



AN OVERVIEW OF THE PROXY ADVISORY INDUSTRY

The ABI's Response to ESMA's Discussion Paper

Introduction

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

This response is made on behalf of the ABI Investment Affairs directorate. The response draws on the views and expertise of the ABI Investment Committee,

comprised of individuals representing 14 prominent UK-based institutional investors, who are primary end users of proxy advisor (PA) services. It therefore represents the UK investor viewpoint.

The Institutional Voting and Information Service (IVIS) have produced a separate response, from the PA function of the ABI.

Executive summary

Investors looking to place capital and companies wishing to raise it are attracted to markets offering sound and effective corporate governance. An effective corporate governance regime sets out a framework of behaviour that encourages a long-term attitude in company management and among shareholders. The relationship between principal (the shareholders) and agent (the directors) lies at the heart of a successful market and should continue to do so. Effective corporate governance relies on the meaningful participation by companies and investors in an on-going dialogue. **For this dialogue to be maintained or strengthened, shareholders must have sufficient rights to exercise effective ownership.** Therefore, it is critical that any reforms should support rather than undermine the centrality of this relationship.

Further precision needs to be brought to the description of the role of proxy advisors in the stewardship chain and to the cause and effect relationship between companies' practices and disclosures, and the resultant proxy voting behaviour by investors. A conclusion appears to have been drawn that correlation reflects causation and influence on proxy voting outcomes, and therefore ultimately corporate accountability. We are concerned that characterising proxy advisors as "influencers" rather than "facilitators" is not an evidence based designation and that it does not reflect the market reality. We therefore believe this requires a much more solid, empirical founding.

In the UK, institutional investors generally use proxy advisors to support their own in-house approach to stewardship. There will inevitably be variation in how these activities are operationalised based on the nature of the institutional investor i.e. size, investment approach and business model. However, a common thread among different approaches is that **the proxy adviser acts as an information agent to aid the stewardship process between investors and companies.** Benefits of this arrangement are that institutional investors are better able to prioritise their engagement activities and focus on key portfolio risks. There are various themes that contribute to these different approaches to stewardship. The implications are important for the review and we explore this in greater detail under question three.

While some investors will be more reliant on the services of proxy advisors in some markets, it is also worth noting that these PA services help to enable investors to exercise their voting rights in an informed manner. Despite this range of approaches, it is difficult to determine with any confidence whether any 'box-ticking' prescriptive approach prevailed and culminated in poorly informed proxy voting. Or, ultimately, whether there were any negative economic consequences. This is primarily because investors are still unable to confirm that votes have been executed as directed to the registrars. Another reason for this is that it has not been custom for investors in Europe to specify how they utilise proxy voting agencies, which ones, and more specifically how voting advice is utilised. The

market cannot determine with confidence if those engaged investors had taken full account of the company's explanations but still come to a negative voting position.

Just in the same way asset managers' investment strategies seek to reflect the objectives of their asset owner clients, as set-out in the investment agreement, proxy advisor services will be driven by the requirements of their client base. Therefore, there is a danger that intervening in the proxy advisory market might not lead to the best outcomes. Indeed, we find the Paper somewhat unclear over the core issues that it is seeking to address. Furthermore, further consideration needs to be given to defining the different types of proxy advisory services. If the changing nature of ownership implies impediments to stewardship in different markets, then we would suggest a different line of enquiry - **greater consideration must be given to identifying the best ways to encourage a larger coalition of internationally engaged investors. Another important question is whether the system under which engagement and voting occurs supports effective stewardship. We would encourage a greater focus on these two key questions that underpin the principles of effective stewardship.**

Therefore, ABI members consider that **a further review of the way in which proxy advisors are being utilised by investors is required before definitive conclusions can be drawn on whether a policy intervention is required.** This would enable a better understanding of the roles of "facilitator" and "influencer" and would help to better inform ESMA and the investment community of the practical role proxy advisors play, and by extension whether a policy option is appropriate. We make suggestions on the design of such a review under question nine.

If upon further review it becomes apparent that the role of proxy advisors has become increasingly influential, and there is clear evidence that this is diluting the principal-agent relationship, ABI members would **support the development of a Code of Conduct. Given the current situation, members favour an industry led approach underpinned by a comply-or-explain framework.** A more detailed proposal of how this could be developed is outlined under question nine.

