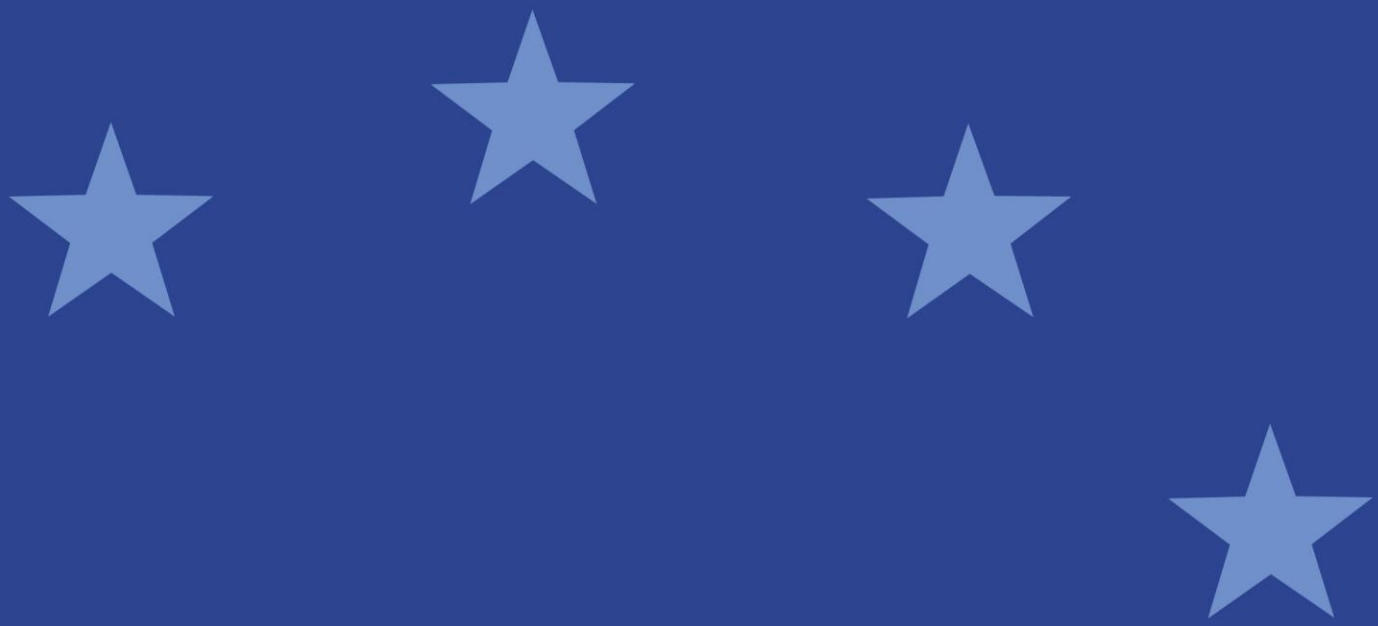
esma European Securities and Markets Authority

Final Report

Feedback statement on the consultation regarding the role of the proxy advisory industry



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I. Executive Summary

Reasons for publication

The European Securities and Markets Authority (ESMA) has conducted analysis and consultation with regard to the role of the proxy advisory industry as service providers to institutional investors who invest in European listed companies. In this document ESMA provides feedback as to the findings of this exercise and offers its views as to the steps it deems appropriate going forward. In March 2012, ESMA published its Discussion Paper on proxy advisors, seeking the input of stakeholders on several key issues relating to the proxy advisory industry, and asked whether market participants see any need for policy action in this area. ESMA has taken into account the market feedback to the consultation on the proxy advisory industry, as well as the other inputs such as contributions from the round table with stakeholders, the advice received from the ESMA Securities and Markets Stakeholder Group (SMSG) and views received through bilateral discussions with market participants.

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After analysis of the inputs received, ESMA concludes that it has not been provided with clear evidence of market failure in relation to how proxy advisors interact with investors and issuers. On this basis, ESMA currently considers that the introduction of binding measures would not be justified. However, based on its analysis and the inputs from market participants, ESMA considers that there are several areas, in particular relating to transparency and disclosure, where a coordinated effort of the proxy advisory industry would foster greater understanding and assurance among other stakeholders in terms of what these can rightfully expect from proxy advisors. Such understanding and assurance will help to keep attention focused where it belongs, namely on how investors and issuers can, from their respective roles foster effective stewardship and robust corporate governance, and ensure efficient markets. Consequently, ESMA considers that the appropriate approach to be taken at this point in time is to encourage the proxy advisory industry to develop its own Code of Conduct.

In order to put in motion this process, ESMA has drafted a set of principles that offer guidance to those who will develop this Code of Conduct. In addition, ESMA has set out its expectations with regard to the governance of a Code of Conduct. While the principles are directed to the proxy advisory industry, ESMA recognises that proxy advisors do not operate in a vacuum. Consequently, the principles for proxy advisors should be considered in relation to the context in which proxy advisors operate, which entails an understanding of the role and responsibilities of other stakeholders, including those of (institutional) investors and issuers.

Next steps

ESMA shall review the development around the Code of Conduct by two years after the publication of this Final Report and may reconsider its position if no substantial progress has been made by that time.

II. Feedback statement

Background

1. In March 2012 ESMA published its Discussion Paper on proxy advisors[1] seeking the input of stakeholders on several key issues relating to the proxy advisory industry, and asked whether market participants see any need for policy action in this area.

2. The Discussion Paper followed a targeted fact-finding exercise among representatives of the relevant stakeholder groups (proxy advisors, institutional investors, and corporate issuers) which ESMA undertook in the summer of 2011. In addition to this fact-finding, ESMA held several bilateral discussions with market participants from all stakeholder groups, and analysed relevant academic literature and public policy studies. Members of the Consultative Working Group of ESMA's Corporate Finance Standing Committee (CFSC) have also provided input to this work. [2]

3. In its 2011 Green Paper on the European Corporate Governance Framework, the European Commission also addressed the issue of proxy advice. ESMA took note of the responses to the Green Paper, and incorporated these, where appropriate, in its analysis. In this regard, it is worth mentioning that the European Commission is expected to release a Communication or so-called Action plan by the end of 2013, which encompasses both company laws and corporate governance issues, so that proxy advisors could also be taken into consideration therein.

4. Separate consultative work streams on proxy advisors were also initiated outside Europe, i.e. in the United States[3] and in Canada[4], in order to investigate certain concerns raised by market participants (primarily issuers and their advisors) about the services provided by proxy advisory firms and their potential impact on financial markets and to determine if, and how, these concerns should be addressed by securities regulators.

5. The Discussion Paper received the consideration of the SMSG, which published its Opinion on 3 May 2012.[5] In the opinion of the SMSG:

    - the attention should be focused on the advice on how to exercise the voting rights attached to securities (advisory activity);

    - in light of the importance of the institutional and professional investment sector in the EU, and of the vast amount of funds they manage, and the central role played by proxy advisors, some degree of intervention seems appropriate to ensure that investors are assuming their

[1] "An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options", ref. ESMA/2012/212, http://www.esma.europa.eu/system/files/2012-212.pdf

[2] For the members of the Consultative Working Group see: http://www.esma.europa.eu/page/Corporate-Finance-SC

[3] The SEC has initiated a review of the US proxy system by publishing a Concept Release in July 2010, http://www.sec.gov/rules/concept/2010/34-62495.pdf. Proxy advisors are part of this review.

