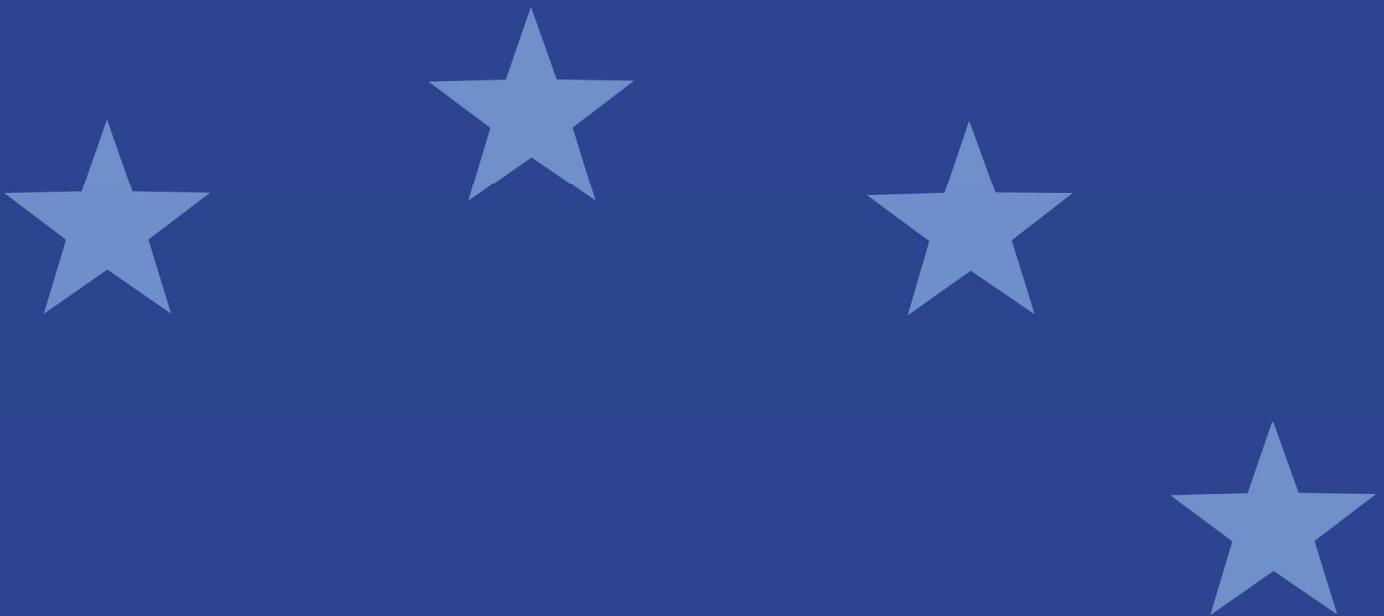




European Securities and
Markets Authority

Discussion Paper

An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options





Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **25 June 2012**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input-Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Legal Notice'.

Who should read this paper

This document will be of interest to market participants such as, but not limited to, proxy advisors, issuers and investors.

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Acronyms used

AIFMD	Alternative Investment Fund Managers Directive (2011/61/EU)
AMF	Autorité des Marchés Financiers
CFA	Chartered Financial Analyst
CFSC	Corporate Finance Standing Committee
CRA	Credit Rating Agency
ECGS	Expert Corporate Governance Service
EFAMA	European Fund and Asset Management Association
EMEA	Europe, Middle East, Africa
ESMA	European Securities and Markets Authority
EU	European Union
FRC	Financial Reporting Council
FSA	Financial Services Authority
ICGN	International Corporate Governance Network
ISS	Investor Shareholder Services Inc.
IVIS	Institutional Voting Information Service
MiFID	Markets in Financial Instruments Directive (2004/39/EC)
OECD	Organisation for Economic Co-operation and Development
PIRC	Pensions Investment Research Consultants
SEC	Securities and Exchange Commission
UCITS	Undertakings for Collective Investment in Transferable Securities

I. Executive Summary

Reasons for publication

This Discussion Paper focuses on the development of the proxy advisory industry in Europe, which mainly serves institutional investors such as asset managers, mutual funds and pension funds. Following its fact-finding work in 2011, ESMA recognises the proxy advisory industry within Europe is, or is expected to be, growing in prominence and investors are, or are expected to be, increasingly using proxy advisor services. In this paper ESMA identifies several key issues related to the proxy advisory market which may have an impact on the proper functioning of the voting process.

This Discussion Paper focuses on the following key issues:

- i) Factors influencing the accuracy, independence and reliability of the proxy advice such as such as the potential for conflicts of interest to play a role, proxy advisors' methodology and their dialogue with issuers; and
- ii) Degree of transparency on management of conflicts of interest, dialogue with issuers, the voting policies and guidelines, the voting recommendations, and the procedures for elaborating a voting recommendation report.

ESMA views this paper as an opportunity to gain evidence on the extent to which market failures related to the activities of proxy advisors may exist, the extent to which EU-level intervention might be appropriate, and what ESMA's role might involve. A better picture of the current situation of the proxy advisors activities in Europe, based on the responses to the questions in this Discussion Paper, will provide ESMA with more clarity about whether and which policy options may be considered.

The range of policy options that ESMA will consider, and on which it seeks further input from market participants, consists of four broad areas, including:

1. No EU-level action at this stage
2. Encouraging Member States and/or industry to develop standards
3. Quasi-binding EU-level regulatory instruments
4. Binding EU-level legislative instruments

ESMA will consider these options based on the feedback it receives from market participants, and, if appropriate, will undertake further policy action, either directly or by providing an opinion to the European Commission. The reason to bring up some policy options is due to the fact that proxy advisors are currently not regulated at a pan-European level. Nevertheless, there are relevant European rules that apply to investors (e.g. for UCITS management companies when exercising voting rights). In addition, there are also well-recognised corporate governance standards that apply to issuers at a national level (based on the "comply or explain approach") and some complements to improve standards of stewardship among investors.

Contents

The paper proceeds as follows: section II introduces the main issues about the Discussion Paper, section III describes the main features of the proxy advisory industry, section IV defines the key issues for investors on the use proxy advisors' services, section V addresses the key issues for proxy advisors, section VI sets out a framework for discussion on possible policy options and Annex I contains the list of the questions.

This document does not at the current stage include any formal proposals for policy action related to proxy advice and does not prejudge any policy actions that could be proposed or made at a later stage.

Next steps

All feedback received from this Discussion Paper will be duly considered. ESMA expects to publish a feedback statement in Q4 of 2012 which will summarise the responses received and will state ESMA's view on whether there is a need for policy action in this area.

II. Introduction

1. Recently, it appears that there has been a notable increase among institutional investors who are active in Europe in the use they make of proxy advisors. These are firms that analyse the resolutions presented at the general meetings of listed companies in order to submit voting advice or recommendations on these resolutions to their clients. While the European market for proxy advice is relatively small compared to the US, which has a more established market, it seems that in Europe the use of proxy advisors is growing as well.
2. ESMA considers that there are legitimate reasons for institutional investors to make use of proxy advisors. At the same time, ESMA is aware that some market participants (in particular, issuers) have raised concerns with regard to the influence that proxy advisors may have over the voting behaviour of institutional investors. ESMA considers that these two factors, when combined, warrant closer examination of the functioning and the impact of the proxy advisory industry in Europe. It has therefore decided to publish this Discussion Paper, which will allow ESMA to gather further evidence on which it can base its position regarding proxy advisors.

Aim of the Discussion Paper

3. The aim of this Discussion Paper is to give an overview of our understanding of the functioning of the proxy advisory industry in Europe and to gain evidence on the extent to which market failures may exist in practice that are related to the activities of proxy advisors in Europe. The focus of the Discussion Paper is, therefore, on the state and structure of the proxy advisors market in Europe, the methodologies used by proxy advisors, and on discussing the main concerns that have been expressed. In doing so, the Discussion Paper sets out a framework for discussion on several key issues, possible policy options and any other issues where ESMA would welcome further clarification and evidence before coming to a definite view.
4. The key issues with regard to policy options influence the accuracy, independence and reliability of the proxy advice. Other issues take into account the transparency of procedures within proxy advisors and mitigation of conflicts of interest.
5. Proxy advice is typically used by large institutional investors, which have stockholdings in different listed companies throughout Europe. It may be the case, and this Discussion Paper seeks evidence on this issue, that the proxy advice market could benefit from a regulatory framework insuring greater consistency on an EU-level with regard to the ways in which institutional investors interact with proxy advisors.¹
6. The potential policy options for the Discussion Paper range from taking no action to recommending the introduction of formal legislative measures. Other options that may or may not be considered are either to encourage the industry to develop improved investor stewardship and proxy advising standards, or to rely on ESMA's competence to develop or recommend the development of quasi-binding EU-level regulatory instruments, such as recommendations and guidelines.

¹ As far as the scope of action is concerned, direct references may be found in UCITS implementing Directive 2010/43/EU that specifically states that management companies shall develop strategies for the exercise of voting rights. Further, in the technical advice on possible implementing measures of the AIFMD (Directive 2011/61/EU), ESMA points out that AIFMs should develop strategies for the exercise of voting rights as well.

Scope of the Discussion Paper

7. The main focus of the Discussion Paper is on the operation of the proxy advisory industry in Europe and on the role or interaction of the relevant market participants such as proxy advisors, issuers and investors. These market participants are of interest in so far as their activities relate to securities markets and listed companies in the EU.
8. This paper does not include a cost-benefit analysis because ESMA is not proposing any specific measures at this stage. In the case that ESMA would propose any specific measures in this area, these will be accompanied by a cost-benefit analysis and will be consulted with the market before their final adoption.

Process and next steps

9. This Discussion Paper has been developed under the remit of the ESMA Corporate Finance Standing Committee (CFSC). ESMA has undertaken, in the summer of 2011, a targeted fact-finding exercise among representatives of the relevant stakeholder groups: proxy advisors, institutional investors, and corporate issuers. Responses to the fact-finding exercise were received on a confidential basis and have been taken into account in drafting the Discussion Paper. In addition to this fact-finding, ESMA has held several bilateral discussions with market participants, and has analysed relevant academic literature and public policy studies. Members of the CFSC Consultative Working Group have also provided input to our work. The ESMA Securities and Markets Stakeholders Group (SMSG) will also provide advice to us in this area.
10. In its 2011 Green Paper on the European Corporate Governance Framework, the European Commission has also addressed the issue of proxy advice. ESMA has taken note of the responses to the Green Paper, and has involved these, where appropriate, in its analysis.² While the current ESMA work constitutes a separate work stream developed on ESMA's own initiative, ESMA will liaise closely with the Commission in this area going forward.
11. ESMA will duly consider all feedback it receives from this Discussion Paper and expects to publish a feedback statement in Q4 of 2012, which will state ESMA's view on whether there is a need for policy action in this area.

