note 90 at 31.

companies over the following three years actually lagged their peers by 6.6%.[92] It is worth noting this is on the low end of the range found by researchers. A study cited by the U.S. Court of Appeals for the District of Columbia in striking down the SEC's proxy access rules, found that "when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contests."[93] Another study of activist hedge funds found, "only a minority of the targets' stock prices beat market indices over the period of engagement, with financial underperformance being particularly notable in cases where the hedge fund entered the target boardroom."[94]

Apparently hybrid boards repeatedly fail to operate as effectively as other boards. To anyone familiar with the bitter and personally acrimonious relationship between the Agrium board and Jana Partners, this is an unsurprising result.[95] The fact that the empirical evidence didn't apparently impact ISS's recommendation to create a hybrid board is surprising, although typical.

The ISS recommendation is interesting as well because while it "ripped Agrium's corporate governance" in the words of a news report summarizing it[96], Glass Lewis and Egan Jones came to precisely the opposite conclusion. Glass Lewis observed, "…we find Agrium's corporate governance practices have historically been fairly strong… The incumbent board is overwhelmingly independent, meets or exceeds several key measures of corporate governance best practices promulgated by the Canadian Coalition for Good Governance and…has displayed a willingness to regularly and contextually alter its

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[92] Chris Cernich, "Hybrid Boards", *supra* note 90 at 39.

[93] Elaine Buckberg & Jonathan Macey, "Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation" (17 August 2009) at 9 [Buckberg & Macey, "Reports on Effects of Proposed SEC Rule 14a-11"], referred to in *BUSINESS ROUNDTABLE AND CHAMBER OF COMMERCE OF THE UNITED STATED OF AMERICA V SECURITIES AND EXCHANGE COMMISSION*, 647 F (3d) 1144 at 11 (DC Cir 2011) [*BUSINESS ROUNDTABLE*].

[94] William R Bratton, "Hedge Funds and Governance Targets: Long-Term Results" (2010) University of Pennsylvania Law Institute for Law & Economics Research Paper No 10-17 at 2, online: Social Science Research Network <papers.ssrn.com/sol3/papers.cfm?abstract_id=1677517>.

[95] Tingle, "Proxy Advisors' Voting Recommendations", *supra* note 41 at 10.

[96] Peter Koven, "Jana Predicts Two Dissident Candidates Will Join Agrium Board", *Financial Post* (8 April 2013), online: Financial Post <business.financialpost.com>.

composition based upon the Company's strategic focus and operating strategy."[97]

Variation between the proxy advisory firms in what they consider to be "good governance" is surprisingly common. One set of researchers reported,

> "[W]hile all of the proxy advisors considered a few specific factors important – such as poor director attendance – on most issues there was substantial variation. For example, ISS was significantly more likely to issue a withhold recommendation when the company board had refused to implement a shareholder resolution that had received majority shareholder support. Glass Lewis was significantly more likely to issue a withhold recommendation if the nominee was an inside director (other than the CEO). Egan Jones was significantly more likely to issue a withhold recommendation if the nominee was a board member at three or more other companies. Proxy Governance was significantly more likely to issue a withhold recommendation if the company CEO received abnormally high compensation."[98]

Besides making it interesting for boards attempting to anticipate the likely response of proxy firms to a proposal, these variations suggest that the process at arriving at the formula for good corporate governance is not analogous to a science. Whatever the exact confidential processes used by the proxy advisory firms to arrive at their recommendations, they might as easily be called "idiosyncratic" as "proprietary."

This leads us to an overarching concern about proxy firm's approach to corporate governance: there is considerable evidence that good governance does not primarily consist in the adoption of specific governance best practices. Companies with apparently impressive governance regimes can implode in what can only be called massive failures of corporate governance. The most famous of these is Enron, whose independent and impressive board routinely won both plaudits and awards for corporate governance.[99]

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[97] Glass Lewis & Co Proxy Paper: Agrium Inc (26 March 2013) at 17 ["Glass Lewis Proxy Paper"].

[98] Choi, Fisch & Kahan, "Power of Proxy Advisors", *supra* note 83 at 880–81.

[99] Prior to Enron's collapse, it was a six-time winner of Fortune Magazine's award for most innovative company in America. "CEO Jeffrey Skilling appeared on the cover of the May 14, 2001 issue of Business Week and in the October 1, 1999 issue of CFO Magazine. Former CEO Kenneth Lay had been honored by Business

Hewlett Packard had a strong independent board with an independent chairwoman and highly-trained board committee chairs. It was considered a paragon of corporate governance until "allegations of board leaks, potential criminal behavior, and internecine conflict between board members lead to the chair's resignation and scandal for the entire corporation."[100] In Canada, activist shareholders targeted Canadian Pacific Railways in 2012, claiming its board and management were responsible for major operational failures.[101] Shareholders successfully replaced the board and senior management; over the next year the corporation's share price tripled and its operational results set new records.[102] But just the year before, in 2011, the Globe & Mail's annual Board Games Corporate Governance Rankings, using metrics similar to those of the proxy firms, ranked Canadian Pacific's corporate governance fourth best in the country.[103]

Various firms, including ISS, attempt to distill the quality of a company's corporate governance to an easily understood "score". These scores measure a company's adherence to formal best practices. Aside from assisting institutional investors understand at a glance how things stand with a company, ratings like this are necessary in order to create tradable indices products and the governance inputs for social responsibility funds. Some of these products are offered by entities affiliated with the proxy advisory firms.

Week in 1996 and 1999 as one of the top 25 managers. Enron CFO Andrew Fastow received one of CFO Magazine's twelve CFO awards. His award, oddly enough, was for capital structure management." Stuart Gillan & John D Martin, "Financial Engineering, Corporate Governance, and the Collapse of Enron" (2002) Center for Corporate Governance, University of Delaware College of Business & Economics Working Paper No 2002-001 at 5, n 3, online: Social Science Research Network <papers.ssrn.com/sol3/papers.cfm?abstract_id=354040>. See also Bruce Mizrach, "The Enron Bankruptcy: When Did the Options Market in Enron Lose its Smirk?" (2006) 27:4 Rev Quantitative Finance & Accounting 365 at 372 for examples of praise for Enron's management by others in the industry prior to its collapse.

[100] Usha Rodrigues, "The Fetishization of Independence" (2008) 33:2 J Corp L 447 at 449.

[101] Edward Welsch & Ben Dummett, "Activist Investor Wins Proxy Vote at Canadian Pacific", *THE WALL STREET JOURNAL* (17 May 2012) online: <online.wsj.com>.

[102] Solarina Ho, "CP Rail Posts Record Results, Shares Hit New High", *REUTERS CANADA* (29 January 2014), online: <ca.reuters.com>; Brent Jang, "Activist Investor Ackman Unloads $835-million CP Stake", *THE GLOBE AND MAIL (*24 October 2013), online: <www.theglobeandmail.com>.

[103] "Board Games 2011 Corporate Governance Rankings", *THE GLOBE AND MAIL* (25 November, 2011), online: <http://www.theglobeandmail.com>.

When researchers have looked at these governance scores and measured them against long-term outcomes, the results at this point should not be surprising. First, among the four rating services examined by one group of scholars, "Since the commercial firms use the same basic governance data, examine similar governance dimensions (eg. anti-takeover provisions, board structure, and executive compensation), and all claim to measure overall "corporate governance," we would expect their ratings to be highly correlated. However, one key finding is that... these four ratings are close to being uncorrelated..."[104] As we have seen generally with proxy advisor recommendations, "...many large firms with substantial investor track followings and long track records receive wildly disparate grades from the various services: AT&T, General Electric, General Motors and Safeway received near perfect scores from one rating firm (a 99 or 100 from ISS) and near-failing grades from another..."[105]

The second unsurprising conclusion is that when the ratings are compared to actual real-world outcomes they prove to have little predictive power: "One especially interesting result is that CGQ [the measurement from ISS]...exhibits no predictive ability, and when CGQ is significant more often than not it has an unexpected sign (eg., higher CGQ seems to be associated with lower Tobin's Q [a standard measure of corporate performance] and in some models *more* class-action lawsuits.)"[106]

When examined in light of the empirical evidence, the process by which proxy advisors generate their rules seems mostly designed to reflect the prejudices of a minority of institutional investors. There is no evidence that the process produces rules generative of good corporate governance and considerable evidence that it does not. This suggests a certain negligence on the part of the agent (the proxy advisors) tolerated by inattentive and disengaged monitors (investment funds) with a net loss to the principals (the beneficiaries of those investment funds).