[4] http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120621_25-401_proxy-advisory-firms.htm

[5] The response of the SMSG can be found in Annex III. For members and status of the SMSG see: http://www.esma.europa.eu/SMSG

basic responsibilities when acting as shareholders;

- therefore, the SMSG considers that proxy advisors should be subject to regulation (i.e. a Code of Conduct for proxy advisors adopted in the form of ESMA guidelines under Art 16 of the ESMA Regulation) that ensures their integrity and the quality of their advice and this regulation should establish minimum standards applicable throughout the Union.

6. On 12 June 2012, ESMA held a round table (Round Table) with market participants in order to gain additional, significant input to the work. The participation was high with more than 25 institutions/companies from a broad array of backgrounds around the table, almost all of which also submitted a written contribution to the consultation. The outcome of the Round Table has also been duly considered when analysing and selecting the key issues for the way forward.

Results of the consultation

7. The consultation period of the Discussion Paper ended on 25 June 2012 and the number of submissions totalled 63 (including 57 non-confidential responses), which showed great interest in the topic and in the role of the proxy advisory industry.[6]

8. The majority of the responses originated from the investors' community (40% of the total). All the main proxy advisors operating throughout Europe (7) submitted a contribution. The participation from the issuers' community was also good (24% of the total). Overall, the feedback received has been of good quality. As expected the tenor of the responses differs between the respective stakeholder groups. Proxy advisors underline the specificities of the industry and the competitive pressure they have to cope with. With a few exceptions, they are rather negative on the justification of any kind of intervention and are worried that it would cause additional costs for running their operations. The investors' community seems relatively comfortable with the advice and/or recommendations given by proxy advisors. Stronger concerns, together with the request for some form of regulation, come from the issuers.

9. The Discussion Paper invited contributors to provide ESMA with their input on 12 questions, which ranged from the degree of influence of proxy advisors on investors' voting to the key issues related to the offer of their services, ending with the existence of a need for any policy action in this area (see the analysis of the responses to the questions in paragraphs 18-92).

10. After considering all the inputs ESMA determined its final policy position, which is described more in details in the paragraphs below.

11. The range of policy options that ESMA consulted on, consisted of four levels, namely:

    1. No EU-level action at this stage

    2. Encouraging Member States and/or industry to develop standards

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[6] See the list of public contributors in Annex II.

Furthermore, the responses can be viewed at http://www.esma.europa.eu/consultation/Consultation-DP-Overview-Proxy-Advisory-Industry-Considerations-Possible-Policy-Options#responses

3. Quasi-binding EU-level regulatory instruments

4. Binding EU-level legislative instruments

12. Among the four options proposed in the Discussion Paper, ESMA supports option 2, i.e. encouraging the industry to develop its own Code of Conduct. The rationale for this decision mainly relies on the feedback coming from the market. ESMA asked specifically whether stakeholders consider that there is market failure in relation to how proxy advisors interact with investors and issuers. The feedback did not provide any clear examples of such market failure.

13. On this basis, ESMA considers that the introduction of binding measures would not be justified. However, based on its analysis and the inputs from stakeholders, ESMA considers that there are several areas, in particular relating to transparency and disclosure, where a coordinated effort of the proxy advisory industry would foster greater understanding and assurance among other stakeholders in terms of what these can rightfully expect from proxy advisors.

14. Such understanding and assurance will help to keep attention focused where it belongs, namely on how investors and issuers, from their respective roles (in terms of fostering effective stewardship and robust corporate governance), can ensure efficient markets. Consequently, ESMA considers that the appropriate approach to be taken at this point in time is to encourage the proxy advisory industry to develop its own Code of Conduct.

15. ESMA has drafted a set of high-level principles (that can be found below) to address the key takeaways from the inputs received. Each principle is complemented by a rationale. The detailed analysis undertaken by the Securities and Markets Stakeholder Group may also serve as a useful input for the development of a Code of Conduct. Annex II contains the Group's analysis. The principles are meant to serve as guidance for the industry in the development of a Code of Conduct. The industry should not refrain from elaborating and improving on these principles in the drafting process of the code of conduct. In the course of that work, additional principles could also be integrated should the industry participants deem it appropriate.

16. While these principles are directed to the proxy advisory industry, ESMA recognises that proxy advisors do not operate in a vacuum. Consequently, the principles for proxy advisors should be considered in relation to the context in which proxy advisors operate, which entails an understanding of the role and responsibilities of other stakeholders, including those of institutional investors and issuers.

17. Thus, ESMA's aim is to convey the message that all the actors in the marketplace, from their relative perspectives, can contribute to a better functioning of the proxy advisory market, and by so doing, of the proxy voting chain as such.

Guidance for a proxy advisory industry Code of Conduct

GENERAL CONSIDERATIONS AND CONTEXT

18. In order to appropriately position any principles applying to the activities that proxy advisors undertake, ESMA considers that it is necessary to first discuss the context in which proxy advisors operate, so as to clearly distinguish the expectations for the proxy advisory industry from those for other parts of the investment and voting chain.

19. As a conceptual starting point, and in line with generally accepted standards of stewardship, ESMA considers that the responsibility for voting lies with the investor, and this responsibility should not be delegated to any party not bound by a fiduciary mandate in relation to the assets over which stewardship is exercised. Discharging this responsibility appropriately requires investors to: (1) consider the proposals which issuers raise in general meetings (this may involve a dialogue with the issuer); and (2) make informed decisions.

20. Within this framework, ESMA considers that 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.[7]

21. Investors can legitimately use external advice in order to make informed decisions, bearing in mind that proxy advisors cannot be held responsible for the way an investor uses their advice. 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 mechanistically relied upon. Consequently, investors should to the extent possible ensure that the voting decisions themselves, and the processes leading up to making those decisions, are appropriately carried out, whether fully by themselves, or with contributions from service providers such as, for instance, proxy advisors.

22. ESMA learned from the stakeholder consultation that the use investors make of proxy advice varies considerably and that the correlation between votes cast by investors and the advice provided by proxy advisors, and consequently, the related level of influence, cannot be easily interpreted. Consequently, a sufficient degree of transparency about the use of these services could be beneficial for a better understanding of the dynamics of the voting process and of how investors exercise their stewardship responsibilities. In this context, ESMA welcomes initiatives in this area which can be implemented in various ways.[8]

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[7] For ease of purpose, institutional investors are to be understood here, as appropriate, as either asset owners or asset managers, in recognition of the fact that the actual voting may be undertaken by asset managers. However, where an asset manager discharges a fiduciary mandate for an asset owner, his voting activities should be in line with the policies with regard to stewardship and voting as set out in the mandate, so as to ensure that the asset owner retains the ultimate responsibility for exercising, directly or indirectly, stewardship over his assets.

[8] As an example the UK Stewardship Code (September 2012) states in its Principle 6 that "Institutional investors should disclose the use made, if any, of proxy voting or other voting advisory services. They should describe the scope of such services, identify the providers and disclose the extent to which they follow, rely upon or use recommendations made by such services" (see http://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx)

23. Given their role in the chain and given the fact that the responsibility for stewardship should always lie with the investor, proxy advisors should, in principle, not be understood to be engaging with issuers on behalf of their clients (the investors) on general matters of stewardship.