² The European Commission consultation on the EU corporate governance framework, the feedback statement and individual responses can be found at: http://ec.europa.eu/internal_market/company/modern/corporate-governance-framework_en.htm. The specific questions on proxy advisors in the European Commission Green Paper, pages 14-15 can be found at: http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf.

III. Description of the proxy advisory industry

12. For investors, the ability to vote on items at a general meeting is key to exercising their ownership rights and influencing investee company policy. Recent years have witnessed a greater propensity of institutional investors in Europe to vote, for which there are two main drivers. Firstly, there has been a greater focus on the corporate governance practices of issuers, which have increasingly been recognised as an important factor in (long-term) value creation. This has created a greater incentive for institutional investors, in particular those following an activist investing strategy, to exercise their voting rights. Secondly, and more recently, there has been greater pressure on institutional investors to effectively exercise their stewardship responsibilities, in particular by actively engaging with their investee companies.
13. These two developments have occurred in a context where institutional investors hold very large, diversified portfolios that can contain hundreds of names. Keeping track of agenda proposals across a large number of companies in different countries with diverse corporate governance traditions and practices is time consuming and costly.
14. ESMA considers that proxy advisors can play a constructive role in facilitating the monitoring of corporate proposals by, and lowering the information and monitoring costs for, institutional investors. This can translate into greater shareholder involvement with corporate decision making and thus to greater corporate accountability to investors.
15. At the same time, ESMA is aware that there exist concerns (in particular among issuers) about the use and potential overreliance by institutional investors on the voting recommendations of proxy advisors. These issues will be discussed in more detail in section IV. In section III below, we will first provide an overview of ESMA's understanding of the activities of proxy advisors in the European market.

III.I. Proxy advisors and their roles

16. Proxy advisors can offer a variety of services. The first type of services consists of analysing the proposals for general meetings and providing voting recommendations, either based on the proxy advisor's own voting policy or on the investor's customised voting policy. The second type of activity consists of offering services with regard to the whole voting logistic and transmitting the voting instructions to the issuer, e.g. through a voting execution platform.
17. Proxy advisors usually work for institutional investors such as asset managers, mutual funds and pension funds. In addition, depending on their particular business activity, proxy advisors can provide a range of other analytical and consulting services that are connected to the voting process and to corporate governance issues in general.
18. Institutional investors make use of proxy advisors for multiple reasons. Proxy advisors' recommendations are used as a source of information when deciding how to vote and serve as an input to the investors' analysis. Investors use the information to obtain a more considered understanding of different agenda items and to come to an informed voting decision, allowing them to optimise their own limited resources. The purpose of proxy advisors is to facilitate institutional investors to exercise their votes in a timely and informed manner. Without the services of a proxy advisor, institutional investors may have to build systems and processes for managing a complex and variable set of voting decisions and operating procedures to accommodate the global general meetings' system.

Some respondents to the ESMA survey provided feedback that proxy advisors on the whole fulfil a useful function in increasing the number of votes that issuers receive, next to improvement of the quality of votes.

19. Institutional investors invest in many companies in different countries, which are subject to different corporate legal systems and different rules on governance. Within this framework, proxy advisors may provide valuable information of corporate governance specificities in a certain country of which investors are not necessarily aware.
20. At the same time, cross border voting has increased in recent times. This might be a reason to make use of proxy advisors, for example, if there are language barriers. Proxy advisors provide their clients with company information which is not always available in English and they could serve as a useful “translator” to enable investors to vote. Another reason to make use of proxy advisors could be the need for a platform from which to send voting instructions. Access to an electronic voting platform can be a prerequisite for being able to vote cross-border.
21. Furthermore, compliance and stewardship pressures for greater shareholder engagement and active voting could arguably result in a higher use of proxy advisors.
22. Additionally, most general meetings around the world are concentrated within a certain period of the year. In this context it may be inefficient or unfeasible for an institutional investor to gather information and knowledge about every company in which it has a significant investment and it may also be difficult to attend and vote at all general meetings.

III.II. Overview of the proxy advisor market

23. The history of proxy advisers dates back to the 1980s when the firms ISS and PIRC were founded. In the 1990s, but even more in the 2000s many new proxy advisors entered the market, both in the US (such as Glass Lewis and Egan Jones) and in Europe, such as Ivox (Germany), Manifest and IVIS (UK), Proxinvest (France), Shareholder Support (the Netherlands), GES Investment Services and Nordic Investor Services (Sweden). Some acquisitions have led to the disappearance of proxy advisory services offered by investor services institutions such as Deminor (taken over by ISS in 2005).
24. The increase in the number of US proxy advisory firms in the 2000s was related to the 2003 SEC regulation demanding mutual funds to exercise voting power in the best interest of beneficiaries.³ The increased activism of institutional investors themselves (triggered by corporate governance scandals) also contributed to the focus on shareholder voting. Overall, US based proxy advisors tend to have a more global presence and are also active in Europe, whereas European firms have a more national or regional focus. On the other hand, European proxy advisors tend to be more specialised in matters of their home country, and to be working more on the basis of customised voting policies and research. In addition, they are mostly specialised in proxy advice itself instead of providing on a broad basis other consulting services to issuers. There are many proxy advisors located all over the world, but only a few are global players. Furthermore, a number of (both small and large) proxy advisors are more nationally organised, as is the case in Europe. Possible explanations could be that (1) in the EU there are a number of corporate governance systems reflecting each Member State’s specific circumstances; and (2) institutional investors in the EU are more inclined to buy multiple voting recommendations from several providers at the same time.

³ The final rule on Proxy Voting by Investment Advisers can be found at: <http://www.sec.gov/rules/final/ia-2106.htm>.

25. In the US, research has been done on the market shares of different proxy advisors. ISS is claimed to have around 61% of the market, Glass Lewis around 36% and other proxy advisors active in the US the remaining 3%.⁴ In Europe, market shares have not been measured on a European level so far. Therefore we cannot provide exact data regarding market structure and concentration. Although these figures are not available, in the ESMA survey respondents consider ISS as the leading proxy advisor in Europe.
26. In Europe initiatives have been taken by federations of institutional investors to set up entities that provide proxy advisor services, as for instance: IVIS in the UK (by the Association of British Insurers) and IVOX in Germany (by investment fund association BVI). Furthermore, some local shareholder associations offer also proxy advisory services but their market share is marginal. Some strategic alliances have been set up, e.g. between Hermes Equity Ownership Services (Hermes EOS), an “advisory service which enables its clients to be responsible investors and owners of companies”, and proxy advisory firm Glass Lewis that provides proxy research and vote execution. Another example of an alliance is the Expert Corporate Governance Service (ECGS) that, among other services, provides institutional investors with global asset portfolios proxy voting advice based on local market expertise from local proxy advisors such as Proxinvest (France) and Shareholder Support (The Netherlands). For illustrative purposes, BOX 1 gives a limited overview of some of the players in the proxy advisor’s business (data based on publicly available and institutional information such as the company website and public reports).

BOX 1: Non-exhaustive list of some proxy advisors active in Europe, including some data on employees, number of clients and researched companies.

- **Glass Lewis** (US) employs more than 100 people in six offices and serves over 500 institutional clients that collectively manage more than \$15 trillion in assets. Glass Lewis aims to help institutional investors to make decisions by displaying and assessing business, legal, governance and accounting risk at more than 20,000 companies in over 80 countries.
- **ISS** (US), regularly represented as the leading proxy advisory firm in the world, is a subsidiary of MSCI Inc, a provider of investment decision support tools, listed on NYSE. It has more than 1,700 clients, managing \$26 trillion in assets and over 600 employees. ISS provides corporate governance products and services to institutional investors.
- **IVIS** (UK) is a provider of corporate governance voting research. For its subscribers it reviews UK based companies’ annual reports, accounts and company meeting notices for compliance with Corporate Governance best practices. IVIS states to have subscribers that include the top 15 investors in the FTSE All Share. It is part of ABI which represents the interests of the UK’s insurance industry with £1.5 trillion assets under management.
- **Manifest** (UK) provides global proxy voting and corporate governance support service to institutional investors and governance professionals. Manifest states that its total equity assets under administration exceed £3 trillion and that it provides a global coverage across at least 80 markets.
- **PIRC** (UK) is a UK research and advisory consultancy providing services to institutional investors on corporate governance and corporate social responsibility. It has clients ranging from pension funds, faith-based investors and trade unions to banks and asset managers, with combined assets exceeding £1.5 trillion.

⁴ See Tamara C. Belinfanti, The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control, Research Paper Series 09/10, also available at <http://ssrn.com/abstract=1557744>. The calculation used is based on the aggregate portfolio equity size of each proxy advisors institutional clients.

- **Proxinvest** (FR) provides services to large and small investors without advisory services for issuers. It offers coverage of all companies in the MSCI Europe index and FTSE Eurofirst 300. The shares of French companies held by Proxinvest clients represent a portfolio of more than € 60 billion.

Human resources

27. Proxy advisor staff numbers tend to vary due to the highly concentrated and seasonal nature of the general meeting season and from year to year. As the general meetings advisory business is seasonal, it could require the employment of temporary staff. In this respect, proxy advisors have differing policies varying from not using temporary staff to hiring temporary staff based on personal recommendation or giving them responsibilities only after a training period or letting them do only simple tasks.
28. In addition, proxy advisors may provide in-house training programs and may have processes in place where senior staff members periodically review the analyses for quality and consistency control. For most proxy advisors, a base salary appears to make out the bulk of staff earnings, although we do not have a great level of information on remuneration or bonus practices.

