European Securities and Markets Authority

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SECURITIES AND MARKETS STAKEHOLDER GROUP

ESMA's Discussion Paper on Proxy Advisors – Opinion of the SMSG

I. Executive summary

1. The members of the SMSG welcome the opportunity to comment on the Discussion Paper on proxy advisors dated 22 March 2012 (ESMA/2012/212). Proxy advice covers two distinctly different activities:

   - Advice on how to exercise the voting rights attached to securities (advisory activity)
   - Assistance in the exercise of voting rights attached to securities (agency activity)

   The former is relevant to ESMA, whereas the latter involves matters of company law that are outside the remit of ESMA. Consequently, the SMSG limits itself to addressing the advisory activities of proxy advisors (PAs).

2. Although it is also sometimes provided to individual investors, proxy advice is mostly relied upon by professional investors, notably institutional investors, and advice is typically provided by a few PAs who operate cross border. In the opinion of the SMSG, PAs should be subject to regulation that ensures their integrity and the quality of their advice and that regulation should establish minimum standards applicable throughout the Union. At this point in the development of EU law, a sufficient and proper measure would be to include these standards in a Code of Conduct (CoC) for PAs adopted in the form of ESMA guidance under Art 16 of the ESMA Regulation (EU) No 1095/2010 directed to national competent authorities (CAs) to ensure that their regulation of PAs involves a uniform approach that observes these minimum standards.

3. It is not necessary to introduce an authorisation regime for PAs at Union level. Rather, it is sufficient that the industry observe the minimum standards of the CoC on a comply or explain basis monitored by CAs and that those standards apply to all parties that engage in proxy advice on a professional basis. Furthermore, national CAs should register PAs and this information should be communicated to ESMA and made available by ESMA to allow continued monitoring and transparency of the industry at a Union level.

4. The issues to be addressed by the CoC should reflect the difference between advice that is offered in a non-public way by the PA to its clients, and advice that is made public by the PA. It should also reflect the fact that some PAs offer their advice on a professional basis as their main business activity, whereas other PAs may operate as non-profit organisations that only offer advice as an auxiliary service. It is important that the standards do not create unreasonable fixed costs that may hamper competition by disadvantaging new entrants. Guidance for proper conduct can be derived from present EU law and initiatives taken by IOSCO in respect of credit rating agencies. Furthermore, the market abuse regime set out in the MAD must inform the CoC to avoid inappropriate behaviour by PAs.

5. This opinion points to issues that may form part of a CoC, notably on the integrity of the PA, the quality of advice and the level of transparency necessary when giving advice.

II. The nature of proxy advice

6. Proxy advice covers two distinctly different activities:

   - Advice on how to exercise the voting rights attached to securities (advisory activity)
   - Assistance in the exercise of voting rights attached to securities (agency activity)

   The ESMA Discussion Paper (DP) is concerned with voting rights attached to shares, but in the opinion of the SMSG there is no reason to make a distinction between voting rights attached to shares or to those attached to bonds and consequently this opinion refers to voting rights attached to securities. The remit of ESMA is the securities markets; the authority of many of the national supervisors in its Board of Supervisors is also limited to securities markets. Certain issues, notably within company law, are thus outside the scope of ESMA's activities. The SMSG is ultimately subject to the same limitations as apply to ESMA and consequently the SMSG limits itself to address the advisory activities of proxy advisors (PAs).

7. However, the importance of proxy advice is such that it would be unfortunate if the company law aspects of these activities remained unnoticed in the current work to reform company law in respect of publicly traded companies.[1] Thus, the SMSG calls upon the Commission: to continue its analysis as presented in the recent 2011 Green Paper on the European Corporate Governance Framework; to include PAs and their agency activities when contemplating the future regulation of company law; and draws attention to the following issues as worthy of special consideration:

   - Identification of shareholders, where shares are held by intermediaries, partly to provide transparency, partly to ensure access to the general meeting and exercise of voting rights;
   - Technical requirements for proxy voting or on-line participation in general meetings and absentee voting;
   - Barriers to cross-border voting, especially for small investors; and
   - Disclosure of voting policies by institutional investors and the implementation of measures encouraging the adoption of stewardship codes.

   These issues are relevant to all shareholders and important in facilitating cross-border investment and by extension they are also important for PAs acting as agents on behalf of shareholders.