24. Where issuers wish to discuss issues related to voting, engaging in direct dialogue with investors, and discussing the investors' voting policy with them, offers the most effective and preferred route. This approach is in line with generally accepted standards of good corporate governance, which recognise that there should be a dialogue between issuers and investors based on the mutual understanding of objectives. Consequently, issuers are expected, where appropriate, to discuss governance and strategy with institutional investors, and develop an appropriate understanding of the issues and concerns of these investors. In this context, the general meeting is to be understood as the formal forum where direct communication with investors takes place, and it is therefore key that investors are encouraged to participate in general meetings, i.e. through voting on the resolutions that the issuer has proposed.

25. Additional to the direct contacts between issuers and investors as outlined above, issuers and proxy advisors may choose to be in direct contact as well. ESMA considers that contacts between issuers and proxy advisors (where these exist by mutual consent) should be focused on helping the other to better understand the basis for their positions in the voting process (i.e. the considerations for the issuer to propose certain resolutions to the general meeting, and the considerations for the proxy advisor to come to a certain opinion with regard to these resolutions). Issuers may legitimately fact-check the opinions of proxy advisors as regards to their resolutions (where proxy advisors choose to be in dialogue with issuers on these matters). However, there should be no other expectations for the contacts between issuers and proxy advisors.

26. As service providers to institutional investors proxy advisors are one element in the voting chain. ESMA is aware that there are other elements in the voting chain that have an impact on the effectiveness with which institutional investors can discharge their ownership rights, amongst them custodians, sub-custodians, and other intermediaries and service providers who can affect the quality or the outcome of the voting process. ESMA recognises that in the voting chain proxy advisors can only directly influence those aspects relating to the services that they themselves offer. Shortcomings that have been identified in other parts of the voting chain, and of which ESMA has been made aware by respondents to its consultation, may either require action by institutional investors and issuers vis-à-vis the other service providers and intermediaries of which they make use, or may require coordinated legislative action on a European level.

27. In view of the considerations outlined above, and on the basis of the inputs received during the consultation process, ESMA has identified the following principles that are intended to offer guidance to the industry committee developing a Code of Conduct for the proxy advisory industry:

PRINCIPLES REGARDING THE PROXY ADVISORY INDUSTRY DERIVED FROM ESMA'S ANALYSIS

1. <u>Identifying, disclosing and managing conflicts of interest</u>

<u>Principle:</u> Proxy advisors should seek to avoid conflicts of interest with their clients. Where a conflict effectively or potentially arises the proxy advisor should adequately disclose this

conflict and the steps which it has taken to mitigate the conflict, in order that the client can make a properly informed assessment of the proxy advisor's advice.

Rationale: Considering their important role in the voting process, proxy advisors can, like many intermediaries, be subject to conflicts of interest. They should therefore identify, disclose and manage these conflicts to ensure the independence of their advice. ESMA learned from the market consultation that market participants are concerned regarding potential conflicts of interests, in particular about circumstances where: (i) the proxy advisor provides services both to the investor and to the issuer; and (ii) where the proxy advisor is owned by an institutional investor or by a listed company to whom, or about whom, the proxy advisor may be providing advice.

2. Fostering transparency to ensure the accuracy and reliability of the advice

Principle: Proxy advisors should provide investors with information on the process they have used in making their general and specific recommendations and any limitations or conditions to be taken into account on the advice provided so that investors can make appropriate use of the proxy advice.

Rationale: Proxy advisors may have systems and controls in place that guarantee proper and sound advice. These systems and controls may increase the reliability of the advice and enlarge accuracy. ESMA learned from the market consultation that the market would specifically favour greater transparency of these systems and controls, including, but not limited to (i) disclosure of general voting policies and methodologies, (ii) consideration of local market conditions and (iii) providing information on engagement with issuers.

2.i. Disclosing general voting policies and methodologies

Principle: Proxy advisors should, where appropriate in each context, disclose both publicly and to client investors the methodology and the nature of the specific information sources they use in making their voting recommendations, and how their voting policies and guidelines are applied to produce voting recommendations.

Rationale: To allow all stakeholders, especially investors and issuers, to better assess the accuracy and reliability of the proxy advisor's services, proxy advisors are expected to be transparent on their voting policy and on the main characteristics of the methodology they apply, which form the rationale of their recommendations. This is also in line with the overall message that ESMA received from the market consultation for greater transparency, where appropriate, by proxy advisors about their activities and processes.

2.ii. Considering local market conditions

Principle: Proxy advisors should be aware of the local market, legal and regulatory conditions to which issuers are subject, and disclose whether/how these conditions are taken into due account in the proxy advisor's advice.

Rationale: Proxy advice generally is a cross-border activity which requires the awareness of different laws, rules and regulations governing issuers' activities in each relevant jurisdiction. Therefore proxy advisors, as ESMA also learned from the market consultation, are expected to have a proper knowledge of the national and regional context, irrespective of whether proxy advisors choose to apply an international benchmark, or their client's own preferences/policies, in forming their opinion of individual meeting resolutions. Such knowledge of local/regional conditions is needed in order to develop an accurate voting policy, and, as a result, an appropriate advice.

2.iii. Providing information on engagement with issuers

Principle: *Proxy advisors should inform investors about their dialogue with issuers, and of the nature of that dialogue.*

Rationale: Proxy advisors can choose whether or not to have a dialogue with issuers. If they do choose to have such a dialogue, it is up to the proxy advisor what should be the timing, frequency, intensity and format for this dialogue. A proxy advisor should disclose to investors whether there is a dialogue between the proxy advisor and an issuer. Where such a dialogue takes place, it should inform investors about the nature of the dialogue, which may also include informing his clients of the outcome of that dialogue. ESMA learned from the market consultation that some proxy advisors do not conduct dialogue with issuers. When there is dialogue, the nature and degree of that dialogue differs significantly among proxy advisors, as well as the level of transparency on the fact that dialogue is taking place.

ESMA's expectations with regard to the operation of the Code of Conduct

Review clause

28. ESMA shall review the development of the Code of Conduct by two years after the publication of this Final Report. In order for ESMA to be able to conduct this review, the industry committee should provide ESMA with all relevant materials needed for such an assessment. If for any reason the application of the Code of Conduct has not contributed to satisfactorily addressing the objectives underlying the principles by the time of this review, or if subsequent market developments cause concerns that a Code of Conduct cannot adequately address, ESMA may reconsider its current policy position and may proceed with more formal measures. ESMA will communicate the findings of its review to the European Commission.

Governance expectations

29. In order to ensure a robust process in developing, maintaining, and updating the Code of Conduct, which takes due account of the legitimate views and interests of all relevant stakeholders, the industry committee (Committee) which would draft the Code of Conduct is expected to take into consideration and distinctly address the following key governance parameters:

- The Committee should adopt all necessary measures (including those relating to governance, membership, and decision making) that ensure that it can appropriately carry out its work. The Committee is expected to be transparent about its composition and status, including the selection of its Chair, who should be independent and possess relevant skills and experience. While it is expected that the Committee will contain a broad representation of proxy advisors, independent members or members representing other stakeholder groups could also be part of the Committee, if desired.

- While ESMA would expect to be periodically updated on the progress of the work relating to the development and operation of the Code of Conduct, it should be understood that the Committee will be working independently from ESMA, and assumes full responsibility for the outcome of its work. During the elaboration phase of the Code of Conduct, ESMA may engage with the Committee to discuss the further development of the Code of Conduct and the progress achieved.