Business model and fee structures

29. Proxy advisors make earnings by providing customised and standardised proxy reports, corporate governance advice, voting logistics, advice on remuneration policies and possibly other services both for investors and issuers. Revenue streams for proxy advisors differ depending on the type of services offered and the revenue model but a common characteristic with European firms is that they appear less dependent on fees obtained outside proxy advice. Fees for clients differ based on client type and/or the market where the general meeting is based (e.g. whether it is a developing country or western) but not on a geographical basis as to where the proxy advisor or its customer is located. Another consideration for determining the level of fees is the amount of the assets under management, although due to the bargaining power of the big investment funds, this is more difficult to assess.
30. As regards the pricing in relation to volume consideration, fees for proxy reports can be based on various criteria, e.g. the number of meetings covered, the number of indices and companies included and the number of reports downloaded (either per index or for unlimited access). In relation to the scope of the research, some respondents to the ESMA survey stated that generic advice is less expensive than customised advice, taking into account as well the complexity of the voting policy. Fee structures for the voting logistics (electronic platform) depend on specific parameters such as ballot volume (with a special charge for reconciliatory services) and the number of accounts (when the beneficial owners are private customers rather than the asset managers). With regard to the latter, flat rates are the normal standard practice but some proxy advisors offer a choice between a fixed subscription fee for standard services and special fees for additional related services.

Internal organisation

31. Whether a proxy advisor has a specific compliance department, depends on the overall size of the company and the degree to which proxy advisors are obliged to comply with detailed regulatory oversight. However, most proxy advisors seem to have adopted for their internal organisation rules and procedures regarding the (1) publication of proxy advisors general voting policies and guidelines, (2) publication of voting recommendations and any dialogue with the company to that, includ-

ing quality control, (3) mitigation policy regarding conflicts of interests and (4) staff recruitment policy.

32. Feedback from the ESMA survey indicates that proxy advisors' own voting policies and guidelines are being regularly reviewed. Dependent on the proxy advisor, general voting policies and guidelines of proxy advisors are made publicly available, are updated once a year and they can be subject to consultation with investors and/or issuers. However, some proxy advisors do not want to share the content of the voting policies and guidelines with the public. Some proxy advisors have no own voting policy but follow the clients voting policy and guidelines or, in the absence of client guidelines, use public standards such as the corporate governance principles of the International Corporate Governance Network (ICGN).
33. The policy on mitigation of conflicts of interest varies among the proxy advisors. Some firms do not provide consultancy services at all, others have conflict of interest policy procedures, while others disclose conflicts of interests or install firewalls. (Please refer to section V.I. for further information on conflicts of interest).

III.III. Operational information

34. Feedback from the ESMA survey indicates that proxy advisors follow a certain schedule in order to arrive at their conclusion. Although the structure may vary between different proxy advisors, roughly the following steps are common when creating a voting recommendation or a research report.
35. Selecting the range of services that the client wishes to be provided with is the first step. Since this Discussion Paper mainly focuses on the issues connected with the voting recommendations, the process described below encompasses only this type of service.

III.III.I. Voting policies and guidelines

36. Depending on the client, the proxy advisor's voting recommendations may be based on the customised voting policies and guidelines or those prepared "in-house" i.e. by the advisor. A number of companies offer both types of services.
37. ESMA learnt that US proxy advisors tend to rely more on their own voting policies, whereas European ones generally tend not to develop their own guidelines but follow client's policies or general recommendations. The voting policies and guidelines prepared are based on the relevant corporate governance standards. In the majority of cases these policies are usually formulated through a bottom-up process where information is collected from a diverse range of market participants (including issuers) through multiple channels. This policy can be (fully) adapted to local circumstances in a given country, or can incorporate more general beliefs about what constitutes good governance. Corporate governance codes, listing rules, company law, (local) regulations, new market trends, practices and academic research are used to create a set of guidelines against which corporate disclosures can be benchmarked. Moreover, it seems to be common practice for proxy advisors to integrate feedback from clients and, if available, issuers.
38. Dialogue can take place between proxy advisors, investors, clients, issuers, academics and regulators through industry conferences, newsletters or bilateral talks. Roundtables which some proxy advisors organise with various industry groups or other experts are also a way of receiving information and hearing different perspectives. Some proxy advisors are open for discussion about their policies and

guidelines throughout the year while others are only open for discussion after the general meeting session.

39. If an investor wants his own policy to be applied, he will discuss and reach an agreement on his priorities and key principles with the chosen proxy advisor. Based on these considerations, proxy advisors will then translate and substantiate these concepts into customised guidance that contains operational rules. It is our understanding that it is best practice to review these guidelines and policies at least annually or when there is a regulatory change.
40. When it comes to customised voting recommendations, it is hard to evaluate the amount of extra work the provision of such a customised service entails in comparison to voting recommendations following the voting policy of a proxy advisor. If the production of customised recommendations requires greater resources, the economic logic would indicate a different price for that service. Consequently, the type of services and the price requested for the customised voting recommendation may determine which voting policy (i.e. that of the proxy advisors policy or the investors' own policy) is followed. This may, in particular, be relevant for smaller investors. Proxy advisors, however, have to make sure voting policies and guidelines are sufficiently flexible to be applicable to the circumstances of each jurisdiction, sector and issuer. We come back to the voting policies in section V.II.

III.III.II. Voting recommendations

Preparing voting recommendations

41. When the general meeting agenda is published, proxy advisors verify the agenda and collect additional data they deem necessary to draft the voting recommendation. The information required may be collected from multiple sources such as regulatory disclosures, newspapers/media, trading venues, data vendors and custodians. Also the reviewed company itself is an important source, either from annual or quarterly reports, the company website and other corporate information, or through dialogue.
42. Generally, proxy advisors use a predefined methodology and correspondent algorithms to separate the agenda items for the general meeting into comparable data points to facilitate the assessment process. After verifying the information on voting requirements, the analysis starts. The voting template system which generates voting recommendations is usually a combination of hard data points and more subjective reasoned questions to be answered by analysts in a questionnaire. The drafting of voting recommendations is based on the voting policies and guidelines selected by the client. Most proxy advisors have a quality control system established to scrutinise the content of the reports, such as a review of the report by a second analyst and procedures to ensure the integrity of the document.
43. Typically, voting recommendations are based on publicly available information, although proxy advisors may enter into dialogue with issuers and other stakeholders, either before or during the general meeting season. The answers to the ESMA survey show that most proxy advisors engage in dialogue with the issuers at some stage of their research process and consider criticism by issuers as part of this dialogue. Engagement with issuers is being used in order to get a better understanding of company-specific issues and to enable proxy advisors to provide a more informed voting recommendation. Some proxy advisors, however, have a clear policy of not getting in touch with issuers to avoid being lobbied, being influenced, or potentially receiving inside information.

44. Depending on the proxy advisor, issuers may or may not be provided with the content of the final version of the voting recommendation before or just after its publication. This type of consultation is usually launched by proxy advisors in the expectation of receiving corrections to factual errors only. However, according to responses to the ESMA survey, issuers' comments may go beyond that scope. Moreover, if the issuer is aware of the content of the recommendation, the company may be better prepared for the discussion during the general meeting.

Final voting recommendations

45. Voting recommendations are usually queued for production on a client deadline basis during the general meeting season as the majority of investors work to meet proxy deadlines rather than general meeting dates or the date materials are received. The proxy document typically follows the order of the general meeting agenda with an explanation of each of the recommendations where shareholder votes are needed. Voting recommendations for the general meeting will generally not be published for a broad audience. Proxy advisors make the argument that this information belongs to the proxy advisor and its paying client. As an alternative to providing voting recommendations, it is also possible that proxy advisors provide descriptive reports in order to facilitate their client-investor's own analysis. We address voting recommendations further in section V.III.

IV. Key issues: investor use of proxy advice and voting behaviour

46. This part of the Discussion Paper looks at the ways in which institutional investors make use of the services of proxy advisors and reflects on some of the perceptions of the proxy advisory industry as to the extent to which investors rely on proxy advice.

IV.I. Selection and use of proxy advisors by investors

47. In Europe, the provision of proxy advisor services has developed to different degrees among Member States, but overall the provision of such services is a relatively recent phenomenon in Europe and is still developing. The proxy advisory industry is small when compared to the US market, which has a more established proxy advisor market, reflecting its specific regulatory landscape. However, it seems clear that the proxy advisory industry within Europe is growing in prominence and investors are increasingly using proxy advisor services for the purposes of voting and carrying out their stewardship responsibilities in general. Some of our industry feedback suggests there could be significant use of proxy advice among investors in the EU.
48. To give an example of research concerning the use of proxy advice, BOX 2 contains the results of surveys held in the Netherlands. The initial thinking of the Dutch Monitoring Committee on Corporate Governance was that proxy advisors have a major influence on the Dutch market. Its thinking was evolved further following a more recent study in 2011.

BOX 2: Case study

A case study: the Dutch proxy advisory market

Evidence by the Dutch Monitoring Committee on Corporate Governance (Monitoring Committee) demonstrates that where proxy advisors are used in the Netherlands, both by Dutch and foreign investors, their advice is disregarded only in a very limited number of cases. Against this background the Dutch Monitoring Committee on Corporate Governance studied in 2010 and 2011 the role and influence of proxy advisory firms.⁵

In its 2010 compliance report, the studies showed a little more than half of the institutional Dutch investors who participated in the survey in 2010 reported that they make use of proxy advisory firms. This is true, in particular, for the larger institutional investors. All responding asset managers reported that they use proxy advisory services. Both general and customised advice is received in roughly the same proportion (54% and 46% respectively). More than half of the institutional investors discuss the voting policy with the proxy advisory firms in advance, even when they receive proxy advisors' own voting policy advice. Two proxy advisory firms in particular are used of which the most popular is ISS (57%), followed by Glass Lewis (26%). Institutional investors that use a proxy advisory service indicate that they disregard the advice only in a very limited number of cases. The Monitoring Committee noted that proxy advisory services have a major influence on how votes are cast at general meetings of shareholders. It has therefore stressed that institutional investors have the responsibility to vote as they see fit.

More recently in its 2011 compliance report, the Monitoring Committee found, while the key results of the survey reflected its findings following the 2010 survey, the “*influence of proxy advisory services is per-*

⁵ Corporate Governance Code Monitoring Committee, Second report on compliance with the Dutch Corporate Governance Code, 14 December 2010 at: http://commissiecorporategovernance.nl/page/downloads/2010_UK_report.pdf; Corporate Governance Code Monitoring Committee, Third report on compliance with the Dutch Corporate Governance Code, 9 December 2011 at: http://commissiecorporategovernance.nl/page/downloads/2011_MCCG_ENG.pdf.

haps not as great as the overall picture suggests” and “perceives a trend in which investors are becoming aware of their own responsibility for deciding how to vote”. It also examined voting behaviour of foreign investors in Dutch companies and found that they also often make use of proxy advisors “mainly to gather information they can take into account when making their own decision on how to vote.” However, the Monitoring Committee noted the selective nature of the sample focussed on “institutional investors that pursue a more active or activist investment policy and should for this reason be regarded as less inclined to rely ‘blindly’ on proxy advisory services”. The Monitoring Committee does suspect that “the more passive investors and smaller investors do less research of their own and tend to rely more on the advice of the proxy advisory services (possibly using information available on the websites of the services)”.