One of the main reasons why investors do not support the introduction of legislation is that it may have the unintended consequence of further validating and embedding the influence of proxy advisors. Following the regulation of credit rating agencies, some investors came to consider regulated advice from credit rating agencies to be beyond reproach or due-diligence, and therefore came to rely on them more and more. Regulating the proxy advisors could lead to a similar situation: investors might end up relying more on the advice provided by proxy advisors once they are regulated.

The existence of a minimum regulated standard may raise the lowest common denominator; but it may also unduly authenticate the voting recommendations provided and thus, albeit inadvertently, come to compel more investors to rely on the advice than may be the case now. Moreover, underfunded trustees under pressure to cut costs may look to the regulated status of proxy advisors as justification to close down in-house expertise; prominent asset managers may also take the same course.

Therefore, we would **favour a focus on encouraging the introduction of Codes for Institutional Investors.** In the UK, where the Stewardship Code has been in operation now for two years, the experience has been unequivocally positive. It is a

Financial Services Authority requirement for all UK-authorized Asset Managers to produce a statement of commitment to the Code or explain why it is not appropriate to the company's business model. There are now 234 institutional investor signatories and, along with anecdotal evidence of improvements, early research confirms an increase in meaningful engagement between companies and investors¹.

European markets vary in terms of the nature of share ownership, some being characterised by a dispersed shareholder model whilst others have large bloc shareholders pre-dominating. We therefore believe that **any further development of Codes should be encouraged at a national level**. In order for there to be efficient cross border investment, and so as not to place excessive administrative or regulatory burden on institutional investors, Codes will need to be based around a common set of values. Such Codes should require Institutional Investors to disclose if the investor uses proxy agencies, which ones, and how they use the advice.

Another way to facilitate more and better dialogue between investors and companies would be to help them better identify each other. For instance, an inefficient and costly custody chain severely impedes dialogue between shareholders and companies. **There would be a substantial benefit in a European wide system that allowed for shareholder identification by companies**. The Commission is currently considering a Securities Law Directive. It is our view that this Directive would be a sensible way in which to introduce a shareholder identification regime. This regime should seek to create an efficient voting and custody chain for shareholders and a robust shareholder identification system for companies. We suggest that the aim should be to identify those exercising the fiduciary responsibility – those that have the power to cast the vote, rather than those with the underlying beneficial interest.

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

¹ Investment Management Association: Adherence to the FRC's Stewardship Code. At 30 September 2011.
<http://www.investmentfunds.org.uk/press-centre/press-releases/press-release-2012-06-13/>

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?

Further precision needs to be brought to the description of the role of proxy advisors in the stewardship chain and to the cause and effect relationship between companies' practices and disclosures, and the resultant proxy voting behaviour by investors. A conclusion appears to have been drawn that correlation reflects causation and influence on proxy voting outcomes, and therefore ultimately corporate accountability. We are concerned that characterising proxy advisors as "influencers" rather than "facilitators" is not an evidence based designation and that it does not reflect the market reality. This is a fundamental component of the review, as it appears to have been positioned by ESMA as the key hurdle for consideration of intervention at the EU level. We therefore believe this requires a much more solid, empirical founding.

ABI members typically retain the services of proxy advisors to support and streamline their own internal research processes. Additionally, some members will draw on more than one provider to allow for cross-referencing and quality checks. This allows members to retain and enhance corporate governance intellectual capital and better integrate company specific circumstances into their respective investment processes.

While the voting positions taken by investors are facilitated by the input of proxy advisors, final voting decisions will be more influenced by the actual severity of a company's practices, the case-by-basis engagement process, and in the context of each investor's respective corporate governance policies. Furthermore, recommended voting positions by the in-house corporate governance specialists at asset managers are typically subject to final review by a range of additional investment professionals. For example, in some investor companies, voting analysis and voting recommendations are considered by a permanent Responsible Ownership Committee comprised of senior investment analysts and fund managers.

