

ESMA Discussion Paper: An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options

PIRC Response

PIRC would like thank ESMA for this opportunity to comment on the above discussion paper and for the earlier opportunity to meet ESMA staff and participate in the recent Paris roundtable.

PIRC was the first proxy voting research adviser in Europe (formed in 1986 by a small number of public pension funds), and developed the first proxy voting service following the publication of the Cadbury Code report in 1992. From the very beginning PIRC has seen it as important to recognise the value of the voting advice it has provided to the investment strategies of our clients, and primarily for that reason has always believed that it should be a regulated entity taking its place amongst others active in the institutional investment markets such as asset managers, brokers, custodians, registrars and of course companies too.

PIRC is regulated by the UK Financial Services Authority.

1. Context:

The ESMA consultation document appears at a time of significant change amongst the continent's institutional investor community: stewardship is on the rise. The long called for action by the institutional investor community has begun to make itself felt, albeit most actively expressed in the UK market. This new found stewardship activism is already providing some of the answers to the questions raised by the European Commission in its two recent challenging consultation exercises on corporate governance in the wake of the global financial crisis.

Furthermore the ESMA consultation has chosen a good moment to ask further questions not just of the institutional shareowners themselves, but a vital part of the governance architecture of Europe, the role of the proxy research advisers (PRAs).

PIRC sees a definite if modest growth in the demand for stewardship services in the UK market, and in particular amongst its own client base, from both pension funds and asset managers. These clients are making ever more sophisticated demands of the PRAs. PIRC in particular is rising to the challenge to provide greater quality services to facilitate its clients desire to be more effective in their governance efforts in order to ignite the processes which seek to add more value to their investment strategies. Such demand has been additional to rather than at the expense of demand for traditional vote recommendation services.

This is precisely what we hoped to see when we drew attention to the weaknesses in our own strategy in May 2009 in our Manifesto on the Crisis¹. We said then that we had to move beyond governance compliance to adding value to our investor clients. We identified two areas in which this should happen: 1, by combining appropriate financial metrics with our traditional best practice governance approach, and 2. by focusing on where our investor clients could begin to make an impact, in particular through much greater scrutiny of the election and role of company directors.

Our public pension fund clients in particular are beginning to focus on substantial company engagements that require more advanced research and analysis from us and more sophisticated proxy voting strategies.

2. Methodology, engagement, quality:

PIRC has always believed in regulated capital markets and over the years has contributed to the long debate about financial regulation with regard to markets, pension funds and asset managers. But it has also believed that with the growing scrutiny of the issuer community in Europe through the development of corporate governance best practice, via Codes, guidelines or legislation, the proxy advisory industry also needed to recognise the importance of being transparent and accountable for its activities. In this context we saw the growing criticisms of the institutional investor community in the wake of the global financial crisis as a time to reflect on our own role and accountability.

To this end PIRC has issued for discussion its own document on the 'Principles of best practice for proxy voting and corporate governance advisers' in January 2010².

In addition PIRC is the first and currently only proxy research adviser to publish a list of its global proxy voting recommendation to clients, quarterly in arrears, on its website³.

Our research methodology is based on having proxy voting guidelines for the markets we cover so that we can provide proxy advice for each company contained in our clients' portfolios. In the UK, we provide these guidelines to companies each year when updated. Each new entrant to the universe of companies we cover is contacted to ensure the company is aware of our intention to report to shareholders ahead of its general meetings and from whom we request copies of shareholder documentation (articles/byelaws etc) in the UK. We are endeavouring to provide this to all companies we research but communication with many markets is hampered by lack of appropriate contacts and timescales during the proxy seasons in each market. In the UK we also provide draft reports to companies with 48 hours for company

¹ <http://pirc.co.uk/sites/default/files/Manifesto%20new.pdf>

² <http://pirc.co.uk/sites/default/files/Best%20Practice%20Principles.pdf>

³ <http://pirc.co.uk/public-voting-disclosure>

comments. This is not possible in all jurisdictions due to restrictions in timetables for the release of corporate information.

Final reports are then sent to UK companies after client despatch and this practice is being rolled out across all markets for 2013.

We have an internal quality management system involving draft reports being assessed against formal standard operating procedures and guidelines and then reviewed by senior researchers and the use of a policy forum with written terms of reference for particularly contentious issues. This involves managers and executive directors as well as drafters and senior researchers. Where a material factual error has not been picked up by this process and has been brought to PIRC's attention by an issuer or client, PIRC will re-publish its amended report and amend its internal records.

3. Conflicts and transparency:

Many of the companies when in receipt of draft PIRC proxy reports use this opportunity to comment on and dialogue with PIRC over the contents and voting recommendations. However PIRC does not offer consulting services to listed issuers. PIRC services are for institutional investors and consulting to listed issuers is in conflict with our mission and objectives.