The Monitoring Committee intends to further examine the role of proxy advisors in 2012 “in order to obtain a more complete picture of how they influence voting at general meetings of shareholders in the Netherlands.”

49. It is not uncommon that investors retain more than one proxy advisory firm (at least in the case of larger investors), in order to obtain multiple opinions, to compare the analyses and/or to observe the differences, if any (i.e. to get a fuller picture of the agenda item). Moreover, investors with diversified shareholding portfolios seem to prefer worldwide voting solutions, thus looking for proxy advisors offering ‘global coverage’, although local knowledge of company law, of corporate governance codes and of local habits may be an important consideration as well. Another important factor when choosing proxy advisors relates to the processing of voting instructions, which requires a technological investment that may be out of reach of some of the smaller or newer entrants in the market.
50. Investor feedback to the ESMA survey indicates that the accuracy, independence and reliability of a proxy advisor’s research and advice are the most important priorities when selecting proxy advisor services. The ESMA survey also indicates that proxy advisors’ fees for the provision of their services are most likely a crucial factor when it comes to the selection of a proxy advisor. Well-established proxy advisory firms, benefiting from economies of scale and a large existing customer base, may be in a position to offer more competitive prices for their proxy services.
51. It seems that the hiring policies of some institutional investors may exclude smaller proxy advisory firms who cannot fulfil global requirements such as a minimal amount of client assets under proxy voting advice, several years of experience providing such services to certain type of clients (e.g., pension funds), a minimum number of companies in the proxy voting portfolio or coverage of specific jurisdictions. Investors using the services of the globally active proxy advisor do not face the searching costs associated with selecting several providers in different countries or for different tiers of listed companies.

IV.II. Correlation between proxy advice and investor voting behaviour

52. A number of studies have shown the existence of a high level of correlation between proxy advisors’ voting recommendations and the actual voting behaviour of institutional investors. This has led some observers to question whether institutional investors form their own, sufficiently independent judgment of the voting recommendations they receive.
53. Respondents to the ESMA survey highlighted this correlation but provided alternative interpretations or explanations to them. At this stage ESMA does not endorse any particular view but is seeking feedback with evidence on these issues. On the whole, issuers’ representatives had a perception that proxy advisors influence investors in their voting behaviour or that there is a growing influence,

with the high correlation as evidence of this. Some go further and suggest this reflects the possibility that investors may not appropriately verify the recommendations they receive, which is seen by respondents as a 'box ticking' approach. However, others accept that the correlation alone is not necessarily exclusively the result of the voting recommendations or they state that there is no direct empirical evidence on the extent to which there is influence in practice. On the one hand, a clear majority of issuers did at least perceive some level of influence by proxy advisors over voting behaviour. On the other hand, investors provided contrasting explanations that, broadly indicating, despite general perceptions, they are not influenced by proxy advisors but used them as source of information. The specific counter-arguments are set out below.

- In addition to retaining proxy advisors, investors carry out their own research and analysis. Proxy advisors, therefore, serve as a check on their own work.
- In order to gain a broader view on shareholders meeting proposals, investors may retain more than one proxy advisor (e.g. a regional or local advisor in addition to one of the global market leaders). This seems to be a fairly common practice, particularly amongst the larger European institutional investors. Retaining more than one proxy advisor can help institutional investors with forming their own judgement of the meeting proposals. Some investors pay particular attention to the differences between the advices they receive from these multiple providers.
- Although investors may agree with the voting recommendation, this may be for different reasons. There are only three available options of voting (for/against/abstain) but a multitude of reasons to agree or disagree with a certain proposal, and so there can be different reasons why both the proxy advisor and the investor would choose the same voting outcome.

54. Proxy advisors explained to us that their aim is to base their recommendations on the institutional investor's own preferences, resulting in a correlation between recommendations and actual voting. This can happen either directly, because the proxy advisor uses a customised voting policy which has been created together with the investor, or indirectly, because the proxy advisor can monitor the voting behaviour of the investor via the voting execution platform that the proxy advisor offers.

Investor voting behaviour

55. The level to which investors find it important to make a fully informed decision varies. Views from the ESMA survey seem to indicate that some investors only take a 'box ticking' approach on some issues, while others view active shareholder engagement with corporate governance issues as a key value driver for their investment strategy. Their underlying approach to engagement also influences how investors make use of the proxy advice they receive.
56. ESMA's understanding is that larger institutional investors, in particular, have at their disposal greater internal resources for verifying the voting recommendations. However, larger investors also usually have a more diversified portfolio, which means that even when greater resources are available, they will still find it useful to outsource at least some of the analysis of meeting proposals to proxy advisors, also given the highly concentrated nature of the general meeting season.
57. The issue of investor voting behaviour has also been flagged by the OECD in a report on corporate governance and the crisis. The OECD Report on corporate governance concludes: *More recently questions have started to be raised about the influence of proxy advisors with many companies fearing "tick the box" advice with investors avoiding their responsibilities. In Australia, North America and Western Europe, large institutional investors (which tend to have large portfolios but limited resources devoted to proxy voting) are highly reliant on proxy advisors. While some*

*institutional investors employ proxy voting research to identify contentious issues efficiently, others adhere strictly to the recommendations of proxy advisers, particularly for companies in which they have smaller stakes and foreign holdings. Proxy advisers also derive their considerable influence from their role in developing and implementing voting guidelines for institutional investors.*⁶

58. Investors appear to prioritise the resources they have available based on the impact that the vote may have on portfolio performance, e.g. taking into account the size of the stake they have in the firm, the performance of the firm (where a relatively poor performance increases the need for monitoring), or the potential value implications of the proposal (as in the case of a change in corporate strategy, a merger, an acquisition, or other corporate actions). Also it appears that recommendations for domestic investee firms are monitored more closely, as the institutional investor has a deeper knowledge of local circumstances and is subject to closer scrutiny of his voting behaviour by national stakeholders.
59. Certain resolutions taken during general meetings may be of less importance to investors, and such resolutions may also be part of the explanation of the high voting correlation between proxy advice and investor voting decisions. For example, the appointment of auditors may be seen of less importance or concern to investors than more substantive issues like major business decisions or significant corporate governance matters such as director remuneration.
60. Investors that follow the voting recommendation of their proxy advisor may in practice, depending on the specific investment strategy, be reluctant to deviate from the voting recommendation made by this proxy advisor. Motives for this behaviour could be the additional administrative work for the investor himself or additional efforts if a compliance manager must document and explain such deviations. However, the nomination of the proxy advisor mostly counts as delegation with the effect that the respective investment or compliance manager would still be obliged to effectively monitor delegation to the proxy advisor (and also to document such measures of oversight).

Questions (we would welcome supporting evidence and reasoning in your response)

1) How do you explain the high correlation between proxy advice and voting outcomes?

2) To what extent:

a) do you consider that proxy advisers have a significant influence on voting outcomes?

b) would you consider this influence as appropriate?

IV.III. Investor responsibilities

61. Shareholders, as investors, have taken a risk through their investment. Their investment also carries certain rights, including the right to vote. In the case of institutional investors, they may also be subject to additional requirements such as stewardship responsibilities, which is discussed in further detail in section VI.I.

⁶ See OECD, CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS Conclusions and emerging good practices to enhance implementation of the Principles (2010).

62. Consequently, investors play an important role in the governance of listed companies. This role and responsibility should not be shifted to proxy advisors. However, the use of proxy advisors may be a useful tool for investors in carrying out their role and responsibilities. In the ESMA survey, we questioned investors as to whether they use proxy advisor services as a form of insurance against liability. A variety of responses were received though no response directly answered this question affirmatively. The general feedback was that the proxy advisors only provide recommendations while the ultimate vote remains with the institutional investor. Most respondents see the use of proxy advisor as a practical way of implementing voting across a diversified portfolio.

Question (we would welcome supporting evidence and reasoning in your response)

3) To what extent can the use of proxy advisors induce a risk of shifting the investor responsibility and weakening the owner's prerogatives?

V. Key issues: proxy advisors

63. This part of the Discussion Paper explores some of the key issues in relation to proxy advice. The results of the ESMA survey highlighted a number of key issues relating to proxy advisors, which broadly fall into two categories. Firstly, there are a number of issues identified that can be seen as factors which potentially impact the accuracy, independence and reliability of the proxy advice given to investors, such as the existence of conflicts of interest. Secondly, there are comments as to whether and, if so, how the issues identified needed addressing. Feedback from the ESMA survey varied with some respondents suggesting no action needs to be taken at EU-level while others were calling for regulatory intervention, e.g. through improved transparency. We are therefore seeking to use this Discussion Paper to gather evidence to determine how the issues identified below have an impact in practice and see whether further action is appropriate. The specific policy options are detailed in section VI.

V.I. Conflicts of interest

64. If firms providing proxy advisor services have any real influence on significant investor voting decisions, it is crucial that their advice should be independent and objective. The existence of material conflicts of interest, should they exist, potentially jeopardises this goal.

Conflicts in practice

65. A clear conflict exists when proxy advisors provide corporate ratings or other consultancy services to issuers and at the same time offer proxy research and advice to institutional clients with respect of those issuers. The risk is that proxy advisors could provide inappropriate proxy advice to investors, as they are effectively advising investors on how to read statements by issuers which they themselves may have influenced through their advice to those issuers. We have learned that in practice proxy advisors either do not provide advisory services to both issuers and investors (in respect of those issuers) or have in place a range of risk mitigation measures (though we express no view on the effectiveness of those measures at this stage).

Other potential conflicts

66. Respondents to the ESMA survey highlighted concerns, although without specific evidence, that conflicts may also arise in other circumstances. This might be the case, for example, where an issuer or its shareholders could influence the advice proxy advisors give to investor clients because of the nature of the issuer's relationship with the proxy advisor (e.g., the proxy advisor may have some other commercial or personal relationships with the issuer or the issuer's major shareholders). Another conflict might arise when a proxy firm is part of a group in which another entity provides services with conflicting interests or if a proxy advisory firm's shareholders, directors or other related persons may have a significant interest in or serve on the boards of issuers that have proposals on which the proxy firm is offering voting advice.
67. A last category of concerns expressed by respondents to the ESMA survey relate to the influence that investor clients might have on the proxy advice given to other investor clients, e.g.:
- by submitting to the proxy advisor its own recommendations for voting at a general meeting which the proxy advisory firm acts upon, e.g. by using it as part of the basis to develop its own voting recommendations. This could be to maintain its business relations with the investor

even if it is not necessarily the best course of action for the proxy advisor for the purposes of providing objective and independent advice; or

- by generally seeking to achieve favourable outcomes through their proxy advisors in relation to issuers with which the client has a relationship, particularly where a proxy advisor is in some way closely related or attached to an investor such as an asset management firm.