- The Committee is expected to develop a Code of Conduct that sets clear expectations (in terms of principles, guidance, and examples of good practices) and that is workable (from an operational point of view) for those who subscribe to it (which may imply a comply or explain approach, provided that the given explanation is sufficiently precise, specific and comprehensive).

- The principles contained in this report offer guidance for the detailed elaboration of the Code of Conduct. In addition, the industry may also consider additional or alternative elements that it deems appropriate to ensure that the objectives for the Code of Conduct are met.

- The Code of Conduct should adequately address the needs and concerns of all relevant stakeholders (including proxy advisors themselves, institutional investors, and issuers). To this end, the Committee is expected to carry out a robust and public consultation of stakeholders in developing or reviewing the Code of Conduct.

- The Committee is expected to implement an appropriate and periodic monitoring process to evaluate the effectiveness of the Code of Conduct, and it is expected to publicly communicate the parameters by which the effectiveness of the Code will be assessed. The results of this monitoring process should be made public. Where these results, or new market developments, necessitate changes to the Code of Conduct, these should be appropriately implemented, subject to a process of robust and public consultation.

Responses to the individual questions in the Discussion Paper

- **Q1: how do you explain the high correlation between proxy advice and voting outcomes?**

30. Most respondents acknowledged there is a high correlation between voting outcomes and proxy advices, although high correlation differs from causality since voting outcomes might be linked to external factors. From a general point of view, high correlation exists but is normal, sound and not surprising, considering, among others, the following:

    - normal and well-functioning advisor-client relationship (otherwise proxy advisors would lose business);
    - use of automated voting;
    - common cultural approach, a rising stewardship trend and a similar conception of best governance practices shared by investors and proxy advisors;
    - numerous standardised resolutions and routine, non-contentious items;
    - only three possible alternatives when voting proposals and in practice only a binomial vote (for/against);
    - causality is difficult to establish since investors are not likely to admit blindly relying on proxy advisors.

31. In some cases high correlation might not be as obvious as it seems. According to the responses received, notably from investors and other stakeholders, this positive relation would tend to be less strong when e.g. the resolution is more controversial, when investors hold a large stake, when domestic shareholding concentration is high, when the relative value of the stake in the portfolio is high, or when the investee company is domestic.

32. **In brief:** The general feeling is that there exists a high correlation between proxy advice and voting outcomes, though it is questionable whether this correlation is caused only by the proxy advice.

ESMA's view

33. ESMA believes that the quality of the advice should prevail rather than to judge on the correlation per se. In any case, the collection of more evidence on the actual use of proxy advisors by institutional investors may be useful to answer this question. Therefore, as set out in paragraph 22, ESMA considers it useful for institutional investors to disclose their use of proxy advice.

- **Q2: to what extent a) do you consider that proxy advisors have a significant influence on voting outcomes? b) would you consider this influence as appropriate?**

34. Almost half of the respondents consider that proxy advisors, beyond the correlation stated above, have a more or less significant influence on investors' behaviour and votes, although some contributors highlighted that there is no empirical or statistical evidence on the influence. Most respondents consider that the potential influence of proxy advisors is not disproportionate or undue per se, and that their level of influence will mostly depend on how investors use them. In this regard, this influence might even be acceptable and/or beneficial to others provided that e.g. it reflects corporate governance best practices and increases the number of investors who actually vote.

35. Some respondents listed several facts that can explain the actual influence of proxy advisors, if any. Examples are the impact of US advisory firms and governance practices in Europe, a rising trend to delegate stewardship responsibilities, a lack of resources for investors (especially when they are smaller and less sophisticated), the importance of the items in the agenda, the contractual relation between proxy advisors and clients, the structure of the portfolios and the use of voting platform.

36. Some members of the issuers' community expressed concern and considered that proxy advisors' influence is not appropriate to some extent. Issuers think this may be due to e.g. proxy advisors not having the competence to deal with various jurisdictions and industries appropriately, lack of clarity about the methodology and lack of accuracy/accountability, use of black-box and tick-box approaches, oligopolistic business and some questionable practices (such as the "quick vote" option).

37. **In brief:** There is a perception of some degree of influence of proxy advice on voting outcomes, although clear evidence is rarely available and therefore any judgement on the inappropriateness of this influence is premature.

ESMA's view

38. In ESMA's opinion, any approach taken should consider that the ultimate decision and the voting responsibility are on the investors' side. As set out in ESMA's general considerations this responsibility should not be delegated.

- **Q3: to what extent can the use of proxy advisors induce a risk of shifting the investor responsibility and weakening the owner's prerogatives?**

39. A slight majority of investors admits that under certain circumstances there might be an increased risk of shifting the investor responsibility and weakening the owner's prerogatives, although the views are quite cautious and the risk is not self-addressed but rather referred to other investors. Nine of the investors do not see risk of shifting the investor responsibility and weakening the owner's prerogatives: proxy advisors are seen only as information providers, investors engage directly with investee companies. Only two investors admit openly that there is an increased risk.

40. A majority of proxy advisors does not see a risk of shifting the investor responsibility and weakening the owner's prerogatives; for the others it could be a risk either when the control over guidelines is with the proxy advisor or when investors (especially those without strong views) do not vote actively

and the control of the actual decision making process is left to proxy advisors.

41. The vast majority of issuers share the view that there is a risk of shifting the investor responsibility and weakening the owner's prerogatives, either by responding straightforward by answering "yes" or by responding "yes under certain circumstances" or by outsourcing without sufficient controls or insufficient accountability for proxy advisors. The use of voting platforms pre-filled in accordance with a particular proxy advisor's recommendations undermines the investor's ability to make their own decisions.

42. With regard to the group of 'other respondents', some see a risk of shifting the investor responsibility and weakening the owner's prerogatives e.g. due to the lack of resources at the level of investors or because of the difference between EU legislation (Directive 2010/43/EU) and legislation in other parts of the world. Some other respondents in this group do not see such a risk.

43. **In brief:** There is a potential concern that an increased use of proxy advices can lead to a higher risk of shifting the investor responsibility, especially for particular groups of investors (e.g. smaller ones) and for specific voting mechanisms (e.g. through a pre-filled voting platform).

ESMA's view

44. Also bearing in mind that proxy advisors cannot be held responsible for how the investor uses their advice, it is important that any approach taken affirms the investors' stewardship responsibilities.

- **Q4: to what extent do you consider proxy advisors a) to be subject to conflicts of interest; b) have in place appropriate conflict mitigation measures in practice? c) to be sufficiently transparent regarding conflicts of interest they face?**

45. The vast majority of contributors provided an answer on section 5, conflicts of interest, either directly (i) by answering the questions directly, (ii) answering some of the (sub-) questions or (iii) by providing a general response to all of the questions.

46. A great majority sees potential conflicts of interest, in particular on the following issues (in order of the number of mentions):

a) Providing at the same time services to the client (investor) and to the company (issuer), which is the case if the proxy advisor provides voting recommendations to the investor and corporate governance services to the issuer.
b) Ownership issues when: (i) the proxy advisors' parent is a listed company (=issuer) or (ii) the proxy advisors' parent is an institutional investor.
c) General reference to conflict of interests: many respondents referred to potential conflicts of interest in a general way ("any conflicts of interest should be disclosed").
d) Other examples: We noted other examples which the respondents claimed to be conflict of interests issues, highlighting the following examples:
    i. conflicts of interest when the proxy advisor enters into a dialogue with the issuer;
    ii. commercial or personal relationship with the issuer or the issuer's major shareholder;
    iii. promotion of in-house recommendations;
    iv. the proxy advisor can offer for the same issuer different vote recommendations to

various clients. Long term investors have other objects than short term investors.