PIRC is subject to the conduct of business rules of the FSA. This provides a transparent process monitored by the FSA from time to time. Compliance with FSA regulation helps PIRC mitigate specific conflicts, for example, declaration of a personal shareholding in any reportable company. In addition PIRC has a conflict of interest policy whose primary objective is transparency and disclosure with regard to any potential or actual conflict. This may involve disclosure in a proxy report about any conflict involving a particular company where for example a client is sponsoring a shareholder proposal. We have a process to manage conflicts that involves disclosure and dialogue with the parties involved. PIRC is in the process of adding its formal policies regarding mitigation of conflicts of interest to its web site.

Our voting recommendations to clients are based on our guidelines in each market and those guidelines are reflected in the recommendations we make for the agenda items on any company's proxy statement.

4. Policy options:

We recognise that PRA businesses are currently not subject to any particular regulatory regime in general. It seems reasonable to PIRC that PRAs should be subject to an appropriate regime of standard setting and best practice compliance – as are many of the other players in today's capital markets. In this sense the question we ask is why PRAs are *not* regulated in some sense?

Of course it is the type of regulation that is the question to consider. And in this respect we believe that the considerations set out under Option 3 in the ESMA consultation document seem most appropriate to PIRC.

PIRC is sceptical of the traditional self-regulatory regimes that still operate in some parts of the domestic UK market and we believe that a clear and independent code of best practice could be established that would begin a process of moving to a more transparent regime to enhance quality and best practice by PRAs. PIRC believes that there could be a role for ESMA here as set out in Option 3 discussed in the consultation document. PIRC also recognises that such standards for PRAs would also involve appropriate stewardship standards for investors that relate to proxy advisers. We believe that this approach would fit well with the 'comply or explain' regime in other parts of the EU governance framework.

In addition PIRC is of the view that such a regime would also enable PRAs to provide considerable expertise and insight into the proxy process to enhance the EU wide corporate governance framework. There has in PIRC's view been a lack of recognition by local market regulators and standard setters of the unique knowledge and understanding of PRAs about the practical and day to day workings of the corporate governance regimes in the EU. We believe Option 3 could create an environment where this problem can be addressed.

It is also our strong view that PRAs need to be represented by some kind of professional or industry body, despite the relatively small number of firms involved. PIRC is considering initiatives in this area.

The terms of Option 3 allow for direct regulation of PRA's or indirect regulation through investors. Given the significant European market share of US based PRAs we welcome the caution with which ESMA is proceeding with regard to the competition implications of adopting a strict regulatory approach (Para 144 under Option 4). A regulatory solution must clearly apply to all players regardless of the PRAs or investors' legal residence.

Summary

In PIRC's view, proxy advisors are playing a constructive role in promoting wider ESMA objectives: voting has increased; investors have a real means of delivering desired stewardship; better stewardship promotes long-termism and challenges bad or secretive management - informed voting strengthens the ability of investors to enforce that kind of accountability. Congruence of voting and advice is an appropriate response as there are many non controversial issues to vote on, and the methodologies of the advisers have been agreed by their clients. If investors disagreed they would not pay for proxy advisory services.

PIRC believes that the proxy advisory business should be a fully professional business. It is appropriate PRA methodologies should be transparent and accountable, and thus regulated in some form. This will in our view lead to improved research and analytical quality. PIRC is regulated by the FSA and this creates a

framework for conflict management etc aligned with the investors. Proxy Advisors should be transparent with their methodology for all stakeholders but transparent on their capabilities only with clients. Issuers, at least in the EU, should be sent analysis first to help iron out factual issues but with a limited response timeframe.

Consultation Questions Response

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

Many investors sign up to proxy advisors as part of best practice stewardship. This can be as a result of a desire to implement local market codes or guidance (cf the UK Stewardship Code) or to facilitate the exercise of shareholder rights and enhancing the accountability of issuers to their owners. In addition proxy advisors provide services for asset managers who may not be in a position to facilitate the exercise of proxy voting efficiently across thousands of holdings themselves. Many clients do not have the time to consider alternative voting scenarios, from those put forward by the proxy advisors. In addition proxy advisors provide a specialist service that many asset managers cannot provide as part of their own portfolio services to their institutional clients.

That said, asset managers do vary their voting outcomes from those recommended by the proxy advisors on selected occasions and in particular when they retain the voting decision internally (such as in mergers and acquisitions) or where they have a unique relationship with the issuer's management in which they adopt different policies due to their relationship with the issuer.