68. The conflict of interest risk may be diminished in cases where the relative influence of the proxy advisor's client is low or where investors rely on multiple proxy advisors. A proxy advisor's reputation and its intellectual capital strength are vital assets to its business. If an advisor is not behaving objectively and independently it puts these assets, its reputation and, therefore, its business at risk.
69. These above-mentioned examples of conflicts of interest have been brought to our attention as potential issues through the ESMA survey and more generally in the responses to the European Commission's Green Paper on the EU corporate governance framework. However, no factual evidence has, so far, been provided that demonstrates the extent to which these conflicts materialise and, taking into account conflict mitigation measures in place, have an impact on the independence of proxy advice provided to investors.
70. We do note that in the feedback statement and individual responses (by those who provided answers to the relevant questions) to the European Commission's Green Paper, there was overwhelming support for improved transparency particularly as regards conflicts of interest for proxy advisors. This feedback focuses on how proxy advisors may disclose information on potential conflicts of interest to their investor clients and how they manage those conflicts to ensure their advice is sufficiently objective and independent. Other suggestions go further and request for a disclosure of this information more broadly through a code of ethics or code of conduct.

Market feedback

71. We would welcome responses to this Discussion Paper that demonstrate clear evidence of any of the above or other conflicts of interest, the risks in practice as a result of such conflicts, the extent to which such conflicts are appropriately mitigated where they do exist and whether there is market failure as a result of any conflicts which needs addressing. If there is market failure in this area, we would also welcome views on the appropriate course of potential remedial action if any.

Questions (we would welcome supporting evidence and reasoning in your response)

4) To what extent do you consider proxy advisors:

- a) to be subject to conflicts of interest in practice?***
- b) have in place appropriate conflict mitigation measures?***
- c) to be sufficiently transparent regarding the conflicts of interest they face?***

5) If you consider there are conflicts of interest within proxy advisors which have not been appropriately mitigated:

- a) which conflicts of interest are the most important?***
- b) do you consider that these conflicts lead to impaired advice?***

V.II. Voting policies and guidelines

72. The general aspects of voting policies and guidelines are described in section III.III.I. However some issues that may have an impact on the accuracy, independence and reliability of the ultimate voting recommendations/proxy advice in this area have been brought to our attention and we invite discussion on those.

Taking into account local market and regulatory conditions

73. A criticism made to us is that proxy advisors may apply a one-size-fits-all approach and do not sufficiently take into account local market conditions, such as business practices and regulatory regimes. However, proxy advisors state they do take into account local market conditions but also indicate this to be subject to their general philosophy including ensuring director accountability, promoting shareholder rights and encouraging strong links between remuneration and performance in order to foster sustainable shareholder returns.

Dialogue with investors and issuers

74. By the very nature of their relationship with proxy advisors, investors have a direct influence in the voting policies and guidelines applied by the proxy advisor, either by having influence in the development of those policies and guidelines or simply by accepting the proxy advisor's own standards. Some of our feedback indicates that dialogue with issuers can bring additional value to the development of such standards, e.g. by ensuring they appropriately take into account local market conditions and regulatory regimes, but also that these standards are clear and may serve as a future reference tool for the issuers. They can also enable issuers to have a better insight into how proxy advisors ultimately develop their advice. The main counterargument is that the views of issuers can be less relevant in this context as the investors are still responsible for their stewardship responsibilities.

Question (we would welcome supporting evidence and reasoning in your response)

6) To what extent and how do you consider that there could be improvement:

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

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

V.III. Voting recommendations

75. The process for preparing voting recommendations is described in section III.III.II. However several issues that may impact the accuracy, independence and reliability of the voting recommendations and proxy advice have been brought to our attention and we invite discussion on those.

Methodology - transparency and the 'black box' issue

76. Investor respondents to the ESMA survey mostly answered that information about resources and processes relating to the preparation of the voting recommendation is sufficient. However, some issuers claim that they perceived the information on the process of preparing the recommendations as

insufficient. Feedback to both us and in response to the European Commission's Green Paper refers to the "black box" issue, meaning a lack of sufficient transparency in relation to key aspects of proxy advisor's methodology, especially on how voting policies and guidelines are applied to produce voting recommendations.

77. The lack of transparency has raised suspicion among some issuer representatives that proxy advisors may not be appropriately applying the relevant voting policies and guidelines, but are instead adopting a highly mechanical and potentially box-ticking approach in their analysis. This could particularly be a cause for potential concern if investors are relying heavily on proxy advice in practice and such advice has not been appropriately produced.

Dialogue between proxy advisors and issuers in developing proxy voting recommendations

78. Proxy advisors may or may not engage in dialogue with issuers when developing specific voting recommendations. There is no standard practice. Issuer representatives argue that such dialogue should be encouraged or required because it may help to improve the accuracy of proxy advice by ensuring that factual errors can be addressed and it potentially reduces misunderstandings concerning specific resolutions or the local corporate governance framework. Furthermore, dialogue could avoid potential harm to a company's reputation as a result of errors or omissions in the proxy advice and may help to better clarify issuers' understanding of the proxy advisor's policies.
79. It is unclear to what extent factual errors within proxy advice do take place and pose a problem in practice. However, some issuer representatives argue that proxy advisors should make their draft advice available to the issuers concerned, particularly to address such potential errors. Others go even further and suggest that issuers should be able to comment on the content of the advice as well and should be able to submit a dissenting opinion with the advice before it is submitted to the proxy advisor's clients.
80. In France the 2011 AMF Recommendation states proxy advisors should engage in dialogue with issuers and submit their draft report to the relevant company for review. Alternatively on a "comply or explain" basis, proxy advisors which do not engage in dialogue should clearly state this in their advice and explain the reasons why.⁷
81. Proxy advisors that do not routinely give issuers an opportunity to review their advice or otherwise engage in dialogue adopt this policy for a range of reasons. These reasons may include:
 - Avoiding interaction during the busy general meetings season, partly as a result of resources and partly to avoid influence through lobbying efforts by issuers.
 - Avoiding any possibility of receiving inside information and committing potential market abuse. Feedback from the industry indicates that voting recommendations are generally based upon publicly available information only. Issuers that want to provide proxy advisors with additional information may generally be asked to first make that information public before proxy advisors accept that information.

⁷ AMF, Recommendation No. 2011-06 of 18 March 2011 on proxy advisory firms (English translation), at: http://www.amf-france.org/documents/general/9915_1.pdf

- Seeking to comply with the CFA Analyst Objectivity Standards.⁸ Requirement 6.0 of these Standards states: “*Relationships with subject Companies [...] Research analysts must be prohibited from: (a) Sharing with, or communicating to, a subject company, prior to publication, any section of a research report that might communicate the research analyst’s proposed recommendation, rating, or price target.*”

82. Where proxy advisors do give issuers an opportunity to review draft advice or otherwise engage in dialogue there are different practices. They may engage with issuers when they are drafting the advice or just before they are ready to submit their advice to investors (ex-ante), or they may send the advice to the issuer after it has been sent to investors (ex-post). It is not clear to what extent issuer feedback is taken into account in practice, i.e. whether they only allow issuers to make accuracy checks or whether they also invite comments on the substantive content of the advice as well. However, we are aware that some proxy advisors have the resources to respond to feedback by issuers. On the other hand, we are aware that some issuers are concerned that, while they may be given the opportunity to offer feedback, they do not have sufficient time in practice to review the draft material to correct factual mistakes or comment on the advice given.
83. Proxy advices such as voting recommendations are not generally published by proxy advisors, on the basis that it is exclusively for its own and its client’s use. However, as mentioned in the last section, some proxy advisors may make draft research and advice available to the issuer to which it relates. Although we recognise there may be commercial sensitivities and confidentiality issues in relation to disclosing proxy advice, we would welcome views as to whether the market could benefit from improved transparency in this area and also whether there may be risks in doing so.

Standards of skill, independence and experience of proxy advisor staff

84. The availability of skilled and knowledgeable proxy advisor staff is a key factor in the production of accurate, independent and reliable proxy research and advice. Proxy advisors state their employees generally have wide expertise and come from a variety of backgrounds and markets which give them the necessary experience to prepare appropriate proxy advice. Further, some proxy advisors provide their employees, including temporary staff, with in-house or external training programmes.
85. On the other hand, it has been suggested to us that one of the challenges, bearing in mind the seasonal nature of the general meetings season, is the scarcity of skilled and knowledgeable staff in the industry, including skills to appropriately consult with issuers and investors. This results in, according to some feedback to the ESMA survey, a need to recruit (less experienced) temporary staff during the busier general meeting season or in outsourcing some of the work. Almost all proxy advisors who participated in our survey employ temporary staff, but the degree to which this takes place, varies between firms. Temporary staff could therefore create a risk of less adequate or less accurate research and advice being prepared in relation to specific issuers, particularly bearing in mind the large number of issuers being analysed, and the very tight deadlines involved. As a result, specific factors or issues related to issuers may not always appropriately be taken into account.
86. However, proxy advisors state they have processes and controls in place to ensure that the research undertaken is both accurate and timely. For example, temporary staff may be only given more sim-

⁸ CFA Institute, Research Objectivity Standards, at: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n2.4006>

ple data processing tasks, and/or the work prepared by temporary staff is subject to supervision and reviewed or controlled by senior analysts.

Transparency

87. Transparency is an important theme which underlies all areas described in section V. Transparency in general implies openness and enables informed decision-making by the parties involved. Improved transparency could be envisioned, for example, by clarity on the scope or nature of dialogue with issuers, by providing issuers with a summary of voting recommendations, or through disclosing information concerning voting policies and guidelines, the production process and methodology of the recommendations and by information on the staffing. Any measures for improved transparency should consider, among others, competition issues and commercial confidentiality issues of proxy advisors.