47. Some respondents highlighted the mitigation measures in place for dealing with these kinds of conflicts. A majority of the respondents welcomes more transparency and disclosure regarding any potential conflicts of interest, while none of the respondents provided factual cases or examples of market failures.

48. Specifically speaking, most investors recognized potential conflicts of interest, but also the mitigation measures of the proxy advisors which are in place and which have improved. The vast majority of investors welcome further transparency, preferably by industry solutions.

49. The majority of proxy advisors conceded that proxy advisors are subject to certain potential conflicts of interests. Other proxy advisors confirmed expressly that they have no (paid) corporate governance consultancy services or that their consultancy services are only a side business with no significant contribution to the overall business. Some of the proxy advisors claimed that they already have mitigation measures in place (e.g. Chinese walls) and already disclose their conflicts of interest policy.

50. Issuers see the conflicts of interest issue more diversely, ranging from the discouragement of the consulting service business regulated by strict rules to more moderate opinions where there are doubts that the potential conflicts are serious enough to have de facto influence on the preparation of the voting recommendations. A strong majority is for enhanced transparency and disclosure. The majority does not see enough mitigation measures of the proxy advisors or is unaware that mitigation measures of the proxy advisor exist (although many proxy advisors publish relevant information on the website). Although encouraged none of the issuers provided factual cases or examples of market failures.

51. Many of the other respondents just provided a general answer or no answer on question 4 and 5. In general they welcome as well more disclosure and transparency.

52. **In brief:** The consultation brought to our attention that market participants see some (potential) conflicts of interest - although no clear evidence of market failure stemming from this has been brought to ESMA's attention during the consultation.

ESMA's view

53. Further noting that some proxy advisors already provide comprehensive information on their conflicts of interest mitigation, more transparency/disclosure on the conflicts and the mitigation measures of all proxy advisors and/or the promotion of better communication thereof could suffice to deal with conflicts of interest in general. Consequently, ESMA has developed key principle 2 for this issue to provide guidance to the market. Additionally, in operational terms, proxy advisors may consider the following:

- To define and apply appropriate measures to identify potential, and manage actual, conflicts involving the firm, its executive management or supervisory board members, and/or its analysts/staff.

- Proxy advisors may prominently, and in an easily accessible way, disclose to their clients (investors and, where applicable, issuers) how they mitigate general and specific conflicts of

interest and may inform their clients about any actual conflict of interest.

- Proxy advisors may publicly and prominently disclose, in an easily accessible way, how they mitigate these conflicts of interest, supported by illustrative examples.

➢ **Q5: if you consider there are conflicts of interest within proxy advisors which have not been appropriately mitigated a) Which conflicts are the most important b) Do you consider that these conflict lead to impaired advice?**

54. The consulting services issue is seen as the most important potential conflicts of interest. Further, repetition of the statements under question 4 or cross-references to the respective question 4 or 5 have been made. The response relating whether these conflicts lead to impaired advice could be summarized as follows:

- overall no evidence or practical examples of impaired advice;

- perception by some respondents that the consulting services conflicts of interest potentially impair the advice;

- many respondents did not provide a view on this issue, but instead only to question 4.

55. **In brief:** See Q4.

➢ **Q6: To what extent and how do you consider that there could be improvement**

a) for taking into account local market conditions in voting policies?

56. Most investors recognised that the legal framework and local practices should be always taken into account. In the opinion of several respondents, proxy advisors are doing so either when drafting their policies and guidelines or when providing their advice to clients, but it has been also recognised that there is still room for improvement , for example, with more transparency and detailed information by issuers and more dialogue. Several respondents say that local practices and culture can never justify proposals on the agenda that if approved may result in weak governance structures.

57. From their point of view, proxy advisors all declare to take into consideration the different local legal regimes and practices. But they also say that local market conditions are not always best practice, so they apply a kind of international benchmark with some exceptions.

58. Although some issuers recognise that there has been an improvement in recent years, there is a strong feeling that proxy advisors do not take into account local legal framework and practices (one says they apply an Anglo-Saxon approach, others say that they apply a kind of standard international policy), that they do not devote enough resources and that there is a lack of specific knowledge. Several respondents expressed the view that proxy advice is a kind of box ticking exercise. Ways of improvement could, for example, be the publication of proxy advisors' local guidelines and policies or more dialogue with issuers.

59. Among the other respondents, though, it is generally recognised that local conditions should be taken into account. There is no common view about proxy advisor practices. Some say they devote

resources and have local experts, others say that they do not. Several respondents say that proxy advisors should focus much more on the explanations given by issuers in their annual "comply or explain report". They feel the focus is only on the comply part.

b) on dialogue between proxy advisors and third parties (issuers and investors) on the development of the voting policies and guidelines?

60. Investors generally recognised that dialogue between proxy advisor and investors is needed and welcome. The dialogue with investors must be orientated on the development of their voting policies and voting guidelines, while the dialogue with the issuers should be more transparent and with a limited role to play in the development or refinement of a proxy advisor's guidelines so they do not influence a proxy advisor's recommendation.

61. All proxy advisors recognise that they have dialogue with their clients (investors) and this is very important for them in the development of voting policies and guidelines. One of them only does it at the end of the process providing for a period of comment from clients before final publication. Three proxy advisors hold dialogue with issuers during the formulation of their proxy voting policies. Two proxy advisors think that there would be a conflict of interest or that their judgement would be impaired if they held discussion with issuers about voting guidelines. One proxy advisor provides opportunities for issuers to participate in formal briefings/seminars as well as independently organised conferences where voting guidelines are presented and debated openly.

62. Most of the issuers support proxy advisors entering into dialogue with issuers. Some of them recognise that they have dialogue with proxy advisors, but they complain in a more general way that too often proxy advisors refuse to engage with companies (these dialogues are after the companies' annual general meeting instead of being before or at other times during the year). Also, some issuers would like greater transparency on the voting guidelines so they: may consider adjusting their annual general meeting proposals accordingly; or know in advance that they have to undertake more efforts to convince their shareholders of the issuer's view.

63. Most of the other responses identify dialogue with third parties as something that is needed and that can be improved. Some respondents demand a greater level of transparency in the process and that the methodologies and voting policies could be made available or published by the proxy advisors. Others notice that the proxy advisor must be independent and that companies should not influence the advisor's judgements.

64. **In brief:** It is generally recognised by the respondents to the consultation that proxy advisors should take local market conditions into account in voting policies. There could be a better explanation when these conditions are not best practice and when proxy advisors prefer to apply a kind of international benchmark. Dialogue between proxy advisors and third parties is seen as something that is needed, but there is no consensus among the responses to the consultation about the degree, the frequency and the intensity of it, also bearing in mind the actual functioning of the voting chain.

ESMA's view

65. ESMA developed key principle 2.ii and 2.iii for these issues to provide guidance to proxy advisors on how to deal with engagement with issuers and local market conditions. ESMA's views on these issues are elaborated further under question 7.

- **Q7: to what extent do you consider that there could be improvement, also as regards to transparency, in:**

  a) the methodology applied by proxy advisors to provide reliable and independent voting recommendations?