Although many investors will have their own corporate governance policies and approaches to engagement, focusing to a greater or lesser extent on different areas of concern, many, if not all, will be guided in a normative sense by various universally accepted policies. This means that if a company's practices are found to flagrantly contravene such policies there is a strong likelihood that those engaged investors may come to similar conclusions when exercising proxy voting. So too it is likely in this scenario that such practices would contravene the 'house' policies of those proxy advisory agencies that provide specific voting recommendations. While this would culminate in a hypothetical correlation between voting recommendations and ballot outcomes this would be as a result of the actions and decisions taken by the company in question and not the influence of proxy advisors.

There are also simple examples of policies that have been developed over time by institutional investors that have come to be widely observed by the market, both in terms of investor expectations and company practices. It is therefore unsurprising that proxy advisors research would highlight contraventions and investors would

take action in their voting. The most obvious example of this is share capital pre-emption rights. In the UK institutional investors reached a broad consensus that beyond modest-sized issues the dilutive cost to shareholder value of permitting non pre-emptive issues of equity exceeded the benefits. Companies needed a reasonable degree of assurance that resolutions could be put to shareholders at AGMs at a time that no issue would be in prospect but the need for which might eventuate during the coming year. The interests of both companies and shareholders therefore were served by benchmark levels for routine authorities becoming accepted.

Furthermore, the development of corporate governance best-practice and policy is typically an inclusive, open forum process and tends therefore to be reflexive to the thoughts of prominent institutional investors. This can lead to a degree of convergence in respect of key policy issues. This should be seen as an example of effective outreach, and may be beneficial in fostering more of a market consensus and consistent messaging to companies. In this sense, proxy advisors are naturally pursuing a condensation of their clients' policies. Therefore, we should not discount the possibility that on occasion a large portion of a proxy adviser's client base finds a natural fit with their voting recommendations. Some investors can feel frustrated that the lower common denominator of policy is not tough enough on companies, while for others it is too tough.

Those investors at different ends of the policy spectrum, or with very specific, nuanced policy requirements, may be more likely to adopt the custom method whereby the proxy advisor produces voting recommendations tailored to the agreed bespoke voting guidelines. Adopting this approach does not imply any less engagement will occur, or that the investor feels bound to the outcomes of the policy irrespective of a company's unique circumstances. While this provides some diversity in approach, where companies contravene best-practice it is relatively common that there are a range of issues at play. This means the level of dissenting votes could be driven by various policy contraventions. However, there is no evidence that any such correlation implies influence.

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?

Institutional investors use proxy advisors to support their own in-house approach to stewardship. There will inevitably be variation in how these activities are operationalised based on the nature of the institutional investor i.e. size, investment approach and business model. However, a common thread among different approaches is that the proxy adviser acts as an information agent to facilitate the stewardship process between investors and companies. Benefits of this arrangement are that institutional investors are better able to prioritise their engagement activities and focus on key portfolio risks. Therefore, as noted, we believe it would be more accurate to describe the role of proxy advisors as "facilitators" rather than "influencers".

Although arrangements at ABI members typically reflect the former, other investors that may not have the same in-house expertise or resources are known to be more reliant on their advisors policies and recommendations, thus closer to the latter. For some, this may mean overlaying their policies onto the proxy advisors house

guidelines, particularly in overseas markets, and therefore retaining some influence and control over voting outcomes. In some cases, investors see their ownership obligations as a compliance exercise, resulting in a fully out-sourced process. In such cases, voting decisions will follow verbatim the recommendations of the proxy advisor without due-diligence. The risks attached to this arrangement increase where the advisor makes prescriptive judgements that fail to properly take account of the unique circumstances prevailing at specific companies.

There are various underlying themes that may go some way towards explaining the changing nature of approaches to stewardship. One of them is simply that the composition of owners in developed markets has undergone major changes over the past 20 years. For instance, over that period in the UK, ownership of equities by UK institutional investors decreased from around 60% to 40%. Such a shift brings new realities to the traditional principal – agent landscape and may reflect a decline in traditionally engaged institutional investors.

Moreover, this internationalisation of ownership means that global investors are faced with a depth and breadth challenge when allocating corporate governance resources across markets with varying investment risk profiles. For instance, if they are weighted towards a country with a particularly weak corporate governance framework, it may be necessary to prioritise engagement with those portfolio companies that represent a heightened risk. Others will also adopt a value at risk approach and therefore only focus on large portfolio holdings where the importance of protecting and enhancing value is greater for clients.