B. AMBIGUITY AND COMPLEXITY

Even when an issuer and its lawyers are armed with the latest proxy guidelines of an advisory firm, it is often difficult to predict a proxy advisor's recommendations in specific situations. The U.S. Chamber of Commerce described ISS's process for making voting recommendations as a "black

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[104] Daines, Gow & Larcker, "Rating the Ratings", *supra* note 63 at 17.

[105] *Ibid.*

[106] *Ibid* at 4. See also the evidence of the failure of other governance indices, *supra* note 84.

box".[107] The SEC's request for submissions about whether it should regulate proxy advisory firms was met with an enormous number of submissions from issuers. Summarizing these responses, one study reported: "The single most significant concern on the part of issuers is for the Commission to increase transparency on the part of proxy advisory firms."[108]

This lack of transparency comes in a number of different forms. Sometimes the ambiguity is built into the language of the guidelines. A "withhold" vote can be recommended against a director, for example, for failing to "facilitate constructive shareholder engagement,"[109] failing to "replace management as appropriate,"[110] or allowing "material failures of governance" and "stewardship."[111] There is nothing inherently incorrect about these guidelines, but they are obviously subject to a great deal of interpretation.

Some of the ambiguity in the application of proxy guidelines arises because the necessary information to understand the recommendation cannot be published in advance. For example, most of the models that are used to generate recommendations in connection with corporate pay practices (and thus eventually about the election of compensation committee members) involve comparisons with peer group companies, presumably specific to each issuer.[112] Needless to say, there is considerable room for differences of opinion about the appropriate peer group, particularly given the small size of the Canadian market. As well, some models are simply not disclosed in the public guidelines, but described in general terms, such as the financial model for evaluating the cost of proposed equity plans.[113]

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[107] Rachel McTague, "Chamber Approaches RiskMetrics with Proposed Changes to Policy Setting" (2008) 40 Securities Regulation & L Report 569 at 589.

[108] Kenneth L Altman & James F Burke, "Proxy Advisory Firms: The Debate Over Changing the Regulatory Framework, An Analysis of Comments Submitted to the SEC in Response to the Concept Release on the US Proxy System" SPECIAL REPORT by The Altman Group (1 March 2011) at 18, online: <astfundsolutions.com/pdf/TAGSpecRptProxyAdv.pdf> [Altman & Burke, "Proxy Advisory Firms"].

[109] ISS Guidelines, *supra* note 52 at 5.

[110] *Ibid* at 12.

[111] *Ibid.*

[112] *Ibid* at 27.

[113] *Ibid* at 30. Comment letter from Roderick A Palmore, Executive Vice President, General Counsel and Chief Corporate and Risk Management Officer of General Mills (20 October 2010) "Re: Concept Release on the US Proxy System – File Number s7-14-10 (Release Nos. 34-62495; IA-3052 and IC-29340)", online: US Securities and Exchange Commission <www.sec.gov/comments/s7-14-10/s71410-

It is not clear why ISS (and the other advisory firms) deliberately keep some of their guidelines secret. ISS indicated to the CSA that it

> "has developed proprietary methodologies and models to facilitate quantitative analysis of certain governance issues, including but not limited to, for example, compensation related issues. ... [These] competencies...are developed by ISS at considerable cost and effort to enhance the value of our products and services to our clients. We would therefore view it as inappropriate and competitively harmful if ISS were required to divulge its proprietary methodologies publicly... ISS clients, who consist of institutional investors capable of making sophisticated investment decisions, are also capable of evaluating the quality and effectiveness of the analytical methods employed by ISS."[114]

This explanation is puzzling for several reasons. First, ISS's competitors have "methodologies and models" of their own. While the precise details may vary from advisor to advisor, the general formula for evaluating the merits of a compensation scheme is known to all: how does it compare to the company's peers? How much of the compensation is "at risk," subject to performance requirements? How faithfully do the compensation levels reflect the returns generated by the company to its shareholders? The relative weighting of these factors would only be of mild interest to other advisory firms – it is difficult to see how they would change the competitive landscape.

Indeed, the second curiosity about this response is that there is very little evidence of vigorous competition between the firms on the basis of the quality of their recommendations.[115] As discussed above, two firms essentially own the market, their relative market share has been unchanged for many

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160.pdf> (General Mills told the SEC that, "[f]actual data and mathematical models and methodologies used to prepare recommendations about compensation programs and compensation plans must be publicly available to issuers and investors" at 6).

[114] Comment letter from Debra L Sisti, Vice President & Martha Carter, Managing Director of Institutional Shareholder Services (10 August 2012) "Re: CONSULTATION PAPER 25-401: POTENTIAL REGULATION OF PROXY ADVISORY FIRMS" at 12, online: Ontario Securities Commission <www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120810_25-401_sistid_carterm.pdf> [ISS Comment Letter].

[115] Possible reasons for this are discussed in the text accompanying notes 50–55 above.

years and there are obvious barriers to new entrants. An SEC Commissioner put it this way: "As an economist, my concern is heightened by the lack of competition in the proxy advisory market, which appears to be a stable duopoly preserved by near-impenetrable barriers for new entrants."[116]

That brings us to the third curious feature about ISS's explanation: how could its clients evaluate "the quality and effectiveness" of its methods and models without seeing those methods and models? Institutional investors confront precisely the same black box as issuers. Voting recommendations are made and it is impossible to understand precisely how they were generated. It might be argued that if the proxy advisors' commitment to secrecy prevents investors from evaluating the merits of their processes on principle, they are still free to examine the empirical results. The problem here is that even if institutions were prepared to engage in this kind of detailed analysis of outcomes (and if they were this interested in voting outcomes the proxy advisory industry would no longer be needed), it is almost impossible to attribute corporate outcomes to the results of a specific shareholder vote (particularly on a routine matter like executive compensation). In any event, there is plenty of empirical evidence, referenced throughout this article, that proxy advisors' voting recommendations and estimates of the quality of corporate governance are unreliable, and this research doesn't appear to have made much difference to ISS' investor clients.

It seems likely that the commercial harm that would be suffered by ISS is probably outweighed by the merits of making public to issuers and investors how it generates its voting recommendations. Our public disclosure rules routinely override the interests of issuers in retaining confidential business information in favour of having a fully-informed market.[117] If we take corporate democracy seriously, then the consumers and subjects of proxy

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[116] Michael S Piwowar, Commissioner of US Securities and Exchange Commission, "Opening Statement at the Proxy Advisory Services Roundtable" (Speech delivered at the US Securities and Exchange Commission Proxy Advisory Services Roundtable, 5 December 2013), online: US Securities and Exchange Commission <www.sec.gov/News/Speech/Detail/Speech/1370540449928>.

[117] See Toronto Stock Exchange, *Policy Statement on Timely Disclosure* (Toronto, ON: TSX, 2014) online: Toronto Mercantile Exchange <www.tmx.com/en/pdf/PolicyStatementOnTimelyDisclosure.pdf> (companies must comply with the guidelines in this policy statement that expand the requirements of securities law); Ontario Securities Commission, *Investors Disclosure Documents* (Toronto ON: OSC, 2014) online: Ontario Securities Commission <https://www.osc.gov.on.ca/en/Investors_disclosure-requirements_index.htm> (review of the documents that firms must disclose).

advisors' voting recommendations should understand how they are generated.

Another source of uncertainty for an issuer is that some voting recommendations depend on information that is not publicly available to the proxy advisory firm. So, for example, the ISS Guidelines indicate that while a director will be targeted if he or she attended fewer than 75% of the board and committee meetings, an exception will be made if the reasons for non-attendance include "illness or absence due to company business."[118] The difficulty is that this sort of information is not normally disclosed anywhere in the public record.