   The present drive to make shareholders take responsibility for their investments and engage in the companies where they invest, and especially for institutional investors to assume stewardship, is commendable and proxy advice should form part of these endeavours to ensure that investors can

[1] This work covers, *inter alia*, existing EU law, such as Directive 2007/36/EC on Shareholders' Rights and Directive 2004/25/EC on Takeover Bids, and potential legislative actions such as the Commission's Consultation on the future of EU company law and Consultation on securities law.

exercise their rights on an informed basis, at competitive prices and in an effective manner, if necessary by relying on PAs acting as advisors or agents.

Competition issues are also outside the scope of ESMA, however, it is important that all initiatives at a Union level consider their possible impact on competition both within the Union and on a global scale. The present state of the PA industry appears to be oligopolistic and compared to the US the industry in the EU displays a greater fragmentation, which may be explained by the greater variety among Member State jurisdictions in respect of regulation and language.

It is important for PAs to have an in-depth understanding of national law in each particular jurisdiction, including local traditions and customs, and this capability is particularly important to small and mid-sized enterprises (SMEs) that are often only traded on their national market. To ensure a proper understanding of national law and the local environment and to ensure efficient competition, it is important to enable new and small local PAs to enter the market.

The DP points out that some large institutional investors prefer PAs that offer agency services in respect of voting services and a global standardised reach by their advisory services. This is a natural development and should not in itself be discouraged, especially as the DP also shows that some of these large investors tend to rely on more than one PA, which ensures competition.

However, it is important not to burden the PA industry with too many fixed costs in the form of compliance requirements that would serve as a disadvantage for small and local PAs. Furthermore, it should be an issue of particular concern to monitor and prevent larger PAs with a cross-border capability from tying their agency services (voting systems) to their advisory services, e.g. by only accepting to vote as an agent on behalf of a client if that client also procures its advisory services. The two different services, advisory and agency, are distinct as noted above, and should not be tied-in to the detriment of competition. Thus, it should be possible for an institutional investor to contract a PA to act as its agent and vote on its behalf while relying on advice on how to vote provided by another PA.

Where several shareholders with substantial holdings in a company rely on the same PA, they may receive identical advice which will have a coordinating effect on the voting pattern of the company. Nevertheless, this should not in itself be construed as 'acting in concert' in the meaning applied by the Directive (2004/25/EC) on Takeover Bids or Directive (2004/109/EC) on Transparency, that are currently under revision.

III. Is regulation necessary?

8. Proxy advice is mostly relied upon by professional and institutional investors, who avail themselves of this service in order to avoid the considerable costs connected with scrutinising agendas in the many companies in which they hold investments. It should be noted that proxy advice is thus an efficient way of ensuring that a diversified investment strategy does not become a passive investment strategy. It also helps facilitate cross-border investment because investors may acquire advice on how to navigate in a foreign jurisdiction where the cross-border context could otherwise discourage investment.

   However, proxy advice is not entirely directed at professional investors. Some proxy advice is available for retail investors and may even be offered for free as an auxiliary service to investment advice. The beneficial effects of proxy advice apply equally to retail investors.

Professional investors are in many ways capable of fending for themselves and although the market for PAs displays characteristics of an oligopoly, it is reasonable to assume that there is sufficient competition to ensure that professional investors can expect PAs to accommodate their needs. This would indicate that there is at present no need for legislation at a Union level.

However, professional investors avail themselves of proxy advice because they find it cost efficient to delegate these issues to the PA. This would suggest that even professional investors rely on certain basic assumptions with respect to the service they get from the PA, and in particular that they rely on the quality of the advice and on the integrity of the PA as they may find these attributes difficult or costly to monitor. This is even more the case with respect to retail investors' reliance on PAs. Given the importance of the institutional and professional investment sector in the EU, and the vast funds they manage, and the related centrality of proxy advice, some degree of intervention seems appropriate to ensure that the basic assumptions of investors are in fact reflected in industry behaviour.

Furthermore, it is important to ensure that the EU regime for combating market abuse is observed in this area as well.

9. In the opinion of a majority of the SMSG, the proper regulatory instrument to achieve these objectives would be to establish a set of minimum standards in a Code of Conduct (CoC) adopted by ESMA in the form of guidance under Art 16 of the ESMA Regulation (EU) No 1095/2010 directed to the national competent authorities (CAs) to ensure that their regulation of PAs entails a uniform approach that observes these minimum standards. In this way, ESMA performs its obligation under Art 1(3) of the ESMA Regulation to act in the field of activities of market participants, including matters of corporate governance, to monitor these new financial activities and promote the convergence of the regulatory policies that the DP shows are developing among competent authorities (CAs). It would be unfortunate if this emerging national regulation develops in an uncoordinated way that may hamper cross-border activity within this industry and consequently coordination by ESMA is called for.