Furthermore, the approaches by investors from countries where the responsibility to vote at company meetings has historically emanated from a compliance requirement, rather than the engaged approach, have traditionally been more reliant on proxy advisors. The most commonly observed institutional investors associated with this approach are from the U.S. As the two biggest proxy advisors (ISS and GlassLewis) are incorporated in the U.S. and predominately advise U.S. investors it is difficult to see how European directed regulation could have a meaningful impact. Here it is worth noting that the Securities and Exchange Commission's Investor Advisory Committee are reportedly drawing up U.S. Code for Institutional Investors in response to this. Other international investors will openly note that they do not understand well enough the corporate governance system in some overseas markets yet to exercise appropriate judgement over proxy materials. Pragmatically, others will be concentrating on developing their understanding towards a more active and informed approach.

While some of these investors will be more reliant on the services of proxy advisors in some markets, **it is also worth noting that these PA services help to enable investors to exercise their voting rights.** Through this diversity of approaches it is difficult to determine with confidence if there are situations in which, owing to a deficit in informed investors, the 'box-ticking' prescriptive approach prevailed and culminated in poorly informed proxy voting, and ultimately negative economic consequences.

It has not been custom for many investors in Europe to make it clear how they make use of proxy voting agencies, which ones, and more specifically how voting advice is utilised. The market cannot determine with confidence if those informed investors had taken full account of the company's explanations but still came to a negative voting position. Ultimately, some aspects of corporate governance analyses are

subjective and different actors will disagree on occasion. Just in the same way asset managers' investment strategies attempt to reflect the desired objectives of their asset owner clients, as set-out in the investment agreement, proxy advisor services will be driven by the requirements of their client base. Therefore, there is a danger that regulating proxy advisors would not address the core of the issue.

If the changing nature of ownership implies impediments to stewardship in different markets then the main question is how best to encourage a larger coalition of internationally engaged investors. Consideration must also be given to the assessment of whether the system under which engagement and voting occur supports stewardship. The fiduciary responsibility for the decisions taken on proxy votes ultimately remains with investors. Therefore, we would favour a focus on encouraging the introduction of Codes for Institutional Investors.

European markets vary in terms of the nature of share ownership, some being characterised by a dispersed shareholder model whilst others have large bloc shareholders pre-dominating. Therefore, we believe that the development of Codes should be encouraged at a national level. In order for there to be efficient cross border investment, and so as not to place excessive administrative or regulatory burden on institutional investors, Codes will need to be based around a common set of values. Such Codes should require Institutional Investors to include a requirement to disclose if the investor uses proxy agencies, which ones, and how they use the advice.

Another way to facilitate more and better dialogue between investors and companies would be to help them identify each other. For instance, an inefficient and costly custody chain severely impedes dialogue between shareholders and companies. A recurrent complication in the system is through which securities ownership is managed and accounted for via custody accounts, where multiple investor accounts are commingled in global 'pooled' nominee accounts. Where there are pooled accounts of this type in the ownership chain, it becomes difficult for an investor to be able to identify themselves, and it is also difficult for an issuer to identify and characterise their shareholders to facilitate engagement.

There would be a substantial benefit in a European wide system that allowed for shareholder identification by companies. The Commission is currently considering a Securities Law Directive. It is our view that this Directive would be a sensible way in which to introduce a shareholder identification regime. This regime should seek to create an efficient voting and custody chain for shareholders and a robust shareholder identification system for companies. We suggest that the aim should be to identify those exercising the fiduciary responsibility - those having the power to cast the vote, rather than those with the underlying beneficial interest.

This issue of shareholder identification may go some way to explaining the recent growth in the provision of proxy solicitation services. Proxy solicitor companies are typically retained by companies for their share register analytical expertise and to ensure voting has been undertaken and in what direction. At some companies it is essential to ensuring that company general meetings meet quorum requirements. While this service may be worthy and valuable on occasion and a reality under the current system, it is questionable why it should be necessary *ad infinitum* under a properly functioning ownership chain, especially given the additional cost it represents for beneficial owners.