The Agrium proxy battle presents another example of this sort of ambiguity. Jana Partners targeted five incumbent directors for removal. One of these directors was targeted because the long-serving director had no shares in the company.[119] This also offends one of ISS' criteria for an acceptable director: they possess an "ownership stake in the company".[120] But the appropriate size of an ownership stake is obviously a function of the percentage of a directors' net-worth tied up with the company. Directors' net worth is not (thank heavens) a matter of public record. There is also ambiguity in what counts as "ownership". Do deferred stock units or phantom shares count? Stock options? Conditional, long-term share grants? The director in question at Agrium had few shares but more than a decade-worth of deferred stock units representing a massive economic interest in the value of Agrium shares.[121]

Even the core concept of "independence" used by proxy advisory firms depends on information that is usually available to the board, but unavailable to outside parties. On the one hand the list of disqualifying relationships used by proxy advisory firms are obviously too narrow to capture the full range of incentives and relationships that might cause an outside director to

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[118] ISS Guidelines, *supra* note 52 at 11.

[119] Letter from Jana Partners to Agrium Shareholders (7 March 2013) "Agrium Dissident Jana Seeks to Replace Five Directors", online: Stockwatch <www.stockwatch.com/News/Item.aspx?bid=Z-C:AGU-2046984&symbol=AGU&region=C> (Frank Proto, the longest serving member of the board, did not purchase shares in nine years and was one of five directors that Jana sought to replace).

[120] ISS Guidelines, *supra* note 52 at 8.

[121] Agrium, *Notice of Annual General Meeting of Shareholders and Management Proxy Circular* (9 April 2013) at 44–46, online: Agrium <www.agrium.com/system/files/2013_proxy_circular.pdf> [Agrium, *Proxy Circular*].

favour management.[122] Most scholars who have looked closely at the governance failures at Disney surrounding the hiring and termination of Michael Ovitz, for example, have concluded that the relationships that existed between Disney CEO Michael Eisner and the nominally independent directors rendered "the bulk of the Disney board…not independent in any common sense of the term."[123] Scholars looking at the apparently independent directors on the Hollinger board have drawn similar conclusions.[124]

On the other hand, many individuals identified by the proxy guidelines as "non-independent," are extremely effective directors, even at the monitoring aspects of the job. Former CEOs, for example, are caught in the ISS definition of "Affiliated Outside Director," an ISS non-independent category.[125] But anyone with a range of boardroom experience knows that, in many cases, few independent directors can match the searching skepticism of a previous CEO evaluating the decisions of his successor. In fact, the dynamic is often such that it is often felt to be unfair to the incoming CEO to retain his predecessor on the board.

Company founders also fail the ISS test for independent directors, but they bring the same incentives and familiarity with the company that make ex-CEOs such effective monitors.[126] In fairness ISS does recognize this and advises in a footnote that, "little or no operating involvement may cause ISS to deem the founder as an independent outsider." However, a lot of uncertainty for corporate counsel hangs on that "may". Plus, how does ISS measure the degree of a founder's "operating involvement?"

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[122] See *In re Oracle Corp. Derivative Litigation,* 824 A (2d) 917 at 938, 942 (Del Ch 2003): The SLC (Special Litigation Committee tasked with investigating potential insider trading by executives) did not meet its burden to prove it, or either of the members, was independent. The chancery court's independence test was whether the individual SLC member was incapable of making a decision with only the best interests of the corporation in mind, or, as a corollary, without considering any way in which his decision would impact him. The ties that the SLC members and directors had to one university, as alumni, tenured faculty professors, very major contributors, and speakers were too vivid to be ignored.

[123] Claire A Hill & Brett McDonnell, "Disney, Good Faith, and Structural Bias" (2007) 32:4 J Corp L 833 at 845–46.

[124] See a Hollinger case study by JE Boritz & LA Robinson, "Hollinger International Inc" (May 2004) Center for Accounting Ethics School of Accountancy University of Waterloo at 9, online: University of Waterloo <accounting.uwaterloo.ca/ethics/Hollinger%20case%20V10.pdf>.

[125] ISS Guidelines, *supra* note 52 at 7.

[126] *Ibid* at 7.

Agrium again illustrates this point. Jana's proposed independent directors had arrangements that tied their compensation to Jana's net profits arising from the Agrium transaction.[127] The bonuses became due on the earlier of the third year anniversary of Agrium AGM or the sale by Jana of its shares. They are thus best categorized as "short-term". ISS effectively accepted these bonuses as not compromising the independence of the directors, notwithstanding the obvious risk these bonuses would focus the Jana directors on the short-term, tie the nominee directors to Jana's controversial plans for Agrium, and increase the rewards for excessive risk-taking.

ISS admitted these sorts of bonus arrangements were controversial, citing negative investor reaction to the compensation structure.[128] Corporate law scholars are generally united in condemning these sorts of bonuses. John Coffee at Columbia has written, "third party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk."[129] Stephen Bainbridge at UCLA simply said, "if this nonsense is not illegal, it ought to be."[130] ISS ultimately accepted the bonuses, however, citing the impossibility of guessing at the degree of independence the nominees would show "once inside the boardroom"[131] – a curious position for ISS to take given its usual confidence in evaluating director independence from the outside, but it is my point exactly.

From the standpoint of the argument being developed by this paper, the key point is that proxy voting recommendations are made on the basis of information proxy firms do not possess and policies that are unavailable for outsiders to evaluate. The potential for inaccurate advice seems obvious.

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[127]See ISS Proxy Paper, *supra* note 90 at 29. See also Agrium, Proxy Circular, *supra* note 121 at 2: "JANA's dissident nominees have agreed to accept special incentive payments from JANA for serving on Agrium's Board. These payments are structured to incentivize short-term actions, even if they are taken at the expense of greater long-term value. This kind of "golden leash" arrangement is unheard of in Canada".

[128] ISS Proxy Paper, *supra* note 90 at 29.

[129]John C Coffee, "Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?" (29 April 2013) The CLS Blue Sky Blog, online: <clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes>.

[130] Stephen Bainbridge, "Can Corporate Directors Take Third Party Pay From Hedge Funds?" (April 8, 2013) Stephen Bainbridge's Journal of Law, Politics and Culture (blog), online: <www.professorbainbridge.com/professorbainbridgecom/2013/04/can-corporate-directors-take-third-party-pay-from-hedge-funds.html>.

[131]ISS Proxy Paper, *supra* note 90 at 30.

C. COMPLEXITY AND STAFFING

According to ISS, it annually provides advice in relation to more than 40,000 meetings in over 100 countries.[132] It does this with a research staff of fewer than 200 persons.[133] Glass Lewis handles the meetings of 23,000 companies with a total of 300 employees, only 200 of which are involved in research.[134] As well over half of the shareholder meetings covered by these firms occur between April and June, both firms are forced to hire temporary workers to manage the volume.[135] ISS advises it more than doubles its staff with temporary employees during proxy season.[136]

The sheer volume of material that must be analyzed for proxy firms to make a recommendation on each of hundreds of thousands resolutions a year, alone accounts for the one-size-fits-all or check-the-box nature of their proxy advice, an issue taken up in this paper's companion study of proxy voting guidelines.[137] What we are interested in here, however, is the mismatch between the volume of work to be done in a very short period of time and the number of employees available. We are also interested in the mismatch between the complexities of that work and the relatively junior (even temporary) analysts employed by the proxy firms.

A common feature of responses to the CSA's request for comment on proxy firms were concerns about the competence of proxy firm analysts to understand and correctly evaluate meeting proposals.[138] "Properly evaluating

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[132] See ISS make reference to these statistics on the home page of their Proxy Voting Services section of the website, under the subsection "Global Meeting Results", online: ISS <www.issgovernance.com/governance-solutions/proxy-voting-services/global-meeting-results>.

[133] "A dialogue with Institutional Shareholder Services," 39 Audit Committee Leadership Network in North America ViewPoints (7 November 2012) at 6, online: <www.tapestrynetworks.com/initiatives/corporate-governance/global-audit-committee-leadership-networks/upload/Tapestry_EY_ACLN_Nov12_View39.pdf> ["Dialogue with Institutional Shareholder Services"].

[134] "About Us", online: Glass Lewis & Co <www.glasslewis.com/about -glass-lewis/>.

[135] Dialogue with Institutional Shareholder Services, *supra* note 133 at 3.

[136] RiskMetrics, *Annual Report* (Form 10-K) (2009), online: <apps.shareholder.com/sec/viewerContent.aspx?companyid=MSCI&docid=7076570 > [Form 10-K RiskMetrics] ("[d]uring the proxy season (March to July), ISS typically retains approximately more than 200 temporary employees" at 18).

