

## ADVICE TO ESMA

### ***ESMA Call for Evidence on the Impact of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis - Opinion of the SMSG***

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#### **1. Executive summary**

1. The members of the SMSG welcome the opportunity of the ESMA Call for Evidence to express their view on the development of proxy advisors activity in the past years.
2. The Call for Evidence has the purpose to gather information on the impact the Best Practice Principles for Providers of Shareholder Voting Research and Analysis adopted in March 2014 had on the activity of proxy advisors. The Principles were adopted following the Final Report of February 2013, where ESMA recommended the adoption of a self-regulation code and committed in undertaking a review of the code after two years.
3. The members of the SMSG believe it is too early to assess in a definite way the effectiveness of the self-regulatory framework now in place, considering that only a full proxy season has been completed since the adoption of the Principles.
4. As to the scope, the Principles correctly distinguish between providers of shareholder voting research and analysis, which are the key activities of proxy advisors, and providers of additional services.
5. The Principles address the main issues raised by the ESMA Final Report, which are: quality of service; conflicts of interest; communication with issuers and the public. The members of the SMSG believe that special attention should be given to the issue of conflicts of interest, especially due to the concentration in the proxy advisory industry.
6. The quality of the Statements of Compliance varies among different proxy advisors. It would be useful if they were published at the same time during the year, in a standardised format and on an annual basis, in order to ensure their comparability.
7. It is too early to observe a significant impact of the Principles on the activity of proxy advisors; however, improvements were reported on the side of transparency.
8. The members of the SMSG believe that special attention should be given to the monitoring process on the implementation of the Principles in order to enhance their effectiveness; the monitoring activity could be carried out by an independent committee, even industry based but with an independent chairman.
9. Although proxy advisors may play an important role in the voting process, the ultimate responsibility to monitor investments and make voting decisions lies with institutional investors. Therefore, the promotion of stewardship codes for institutional investors and their asset managers should be enhanced. In addition, the functioning of the full voting chain should be further investigated.

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## **2. Introduction**

10. In February 2013, ESMA published a Final Report on the role of proxy advisory industry, which followed a public consultation undertaken in 2012 on a Discussion Paper, seeking input from stakeholders on several key issues relating to the proxy advisory industry and asking whether market participants saw any need for policy action. The SMSG published an Opinion on the Discussion Paper on April 26th, 2012. In its Final Report, ESMA encouraged the industry to develop its own code of conduct and drafted a set of high-level principles to serve as guidance for the industry. ESMA also committed to undertake a review of the code of conduct after two years of the publication of its Report.

11. Following the publication of ESMA's Final Report, a number of proxy advisors established an industry group (the Best Practice Principles Group - BPPG) to draft a code of conduct. In March 2014, after a consultation undertaken during the second half of 2013, the BPPG published the Best Practice Principles for Providers of Shareholder Voting Research and Analysis ("the Principles"), consisting of three main principles (Service Quality, Conflict of Interest Management, Communications Policy) and accompanying Guidance, which have to be applied on a comply or explain basis. Signatories to the Principles undertook to publish a Statement of Compliance describing how they apply the Principles and, where any of the Principles have not been applied, provide a reasoned explanation as to why.

12. The purpose of the current Call for Evidence is to gather information on how stakeholders perceive the most recent proxy seasons after the adoption of the Best Practice Principles and to assess new trends or changes in proxy advisors' approach, in order to allow ESMA to proceed with the said review.

13. The members of the SMSG welcome the opportunity of the ESMA Call for Evidence to express their view on how the activity of proxy advisors evolved over the past two years and on their impact in the voting process of listed companies in Europe.

14. In general we think that it is too early to assess in a definitive way the effectiveness of the self-regulatory framework in place. A full proxy season has just been completed and most of the Signatories did thus only publish their Statement of Compliance after the 2014 proxy season. So while it is appropriate to acknowledge the state of implementation it would be advisable to undertake a further review at some later stage.

## **3. General questions**

### **3.1 Background**

**Q1:** What is the nature of your involvement in the proxy advisory industry (proxy advisor, investor, issuer, proxy solicitor etc.)? To facilitate the comprehensibility of your response to this Call for Evidence, please describe your role in and your interaction with the industry.

15. The members of the SMSG represent different stakeholder constituencies (academics, consumers, financial institution employees, financial market participants, small and medium sized enterprises, users of financial services) and, as such, express different perspectives and views on the proxy advisory activity.

For this reason, the SMSG will answer only to the general questions and will not address the specific questions raised in the Call for Evidence.

**Q2:** Have you previously had concerns with the functioning of any areas of the proxy advisory industry? If yes, please specify.