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?

Material conflicts of interest do exist at some of the larger proxy advisory agencies. For instance, some are wholly owned subsidiaries of listed companies, whom themselves are subject to the high corporate governance expectations of the market. Similarly, large institutional investor clients that contribute material revenues to proxy advisors could seek to influence the advice provided to other clients for their own economic benefit or, for example, in relation to their parent company's general meeting. However, the most material conflict relates to the provision of corporate governance ratings and consultancy to issuers at the same time as providing voting recommendations on them to investor clients.

There are two aspects to this potential conflict. One is the 'pay to play' allegation that corporate issuer clients purchase consultancy services to provide them with the recipe for obtaining a favourable vote recommendation with a view to influencing the corresponding analysis. This also serves to raise the weight of expectation that, if the so called blueprint has been followed, and the consultancy side has been effective, then the investor analysis should come to the 'right' conclusion. The other is the economic conflict allegation that the weight of revenues from those corporate issuer clients could serve either to distort objectivity, or more directly, lead to senior management influence on analysts' research and conclusions.

For the ABI the primary source of potential conflict of interest is represented by IVIS, its PA function, which prepares reports on those ABI members that are UK-listed insurance companies. This conflict of interest is managed by strict adherence to the ABI guidelines. For these member companies, IVIS will also gauge the views of a wider pool of the largest shareholders to check on the wider sentiment. IVIS also has a small group of corporate clients who subscribe to the service either through their Human Resources team or secretarial office. Such clients usually subscribe to a range of reports as a means to track market trends and the number of clients and the revenues generated are considered immaterial.

It is important to note that such conflicts exist for other professional services companies. For instance, auditors provide the statutory audit on behalf of shareholders and are appointed annually by them, yet tangentially accrue significant revenues from consultancy work tendered by company management. Similarly, investment analysts issue buy and sell recommendations to institutional investor clients on companies that the corporate advisory business accrues significant revenues from.

In the case of traditional investment research there are some parallels with this situation and it is unsurprising that various proxy voting agencies have turned to the

CFA Research Objectivity Standards as means of mitigation. These standards were originally developed in response to problems relating to undue pressure from issuers attempting to influence the research and recommendations of investment analysts. The CFA standard would go some way towards providing a consistent disclosure framework so that clients are provided with transparency over any conflicts as well as the mitigation policies in place, and can make an informed decision whether or not to procure their services. It also has the benefit of being a standard already widely adopted and familiar to the investment industry. Furthermore, the clear disclosure of a potential conflict reduces its impact, raises awareness, and aids its management.

As alluded to previously, most institutional investors retain multiple proxy advisors. This is designed to offer a range of views and protects the investor against a single provider making an error in its advice such as missing an important change of governance or remuneration. Notwithstanding this, it is important that the analysis provided is of a high standard and represents genuinely independent advice. Institutional investors are the users of these services and it must fall to them primarily to hold agencies to account when the standards of analysis fall below what is expected.

While ABI members would favour clearer disclosure of potential conflicts, they are not convinced of the need for regulatory intervention at this time. There is also a concern that additional regulation is likely to increase the cost of such services and create a barrier to entry for new participants serving to concentrate further what is already an entrenched market. It is also unlikely to be in the wider public interest as additional costs may be passed onto underlying beneficiaries through the Total Expense Ratio of funds.

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?**

Based on members' experiences, major proxy advisors country level policies do tend to adequately take account of the local context. It is important to note though that they will also reflect to varying degrees universally accepted principles. For instance, this could mean that although historically companies in a particular market have on occasion combined the roles of Chairman and Chief Executive, that some may still recommend a negative voting sanction. However, balancing local practices with overarching normative principles, such as the International Corporate Governance Network Global Principles, is an approach widely adopted by many institutional investors. This is a difficult balance to strike. Some companies consider they are global in nature and point to practices at their global competitors, whereas others may point to the normality of certain customs in their market.

The differences in corporate governance cultures across different markets can also at times create a tension with some of those overarching policies; particularly as investors' corporate governance expectations have increased. However, this principle - agent tension should not necessarily be viewed as a problem *per se*. It is this market tension that gradually serves to improve practices via the harsh light of

corporate control, and as more investors become comfortable with practices in less developed markets the cost of capital companies seek to access is likely reduced.