[137] See Tingle, "Proxy Advisors' Voting Recommendations" *supra* note 41.

[138] See e.g. EC, *Proxy Discussion Paper*, *supra* note 10, cited in comment letter from Stephane Lemay, Vice President, General Counsel and Secretary of POWER FINANCIAL CORPORATION (19 September 2012) "Re Canadian Securities

special transactions almost always requires expertise, including technical expertise and industry expertise... Based on some of our issuer clients' experiences... the proxy advisor may not have, or be applying inappropriately, the expertise necessary to comment on management's recommendations in respect of special transactions."[139]

There is a divergence in training and experience between the (usually) senior legal teams employed by issuers and the staff at proxy advisory firms. Corporate legal agreements and transaction structures can be among the most complex in existence. Many of the anecdotes related in the CSA response letters involve proxy firm employees misunderstanding an agreement, getting hung up on irrelevancies, or failing to understand the alternatives to a transaction. (The alternatives to a transaction become relevant when a "no" vote is recommended.)

For example, Pfizer commented in a letter to the SEC, "...one [proxy] firm issued a number of reports indicating that Pfizer requires a 'super-majority' shareholder vote on certain matters. The super-majority voting requirements were deleted from our Restated Certificate of Incorporation in 2006. However it appears that the analysts reviewing our filings did not understand the various documents filed..."[140]

Administrators Consultation Paper 25-401 – Potential Regulation of Proxy Advisory Firms" at 9, online: Ontario Securities Commission <www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120919_25-401_lemays.pdf> ("[t]emporary staff could therefore create a risk of less adequate or less accurate research and advice being prepared in relation to specific issuers" at 25) [Power Financial Comment Letter]; Comment Letter from Lindsay Mathews, Vice President, General Counsel and Corporate Secretary of Gildan (21 September 2012) "Re CSA Consultation Paper 25-401: Potential regulation of Proxy Advisory Firms", online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120921_25-401_mathewsl.pdf> [Gildan Comment Letter] ("Furthermore, it is also unclear as to whether P[roxy] A[dvisory] Firms employ, or retain, the necessary technical people to effectively review proxy material" at 4).

[139] Comment letter from Carol Hansell, Partner of Davies LLP (20 September 2012) "CSA Consultation Paper 25-401" at 6, online: Ontario Securities Commission <www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120920_25-401_hansellc.pdf> [Davies Comment Letter].

[140] Comment letter from Matthew Lepore, Vice President and Chief Counsel Corporate Governance of Pfizer (23 September 2010) "Re: File No. S7-14-10 Release Nos. 34-62495/IA-3052/IC-29340 Concept Release on the US Proxy System" at 6, online: US Securities and Exchange Commission <www.sec.gov/comments/s7-14-10/s71410-277.pdf>.

In a letter to Canadian regulators, CI Financial described an analyst's failure to understand a provision in a proposed stock option plan, mistaking it as granting the directors the power to unilaterally revise the plan, when its effect was, in fact, the opposite.[141] A relatively untrained analyst can misunderstand even very basic legal language. One Canadian issuer had the author of a proxy recommendation object to the phrase "...to transact such other business as may properly come before the Meeting or any adjournment," apparently not understanding that this language is both benign and virtually standard in meeting materials.[142]

Because it is difficult to get visibility on the rationale for voting recommendations from the proxy advisory side of ISS, the most illuminating interactions occur with the side of ISS that provides consulting services to issuers hoping to design structures that will pass ISS review. Canadian lawyers report experiences that range from being told by the consulting side of ISS that their analysts are not capable of understanding a shareholder rights plan (admittedly a very complex document), to obtaining approval for a transaction from the consulting side of ISS only to have the transaction rejected by the proxy advisory side.[143] Legal structures are rejected because of possible contingencies that, when pressed, ISS analysts admit they cannot explain how they could occur.[144] Legal terms that have previously been acceptable are rejected without explanation or notice.[145] In one case the option plan of a TSX issuer was rejected because it did not prohibit a board action that was, unbeknownst to the ISS analyst, already against TSX rules.[146]

D. MISTAKES

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[141] Comment letter from Sheila A Murray, Executive Vice President, General Counsel and Secretary of CI Financial (21 September 2012) "RE: CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 3, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120921_25-401_murrays.pdf> [CI Financial Comment Letter].

[142] Comment letter from Tom Enright, President and Chief Executive Officer of Canadian Investor Relations Institute (12 September 2012) "Re: CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 21, online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120912_25-401_enrightt.pdf> [Canadian Investor Relations Institute Comment Letter].

[143] Interview of Trudy Curran, Senior Vice President, General Council and Corporate Secretary of Canadian Oil Sands (17 May 2013).

[144] *Ibid.*

[145] *Ibid.*

[146] Experience of the author.

Because advisory firms do not directly bear the costs of poor or mistaken proxy recommendations, there is a significant chance these firms will respond to other incentives. The most obvious of these is the way the profitability of the advisory firm can be increased by keeping research and analysis costs as low as possible. Mary Schaprio, the Chairwoman of the SEC, indicated in a recent speech that proxy advisory firms, "may fail to conduct adequate research, or may base recommendations on erroneous or incomplete facts."[147]

In theory the proxy advisory firm that underinvests in research and analysis might be subject to market discipline as client investment funds see the value of their portfolios compromised by mistakes made by the firm, but it seems likely this does not occur. The historical apathy of most institutional investors to governance matters suggests they expect only a very small benefit from casting the correct vote at shareholder meetings.[148] As well, the damage effected by sub-optimal shareholder voting is rarely visible to those outside the company. Insiders might be of the view that a compensation committee chair voted off the board represents a material blow to the quality of governance in the company, but how would an investor be able to form an opinion about this?

The evidence we do have suggests that institutional investors are rarely held accountable for the way the shares held in their portfolios are voted, so it is very likely that proxy advisory firms are not be held accountable either. In these circumstances additional time and effort spent by advisory firms to prevent mistakes will have no impact on their ability to attract new clients for their recommendations, but will decrease their profitability. In other words, in a situation where there are no penalties for mistakes, along with incentives to run the risk of mistakes, we should expect to see mistakes.

There is empirical evidence that appears to bear out the expectations set by agency theory. One study found that proxy advisors' governance ratings "have either limited or no success in predicting firm performance or other outcomes of interest to shareholders," explaining the results thusly: "Our view is that a more plausible interpretation of the weak and mixed results we

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[147] Mary L Schapiro, "The Guardian of Honest Disclosure" (An Invitation to Directors for the NACD Directorship Annual Corporate Governance Conference, 17 December 2010) at 48, online: <http://www.nacdonline.org/Magazine/Article.cfm?ItemNumber=9321>.

[148] Tingle, "Proxy Advisors' Voting Recommendations", *supra* note 41 at 7. See also *supra* notes 30–40.

find is that the commercial [governance] ratings contain a large amount of measurement error."[149]

Surveys of corporate issuers about their experiences with third party proxy recommendations tell a similar story. A study conducted by the American Society of Corporate Secretaries & Governance Professionals found that "65% of respondents experience – at least once – a vote recommendation based on materially inaccurate or incomplete information, or where the proxy advisory firm reported as fact information that was incorrect or incomplete. One quarter of those respondents experienced inaccurate or incomplete information on several occasions."[150] Another recent survey found that in a two year period, 53% of respondents had encountered factual mistakes just on the compensation analysis performed by proxy analysts.[151] The results in Canada appear to be similar. Over a five-year time frame only 13% of the members of the Canadian Investor Relations Institute reported no factual inaccuracies in the proxy firms' work.[152] Fully 40% of their membership indicated mistakes occurred "half the time" or "occasionally;" 25% reported mistakes occurred "frequently."

The filings with the CSA and the SEC are filled with descriptions of mistakes made by proxy firms.[153] In Canada, proxy advisors misidentify directors as independent,[154] they make mathematical mistakes in performing the

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[149] Daines, Gow & Larcker, "Rating the Ratings", *supra* note 63 at 46.

[150] Comment letter from Neila B Radin, Chair of Securities Law Committee of The Society of Corporate Secretaries & Governance Professionals (27 December 2010) "Re: Concept Release on the US Proxy System, File No. S7-14-10 Proxy Advisory Firms (Section V)" at 6, online: US Securities and Exchange Commission <http://www.sec.gov/comments/s7-14-10/s71410-289.pdf> [Society of Corporate Secretaries Comment Letter].