16. The SMSG commented the ESMA Discussion Paper on proxy advisors (dated 22 March 2012) in its Opinion of April 26, 2012.

**Q3:** Did you become aware of the BPP at the time of their publication, i.e. March 2014? If yes, how did you become aware of the BPP? If no, when did you become aware of the BPP and how?

17. Yes.

### **3.2 The BPP on paper**

**Q4:** What is your view on the width and clarity of the scope of entities covered by the BPP (i.e. do you consider that the BPP cover the European proxy advisory market appropriately)? Please explain.

18. The approaches to the definition of the proxy advisory activity are diverse.

19. The definition of proxy advisor adopted in the proposed revision of the SHRD, in the text approved by the EU Parliament on July 8th, 2015 is narrow, since it makes reference to a legal person that provides on a professional basis recommendations to shareholders on the exercise of their voting rights.

20. The (BP) Principles distinguish between proxy advisors providing shareholder voting research and analysis (including data and analysis, company-specific research, advice or opinion, ESG ratings, policy guidance, voting recommendations, alerts, bulletins and newsletters), which are the key activities of the Signatories, and providers of other additional services (such as vote agency, engagement and governance overlay services).

21. We generally agree with this approach which reflects the distinction adopted by our Opinion of April 2012, distinguishing the advisory activity ( i.e. the advice on how to exercise the voting rights attached to securities) from the agency activity (i.e. the assistance provided in the exercise of voting rights attached to securities).

**Q5:** In your view, are the BPP drafted in a way so that they address the following areas identified in ESMA's 2013 Final Report? Please provide examples to support your response.

- (a) identifying, disclosing and managing conflict of interests;
- (b) fostering transparency to ensure the accuracy and reliability of the advice;
- (c) disclosing general voting policies and methodologies;
- (d) considering local market conditions;
- (e) providing information on engagement with issuers.

22. Yes, the Principles address the main issues raised by the ESMA Report. However, we believe that, especially due to the concentration of the industry, special attention should be given to the topic of conflicts of interest. In particular, among the areas of conflicts of interest that should be taken into consideration, there are: (i) the sale of reports or corporate governance ratings by proxy advisors to issuers; (ii) the offering of consulting services, even if through a branch different from that giving voting advice, to issuers while also providing for voting recommendations for the same issuers' general meetings. Another key issue to focus attention on is the adequate disclosure of methodology and explanation of the criteria followed in order to assess the governance solutions, in the light of local market conditions, specific regulatory environment and companies' specific circumstances.

23. The implementation of the Principles concerning the quality of service and the conflicts of interest should be carefully evaluated in the monitoring process.

**Q6:** What is your overall assessment of the quality of the signatory statements? Please provide examples referring to the areas identified under Q5.

24. The quality of the Signatories' statements varies among different proxy advisors and they are not always easily comparable. The Principles require that "Signatories should review their Statement of Compliance from time to time (at least annually) and update it as appropriate to reflect current practice and material changes". It would be useful if they were published during the same time of the year, in a standardised format and possibly ex-novo on an annual basis or, as an alternative, highlighting the changes.

25. The BPP Group committed to publish a framework to make the Statement of Compliance comparable within the end of 2015. This would be a useful tool for enhancing transparency.

26. As to the content, the Principles provide that the Statement should describe in a meaningful way how Signatories apply the Principles and related Guidance; disclose any specific information set out in the supporting Guidance; and, where any of the Principles have not been applied or relevant information has not been disclosed, provide a reasoned explanation as to why.

27. At this regard, special consideration should be given to the quality of the explanation for deviation, considering that information on the compliance to the Principles of best practice and on any deviations from the recommendations set out therein is the core of the comply or explain approach. Useful inputs may be found in the European Commission Recommendation of 9 April 2014 on the quality of corporate governance report.

### **3.3 The BPP in practice**

**Q7:** In your view, are there proxy advisors which possibly fall within the scope of the BPP and have not signed the BPP? If yes, please:

- a. identify such entities;
- b. explain why you consider them to be within the scope of the BPP; and
- c. indicate their size and the coverage of their operations within the European market.

**Q8:** How would you describe the impact which the BPP have had on the proxy advisory industry in practice? Please provide examples to support your response.

28. SMSG did not observe any significant and major impact yet, probably due to the early stage of the process of implementation of the Principles which were only published at the beginning of 2014.

29. However, an improvement in transparency of the activity of proxy advisors has emerged, probably also due to the disclosure of the Statements of Compliance to the Principles.

**Q9:** Have you observed any changes in signatories' practices in the areas mentioned under Q5 since the publication of the BPP in March 2014 and specifically during the 2015 proxy season? Please provide examples to support your view and specify whether these changes addressed the concerns you mentioned in response to Q2, if any.