Question (we would welcome supporting evidence and reasoning in your response)

- 7) 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?***
 - b) the dialogue with issuers when drafting voting recommendations?***
 - c) the standards of skill and experience among proxy advisor staff?***

VI. Considerations and policy options

88. This section includes both considerations and the policy options. It starts with a description of the regulatory landscape within which proxy advisors currently operate in Europe, a comparison between proxy advisors and financial market gatekeepers and some remarks on competition and entry barriers in the proxy advisory market. Thereafter, in light of the current regulatory landscape and the key issues discussed earlier, the section continues with the potential regulatory options, preceded by an analysis of further issues that should be taken into consideration in relation to each option.

VI.I. Current regulatory landscape

US regulatory framework and recent developments

89. Proxy advisors are subject to different regulatory regimes throughout the world. In the US, the furnishing of proxy voting advice constitutes of a “solicitation” and is subject to the information and filing requirements in the proxy rules. However, the SEC adopted the Exchange Act Rule 14a-2 (b)(3) to exempt the furnishing of proxy voting advice from the filing requirements in the SEC (e.g. their voting recommendations including all material information necessary to a voting decision) when certain conditions are met. Even if exempt from these requirements, the proxy voting advice remains subject to the prohibition on false and misleading statements.
90. Due to certain services they provide, some proxy advisors meet the broad definition of “investment adviser” under the Investment Advisers Act of 1940 and are thus subject to specific rules, such as 1) fiduciary obligations to adopt policies and procedures to ensure that proxies are voted in the best interest of their clients and 2) disclosure requirements of their voting policies and voting records. Furthermore, there are specific rules for stocks owned by certain US retirement and pension plans as to necessarily vote their proxies, which in practice extends to most of the investment advisers, whose definition seems to be broad under the US regulation.
91. In addition, according to Rule 14a-8, shareholders owning \$2000 or 1% of a company’s securities for at least one year are able to include their proposals for a vote at a general meeting. This multiplies the number of proposals to be voted on in shareholders’ meetings.
92. These factors seem to have the result that proxy advisors are being used on a large scale in the US market and could explain the degree of reliance on their voting recommendations. An important regulatory factor to be outlined is the fact that if an investment advisor is required to be registered by the SEC, he has to comply with certain disclosures including information about conflicts of interests. Proxy advisors that do not meet the federal securities registration requirements may be registered and regulated by individual States.
93. The SEC has initiated a review of the US proxy system by publishing a Concept Release in July 2010. In this work, the SEC identified the conflicts of interest issue and included a series of questions in order to analyse the accuracy, completeness and transparency in formulating the voting recommendations. So far, the SEC has not yet made public when it will publish its final release.⁹

⁹ The Chair of the SEC, Mary Schapiro, has given an update on the process with regard to the Concept Release in a speech before the Transatlantic Corporate Governance Dialogue in December 2011, see: <http://www.sec.gov/news/speech/2011/spch121511mls.htm>. A preliminary analysis of the responses to the Concept Release can be found in “Proxy Advisory Firms: The Debate Over Changing the Regulatory Framework”, The Altman Group, March 2011, at: <http://www.altmangroup.com/pdf/TAGSpecRptProxyAdv.pdf>.

The regulatory framework in Europe

94. In considering the key issues set out in section V in relation to proxy advisors and the policy options set out later in this section, we have been mindful of the investor and corporate governance regulatory culture and framework that has evolved within Europe.
95. Within Europe, there are currently no EU-level rules that apply directly to proxy advisors. However, there are rules that apply on the investor side. For example, UCITS management companies are required to develop adequate and effective voting policies in relation to voting rights held within managed portfolios in order to ensure that execution of voting rights accords with the investment strategy and objectives of the UCITS concerned.¹⁰ Alternative Investment Fund Managers may also become subject to an equivalent requirement.¹¹
96. Additionally, at national level there are well-established corporate governance standards that apply to issuers. These standards vary between Member States, reflecting specific national company legislation, the variety of corporate structures that operate in Europe, and the different and varying needs and types of investors (e.g., some operate within specific Member States and others operate on a cross-border basis). Corporate governance codes, which generally require issuers to comply with its provisions or otherwise explain why they have deviated from applying these provisions, have become a well-established and recognised feature of the corporate governance framework within some European countries as well as in other jurisdictions. The comply or explain approach is a recognition of the benefits of a more flexible corporate governance framework enabling issuers, on the one hand, to apply corporate governance standards in a way that is effective and reflects the nature of their business and yet at the same time enables investors, on the other hand, to scrutinise the way those standards have been applied where necessary.
97. Overall, the regulatory framework in Europe reflects and recognises that:
- board members of issuers are responsible for the corporate governance culture within their firm, including the way in which governance structures are applied;
 - the board is ultimately accountable to its shareholders, e.g. shareholders are at liberty to question the approach of an investee company if they are not satisfied with its corporate governance disclosures or approach in general; and
 - the risk, voting decision and ultimate responsibility for effective stewardship lies with the investor community.

The development of stewardship standards

98. To complement certain European corporate governance standards, there have also been recent moves to improve standards of stewardship among investors, including in relation to the use of proxy advice. The aim of such standards is to improve engagement between investors and issuers,

¹⁰ COMMISSION DIRECTIVE 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, Article 21.

¹¹ ESMA recently published technical advice to the Commission (*Final report, ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive*). Box 24 (page 58) of the advice covers strategies for the exercise of voting rights, at: http://www.esma.europa.eu/system/files/2011_379.pdf.

which overall should benefit both issuers and shareholders in the longer term through improved governance practices. The following are a non-exhaustive set of examples.

a. The UK FRC Stewardship Code (2010)¹²

The Code contains a set of principles and guidance for institutional investors and aims to enhance the quality of investor engagement with investee companies. Principle 1 of the Code states institutional investors signed up to the Code should disclose the use made of, if any, proxy voting or other advisory services, including how they are used. The FRC also publishes on its website a list of organisations, including proxy service providers, which have published a statement of commitment to the Code.¹³ Several proxy advisors have published a specific statement describing how they apply the principles of the Stewardship Code and how they meet the aims of it. The Code also encourages proxy advisors to disclose how they carry out the wishes of their clients by applying the principles of the Code that are relevant to their activities.

The UK Financial Service Authority (FSA) also requires FSA-authorized asset managers to publish a statement of commitment to the FRC's Stewardship Code or, if it does not commit to the Code, its alternative investment strategy.¹⁴

b. The French AMF Recommendation No. 2011-06 on proxy advisory firms (2011)¹⁵

In its recommendation, the AMF acknowledges the role of proxy advisors, the structure of the market and the fact that the services they provide and the recommendations they issue are part of a contractual relationship with their customer.

The AMF considers that the voting recommendations issued by one or more such firms can have an impact on the passing of certain resolutions at general meetings. For that reason, the AMF encourages relevant parties to implement these provisions for the 2012 general meeting season. One of the main aims of the Recommendation is to promote transparency in the establishment and execution of voting policies by proxy advisors. The voting policy implemented by a proxy advisor should be transparent and should clearly state the proxy advisor's opinion on the issues likely to be presented at the general meetings. It should give investors and issuers a better understanding of the reasons behind the proxy advisor's positive or negative recommendation on a given draft resolution.

Additionally, the AMF recommends that the proxy advisor submits its draft report to the relevant company for review, failing which it shall state in its analysis report that the draft was not submitted for review and explain the reasons why. The AMF recommends also that at the issuer's request, the proxy advisor includes the issuer's comments on the voting recommendations in the final report submitted to the investors provided the comments are concise, help the shareholders understand the draft resolutions on which they are to vote and do not include discussion on the general voting policy.

¹² FRC, The UK Stewardship Code, July 2010, at: <http://www.frc.org.uk/corporate/investorgovernance.cfm>.

¹³ See FRC, UK Stewardship Code Statements at: http://www.frc.org.uk/corporate/stewardshipstatements.cfm#Service_providers.

¹⁴ See FSA Handbook, Conduct of Business Rules, COBS 2.2.3R at: <http://fsahandbook.info/FSA/html/handbook/COBS/2/2>.

¹⁵ AMF, Recommendation No. 2011-06 of 18 March 2011 on proxy advisory firms (English translation), at: http://www.amf-france.org/documents/general/9915_1.pdf.

Moreover, the AMF recommends that proxy advisors establish reasonable and appropriate measures to prevent conflicts of interest and to manage any that arise.

c. The Dutch Corporate Governance Code (2008)¹⁶

The code includes a provision for shareholders and their use of proxy advisors. Best practice provision IV.4.5 states that a shareholder should vote as he sees fit. A shareholder who makes use of the voting advice of a third party is expected to form his own judgement on the voting policy and advice provided by its adviser.

d. The EFAMA Code for External Governance (2011)¹⁷

The Code recommends as best practice that investors, as part of their public policy on how they exercise their ownership responsibilities, should disclose the use made of proxy voting or other voting advisory service and how they are used.

Evolving European corporate governance landscape

99. The corporate governance frameworks in Europe are constantly developing and evolving. Typically, corporate governance codes that apply in European countries are subject to on-going reviews and are regularly updated to reflect developments in market conditions and practice and to address deficiencies. Similarly, the development of stewardship standards is a more recent phenomenon (though some standards exist within national corporate governance codes, such as in the Netherlands and in the UK prior to the launch of the Stewardship Code). These serve not only to increase standards among investors but also proxy advisors which have a commercial interest in helping investors to effectively discharge their stewardship responsibilities.
100. This trend of constantly evolving standards will continue within Europe. In this context, ESMA considers that careful attention must be kept in deciding whether and, if so, in what form there should be standards for proxy advisors. As a prerequisite, it should not work against the recent efforts to improve standards for investor stewardship in the Europe and should not shift away the responsibility for voting and effective stewardship from investors to proxy advisors.

VI.II. General comparisons between proxy advisors and gatekeepers (financial analysts, auditors and CRAs)

101. It is worth briefly exploring whether and to what extent proxy advisors could be compared to other market players that are regarded as gatekeepers in the financial markets, namely auditors, analysts and credit rating agencies (CRAs). Although these players have very different roles, one broad similarity is that they process information by verifying, analysing and/or interpreting it. This process, to varying degrees, aids investor protection, as the information is ultimately used by investors in the market to help make informed (investment) decisions. The important nature of their role coupled with market failures has led to standards being developed in each of these industries aimed at addressing those failures and, among other aims, protecting investors (which are generally set out in

¹⁶ Corporate Governance Code Monitoring Committee, Principles of good corporate governance code and best practice provisions (English translation), at: http://commissiecorporategovernance.nl/page/downloads/DEC_2008_UK_Code_DEF_uk_.pdf.