[151] "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight" Center on Executive Compensation (January 2011) at 10, online: THE WALL STREET JOURNAL <online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf>.

[152] Canadian Investor Relations Institute Comment Letter, *supra* note 142 at 3.

[153] See e.g. Comment letter from Dannette L Smith, Secretary to the Board of UnitedHealth Group (22 October 2010) "Re: Concept Release on the US Proxy System File No. S7-14-10; RIN 3235-AK43" at 9, online: US Securities and Exchange Commission <www.sec.gov/comments/s7-14-10/s71410-235.pdf>, where the UnitedHealth Group wrote that Glass Lewis, "extensively but selectively summarized four-year old investigations, and omitted facts and conclusions of those investigations".

[154] Davies Comment Letter, *supra* note 139 at 4.

calculations called for in their models,[155] they benchmark companies with peers that are not in the same sector as the issuer, much more junior, operate in different labour markets and have quite different financial profiles.[156] In one memorable case, a single Glass Lewis analyst authored two reports (one for each corporate partner to a merger) that provided contradictory assessments of the transaction.[157]

E. CORRECTIONS

Once a mistake is made, even if the issuer discovers it, proxy advisory firms have poor track records of correcting them. In Canada, only 28% of the mistakes found in draft proxy reports were corrected.[158] In the United States 43% of the mistakes were corrected, with a significant percentage of survey respondents indicating a blanket refusal on the part of proxy analysts to revisit their work.[159] Power Financial Corporation reported to the CSA that, "in 2009 for example, the proxy advisor failed to take into account 43% of the corrections suggested by Power Financial."[160] Further attempts by Power Financial to get the errors corrected were ignored.

The lack of communication with issuers exacerbates the difficulty of correcting proxy firm mistakes. The volume of shareholder proposals made by Canadian issuers during proxy season is such that advisory firms tend to

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[155] Comment letter from Brigitte K Catellier, Vice President, Legal Affairs and Secretary of Astral Media (21 September 2012) "CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 2, online: Ontario Securities Commission <www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120921_25-401_catellierb.pdf>.

[156] Comment letter from Lynn Beauregard, President & David Masse, Chairman of the Board of Canadian Society of Corporate Secretaries (21 September 2012) "Canadian Securities Administrators Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms – Request for Comments" at 6, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120921_25-401_beauregardl_massed.pdf>.

[157] Comment letter from Peter Volk, General Counsel of Pacific Rubiales Energy (20 August 2012) "Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 2, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120820_25-401_volkp.pdf>.

[158] Canadian Investor Relations Institute Comment Letter, *supra* note 142 at 14. Unexpectedly the percentage of reported corrections goes up to 48% if the mistake is found in a report after it has been issued. Of course, critics would point out that this might be too late for many investor voting decisions.

[159] Society of Corporate Secretaries Comment Letter, *supra* note 150 at 6.

[160] Power Financial Comment Letter, *supra* note 138 at 4.

provide their recommendations only a week or two ahead of shareholder meetings. For Canada's largest issuers[161] ISS will give 24 - 48 hours for the company to identify factual errors only.[162] ISS will not reconsider any judgment calls. Canada's smaller issuers, on the other hand, receive no notice of the recommendations and have no opportunity to review the proxy advice until a friendly institution forwards it to the company. Even large companies are not permitted to review proxy recommendations rendered in connection with any "controversial or contentious" shareholder meeting agenda items.[163] (These generally consist of recommendations made in connection with controversial M&A transactions and proxy battles.) Glass Lewis provides no opportunities for input by issuers.[164]

A Canadian survey found that fewer than 25% of the respondents always received a draft report from at least one proxy firm "either before or after" the reports were delivered to investors.[165] More than one-third seldom or never received draft reports.[166] Unsurprisingly, these arrangements, when combined with the unpredictable results generated by gaps and ambiguities in

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[161] It is not clear what companies fall into this category. ISS merely refers to the companies it gives an opportunity to review their recommendations prior to being released as "the most widely held index constituents". ISS Comment Letter, *supra* note 114 at 3. In the United States, advance copies are provided to companies found in the Standard & Poor's 500 index: Altman & Burke, "Proxy Advisory Firms", *supra* note 108 at 35.

[162] ISS Comment Letter, *supra* note 114 at 13; Canadian Investor Relations Institute Comment Letter, *supra* note 142 at 8: "The recent survey of CIRI members indicated that among those issuers asked to review and respond to a draft P[roxy] A[dvisor] research report 52% were given less than 36 hours to do so. Furthermore 80% of the issuer respondents indicated a 48-hour to 72-hour timeframe is needed".

[163] ISS Comment Letter, *supra* note 114 at 13.

[164] Comment Letter from Katherine H Rabin, Chief Executive Offiver & Robert McCormick, Chief Policy Officer for Glass Lewis & Co (20 September 2012) "Glass Lewis Response to "Canadian Securities Administrators Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms", online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120920_25-401_rabink_mccormickr.pdf> ("Glass Lewis often engages in discussions with companies outside the proxy season, but generally does not engage in private discussions with companies during the proxy solicitation period" at 10) [Glass Lewis on CSA Consultation Paper 25-401].

[165] Canadian Investor Relations Institute Comment Letter, *supra* note 142 at 6.

[166] *Ibid.*

the proxy advisors' published guidelines and by the prevalence of factual errors, create a great deal of frustration on the part of issuers.[167]

Proxy advisors are unrepentant, however, arguing that the tight time deadlines prevent a more extensive engagement with companies. Indeed, defending itself to the CSA against the charge of too limited engagement with issuers, ISS references time constraints no less than seven times in a single paragraph.[168] In characterizing the issue as a matter only of tight deadlines, ISS is being slightly disingenuous. Even with global custodian voting cutoffs occurring a week or two before shareholder meetings, there are still several weeks during which ISS could engage with issuers. As well, it is likely that, particularly in relation to uncontested votes, companies would gladly provide an additional week or two between the mail-out of its proxy and the shareholder meeting if it meant an opportunity to engage with advisory firms.

The reality is, that the issue is less one of time and more a function of proxy firms' resources. ISS makes the point itself in its response to the CSA: "ISS believes that regulation prescribing increased activity or specific timing with respect to issuer engagement and/or draft reviews would require significant additional resources to manage at a cost that would ultimately have to be borne by our institutional clients."[169] In other words, the economics of the proxy advisory industry would be adversely impacted if ISS were required to engage with Canadian companies in proxy season. This is an almost perfect instantiation of an agency cost: the economic interests of the parties in the proxy advice market would be damaged if they adopted a process designed to produce more accurate information. It is hard to imagine this argument being accepted by securities commissions if made by issuers.[170]

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[167] See e.g. Gildan Comment Letter, *supra* note 138 at 5; Davies Comment Letter, *supra* note 139 at 6: "A recent report and voting recommendation of the Social Advisory Services branch of ISS repeated a number of highly damaging allegations about one of our issuer clients originally made by special interest groups without confirming the allegations with information from a reliable source. Many of the allegations were taken from anonymous anti-industry websites and blogs. The proxy advisor also did not consult with the issuer regarding the allegations prior to issuing the report"; CI Financial Comment Letter, *supra* note 141 at 4.

[168] ISS Comment Letter, *supra* note 114 at 4.

[169] *Ibid* at 15.

[170] See the reluctance of Canadian regulators to streamline disclosure obligations for the smallest issuers in Canada's public markets: Contrast the original streamline disclosure policy of ASC with the subsequent one.

Glass Lewis and ISS have another argument against engaging with issuers – it might adversely impact their independence.[171] ISS describes the view of its clients that "the potential for issuer influence and pressure should be prevented and issuer communication with ISS analysts strictly limited during the completion of meeting research and vote recommendations, in order to ensure that institutional clients receive independent-minded voting recommendations..."[172] Once again, this argument appears disingenuous. It is difficult to see how the independence of ISS' analysts could actually be compromised through the exchange of email or telephone calls with the companies they are covering. The very fact that this view is advanced as emanating from ISS' clients (as opposed to ISS itself) implies that the argument is seen by ISS to be stronger as an argument about client perceptions than as a statement of actual probability.