The issue of dialogue in different markets is a complex one, both for policy development and for country level approaches to engagement. Customs and practices in different markets are rooted in cultural differences and the unique manner in which markets historically developed. These factors have a significant impact on corporate governance and engagement. While proxy voting agencies should be aware of this in their policy development, ultimately, it is up to the investors and companies to tailor their approach to dialogue and policy to more effectively improve standards of governance.

As the market for proxy advisors has gradually become more competitive and clients more discerning, there has been a greater push for more local context and expertise. In recent times, there is evidence of some improvement in this regard, with proxy advisors appearing to recruit more locally based analysts with tailored expertise. This should also lead to a more enriched engagement process and dynamic policy development.

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?***

While improved transparency of analytical methodologies is a sound principle, it should not be seen as a solution in itself. We have some reservations about the practical implications of such transparency, as well as the burden it may represent for fledgling proxy advisors.

The experience in the field of credit rating agencies should be instructive here, as it exemplified how too much transparency can have unintended and detrimental consequences. In that case, complete transparency enabled companies to 'game' the system and eventually led to a significant market failure in relation to the packaging of sub-prime mortgage assets. Therefore, it is critical that any transparency requirements do not give issuers intrusive insight into the inner workings of the analytical rating process to which they are subjected.

Furthermore, we note that there is intellectual capital associated with the provision of research. So, while it is reasonable for clients to have limited access to such methodologies in the course of their own due-diligence and tendering process, and therefore for the onus to be on that two-way process, it would be commercially damaging for many of the proxy advisors to have their specific methodologies publicly aired.

Strict transparency requirements may also have the unintended consequence of pushing proxy advisers towards a more prescriptive, pre-determined, one-size-fits-all approach. We therefore note the tension between more transparency and the desire for proxy advisors to be allowed to continue to undertake a sophisticated

analysis that properly takes into account firm-specific circumstances and local market practices.

Every company is unique, which means that there may be justifiable reasons for averting from the 'norm', both on the part of the issuer, for exceptional circumstances or local practice, and on the part of the advisor for any pre-determined in-house policy they may have. Aspects of such research are based on objective facts as well as subjective opinions. If the subjective realm is suppressed then it would likely decrease its value to clients. Moreover, it would likely stifle the market if the result of all research was anodyne and predictable. This may have implications for industry innovation, as well as deterring new market entrants given that new approaches and intellectual capital would quickly be subjected to well-resourced competitors.

There is an emerging view that investor clients should be given an opportunity to better provide input on market sentiment. Some members have indicated that because proxy advisors regularly engage in dialogue with companies they can be more tuned into company perspectives and thus can become alienated from rapidly evolving investor sentiment on important corporate governance issues. This is particularly important in respect of understanding each company's corporate governance decisions in the context of performance and returns to shareholders. An additional stage of comment from the investors may also serve to facilitate greater focus on accuracy and reliability. Some members have noted concern over what they consider to be a lack of company level knowledge on the part of the proxy advisor researchers. Better investor - client interaction on market sentiment may have the further benefit of exposing the proxy advisor researchers to investment professionals' company specific knowledge of performance and strategy.

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.

ABI members consider that a further review of the way in which proxy advisors are being utilised by investors is required before definitive conclusions can be drawn on whether a policy intervention is required. This would enable a better understanding of the roles of "facilitator" and "influencer" and would help to better inform ESMA and the investment community of the practical role proxy advisors play, and by extension whether a policy option is appropriate.

This could, for example, seek to determine in greater detail what proportion of investors, both asset owners and managers, has an arrangement:

- to have their shares automatically voted in accordance with the voting advice of the advisor with no investor sign-off;
- retain sign-off before voting instructions are confirmed, but generally follow the proxy advisors recommendations;
- adopt a custom policy by "overlying" their in-house policies with the proxy advisors standard policy, but with no sign-off;

- what proportion adopt the custom approach but to inform their own internal analyses and retain sign-off; and
- what proportion draw on standard proxy advisors' reports, possibly more than one provider, to inform their own internal analyses.