¹⁷ EFAMA Code for External Governance, Principles for the exercise of ownership rights in investee companies, 6 April 2011, at: http://www.efama.org/index.php?option=com_docman&task=doc_download&gid=1387&Itemid=-99.

legislation, regulation and/or privately). These standards may include measures to address conflict of interest risks, systems and controls, and standards on training and competence and for appropriate supervision.

102. Auditors have an important regulatory role by verifying certain issuer disclosures are true and fair. Investors and the market broadly rely on that information, which is published, in order to be able to make sufficiently informed investment decisions. Market failures, as revealed by a number of corporate disclosure failures shortly after 2000, demonstrated the clear need for more appropriate auditor standards, particularly those on independence from the issuer.
103. CRAs also play an important role; their ratings are relied upon by many market participants, including major investors and financial and insurance institutions, and therefore the ratings of CRAs should be based on appropriate and robust analysis. CRAs were put under the spotlight in the aftermath of the recent financial crisis, which resulted in a review of how they are regulated and subsequently more stringent standards. EU Regulations were and are set up covering issues such as independence, corporate governance and systems and controls.
104. Analysts also provide key services such as investment research which is relied upon by the market in general, for example in relation to a client which seeks to raise finance from the capital markets or advice on an investment. Therefore there are various standards under MiFID, e.g., to manage conflicts of interest where an analyst is part of a firm that has an investment banking relationship with the company.
105. While broad comparisons could be drawn between proxy advisors, auditors, analysts and CRAs, there are also key differences reflecting each of their differing roles and different payment models. One of the key differences is the hiring obligation. Auditors must be retained by issuers because of their role of reviewing and verifying financial statements. CRAs rate financial instruments, which are seen as essential to raise debt and for regulatory purposes. In contrast, investors have a choice between retaining proxy advisors or using other means by which to discharge their stewardship responsibilities. Furthermore, auditors and (most) CRAs are paid by the issuer, while proxy advisors are paid by investors.
106. By contrast, proxy advisors will generally analyse information which is in the public domain (and already verified) and present their findings to institutional investors. Therefore their role is fundamentally different to auditors, for example. Proxy research and advice is intended for a limited market, specifically their investor client(s). Unlike auditors, analysts and CRAs, where a significant section of the market (in)directly relies on the results of their work, the same cannot necessarily be said in relation to proxy advice. On the other hand, proxy advisors could arguably have some market impact where the ultimate investors choose to rely on a custodian/investment manager to exercise discretion in its voting and if that custodian/investment manager is reliant on the proxy advice for voting purposes.
107. The investor-proxy advisor relationship is generally an exclusive and commercial arrangement negotiated by agreement. There is no urgency to retain proxy advisors in the same way that there is for auditors or CRAs, either because of their regulatory role or their commercial importance. Institutional investors have the ability to ensure or at least examine the extent to which proxy advisors might be subject to a conflict of interest against the investor to help it consider whether it is effectively discharging its stewardship responsibilities. Proxy advice may not necessarily be published and is generally not relied upon by the market for investment decision-making purposes.

108. The investor-proxy advisor relationship might be described as a principal-agent one (some academics view proxy advisors as “information agents”¹⁸), potentially including the “principal-agent problem” as a result of asymmetric information. Investors engage proxy advisors to analyse information and interpret it as proxy advice. Investors will then rely on that information as a factor in helping to determine their voting decisions. However, in practice investors may carry out their own research in any case and use proxy advice as a check against their own work. It is worth reiterating here that ESMA is seeking feedback on the extent to which investors rely on proxy advice and the extent to which that reliance might be considered inappropriate.

VI.III. Competition and barriers to entry

109. At the outset it should be noted that competition issues are outside the scope of ESMA’s competence and we are not seeking feedback on competition issues per se. However, this section does provide useful context on the general issues under discussion that we are seeking feedback on (which includes the impact of policy intervention on competition) and so would be useful to keep in mind when responding to this paper.

The state of competition and market trends

110. The market share of the various proxy advisors in the EU has not been measured. Therefore we cannot provide data regarding market structure and concentration. However, although these figures are unavailable, qualitative analysis from our survey broadly indicates the proxy advisory industry has evolved significantly over the last decade with institutional investors having more choice in selecting their proxy advisors. It also indicates that ISS seems to be the leading player in Europe. Still, respondents provided a range of opinions concerning competition.

111. A majority of respondents to the ESMA survey in 2011 stated that competition among proxy firms is relatively healthy, at least in certain markets such as the UK. Some respondents consider this has benefited shareholders because it has resulted in better research and analysis, improved services, reduced prices, technological advances and more focus on the client. In addition, the information on which proxy advice is based is publicly available which facilitates relatively healthy competition. Overall, in relation to the provision of proxy advice, there was a perception that there exists greater competition in some markets than in others, although competition appears to be on the increase overall. However, the market for providing voting platforms and execution services is far more limited.

112. A minority of respondents took an alternative view (and this view may be specific to the national markets in which they operate). They do not regard competition in the proxy advisory market as healthy and consider that there are competitive and entry barriers which adversely impact clients and the proxy advisory industry overall. They pointed to issues arising out of the non-transparent hiring practices of certain institutional investors, the need for proxy advisors to be endorsed by trade associations and the scale of larger global proxy firms. These circumstances, combined with the very price-competitive nature of the markets, present potential barriers for new and the smaller proxy advisory firms, these respondents argue. Further, pan-European investor associations submitted that there are not that many proxy advisors in the markets and that the larger US proxy firms enjoy a significant share of the market. An OECD report also states, “*Concerns have also surfaced*

¹⁸ Michael C. Schouten, “Do Institutional Investors Follow Proxy Advice Blindly?” (January 2, 2012), at: <http://ssrn.com/abstract=1978343>.

*that the market for global proxy voting advisory services in North America and Western Europe has become highly concentrated, with the growing dominance of one firm through acquisitions and organic growth”.*¹⁹

113. Overall, in light of the potential impact that proxy advisory firms have on investor voting behaviour as a result of their reliance on proxy advice, an environment of healthy competition is an important factor to encourage accurate, independent and reliable research and advice, as well as providing choice among the investors.
114. Looking forward, respondents expected that the provision of proxy advisory services industry will grow in Europe. This partly reflects the size of the market (with over 45,950 listed companies worldwide, including over 13,360 in the EMEA (Europe, Middle East and Africa) as at December 2011.²⁰ Some respondents do not expect major changes to the industry but continued evolution, as proxy advisors respond to client needs. There was recognition that the need for in-depth examination of board decisions is increasing. This reflects the needs of investors which see independent proxy research as a source for analysing detailed information.
115. Respondents have expressed their view that it is important that the effect of any policy intervention does not limit the ability of smaller proxy advisors or potential new market entrants to operate and compete in the market. Possible policy intervention should not increase barriers to the market or lead to unhealthy competition, market concentration within the proxy advisory industry in Europe or, ultimately, lead to decline in the quality of proxy advice provided to investors.

VI.IV. Policy options

116. This part of the paper sets out for discussion a range of potential policy options in relation to the key issues discussed in chapter IV and V.
117. Before discussing the options, it is worthwhile stating the relationship between the key issues and the policy options. Gathering evidence on the impact and influence that proxy advisors in Europe have on investor voting decisions at general meetings through their proxy advice is the first step, before looking more specifically at the potential key issues.
118. If it is established that the role played by proxy advisors is significant, it becomes important to analyse whether the advice is appropriate (specifically, whether it is accurate, independent and reliable, or subject to compromise due to conflicts of interests and the methodology applied) and whether, from an investor’s viewpoint in terms of discharging their stewardship responsibilities, there is an appropriate level of transparency (e.g. in terms of disclosure of the voting policies, guidelines and methodology).
119. If evidence demonstrates that there are market failures, e.g. so that advice given cannot be said to be accurate, independent and reliable, and these market failures give rise to regulatory concerns, there might be increased need for the introduction of measures to address such concerns. Such measures would ultimately aim to achieve better outcomes through the shareholder vote process, e.g., by minimising factual errors contained in reports, mitigating or eliminating conflicts of interest that impair

¹⁹ See OECD, CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS Conclusions and emerging good practices to enhance implementation of the Principles (2010), p. 30

²⁰ World Federation of Exchanges, Monthly statistics, January 2012, at: <http://www.world-exchanges.org/statistics/monthly-reports>.

the independence of any advice and enhancing the level of transparency in the proxy advisor market. Even without clear evidence of market failure, some regulatory initiatives may be considered as necessary in order to prevent potential risks.

120. It is also worth reiterating here that this Discussion Paper also builds on the work carried out by the European Commission on proxy advisors through its Green Paper on the EU corporate governance framework.²¹ The Commission published its feedback statement and individual responses to the Green Paper in November 2011²² noting overwhelming support (by those who provided answers to the relevant questions) for proxy advisors to be more transparent, particularly as regards conflicts of interest. The scope of Commission's consultation question on transparency included:

- conflicts of interest and how these are managed;
- whether proxy advisor apply a code of conduct or internal rules of conduct (though no information was provided by the Commission on what these may include);
- voting policies and records;
- the methodology applied for preparing proxy advice; and
- the extent to which there is dialogue with issuers (in relation to both developing proxy advice and stewardship policies).

Regulatory options

Option one: No action at EU-level at this stage

121. The first option that could be considered is to recommend to the European Commission to take no further action at EU-level on proxy advisors, at least at this stage. This option would reflect that there are different markets within the EU, and that overall the proxy advisory industry in Europe is still developing. Some markets have very little proxy advisor activity, while other markets have more prominent activity (such as France, Germany, Netherlands and the UK). Therefore, the introduction of proxy advisor standards may be appropriate only for some countries and, consequently, under this option it would be up to each Member State (or industry) to develop the appropriate standards where they consider it necessary.

122. This option would follow the way in which the corporate governance landscape has developed in Europe. Different corporate governance standards apply across Europe which reflect local market conditions. Similarly, Member States on an individual basis can assess whether their own corporate governance environment can be enhanced with standards for investor stewardship and/or proxy advisors that are similar and complement their own corporate governance regime.

123. A contrary view of this option could be based on, e.g., the consideration that proxy advisors provide services to large institutional investors with holdings in different Member States, and that their activities take place at an EU-wide level; for that reason it may not be helpful to have different national standards, codes or practices for proxy advisors, which do not provide a consistent regulatory framework.