A CoC would apply as a form of a soft law, and thus would not be too intrusive and would observe the principles of subsidiarity and proportionality of Art 5 TEU. Its purpose would be to establish the basic protection that all parties can expect when receiving advice and to ensure that advice is obtained and dispensed in a manner that does not lead to market abuse. The CoC would be included in guidance according to Art 16 and directed to CAs setting out the minimum standards that should be observed by their national PAs. By setting the applicable standards of a CoC in an instrument subject to Art 16, this ensures that CAs are alerted to the relevant minimum standards that should always be observed and that PAs, who operate across borders within the Union, face the same minimum requirements.

The standards presented in the CoC applicable to the PAs should be based on the 'comply or explain' mechanism, commonly used in soft law instruments and particularly with respect to the governance issues central to the proposed CoC. A PA would be required to disclose on its website whether (1) it complied with the Code and (2) the elements of the Code with which it did not comply and the reasons for the non-compliance. When drafting the CoC it is important not to force unwarranted harmonisation upon the industry by presenting certain options as default settings when in fact different approaches may be equally justified. Where different options are considered equal, the CoC should in stead promote transparency by requiring the PA to explain its choice. Where transparency is

called for, e.g. in case of a conflict of interest, the mode of disclosure should allow for the most cost-effective disclosure possible.

One important consequence of non-compliance, where comply or explain is relied upon, is the detrimental effect on reputation. However, as pointed out by the Commission in its 2011 Green Paper on a European Corporate Governance Framework, it cannot be entirely left to self-regulation, because both the compliance and the explanation, where another solution is preferred, may fail if not monitored by external parties. Consequently, it is recommended that the applicable national standards based on the CoC are monitored by CAs and reported to ESMA both to discipline the transgressors and to provide the necessary transparency that will allow the forces of competition to enhance the overall compliance of the industry.

IV. Activity as a PA

10. In the opinion of the SMSG, it is at this stage unnecessary to introduce an authorisation regime for PAs whereby the activity of offering proxy advice would be conditional upon formal authorisation by a public authority. It is sufficient that the issues addressed by the CoC apply to all parties that engage on a professional basis in proxy advice, especially because these issues will concern basic principles that should always apply to anybody acting as either an advisor or an agent. As the CoC should only address the minimum standards that are necessary to ensure that clients of PAs receive the qualified and unbiased advice they expect, it should avoid introducing too many fixed costs on PA that would disadvantage new entrants and thus impede competition. Although a CoC would mainly be directed at PAs that operate on a professional basis, it should also be considered that proxy advice may be offered by non-profit entities as a mere auxiliary service and it is also for this reason important to avoid excessive standards that may translate into costly procedures.

11. Considering the clear importance of proxy advice and its future potential, as still more funds are managed by professional and institutional investors that rely on proxy advice, it is advisable to monitor this industry. CAs should register parties which provide proxy advice on a professional basis and regularly transmit information to ESMA to allow a combined assessment at a Union level. This registration may not have the effect of covering all proxy advice activity that is in practice offered to investors, because proxy advice may be offered under many different circumstances and not necessarily by PAs, but registration will support sufficient monitoring of the main parties in this industry. ESMA should make the list of PAs publicly available, which may also serve to enhance competition by increasing the visibility of new and smaller PAs. Furthermore, transparency of the extent that individual PAs comply with the CoC may also provide the necessary incentives to enhance performance and competition.

V. Overall policy and scope of the CoC

12. The issues to be addressed by a CoC should reflect the difference between advice that is offered in a non-public way by the PA to its clients and advice that is made public by the PA.

The former is not available to the public and as such its effect on the market may be less pronounced than advice that is addressed to the investing public. However, even non-public advice may have a market impact because the proxy advice industry is characterised by a few PAs that are likely to apply the same methodology and hence advise all their clients in the same way which may produce a significant accumulated effect.

13. The CoC should reflect the overall policy that investors should engage with the company in which they invest and actively seek to encourage the best possible governance of it for the long-term. Proxy advice should facilitate such investor engagement and stewardship.

    Just as the regulation of investment advice does not seek to shift the responsibility of the investor in respect of the risk of the investment, but should support the investor in understanding the risk connected with the investment, so should the regulation of proxy advice not seek to shift the responsibility of the investor in respect of the investor's role vis-à-vis the company, but should support the investor in understanding the role connected with the investment in respect of governance.