Given the internationalisation of equity ownership, to come to meaningful conclusions, the review would have to address a wide pool of geographically diverse investors, as well as remain sensitive to the scope of assets over which stewardship responsibilities are undertaken. The review could also explore how existing disclosures by investment institutions in relation to their stewardship responsibilities describe how proxy advisors are utilised and why this is optimal.

In the UK under the Financial Reporting Council's (FRC) current review of the Stewardship Code, one of the proposals seeks greater clarity from investors as to the use of proxy advisors. The FRC noted that under the existing Stewardship Code some investor statements do not provide sufficient information to assess the quality of stewardship activities undertaken in practice.

The proposed revisions request that signatories disclose not only whether they use proxy advisors but also the extent to which they use, rely upon and follow their recommendations. Given the global nature of many of the investors that are signatories to the Stewardship Code such information would enhance understanding in the area and be instructive for ESMA and market practitioners.

It would also better enable a more lasting market driven solution given asset owners would be equipped with the information to be more discerning, if they so wished to be, on the merits of their mandated asset managers' stewardship practices. This in turn provides a natural incentive for the asset managers to demonstrate the competence and rigour of their in-house stewardship practice. Those asset managers perhaps relying too heavily on proxy advisors may also feel a natural pull to improve their stewardship practices in a bid to avoid laggard status.

If in the light of a more informed evidence base it becomes apparent that the role of proxy advisors has become increasingly influential, and there is evidence that this is diluting the principal-agent relationship and damaging corporate accountability, ABI members would support the development of a Code of Conduct. At this stage members favour an industry led approach underpinned by a comply-or-explain framework.

The Code should be developed under the auspices of a multi-stakeholder forum taking account of the views of, *inter alia*, asset owners, asset managers, companies and proxy advisors. This forum would be tasked with agreeing on best practice principles to be attached to four overarching Code of Conduct pillars: conflict of interest, quality of advice, competence and oversight, and transparency.

For example, this could include minimum requirements such as:

Conflicts of interest

- The disclosure of potential conflicts of interest to clients at the point of contract tender, and more specifically, as part of any company report such conflict may pertain to; and

- disclosure of how conflicts are mitigated in order to retain research objectivity.

Quality of advice

- Companies being reported on should be given reasonable opportunity to provide feedback on the factual elements of those reports that provide specific voting recommendations to investor clients; and
- clear audit trail of the process for assessing issuers and making research recommendations should be available to clients.

Competence and oversight

- Proxy advisor researchers should be trained by senior colleagues to ensure a minimum understanding of company law and regulatory instruments in the jurisdictions they report on; and
- all reports should be vetted by senior colleagues for inaccuracies and to ensure the report is coherent in the context of the company's financial position and business model.

Transparency

- Policy guidelines should be publicly disclosed; and
- proxy advisors should undertake an annual review of their guidelines and consult openly on any proposed changes so as to ensure a wide pool of stakeholders views are considered.

We do not believe regulation would raise standards. Indeed, it may lower them, as the agencies would be forced into a more compliance driven mind-set rather than consider companies individual circumstances. Requiring proxy voting agencies to be regulated would also create a potentially significant barrier to entry and stymie competition.

While we do not support regulation for a number of the reasons set-out, we also feel there is a genuine danger it would serve to further validate and embed the 'influencer' role of proxy advisors. Following the regulation of credit rating agencies, some investors came to consider regulated advice from credit rating agencies to be beyond reproach or due-diligence, and therefore came to rely on them more and more. Regulating the proxy advisors could lead to a similar situation: investors might end up relying more on the advice provided by proxy advisors once they are regulated.

The existence of a minimum regulated standard may raise the lowest common denominator; but it may also unduly authenticate the voting recommendations provided and thus inadvertently come to compel more investors to rely on the advice, rather than undertake their own engagement and research process. Moreover, underfunded trustees under pressure to cut costs may look to the regulated status of proxy advisors as justification to close down in-house expertise. Similarly, prominent asset managers may come to the same conclusion.

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

Members do not consider EU-level intervention appropriate at this time.

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.

As noted previously we believe that there are numerous risks associated with EU level intervention.

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

No.