**Q10:** To what extent do you consider the conduct of BPP non-signatories in relation to the areas identified under Q5 to be different from that of BPP signatories? Please provide examples to support your view.

**Q11:** Do you consider other measures than the BPP necessary to increase understanding of and confidence in the proxy advisory industry? If yes, please explain why and specify the measures which would in your opinion be suitable.

30. As a general and preliminary comment, we appreciate the effort made by the industry adopting the Best Practice Principles, as well as the procedure followed for their adoption, i.e. a public consultation process. We expect that the same approach will be followed for future initiatives for the review of the Principles which we consider should take place periodically.

31. In order to enhance the effectiveness of the comply or explain approach which they are based on, we believe that special attention should be given to the monitoring process.

32. According to the BPPG, the Group will perform an ongoing monitoring of the implementation of the Principles (see p. 2) and will review the Principles and the Guidance no later than two years following the launch. At present, there is no feedback on any activity carried out and it would be useful to know if the members of the Group have met and how many times, if the independent chairman played a special role, and any other relevant information. From this regard, it would be useful if the Group were to publish a (annual) report on its activity and express its view on the application of the Principles and the room for improvements, and any other relevant comment.

33. Another issue to be addressed is that of the composition of the Group carrying out the monitoring, which is fundamental to ensure the quality and effectiveness of the monitoring process itself. The BPP Chairman explains in its Report some of the challenges associated with the set up of a monitoring body: "the Committee determined that the main disadvantage of the private model is that there is not a specific standing review body which covers the industry. Furthermore, its creation would prompt major discussions regarding representation of stakeholders, conflicts of interests of the review body's members, the funding of the review body and the type of organisation that would be responsible for ensuring compliance". We acknowledge the difficulties underlined by the Chairman's Report. However, we believe that the monitoring could be carried out by an independent committee, even industry-based but with an independent chairman, as it was done for the adoption of the Principles, also using independent research or analyses when deemed necessary.

**Q12:** Do you have any other general comments that ESMA should take into account for the purposes of its review?

34. The market of proxy advisory firms is already highly concentrated and the process of concentration is still on-going. From a policy perspective, it is important not to run the risk that the adoption of any binding regulation reinforces such a concentration (for example by introducing too many fixed costs on proxy advisors that would disadvantage new entrants and thus impede competition) or encourage an overreliance on the activity of proxy advisors. We therefore fully support the policy approach followed by ESMA as well as the disclosure requirements and comply or explain approach adopted by the revision of the Shareholder Rights Directive (“SHRD”) as approved by the European Parliament. These approaches appear to be suitable for an industry which relies on reputation and which operates cross-border.

35. Also, we would like to stress the fact that the ultimate responsibility to monitor investments and make voting decisions lies with institutional investors. The use of third-party services (such as those provided by signatories to the Principles) does not shift this responsibility, unless the third party assumes additional [contractual] authority from the client. This is important in order to ensure full accountability for voting behaviour towards the end-investor. Part of the debate on the influence of proxy advisors relates to the technical dependence created by the voting platform provided by large proxy advisors. Some proxy advisors state that their platforms offer the possibility to upload voting recommendations of proxy advisors’ competitors. This may be an interesting point to explore further in view of reducing influence of a single proxy advisor and making the proxy advisory market competitive.

36. As clearly pointed out by ESMA in its Final Report, the responsibility for stewardship always lies with the investor and the role of proxy advisors is to be understood as facilitators for institutional investors to help them to discharge a specific part of the investors’ stewardship responsibilities more efficiently, namely where these responsibilities relate to the investors’ ownership rights and voting activities. Thus, the services offered by proxy advisors are to be understood as a signalling tool in addition to the investors’ own analysis and, therefore, are not meant to be mechanically relied upon.

37. For this reason we think, as stated also in our previous Opinion, that, at EU level, the promotion of stewardship codes for institutional investors and their asset managers should be encouraged, and that a disclosure rule requiring asset managers and institutional investors to disclose whether or not they comply with a code and how they finance independent research free from conflict of interests. A related topic that should further investigated is the functioning of the full voting chain (i.e. how custodian banks process votes; confirmation of votes received by issuers; cross-border voting). These topics are now considered in the revision of the SHRD. The potential need for further measures could be monitored.

38. The distinction of the role of investors ( as engaged shareholders), and proxy advisors (as facilitators for (institutional) investors), is clearly reflected in the proposed revision of the SHRD, in the text approved by the EU Parliament on July 8th, 2015, which provides for separate requirements of policy adoption and disclosure.

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

Adopted on 21 August 2015



Jesper Lau Hansen

Chair  
Securities and Markets Stakeholder Group