    Thus, as a starting point, anyone offering proxy advice should presume that the investor wants to play an active role in the governance of the company for the long-term and the advice should be tailored to that need. However, just as some investors prefer portfolio management, whereby they delegate the actual investment decisions to the portfolio manager, it should be possible for investors to delegate the actual governance of their shares to a proxy advisor. In both instances, this kind of delegation raises particular concerns as to the quality of advice and management, the transparency of the advice given and its underlying rationale, and advisor integrity, notably in respect of possible conflicts of interest, which must be addressed by the CoC.

14. Guidance for proper conduct can be derived from current EU law: the regulation of investment advisors (investment firms) under MiFID[2] may provide a benchmark with respect to PA qualifications and the quality of their advice; the regulation of investment recommendations under Commission Directive 2003/125/EC provides a benchmark with respect to the disclosure of conflicts of interest; and the regulation of credit rating agencies (CRAs) provides a benchmark with respect to the publication of opinions that may affect price formation in publicly traded securities. Furthermore, the market abuse regime in MAD must inform the applicable standards to avoid inappropriate behaviour by PAs.[3] Finally, relevant guidance in respect of the integrity of PAs can be found in the IOSCO principles relating to CRAs.[4]

15. The issues raised in VI - VIII should, as a minimum, form part of the CoC applicable to all parties regularly offering proxy advice on a professional basis.

VI. Integrity and qualifications of the PA

16. Whether the PA acts as an advisor to, or an agent for, the investor, the PA must act loyally in the interest of the investor and with due care.

    Any conflict of interest that might compromise the integrity of the PA must be disclosed to the investor in a way that allows the investor to assess the conflict and at such a time that the investor may decide against engaging the particular PA and incurring the costs of its services. Where proxy advice is made available to the public, the disclosure of such conflicts of interest must be done in connection with the publication of the advice, and in such a way that it forms a natural part of the communication. It may not be necessary or practically feasible to make full disclosure in each particular instance of advice, in which case the disclosure can be made by reference to another source,

[2] Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments, now under review.
[3] Directive 2003/6/EC of the European Parliament and the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), now under review.
[4] IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO Technical Committee, December 2004, revised 2008.

e.g. through a web-link, provided that the reference clearly states that it concerns a disclosure of potential conflicts of interest that may be of relevance to the advice given. Guidance may be taken from the regulation of investment firms in MiFID and of CRAs, and of financial analysts issuing investment recommendations in Commission Directive 2003/125/EC.

17. The PA must have sufficient qualifications to offer proxy advice and its employees must hold the necessary qualifications to perform their function within the PA. This would include a sufficient understanding of the legal environment applicable to any company in relation to which the PA offers advice, and also any special requirements applicable to the investor, e.g. stewardship codes applicable to certain institutional investors. The legal environment would include, *inter alia*, the legislation in force, including securities regulation and any applicable soft law, e.g. codes or recommendations, that may apply to the company in question and the particular investor seeking advice, as well as relevant local customs.

18. A PA should be liable for the quality of its advice in accordance with its contract with the customer and the applicable national law on torts or contractual damage, as the case may be. The PA should have sufficient capital or insurance to cover its liability at all times.

VII Quality of the advice

19. The PA should know its customer and understand the company in relation to which advice is being sought.

20. Advice should only be offered by the PA when the PA has a clear understanding of the issues in question. In general, this would require an understanding of:

    - The company's situation, including its financial situation at least as disclosed by financial reports and any disclosures made as a publicly traded company to the market.

    - National law, including any relevant soft-law standards and standards following from securities regulation or the company's admission to public trading.

    The required level of understanding may furthermore vary from case to case, but as a general minimum the following should apply. In the case of a general meeting of shareholders, the PA should understand the items on the agenda, their legal background and consequences and the motivation behind them. In case of *appointments*, the PA must know the applicable rules on voting in national law and in the company's articles, the current composition of the board and the candidates and their background and qualifications. In case of *corporate action*, the PA should understand the financial situation of the company, and the current and future distribution of control where the action is approved as well as if it is defeated. In case of *takeover bids*, the PA should understand the current situation of the target company and the bidder, the offer document and the consequences where the offer succeeds and where it is defeated.

21. Where a resolution is supported or promoted by a particular party, e.g. the management of the company or an activist investor, the PA should ensure that it understands the motivation behind the resolution, which may necessitate direct contact with the party in question.

    The market abuse regime prohibits the selective disclosure of inside information. Thus, when contacting the management of a publicly traded company or any other relevant party, the PA must take

all reasonable steps to ensure that it does not receive inside information that may contravene the prohibition. Equally, the PA may not disclose inside information in its possession to its clients and should have proper safeguards to ensure compliance. However, the regime does not prevent direct contact between management and investors as long as inside information is not disclosed and, by extension, this applies to PAs. Thus, nothing in the CoC should prevent or discourage PAs from communicating with the management of publicly listed companies, as long as such communication is in compliance with the market abuse regime and applicable national law.