²¹ European Commission, Green paper on the EU corporate governance framework, COM(2011) 164, 5 April 2011, page 14 at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0164:FIN:EN:PDF>.

²² The Feedback statement, 15 November 2011, is available at http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf and the responses in full are available at http://ec.europa.eu/internal_market/consultations/2011/corporate-governance-framework/index_en.htm.

124. We would welcome clear evidence from respondents who support this option that demonstrates that there are either no market failures or, where market failures do exist, they can be locally addressed and no form of guidance or (light) regulation at EU-level is needed. Any counterevidence, which provides arguments for a more harmonised approach, instead of having different national standard codes or practises for each country, will be also taken into account to evaluate this option.

Option two: Encouraging at EU level Member States and/or industry to develop standards

125. This approach, unlike option one, would be an EU-driven approach, though any action may be carried out by the market in general or by Member States. The points made in relation to option one may also be valid for this option as well.
126. Under this approach there might be some form of informal engagement between the European authorities (ESMA and/or the European Commission), Member States, and/or industry to develop standards that are appropriately tailored for the European markets, either in the way of national codes developed by Member States or by encouraging proxy advisors to develop their own code of conduct.
127. Various standards could be developed within the EU: they would address any potential concerns that are identified as result of feedback to this Discussion Paper but also reflect individual business and regulatory environments in the EU. To ensure such standards are useful, investors could be involved in the development of such standards. They might also be accompanied with self-certification (similar to the FRC Stewardship Code) as the proxy advisors could be more incentivised to comply with the standards. Under self-certification, proxy advisors state publicly that they follow a particular set of standards.
128. A more formal approach could be the development of a Recommendation by the European Commission. Such a Recommendation could encourage Member States and/or the industry to develop new or existing standards and best practices that would apply to investors and/or proxy advisors.
129. This option could be a useful approach for those who would like to see some encouragement for further evolution of existing regulatory standards but without introducing formal EU regulatory or legislative measures at this stage.
130. A potential challenge with this option would be that the standards would not be binding and could not be directly enforced, especially in the case of self-certification.
131. As for option one, we would welcome clear evidence substantiating whether a more harmonised or a more national approach would be more appropriate for the proxy advisor industry. From supporters of option two, we would welcome views on what they consider to be the most appropriate approach within this option and on what they see as the additional benefit of such an approach in comparison to option one.

Option three: Quasi-binding EU-level regulatory instruments

132. This option would broadly involve developing regulatory instruments, although this would not be in the form of binding legislation as set out in option four. This might be pursued in different ways.
133. One form would be developing standards on a “comply or explain” basis which would be underpinned by an EU Regulation or Directive. Under this approach, the person or firm to whom such

standards are addressed must either comply with a particular set of standards or otherwise explain publicly why they are not choosing to comply with those standards. The standards could focus on business conduct (e.g., including provisions on conflicts of interest mitigation) and/or transparency related issues (e.g., provisions for public disclosure of information on conflict of interests).

134. A second possibility would be ESMA guidelines or recommendations. ESMA would develop these directly under Article 16 of the ESMA Regulation. They would be addressed to competent authorities and/or to financial market participants. The aim of such guidelines or recommendations would be to establish consistent, efficient and effective supervisory practices within the European System of Financial Supervision. Such an approach would also need to be within ESMA's scope of action.²³

135. Overall, the approach in option three could either apply directly to proxy advisors or indirectly (through investors) as follows:

- *Standards for proxy advisors*: Under this approach, the development of standards addressed directly to proxy advisors would need to be underpinned by new legislation with a requirement for proxy advisors to either comply with certain standards or best practices, or explain why they are deviating from those. Alternatively, such standards could take the form of ESMA guidelines or recommendations if and when they fall within ESMA's scope of action.
- *Stewardship standards for investors that relate to proxy advisors*: Under this approach standards could be developed e.g. pursuant to the UCITS IV implementing Directive²⁴ and potential implementing measures under AIFMD.²⁵ This approach would result in provisions that apply to UCITS managers or AIFMs rather than proxy advisors directly.

136. An advantage of this option could be that it offers a harmonised EU approach, while still affording some level of flexibility for the industry compared to direct regulation. In addition, this approach would fit with the "comply or explain" nature of the existing corporate governance code and, if applicable, the investor code framework.

²³ Regulation 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0084:0119:EN:PDF>. Under Article 16 two conditions must be met; the guidelines or recommendations must:

- a) be issued with a view to:
 - establishing consistent, efficient and effective supervisory practices within the ESFS; or
 - ensuring the common, uniform and consistent application of Union law; or
 - promoting the safety and soundness of markets and convergence of regulatory practice (Article 9(2)); and
- b) be within ESMA's scope of action.

ESMA's scope of action for the development of guidelines and recommendations is set in Article 1(2) and 1(3) of the ESMA Regulation where Article 1(2) lists the EU Directives and Regulations under which ESMA can take action. In addition, ESMA can also act in the field of activities of market participants in relation to issues not directly covered in the acts referred to in paragraph 2, including matters of corporate governance, auditing and financial reporting, provided that such actions by the Authority are necessary to ensure the effective and consistent application of those acts.

²⁴ UCITS IV Implementing Directive 2010/43/EU <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:176:0042:0061:EN:PDF>. Article 21 requires management companies of UCITS to develop adequate and effective strategies for determining when and how voting rights attached to instruments held in the managed portfolios are to be exercised. These strategies should cover, among others, preventing or managing any conflicts of interest arising from the exercise of voting rights.

²⁵ AIFMD 2011/61/EU <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>. ESMA has recently published technical advice to the Commission (*Final report, ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive*). Box 24 (page 58) of the advice covers strategies for the exercise of voting rights and is similar to the Article 21 of the UCITS IV implementing Directive: http://www.esma.europa.eu/system/files/2011_379.pdf.

137. A challenge with this option could be that creating formal best practice standards that apply across Europe would be difficult to do, in view of the different corporate governance environments within Europe and also the varying levels of proxy advisory activity in Member States.
138. We would welcome clear evidence substantiating whether a quasi-binding EU-level regulatory approach as set out in option three would be appropriate for the proxy advisory industry. From supporters of this option we would also welcome views on what they consider the most appropriate approach within this option, and/or whether they consider there to be other alternative regulatory solutions that should be considered.

Option four: binding EU-level legislative instruments

139. This option would involve the introduction of binding EU legislation. In addition to potentially covering the key issues described in section V, such an approach might also include additional measures on authorisation or registration and supervision by national competent authorities or ESMA.
140. Under this option it could be possible to choose a legislative instrument only for a specific measure around a specific issue, whilst still choosing another option for measures around other issues. Also, under this option legislation could come in several grades of interference, for instance only transparency measures, or also measures on conflicts of interests and methodology, while formal authorisation and on-going supervision would be the most interfering option.
141. An argument for this approach could be that proxy advisors are exerting an increasing and significant influence on investors which may raise issues of regulatory concern, e.g. by determining how votes in relation to an investee companies are cast. As there is a limited number of players within the EU markets the influence of each proxy advisor is potentially inappropriately significant and so might need to be subject to disclosure and accountability standards that reflect the nature of their role.
142. Legislation might also help ensure that proxy advisors have a consistent and robust approach in developing their proxy advice and, potentially, gives issuers the opportunity to respond to proxy advice and recommendations which proxy advisors should appropriately consider.
143. On the other hand, counterarguments for this approach could be the following: although proxy advisors play an important role for corporate governance purposes, the introduction of binding legislation for proxy advisors might be disproportionate as this would result in a stricter regulatory regime than currently applies to issuers (in terms of corporate governance) and investors (in terms of stewardship). Corporate governance standards for issuers generally adopt the “comply or explain” framework in the form of codes. Stewardship standards that apply to investors are also currently in the form of best practices or apply the “comply or explain” model, e.g. the FRC’s Stewardship Code.
144. Also, binding legislative measures could have a significant impact on competition in the European proxy advisor markets by potentially changing the dynamics of the proxy advisory industry. This might not be a desired outcome bearing in mind the need for competition in an industry that is becoming increasingly important for investor decision-making purposes.
145. We are aware of the arguments and calls for legislation by respondents to the European Commission’s Green Paper on the corporate governance framework, particularly as regards conflicts of in-

terest. However, where there is support for this option, we would seek clear evidence from respondents who support this option that demonstrates that there is market failure that justifies pursuing this approach. This could be evidence that demonstrates conflicts of interest are not appropriately mitigated and do actually impact the independence and reliability of proxy advice. Conversely, from those who do not support this option, we would welcome reasoning and evidence why another option would be preferable.

Questions (we would welcome supporting evidence and reasoning with your answers)

8) 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.

9) Which other approaches do you deem useful to consider as an alternative to the presented policy options? Please explain your suggestion.

10) 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.

11) 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.

12) Do you have any other comments that we should take into account for the purposes of this Discussion Paper?

Annex I – Summary of questions (by section)

Please kindly note that we would welcome supporting evidence and reasoning in your responses for any of the following questions

IV.II. (Correlation between proxy advice and investor voting behaviour)

- 1) How do you explain the high correlation between proxy advice and voting outcomes?*
- 2) 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?**

IV.III. (Investor responsibilities)

- 3) To what extent can the use of proxy advisors induce a risk of shifting the investor responsibility and weakening the owner's prerogatives?*

V.I. (Conflicts of interest)

- 4) To what extent do you consider proxy advisors:
 - a) to be subject to conflicts of interest in practice?*
 - b) have in place appropriate conflict mitigation measures?*
 - c) to be sufficiently transparent regarding conflicts of interest they face?**
- 5) If you consider there are conflicts of interest within proxy advisors which have not been appropriately mitigated:
 - a) which conflicts of interest are most important?*
 - b) do you consider that these conflicts lead to impaired advice?**

V.II. (Voting policies and guidelines)

- 6) To what extent and how do you consider that could be improvement:
 - a) for taking into account local market conditions in voting policies?*
 - b) on dialogue between proxy advisors and third parties (issuers and investors) on the development of voting policies and guidelines?**

V.III. (Voting recommendations)

- 7) 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?*
 - b) the dialogue with issuers when drafting voting recommendations?*
 - c) the standards of skill and experience among proxy advisor staff?**

VI.IV. (Policy options)

8) 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.

9) Which other approaches are do you deem useful to consider as an alternative to the presented policy options? Please explain your suggestion.

10) 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

11) 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.

12) Do you have any other comments that we should take into account for the purposes of this Discussion Paper?