The fact is that there is little reason to believe that interacting with an issuer would compromise the independence of an analyst. In the extensive debate that has surrounded the independence of analysts employed by investment banks, attention has properly focused on eliminating financial ties between the analyst and the companies she covers, not on the dangers of the analyst interacting with management. Indeed, outside of proxy advisory industry the failure of an analyst to engage with a company they were researching would be seen as a serious omission by all parties, including the institutional consumers of the analyst's research.[173]

As it happens, proxy advisory firms have extensive interactions with issuers on controversial matters, such as Agrium's proxy battle, even going so far as to have face-to-face meetings with senior executives.[174] And, as demonstrated

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[171] For ISS, see Davies Comment Letter, *supra* note 139 at 13. For Glass Lewis, see Glass Lewis on CSA Consultation Paper 25-401, *supra* note 164 at 10.

[172] Davies Comment Letter, *supra* note 139 at 13.

[173] See Eugene Soltes, "Private Interaction Between Firm Management and Sell-Side Analysts" (2013) 52:1 J Accounting Research 245 at 248–49 (discussing the importance of private interactions between analysts and management); Lawrence D Brown et al, "Inside the 'Black Box' of Sell-Side Financial Analysts" (June 2014) 53:1 J Accounting Research 1 at 14–16 (summarizing interviews with analysts concerning private communication with management as both frequent and useful); Suping Chen & Dawn Matsumoto, "Favorable versus Unfavorable Recommendations: The Impact on Analyst Access to Management-Provided Information" (2006) 44:4 J Accounting Research 657 ("it has long been recognized that the firm's management represents one of the most important sources of information" at 658)

[174] Cindy R Alexander et al, "The Role of Advisory Services in Proxy Voting" (July 2009) National Bureau of Economic Research Working Paper No 15143 at 9,

by ISS' highly critical Agrium report, there is little evidence these sorts of interactions impact the advisors' independence.

F. CONFLICTS

The most obvious conflict of interest cited by critics of the proxy industry involves ISS providing consulting services to issuers on corporate governance matters that it will subsequently review on behalf of its investor clients.[175] This issue tends to obscure a number of other conflicts involving proxy firms' business model, which is unfortunate because while it is the most obvious of the conflicts, there is little evidence it materially impairs the quality of proxy advice. First, Glass Lewis does not provide consulting services to issuers and thus is unaffected by this criticism.[176] ISS, for its part, carefully notes the various measures it takes to manage the conflict of interest and a review of CSA response letters fails to turn up concrete examples of this particular conflict impacting ISS' voting recommendations.[177] In the U.S. ISS is registered with the SEC as an investment advisor. The non-partisan Government Accountability Office reported to Congress: "Although the potential for these types of conflicts exists, in its examinations of proxy advisory firms that are registered as investment advisers, SEC has not identified any major violations, such as a failure to disclose a conflict, or taken any enforcement actions to date."[178] Finally, there is some anecdotal evidence that governance practices approved by the consulting arm of ISS are occasionally rejected by the proxy advisory division.[179] Whatever this may imply about the "objective" character of governance standards, it suggests the two divisions of ISS operate independently.

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online: National Bureau of Economic Research <www.nber.org/papers/w15143.pdf>.

[175] Allaire, "Troubling Case of Proxy Advisors", *supra* note 50 at 19; "Corporate Shareholder Meetings", *supra* note 65 at 6–12; Colin Diamond & Irina Yevmenenko, "Who Is Overseeing the Proxy Advisors?" (2008) 3:4 Bloomberg Corporate LJ 606 at 608. This conflict is almost the only area where institutional investors could support additional regulation of proxy advisors: Altman & Burke, "Proxy Advisory Firms", *supra* note 108 at 27–28.

[176] Glass Lewis on CSA Consultation Paper 25-401, *supra* note 164 at 2.

[177] ISS Comment Letter, *supra* note 114 at 8–11. These measures consist of: "a combination of disclosure to our institutional clients, the consistent and transparent application of our voting policies, a robust compliance program, and implementation of a strict "firewall" between ISS research and ICS [the entity that advises issuers]" at 9.

[178] Corporate Shareholder Meetings, *supra* note 65 at 9.

[179] See *supra* notes 90–94.

A second prominently mentioned conflict arises from the status of Glass Lewis as a subsidiary of Ontario Teachers Pension Plan, a significant institutional investor, and ISS, until recently a subsidiary of MSCI, a conglomerate primarily focused on selling products and services to the investor community.[180] This presumably prejudices the advisory firms in favour of institutional shareholders.[181] However, this bias is already built into the proxy firms' business model: institutional investors are their customers. There is no need to look to their ownership structures to find reasons advisors might favour investors in their recommendations. It is unlikely, however, that this bias has much impact in individual cases. For example, while activist shareholder campaigns typically pit a client of an advisory firm against a company, there is no research suggesting proxy firms are reflexively inclined to support dissident shareholder circulars. Many proxy fights, like the one involving Agrium, have proxy firms on both sides of the contest[182] and there are enough differences in interest amongst investors that it would be short-sighted in the extreme for a proxy firm to reflexively support activist shareholders. The pressure of one activist client is unlikely to outweigh the interest of all the firm's other clients to get the best advice possible concerning a dispute.

The conflicts of interest that do appear to be the most damaging to the good governance of Canadian issuers occur at the point where proxy firms' voting policies are generated. There are several ways this occurs. The pro-investor bias, built into a proxy firm's business model, for example, manifests itself in voting policies that strongly support shareholder influence on corporate decision making, even when the empirical evidence militates against it.[183]

The standards of good governance promoted by proxy firms are extremely complicated, involving multiple factors and proprietary, undisclosed models. But there is good empirical evidence that a few, simple, basic factors are a more reliable predictor of corporate performance than proxy firms' "multitude of metrics."[184] For example, Professors Bebchuk, Cohen and Ferrell have found that a few measures of director entrenchment (such as the presence of a poison pill or golden parachute) has significantly more

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[180] Allaire, "Troubling Case of Proxy Advisors", *supra* note 50 at 17–18.

[181] Corporate Shareholder Meetings, *supra* note 65 at 11–12.

[182] Tingle, "Proxy Advisors' Voting Recommendations", *supra* note 41 at 10–11.

[183] Tingle, "Proxy Advisors' Voting Recommendations", *supra* note 41 at 18–27.

[184] Paul Rose, "On The Role and Regulation of Proxy Advisors" (2011) 109 Michigan Law Review First Impressions 62 at 63.

predictive power than other metrics popular with proxy advisors, which appear to have no correlation with firm performance.[185]

> "…[O]ur analysis cautions against the 'kitchen sink' approach of building ever larger indexes of governance measures. Shareholder advisory firms, including industry leader ISS, have put forward indexes of good corporate governance based on a massive number of provisions, and the development and use of these indexes has put pressure on firms to adjust their arrangements in ways that would improve their index scores. As this paper highlights, in any large set of governance provisions, many are likely not to matter or to be an endogenous product of others… [This] can push firms in directions that are counter-productive or at least wasteful, and provides a noisier measure of governance quality."[186]

In a similar vein, Professors Bhagat, Bolton and Romano find the share ownership levels of independent directors are a more reliable guide to future results than all the other metrics used by proxy firms.[187] Proxy firms must have something of value to offer their clients and to differentiate themselves from competitors and it is not hard to see that this would produce a bias in favour of complicated, recondite policies.

The business need of proxy firms to make themselves indispensible to their clients could also lead to the constant tweaking and changing of proxy firms' voting guidelines. This point is made often in the CSA response letters. "We believe the most important conflict of interest relates to the fact that [proxy advisory] firms have a significant incentive to continuously raise new governance issues and add new layers of requirements that issuers must follow in order to avoid negative voting recommendations. New requirements are included in their guidelines every year…"[188] Another CSA response letter makes the conflict explicit: proxy "firms are under commercial pressure to amend their standards more frequently than

[185] Lucian Bebchuk, Alma Cohen & Allen Ferrell, "What Matters in Corporate Governance?" (2009) 22:2 Review of Financial Studies 783.

[186] *Ibid* at 827.

[187] Sanjai Bhagat, Brian J Bolton & Roberta Romano, "The Promise and Peril of Corporate Governance Indices" (2008) 108:8 Colum L Rev 1803.