66. A number of the investors did not answer the question directly and made no comments in respect of their views on improving transparency. Of the investor respondents that did directly answer the question, the majority were of the opinion that transparency in this area was either necessary or could be improved, for example, by: disclosure of the information sources used to put together the voting recommendation; and making the methodology transparent to potential clients as well as current clients through an annual review by proxy advisors of its research techniques – clients could receive the results of this audit upon request. A significant minority of investors were not in favour of increasing transparency in this area either because they thought the current levels of transparency were already sufficient or because they were of the opinion that too much transparency in this area could lead to negative effects.

67. One proxy advisor expressed a view in favour of increased transparency on the basis that a standardised corporate governance questionnaire or form, such as was reported to be used in Italy or Spain, would focus the analysis on hard facts and provide less room for interpretation. The other proxy advisors' were either against greater transparency or expressed no clear opinion on increased transparency. The responses against more transparency included a concern that the AMF Recommendation of 2011 had put full-time proxy advisors at a disadvantage compared to private legal advisors or non-European proxy advisors. Another concern was that technology should not be subject to transparency because it would allow imitation. Furthermore, some of the information about methodology is proprietary and it may be inappropriate for firms to have to share it. Also, firms had already taken steps to improve transparency in response to the needs of their investor clients and this has included making information available on corporate websites. Another point that was made was that if further transparency was important, investors would require it, as it is a commercial, client-led issue.

68. Most issuers saw room for increased transparency. They suggested that voting policies should be clear and should be available to issuers sufficiently ahead of the meeting to allow issuers to be in a position to "fine-tune" their resolutions. They also commented that: non-customised voting policies should be made public; that accuracy by proxy advisors is vital; and that proxy advisors' methodologies needed to be explained.

69. Views from other respondents were generally supportive of transparency. There was a variety of views. There was the view that there should be increased communication between proxy advisors and investors to ensure votes reflect investor's intentions rather than a formulaic approach. Also, while transparency is important, the focus should not be moved away from investors' stewardship responsibilities and their transparency in their own use of proxy advisors. Similarly, asset managers should disclose how they exercise the voting rights of the asset owner. Many respondents also referred to some sort of code or guidance that would encourage proxy advisors to disclose on a comply-or-explain basis how they approach their decisions.

  b) the dialogue with issuers when drafting voting recommendations?

70. A number of the investors did not answer the question directly and made no comments regarding

their view on improving transparency. Of the respondents that did directly answer the question, the majority were of the opinion that transparency in this area was necessary or could be improved. There was a consensus amongst these respondents that the nature and extent of the dialogue with issuers should be fully disclosed (though a minority of investors did consider that dialogue with issuers should not take place due to the conflicts of interest involved). Several respondents were of the opinion that issuers should only be consulted on voting recommendations in respect to factual inaccuracies and that issuers should not be allowed to influence voting recommendations.

71. Proxy advisors expressed views against, or gave no clear opinion on, increased transparency. Among the comments reported, proxy advisors mentioned that issuer engagement takes place across the year as well as during the meeting research process. Also, on-going dialogue with issuers could be useful but should not be a priority for regulation. Issuer engagement creates potential conflict and risks independence of advice, and a proxy advisor's first duty lies with the investors. Most issuers see room for increased transparency for the following reasons: dialogues with issuers would be helpful and help issuers understand the negative voting; dialogue should take place on negative voting and should be mandatory when advice is not published; and it was helpful for issuers to be able to respond directly to proxy advisors, for example on incorrect facts.

72. Most of the other respondents did not respond to this question. Only two considered there could be improved transparency in this area on the basis that this would help provide them with more of the context of the issuer's business strategy and an understanding of the basis of the recommendations. Caution was expressed at the possibility of systematically providing research results to issuers as this could undermine proxy advisor independence.

c) the standards of skill and experience among proxy advisor's staff?

73. All investors who replied to this part of the question recognised the importance of proxy advisor staff having the appropriate skills to carry out their role. However, there was no consensus regarding the benefit of increasing transparency in this area. It was the opinion of a significant portion of the respondents that the competence of proxy advisor staff was a commercial matter that could be solved through competition – if the clients were unhappy with the quality of research, they could look for services elsewhere. A slightly larger number of respondents welcomed disclosure on the background as well as on the on-going internal training provided to proxy advisor analysts.

74. Proxy advisors were generally not in favour of or did not express a particularly clear view on improved transparency on methodology. Among the comments reported, proxy advisors mentioned that: investors are generally satisfied with the work of proxy advisors, reflecting that staff skills and experience are not insufficient; biographies of management and senior staff are already available on websites; staff members generally have degrees in law, business and finance, have broad ranges of experience, and speak many languages; temporary staff are at least graduate, or post-graduate level, receive training, and their work is subject to review by experienced analysts; and while quality staff is essential, it has not been proven that research quality is poor or dangerous to customers.

75. Most issuers acknowledge the importance of increased transparency because of, for example, the complexity of the role played by proxy advisors which should hire sufficiently qualified staff (and as with lawyers and auditors, proxy advisors should justify their skills). Also, disclosure should include the number of analysts in each market and their qualifications. Some other issuers were against or did not give a clear opinion on increased transparency. Their views were that this is a commercial matter which should not be interfered with; that it is important for proxy advisors to have

experienced staff, but the way to test this is through engaging with issuers on the proxy reports; and that it should not be a regulatory concern.

76. Other respondents did not respond to this question or provided no clear view.

77. **In brief:** Although a significant minority of respondents did not see room for a required intervention, there is support for either a need or at least the potential for increased transparency on the methodologies used by proxy advisors (at least with respect to their clients) and, with less emphasis, on the dialogue between issuers and proxy advisors. The quality of the staff is seen more as a commercial matter.

ESMA's view

78. In order to provide some further guidance to the market, ESMA has developed principle 2 and sub-principles 2.i, 2.ii, and 2.iii to address the items raised in Q6 and Q7. Additionally, in operational terms, proxy advisors may consider the following:

<u>With regard to disclosing general voting policies and methodologies (2.i):</u>

- Proxy advisors may publish their general voting policy on their website, including partial or complete updates and an annual consolidated version of the policy.

- Without compromising confidentiality and privacy and considering the legitimate interest of proxy advisors to protect their intellectual property, proxy advisors may make available to their clients and other parties, on a selective basis, a set of information needed for a proper understanding of their methodologies and assumptions so as to better identify how proxy advisors developed their recommendations.

<u>With regard to considering local market conditions (2.ii):</u>

- Proxy advisors should take local/regional market conditions into due account in the development of their voting policies (in particular, good practices set out in national codes as well as the national and regional legislative and regulatory framework, including new developments to that framework) and disclose in which way these local/regional market conditions have been considered and weighted.

- In cases where proxy advisors choose to deviate from local practice as a basis for forming their opinion on an individual meeting resolution (e.g. because a local practice is considered not to be in line with internationally accepted principles of good corporate governance, or because the practice is not in line with client preferences or policies), this should be adequately disclosed and explained.

<u>With regard to providing information on engagement with issuers (2.iii):</u>

- Proxy advisors may wish to have a dialogue with issuers, inter alia in order to better understand the resolutions presented at the General Meetings, to encourage issuers to improve their governance practices, and to avoid factual errors in the reports proxy advisors deliver to investors.