The PA should be obliged to keep a record of all meetings with the management of publicly traded issuers. The record should be available for inspection by the CA. This would help investigations into suspected market abuse. However, the PA should not be obliged to publicly disclose its meetings with managers. Such publication may have an adverse effect on the public, because some may construe this information as an indication that new and price sensitive, i.e. inside, information has been exchanged and forms the basis of the PA's advice. If, on the other hand, the PA voluntarily decides to disclose its meetings with management, the PA must provide an account of the meeting, including the participants, the date, the issues discussed, and whether the meeting was scheduled as part of the PA's normal routine.

There are good arguments both in favour and against letting the management of the issuer review the PAs draft advice, which the DP explores. For this reason, it should not be harmonised at a Union level at this stage and where the Member State has not regulated the issue, it should be an option for the PA to decide whether to provide its draft advice to the issuer before presenting it to its clients. However, where a PA is either obliged to provide its draft in advance to the issuer or decides to do so, this fact should be clearly disclosed in the final advice.

22. When giving proxy advice, the PA must disclose its reasoning to a degree sufficient for the recipients of the advice to satisfy themselves that the advice is of the appropriate quality.

If the PA employs certain principles or a particular methodology to develop its advice, e.g. that certain investments are discouraged out of ethical considerations or that the composition of management should conform to certain ratios, the main outline of the principles or methodology must be disclosed as part of the advice. Similar disclosure should take place where the PA has incorporated principles provided by its client into its advice, if the PA were to make the advice available to the public or other parties.

Where advice is made public, the reasoning should be full and self-explanatory; where advice is offered to a particular client, the client may consent to receiving advice with limited reasoning, however, the PA must be able to offer a full reasoning of its advice if subsequently required to do so, and be obliged to keep sufficient records of the advice given; and the reasoning behind it, should the quality of its advice later be disputed. Failure to provide such documentation may be taken as evidence that the advice was not of a sufficient quality.

VIII Transparency of the advice

23. The PA should be able to decide whether it wants to provide its proxy advice free to the public or whether its advice should be provided solely on a contractual or subscription basis to individual clients.

Where advice is offered to the public, its publication should be timed not to interfere with the market, preferably after the closing of the relevant market. Furthermore, the PA should take reasonable care when drafting public advice to avoid any ambiguities, distortions or inaccuracies that may affect price formation in the marketplace and thus constitute manipulation.

24. If a party regularly provides proxy advice on a professional basis and it employs certain principles or a particular methodology in developing its advice, the main outline of these should be disclosed in the same way as applies to potential conflicts of interest. The PA should not, however, be required to disclose information which represents its intellectual property or know-how in which it has a competitive and reasonable interest in maintaining confidentiality.

    Equally, the PA must disclose its organisational structure, including how the PA ensures that it has a sufficient understanding of the national jurisdictions where it operates and how it avoids conflicts of interest and ensures compliance with the market abuse regime.

    Conflict of interest is relevant whenever other considerations than the best interest of the client may influence the advice offered by the PA. Such influence may be exercised at least by the following three parties:

    - Owners of the PA, either direct owners or related parties within groups of companies, that may affect the financial situation of or employment within the PA.

    - Issuers, who may rely on the PA or group related companies for various services and who may influence the PA by threatening to withdraw it business.

    - Other investors with whom the PA has substantial business and who may influence the PA by threatening to take their business to other PAs.

    Disclosure of ownership interests, individually or group based, should always be made, where the stakes are above certain thresholds. The last two instances, however, would require an ad hoc assessment of whether undue influence is possible and disclosure could be made contingent upon the level of business with any one issuer or investor client exceeding a certain substantial threshold of over all turnover. Disclosure would be relevant, where the PA has provided services to the company it is offering advice about within the last 12 months, but disclosure should only indicate the nature of the service in a general way that does not compromise the confidentiality that the issuer may reasonably expect.

    A duty of disclosure should not apply to actors that provide proxy advice only occasionally and on an ad hoc basis.

    The disclosure can be made in the same general way as disclosure is made with respect to disclosure of potential conflicts of interest, e.g. on the web pages of the PA.

25. If the PA has acted as an agent, the PA is obliged to provide its clients with an account of how it has acted on their behalf in their capacity as investors and how the action taken corresponds to any advice given on these matters. This concluding statement is for the client and should not be made public unless so required by the client.

This opinion will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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