[188] Gildan Comment Letter, *supra* note 138 at 6.

necessary in order to be perceived as being at the forefront of governance and providing value to their institutional clients."[189]

The 2014 voting guidelines issued by ISS include nine changes just to the definition of "independent director."[190] The updates add nine new reasons for issuing a 'withhold' recommendation against a director.[191] They change the formula for evaluating pay for performance and the method of calculating acceptable levels of independent director stock awards.[192] Both of these changes to pay metrics are very complex to understand and apply (like the rules they replace). Out of the many changes to ISS voting policies in 2014, only two were generated by actual alterations in the Canadian legal and business landscape: rules for advance notice by-laws that respond to the recent BC case, *Northern Minerals Investment Corp.* v. *Mundro Capital Inc.*[193] and rules relating to enhanced shareholder meeting quorum requirements for contested director elections, a relatively new defensive tactic in Canada.[194]

It is hard to argue that director independence is a concept that needs further elaboration in 2014. It is equally difficult to imagine that a substantial number of bad actors have been slipping through the director review process unnoticed. With few exceptions none of the scores of technical changes in the 2014 updates will substantively change the quality of governance of Canadian companies. They will, however, provide considerable employment for lawyers and the third party firms that assist companies navigate the proxy advisors complicated rules. These will likely amount to dead loss costs to Canada's public companies. Rule changes that impose costs but few benefits on companies (and their shareholders), while making proxy advisors indispensible, probably should also be classified as an agency cost.

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[189] Comment letter from Norton Rose Canada LLP (now Norton Rose Fulbright) (21 September 2012) "CSA Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" at 7, online: Ontario Securities Commission <https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120921_25-401_norton-rose.pdf>.

[190] ISS' Canadian Corporate Governance Policy, 2014 Updates (21 November 2013) at 5, online: Institutional Shareholder Services Inc <www.issgovernance.com/file/2014_Policies/2014CanadianPolicyUpdates.pdf> [ISS 2014 Updates].

[191] *Ibid* at 7–10.

[192] *Ibid.*

[193] *Northern Minerals Investment Corp v Mundoro Capital Inc*, 2012 BCSC 1090, 36 BCLR (5th) 408 (upholding the use of advance notice by-laws).

[194] ISS 2014 Updates, *supra* note 190 at 11–14.

V. CONCLUSION: THE QUESTION OF REGULATION

The law should not provide remedies for every harm.[195] All regulation imposes costs and while some regulations make markets more efficient – or even create the necessary conditions for markets – others interfere with their efficient operation.[196] The case against regulating proxy advisors and leaving the market for proxy advice alone should therefore be reviewed.

The Arguments Against Regulation

In arguing that it should not be the subject of regulation in Canada, ISS puts a great deal of emphasis on the private market nature of its business: "The provision of our proxy advisory and voting services is subject to the terms of a direct contractual relationship with our clients, with contractual obligations governing confidentiality, delivery times and service levels."[197] In the very last sentence, regulators are reminded that, "market forces rather than regulation are the most appropriate and effective oversight mechanism for the proxy advisory industry."[198]

These are the traditional moves of an industry facing possible regulation and they are not without weight, particularly when the market transactions in question occur between some of the most sophisticated participants in the economy. The entities most complaining about the externalities of these private arrangements are Canada's public corporations – usually regarded as capable of looking out for their own interests.

The problem, of course, is that securities law, generally, regulates market transactions all the time, usually between very sophisticated parties. Regulators and securities lawyers reflexively refer to vulnerable "widows and orphans" when explaining aspects of the securities law regime, but the reality

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[195] Stephen M Bainbridge, "Corporate Governance and US Capital Market Competitiveness" (2010) University of California, Los Angeles School of Law Research Paper No 10-13 at 8–12 (discussion of securities and derivative litigation as potentially more harmful than helpful to shareholders); Roberta Romano, "The Shareholder Suit: Litigation Without Foundation?" (1991) 7:1 JL Econ & Org 55 ("[t]he data support the conclusion that shareholder litigation is a weak, if not ineffective, instrument of corporate governance" at 84).

[196] See Onnig H Dombalagian, *Chasing the Tape: Information Law and Policy in Capital Markets* (Cambridge, Massachusetts: MIT Press, 2015) at 19–23; Jonathan R Macey, "The Regulator Effect in Financial Regulation" (2013) 98:3 Cornell L Rev 591 at 592; John Braithwaite, *Regulatory Capitalism: How it Works, Ideas for Making it Work Better* (Cheltenham, UK: Edward Elgar, 2008) at 197–98.

[197] ISS Comment Letter, *supra* note 114 at 15.

[198] *Ibid.*

is that widows and orphans are not major participants in Canada's capital markets, which are dominated by institutional investors and high net-worth individuals. If securities regulation secures public goods, it is these sophisticated investors that experience the vast preponderance of those goods.

Proxy regulations have been put in place in Canada so that investors have an opportunity to vote on matters where managers are most likely to engage in self-regarding behavior (such as executive compensation, shareholder proposals or the choice of audit firms), to provide investors with a clear understanding of the matters they are expected to vote upon (through mandated disclosure forms) and to give them adequate time to formulate their voting decisions and communicate them to the company (meeting notice and proxy delivery rules). Indeed, the proxy advisory industry was essentially created by regulatory attempts to reform corporate democracy.[199] As one proxy advisory group said in its 2009 annual report: "In general, regulation has been a key driver to our business growth in the past. In the event that the recent financial crisis results in further regulation, we believe that such regulation could be a driver for growth in our business by increasing the demand for our existing products and services."[200]

It is less the case that proponents of regulatory intervention into the proxy advice market are inviting regulators to enter a hitherto autonomous region of private contractual relationships, and more that they are suggesting tinkering in the workings of a market entirely created and constituted by prior regulation. This paper has reviewed perfectly good market-based reasons for doing so. First, market forces seem largely absent in the proxy advice industry. This goes beyond the apparent character of the proxy advice market as a static oligopoly with high barriers to entry.[201] The more profound question is how, even in the presence of real competition, institutional investors could possibly choose between proxy firms competing on the basis of their relative accuracy? There is no obvious way to disentangle voting results from corporate long-term outcomes. As well, there is no obvious incentive for professional fund managers to do this difficult work. If fund managers had incentives to maximize the quality of their voting decisions, we wouldn't have the proxy advisory industry in anything like its present form.

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[199] See text accompanying notes 38–45 above.

[200] Form 10-K RiskMetrics, *supra* note 136 at 15–16: "Regulatory bodies around the world continue to drive change and create opportunities in the markets we serve. ... We believe the increased focus on regulatory requirements around the world will drive further demand for our products and services".

[201] See discussion at text accompanying notes 61–67 above.

Are Proxy Advisory Firms a Suitable Candidate for Securities Regulation?

Section IV of this paper summarizes the available evidence that inaccurate information is produced in the market for proxy advice. The sources of these informational failures include voting policies that are mistaken about what produces good corporate governance, the incompleteness of the information at the disposal of the proxy firms, the opacity of the processes by which recommendations are generated in some areas, the lack of training of proxy firm analysts along with the volume and complexity of the work expected from them in a short period of time, frequent factual mistakes, conflicts of interest, and the inability of informed parties to correct errors.

This paper attempts to show that the most plausible explanation for these sources of inaccurate information are conflicts of interest on the part of proxy firms and institutional fund managers – a common form of market failure. The ultimate owners of corporate Canada's shares are neither the advisory firms nor the fund management companies that consume those firms' research. Rather, it is the ultimate beneficiaries of these funds – ordinary Canadians. These are the proverbial "widows and orphans" conjured in discussions about securities regulation. While these beneficiaries are harmed by a decline in the value of Canadian companies as a result of sub-optimal governance, fund managers and proxy advisory firms are not, provided that the decline is generalized across funds and the relevant benchmarks. Whereas an individual investing her own money in the market is incentivized to maximize the quality of her voting decisions, agents in the market are only incentivized to do enough to satisfy one another and their disengaged and largely ignorant principals – and this unsurprisingly turns out to be a fairly low bar. This paper has reviewed a lot of empirical evidence that proxy advisors' recommendations are economically sub-optimal, but there is no evidence that this makes any difference to their clients. What really does motivate the agents that make up the market is, in the case of proxy advisors, to keep their costs as low as possible, and in the case of fund managers, to improve their performance relative to other funds. This paper has argued that neither of these motivations are likely to improve the quality of proxy advice.