- Proxy advisors may publicly state their policy and procedures regarding dialogue and engagement with issuers, including how issuers can bring factual errors to the proxy

advisors' attention.

- When a draft report is submitted to an issuer before publication, the proxy advisor may grant him a reasonable period for feedback and correction of any factual error found in the report, taking into due account the proxy advisor's contractual obligations to its clients and the deadlines it has to meet.

- **Q8: which policy option do you support, if any? Please explain your choice and your preferred way of pursuing a particular approach within that option, if any.**

- **Q9: which other approaches do you deem useful to consider as an alternative to the presented policy options? Please explain your suggestion.**

	Preferred policy option			
Type	*1* *(No action at EU-level at this stage)*	*2* *(Encouraging at EU level Member States and/or industry to develop standards)*	*3* *(Quasi-binding EU-level regulatory instruments)*	*4* *(Binding EU-level legislative instruments)*
Issuers	0	8	7	1
Investors	12	9	6	2
Proxy advisors	5	1	1	0
Others	0	12	2	1
Total	17	30	16	4

Please note that the table simply adds up the single responses to the consultation, regardless of any further qualitative analysis of other features (i.e. country of origin, nature of the respondents – trade associations vs. individual respondents, and so on). Please also consider that some respondents supported more than one options and this is reflected in the above table (57 respondents to question 8 vs. 67 preferences in total)

79. Some respondents mention a need for further investigation into the significance of the role played by proxy advisors and whether there is currently market failure (i.e. non-EU level action at this stage). Looking at the reactions of the four categories (issuers, investors, proxy advisors and others), there is coherence in the subjects they would like to have addressed, but also in the notion that competition within the industry should not be distorted, that there should be no rise in the barriers to entry and concerns on the increasing costs for voting procedures.

80. Many respondents preferring policy option 2 or 3 would like to see some form of an industry code based on the "comply or explain" principle. Respondents are roughly equally divided between preferring such a code to be developed by the industry itself or on a European level by institutions.

81. Within the responses on other approaches (question 9), some see an idea in indirect standards for proxy advisors through institutional investors, improvements in the (cross border) voting chain with its intermediaries, action by investors to give feedback on their proxy advisor voting guidelines. Some comments refer to the need for investors to be transparent on the use of proxy advisory services.

82. Among the investors who replied to the questions, around 40% of them indicate no EU-level action should be taken at this moment. The points raised were:

- some reactions mention a lack of objective evidence that warrant regulation;
- there is a concern that this concentrated market will get even more so when regulation adds entry barriers or influences competition;
- several investors see other market problems such as obstacles to voting (share blocking) that still exist and insufficiently effective cross-border voting mechanisms as more important;
- when regulation does get developed, independence (conflicts of interest), transparency, accuracy (quality of advice), and competence should be looked at.

83. The general view coming from the proxy advisor industry is that no regulation is warranted at the moment as no evidence of market failure is provided. However, if more evidence becomes available that indicates that the significance of proxy advisors is large and their practices prove harmful to the efficient workings of the financial markets, policy option 2 (using an industry led approach and a comply-or-explain framework) receives preference. This is supported with the following main arguments:

- it is a developing industry which needs flexibility; standards are easier amended than laws;
- creating industry standards provides sufficient transparency;
- proxy advisors are already held to high levels of accountability by their clients.

84. Issuers have responded with a total of 16 policy preferences. As seen in the table, their opinions are 50/50 between the options of industry/member state standards and the EU-level regulatory instruments. Issuers that argue the latter acknowledge the cross-border operations of proxy advisors and thereby mainly aim to prevent separate cross-country sets of rules. Those in favour of a code acknowledge the need for flexibility in this developing business. The main issues put forth are:

- a focus should lie on transparency of procedures, minimization of conflicts of interest and full disclosure of methodology, voting policies, and guidelines;
- independent of the policy option chosen, a comply or explain feature should be inserted;
- barriers to entry or reduced competition should be prevented, as well as a disadvantage of European proxy advisors compared to US proxy advisors.

85. Responses given by issuers state that the focus should be on transparency on the proxy services such as platforms, the voting process, and the number of intermediaries. There is a remark on the impact of the various proposals on investor behaviour.

86. The majority of respondents which are categorized as 'others' indicated a preference for policy option 2. The topics mentioned are largely consistent with those of the issuers:

- the development of a code of conduct should be driven by the EU or ESMA to prevent a conflict of interest and give more pressure to it;

- proxy advisors should be transparent about their processes, the analytical methods used, and conflicts of interest (principal-agent problems);

- independent of the policy option chosen, a comply or explain feature should be inserted;

- the market is already concentrated, so barriers to entry should be prevented;

- the advice of proxy advisors does not weaken the fiduciary responsibility of investors.

87. **In brief:** While the introduction of any binding measures had very little support from the ESMA Discussion Paper respondents, there were arguments for all the other options, with a relative majority of responses expressing preference for option 2 (45% of answers), being a code of conduct. Independently from the classification used for the different options suggested, there was some form of support for the implementation and the introduction of a code (either self-developed by the industry or developed at EU-level by ESMA/European Commission) based on a comply or explain approach in order to address the main key issues associated with the industry. Furthermore, competition within the industry should not be distorted by regulatory actions and disproportionate administrative burdens should be avoided. The key issues to be taken into consideration for a code are accuracy, independence and reliability of the advice. Lastly, it should be kept in mind that investors stay responsible. The advice of proxy advisors does not weaken the fiduciary responsibility of those investors.

ESMA's view

88. ESMA has decided not to come up with formal guidelines on the proxy advisory industry. Instead, it provides key principles to stakeholders on voting issues that could be taken into account. Based on these key principles, a pan-European industry code of conduct would enhance the transparency in this area and would provide the necessary improvements, including investors making an assessment of the methodologies used by proxy advisors and the advice that they provide. Nonetheless, ESMA has introduced a review clause in order to highlight that some formal measures could be required if the industry is unable to regulate itself within a reasonable framework. Lastly, we refer here as well to the remarks on improvements in the (cross border) voting and the voting chain as a whole. This topic was not part of the Discussion Paper but is deemed relevant in broader discussions concerning the functioning of the voting chain.

- **Q10: if you support EU-level intervention, which key issues, both from section IV and V, but also other issues not reflected upon in this paper, should be covered? Please explain your answer.**

89. Needless to say that only respondents choosing policy option 2, 3 or 4 have answered this question. The issues most frequently mentioned are:

- quality of advice with accurate, complete and precise information;

- quality of research in combination with an adequate number of employees;

- transparency on conflicts of interest and how to deal with them (mitigation);
- dialogue/engagement with issuers including review possibilities;
- transparency of the process and decision-making to ensure reliability and independence;
- clarity on the development of voting policies and methodology.

90. Again, respondents refer to the comply or explain principle for issues that should be tackled if action will be undertaken. This principle is needed to build in some flexibility when it is not possible to comply.

91. Some respondents from the investors' side refer to a ban on the provision of both consulting services to the issuer and giving an investor proxy advice on the same issuer. Another investor sees fostering of competition as a key point.

92. As most proxy advisors do not support any policy action, there is only little response on this question. One proxy advisor refers as well to a ban or clear disclosure on the provision of both consulting services to the issuer and investor proxy advice on the same issuer.