The externalities produced by the flawed market for proxy advice are not limited to the gains beneficial holders of Canada's capital would receive from better governance, it includes effects experienced by the issuers themselves. Proxy advisory firms are not merely another private actor in Canada's capital markets. They have become *de facto* regulators of corporate governance in this country. Where the CSA has largely left corporate governance up to issuers, the advisory firms have created rigid rules. Where the CSA confined itself to general principles, the advisory firms have created specific directions.

Where the CSA has refrained from regulating policy outcomes (such as on executive pay structures), the advisory firms have filled the space with prescriptions. When boards and corporate lawyers spend more time with ISS' proxy guidelines than they do with the CSA's national policy on corporate governance, it is difficult for the proxy firms to claim they have not stepped into an arena that Canadian securities regulators have already unambiguously demarcated as within the ambit of their interest. In influencing the quality of governance of Canada's companies, the work of proxy firms also impact the lives of employees, communities and the broader Canadian economy.

The case for regulatory intervention in the market for proxy advice can ultimately be stated quite simply: (1) there is significant evidence of informational failures in the market; (2) there is evidence these failures arise systemically as a logical consequence of the conflicts of interest of the agents that make up the market; and (3) there is evidence of significant externalities in this market, suggesting the full value of good proxy advice is not captured by market participants and that high-quality advice is therefore under-produced. This is precisely the type of market failure securities regulation was designed to fix.

The Form and Cost of Possible Regulation

Some of the regulatory responses urged by critics of the proxy advice industry would impose significant costs on institutional investors (and therefore their beneficiaries) without any obvious gain in the quality of information in the market. An example of this is creating a category of registration for the advisory firms and providing rules governing their activities.[202] This popular suggestion ignores the fact that two of the four major proxy advisors in the U.S., including ISS, are already registered with the SEC under the *Investor Advisor Act of 1940*, with no apparent impact on the concerns discussed above.[203] Nothing about subjecting advisory firms to a set of rules would impact the perverse incentives under which they operate, or address the failure of any set of governance guidelines to accommodate every situation.

There is no way regulations will be imposed on the proxy industry to prescribe better voting guidelines. Canada's securities regulators have indicated in several ways they don't want to get into the business of prescribing governance rules and it is difficult to see how they could avoid

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[202] *Ibid.*

[203] Slaght, "Whatever Happened to the Prudent Man?', *supra* note 67 at 24.

this if the approach they take to the problems with the proxy advisory industry is to regulate the substance of their recommendations.

Another approach by critics of the current proxy advice market is to argue moral or legal suasion should be applied to institutional investors. Institutional shareholders should engage "with proxy advisory firms in a way that would promote better accountability"[204] or take a stricter view on their fiduciary obligations to vote wisely regardless of proxy advice.[205] These proposals ignore the conflicts of interest that generate rational apathy on the part of institutional investors in the first place. As a remedy for the failures in the proxy advice market, this is the equivalent of suggesting the agency cost problems afflicting corporate boards can be solved by encouraging directors and executives to remember their fiduciary duties to shareholders. It is also similar to the argument that conflicts of interest at audit firms can be managed by auditors remembering their duty to the investors who depend on the quality of their audit work. In regulating directors and auditors Canadian regulators have already signalled these legal duties are not sufficient to address systemic conflicts of interest.

There is a relatively modest intervention in the proxy advice market that would largely leave the market in the hands of private parties. Historically, securities commissions in Canada and the United States have addressed informational failures in this market by mandating disclosure. Issuers have certain obligations to provide information relevant to matters the shareholders are being asked to vote upon; other parties are free to disagree, but they are also required to produce disclosure.[206] It is not a conceptual leap for regulators to impose disclosure requirements on the most recent entrant into the proxy information market: proxy advisory firms.

Proxy advisors should provide all Canadian issuers with a copy of their recommendations several days before those recommendations are to be sent out. If timing is of the essence, then issuers should be given an opportunity to "opt in" to a review process by adding an additional week to the time between the notice date and the meeting date. For the vast majority of shareholder meetings, this is easy in practice to accommodate. The kinds of

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[204] Discussion Paper, "The Quality of the Shareholder Vote in Canada", *supra* note 40 at 171.

[205] Slaght, "Whatever Happened to the Prudent Man?", *supra* note 67 ("[a] better solution would be to clarify existing SEC commentary so that fiduciary duties of investment advisers survive the advice of proxy advisors, thus limiting their influence" at 4).

[206] See e.g. *Securities Act*, *supra* note 24 at ss 157.1(1), 146; NI 51-102, *supra* note 24 at 57–66.

meetings where timing is relatively inflexible tend to be the M&A-related votes where advisory firms already meet tight deadlines as well as providing an opportunity for the company and other actors to interact personally with analysts.[207]

Proxy firms' stated belief that the economics of their business model don't support sustained engagement with issuers should be taken seriously. Instead, Canadian securities regulators should permit companies to provide a response to the voting recommendations of the advisors and require the advisory firms to include it in the voting recommendations they deliver to their clients. This is broadly analogous to the proxy access laws proposed in the United States.[208] For most proxy firm recommendations, of course, companies would not provide any commentary, since the vast majority of proxy recommendations support the board's position, but when a company feels the recommendations are incorrect and material, it should have an opportunity to explain the facts the advisors have missed, the mistakes it has made and the reasons why the board made the decision it did. Unlike professional fund managers and the proxy firms, a corporate board is the one constituency with a voice in the proxy process that has a direct interest in ensuring advisors' voting recommendations are accurate and reflect the company's specific, idiosyncratic circumstances.

The Agrium proxy fight illustrates the merits of this proposal. ISS' voting recommendations received a full and vigorous response from the company, which ultimately persuaded Agrium's shareholders to re-appoint the incumbent slate of directors. This is the way corporate democracy (or any form of democracy) is supposed to work. The various parties make their respective cases and the voters' decision is the better for seeing the merits of each party's position tested by the others. The problem is that Agrium is a very large company, with significant human and financial resources and the proxy fight merited extensive coverage in the Canadian media and in various informal shareholder venues. Most Canadian companies are not afforded the opportunity to question proxy advice in this way. Providing issuers with access to the proxy advisors' reports would go some distance to remedying this problem.

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[207] See ISS Comment Letter, *supra* note 114 at 4.

[208] See e.g. the new Rule 14a-11 adopted by the SEC in the wake of Dodd-Frank: Facilitating Shareholder Director Nominations, Exchange Act Rel. No. 62,764 (Aug. 25, 2010). Note the rule was struck down by the US Court of Appeals for the District of Columbia in Buckberg & Macey, "Reports on Effects of Proposed SEC Rule 14a-11", *supra* note 93.

In relation to the specific concerns with the day-to-day work of proxy firms discussed in this paper, it should be noted that companies have the incentives to identify errors in the premises used by proxy advisory firms to generate voting recommendations. It would not hurt the governance of corporate Canada if market actors reminded one another of the scanty (or contradictory) empirical evidence supporting the conventional wisdom around corporate governance. Issuers are also in the best position to explain how the operation of a general governance principle fails in the company's specific circumstances. Canadian securities regulators have made it clear they do not approve of one-size-fits-all corporate governance; proxy advisory firms also disparage it.[209] Companies are in the best position to point out when a proxy-voting rule produces sub-optimal results in practice.

In relation to the ambiguity, vagueness and secrecy of some proxy voting recommendations, we can only hope that a well-reasoned defense by the company of a controversial proposal will force proxy advisors into exposing the specific rationales for their recommendation. If a proxy advisor knows in advance it will have to defend its recommendation from a published attack on it contained in the very document the advisor will be sending to its clients, it seems possible the advisors will do better at justifying their conclusions and this in turn will cast more light on how proxy advice is generated at the various firms.

The proxy-access proposal has one other benefit: it solves some of the problems in the proxy advice market. Since mistakes, errors in judgment, failures to anticipate consequences, and the actual rationale for voting recommendations will be exposed by the issuers' responses, it should make it much easier for institutional investors to form opinions on the relative quality of the proxy advisors' work. This might facilitate the competition in the market that even the proxy advisory firms recommend as the best corrective to failures in their work.

[209] Tingle, "Proxy Advisors' Voting Recommendations" *supra* note 41 at 29–30.