93. Many issuers point specifically at giving issuers the possibility to review the proxy advisor's recommendations, to be able to have contact with the proxy advisor, and to have escalation procedures for issuers in case of disagreement with the proxy advisor. Some even go further and state a need to request the view of an issuer and insert this into the recommendation. Issuers also refer to the publication of the voting policy in due time and that proxy advisors should be obliged to take into account local market conditions. Some form of quality standard that a proxy advisor should meet is seen as helpful.

94. A few other respondents also point to dialogue with issuers and being able to review an advice beforehand. Transparency on the revenue stream of proxy advisors is another suggestion, placed on the proxy advisor's website together with information on the voting policy and potential conflicts of interest. There is a warning on the excessive standardization of proxy advisor analysis.

95. **In brief:** See Q8 and Q9.

- **Q11: what would be the potential impact of policy intervention on proxy advisors, for example, as regards: a) barriers to entry and competition; b) inducing a risk of shifting the investor responsibility and weakening the owner's prerogatives; and/or c) any other areas? Please explain your answer on: (i) EU-level; (ii) national level.**

96. Half of the respondents either did not answer this question or gave answers that were not conclusive (e.g. respondent hopes for solutions that will increase transparency and quality and not increase entry barriers; "comply or explain" ensures that quality is at an appropriate level, may increase transparency but also hinder competition; respondent not able to assess not knowing specific ESMA proposal; regulation at this stage is premature).

97. A slight majority of the other respondents supported the idea of intervention (policy option 2, 3 or 4). Their arguments were as follows:

- Investors pointed out that thanks to the intervention, transparency (also conflict of interest management) and quality will be improved;

- Issuers hope for their engagement to be increased and for the transparency to be higher thanks to the regulatory intervention;

- Others pointed out that increased transparency and proper management of conflicts of interest will be the results of the ESMA work.

98. The rest of the respondents voiced their negative opinion on the possible influence of the intervention. Investors focused on barriers to entry and increased costs, but also pointed out that due to increased concentration competition may be weaker. A possibility of weakened stewardship standards was also mentioned. Issuers mentioned higher barriers to entry, concentration, higher costs, and weaker stewardship standards. From the proxy advisors perspective, barriers to entry (competition) and competitiveness of the EU market compared to the US one were two main points mentioned.

99. **In brief:** It is worth underlining that the feedback received was quite balanced between contributors giving examples of positive and negative impacts of intervention in this market. The overall impression, however, was that a well-constructed and thoroughly consulted code would be welcome.

ESMA's view

100. Taking into account all of the comments, ESMA is aware of both positive and negative consequences of policy intervention. Therefore in all its actions ESMA will aim at recognising and addressing inadequate and adverse influence of a possible code.

- **Q12: do you have any other comments that we should take into account for the purposes of this Discussion Paper?**

101. Some respondents indicated that appropriate measures to improve functioning of the chain of intermediaries (voting chain) should be implemented. Investors claim that due to many intermediaries in the process they are not able to verify whether their vote was cast properly, or even cast. There is no appropriate control mechanism in place. As a result, a solution on how to improve the reliability of the process, i.e. how to make sure the vote will be cast according to investors' instruction, would be welcome/required.

102. A couple of contributors indicated that there was no market failure so far, and any measures should be introduced after such a failure is observed.

103. Other topics that were mentioned and are relevant:

- New solution should be aimed at promoting long term investments;

- Proxy advisors should be shielded from any external pressure;

- New regime should not impose any additional costs on investors;

- Definition of a proxy advisor should be created;
- The Transparency Directive (2004/109/EC) should cover certain aspects of proxy advisors' functioning;
- Investors should be transparent whether they use proxy advisor services or not;
- A European regime should not be stricter than the rules introduced in the US.

ESMA's view

104. Based on the answers received, ESMA recognises that the proper functioning of the voting chain is a key concern to market participants. This was mentioned multiple times by respondents. ESMA acknowledges the importance of this issue. However, as ESMA does not have the mandate to address this issue directly at the current time, ESMA can only play an informal role in this regard.

III. Conclusions

105. The consultation on the proxy advisory industry and the other inputs taken into account throughout the analysis conducted by ESMA shed light on the role played by the proxy advisors in Europe. ESMA learned that the proxy advisory industry in Europe is growing in importance and this fact has led several stakeholders and regulators to devote their attention to this phenomenon in order to better identify the key issues related to the industry and, if needed, the possible responses in terms of policy action.

106. From the analysis of the inputs received, ESMA recognises that there does not appear to exist, at this moment in time, a clear market failure related to the activities of this industry where they relate to the investment chain between investors and issuers, and, therefore, no binding measures are considered necessary at this stage.

107. At the same time, ESMA also learned that a degree of acknowledgement of the presence and principles of this industry would be welcome. In fact, a significant number of market participants have indicated that they would like to see some form of encouragement at European level for the development of a code of conduct.

108. All these elements considered, ESMA has decided on policy option 2 and will actively encourage the industry to self-regulate. In order to initiate this process, ESMA has drafted a set of considerations, principles and governance expectations for the benefit of an industry committee entrusted with the development of the Code of Conduct. The considerations and principles focus on the responsibilities of investors, on transparency and conflicts of interest mitigation by proxy advisors, and on dialogue between issuers and investors.

109. ESMA shall review the development of the Code of Conduct by two years after the publication of this Final Report and may reconsider its position if no substantial progress has been made by that time.

Annex I – List of the public contributors to the consultation on proxy advisors

In total 63 responses were received by ESMA, of which 57 responses were of a non-confidential nature. These respondents are listed below; their responses can be viewed at: http://www.esma.europa.eu/consultation/Consultation-DP-Overview-Proxy-Advisory-Industry-Considerations-Possible-Policy-Options#responses

No	**Institution**
1	ABI
2	AFEP
3	AFG
4	AMUNDI
5	ArcelorMittal
6	ASSONIME
7	Aviva Investors
8	BlackRock
9	BVI
10	Capita Registrars
11	CCMC
12	Chris Barnard
13	CNMV´s Advisory Committee
14	DAF
15	DAI
16	ECGS-PROXINVEST
17	EFAMA
18	Eumedion
19	EuroFinuse
20	Europeanissuers
21	Euroshareholders
22	Eurosif
23	F&C Investments
24	Finland Chamber of Commerce
25	FRC
26	GC100
27	GDV
28	Glass, Lewis & Co.
29	Hay Group
30	Hermes Fund Managers Limited
31	ICGN

32	ICSA
33	IMA
34	Inverco
35	IR Society
36	ISS
37	IVIS
38	IVOX
39	J.P. Morgan AM
40	Legal and General Investment Management
41	Manifest
42	NAPF
44	NBIM
45	PIRC
46	QCA
47	Railpen - SNS Am - Goeff
48	Russell Investments
49	SIFA
50	Smart Consult Srl
51	Sodali
52	Symrise
53	Tapestry Networks
54	The Hundred Group of Finance Directors
55	USS
56	VEUO
57	WKO

Annex II – SMSG advice to the consultation on proxy advisors

Date: 26 April 2012
ESMA/2012/SMSG/25

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.[9] 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.

[9] 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.

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 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[10] 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.[11] Finally, relevant guidance in respect of the integrity of PAs can be found in the IOSCO principles relating to CRAs.[12]

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

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[10] Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments, now under review.

[11] 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.

[12] IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO Technical Committee, December 2004, revised 2008.

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, 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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Guillaume Prache

Chair
Securities and Markets Stakeholder Group