Proxy advisors apply guidelines that their clients approve, including potential voting outcomes for a wide range of routine items. In addition there has been a growth in the number of investors who require custom guidelines based on their own corporate governance policies, to be facilitated by the proxy advisor. In these cases therefore it would be surprising if investors did not follow the overwhelming majority of proxy advisors recommendations. Also a number of often more routine items – reappointment of auditors, election of board directors, approval of bye-law amendments – are considered by many investors as not controversial, and this therefore raises the percentage of correlation. However in PIRC's view many of these items are very important and at times extremely controversial, even if many in the market do not.

There is another point to be made here. Our formal process for bespoke clients is to issue a draft recommendation to their client site based on their template but they have the opportunity to review this. The final recommendation published to their client site will include any changes they wish to make to voting advice.

These are the main reasons the proxy advice provided by most advisors exhibits a high degree of agreement between the views given by the advisors and the actual votes by their clients. Furthermore, advisors use corporate governance best practice guidelines as the foundation for their policies and therefore the advice they provide to

clients is again likely to coincide with the views of the investors who collectively have created “best practice”.

2) To what extent:

a) Do you consider that proxy advisors have a significant influence on voting outcomes?

It is the professionalism of the advisor, the pre-acceptance of the principles and methods of analysis, the diversity of the issues and the speed required which gives the proxy advisors influence on most issues. However on the big and sensitive issues many investors take the time to assess things for themselves with the advisor only being part of the input. In particular on those often controversial issues, many asset managers and larger investors retain voting internally.

While obviously advisors have some influence, the influence they have is a result of choices made by the recipients of their recommendations. The advisors do not compel their clients to take their advice, rather it is a decision by their clients as to the extent to which they follow the advice. Also, larger investors have their own custom policies which tend to follow what they consider to be best practice and therefore the influence is not as universal as the degree of correlation would suggest.

ESMA will be aware that when looking to match voting results to PRA recommendations care should be taken to identify the key concern being expressed by investors who withdraw support. PRAs are very good at flagging up a departure from best practice but the investors are free to choose a variety of voting targets to express any resulting concerns.

b) Would you consider this influence as appropriate?

In so far as proxy advisers retain their professionalism by promoting recognised market best practice and evidenced-based voting recommendations resulting from transparent guidelines and analysis, their influence will always be balanced by their client's own views and policies, however strong their voting recommendations are seen to be.

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

Throughout Europe, fiduciary responsibility for proxy voting and engagement rests with the ultimate decision makers - the investors. All client relationships between proxy advisers and their users recognise this. Thus the investors – as owners – receive voting advice based on data published publically by the issuers. In today's European capital markets, issuers try to communicate directly particularly with their largest investors. We regard the European Central Bank's TSM initiative as a potentially important fillip to this trend as it has the chance of extending powers under UK Companies Act (2006) s793 to issuers elsewhere in Europe. However, the use of omnibus or pooled custodial accounts rather than designated accounts is a significant barrier to such communication.

Issuers, within the legislative constraints of each country market in Europe, structure each vote appearing on each annual meeting agenda and the conduct of all annual meetings. These lines of communication are not weakened by proxy advisors. Shareholders holding issuers to account is the lynchpin of most, if not all, corporate governance arrangements adopted by legislation across Europe. Neither facilitating this process of accountability by investors nor the issuers' prerogatives are threatened by proxy advisors, unless these are dependent on a lack of comprehension or transparency.

Unfortunately some owners resent the 'intrusion' of analysis or the application of governance best practice where this is inconvenient to their old style of operation. This is a matter decided solely by the underlying investors as to whether or not they follow the proxy advisor's advice. Investors who have strong views will follow their own course either directly or via a PRA template service while those who do not will rely on the advice provided by a PRA or their external investment manager.

4) To what extent do you consider proxy advisors :

a) to be subject to conflicts of interest in practice?

The principal threat of a conflict of interest is where a proxy advisor also provides services to the issuer community. It is necessary to distinguish between those proxy advisors who may be part of a larger organization and which provide other services to the issuers and those smaller organisations that do not provide any advice to the issuers.

There are other less dramatic conflicts that occasionally arise. For example, where a client of a proxy adviser is an active participant in a company annual meeting, perhaps by submitting a shareholder proposal at an issuer for whom the proxy adviser has made voting recommendations. In preparing its proxy report on the company the proxy advisor should in our view disclose this potential conflict in the body of its report.

In addition proxy advisers should be required to disclose shareholdings in companies for which proxy reports are prepared.

b) have in place appropriate conflict mitigation measures?

The disclosure and management of actual or potential conflicts of interest is a common feature of many parts of the financial services industry, and in PIRC's view the proxy advisory industry should be no exception. We address mitigation below.

c) to be sufficiently transparent regarding the conflicts of interest they face?

In PIRC's view as the commercial relationships are often undisclosed where they exist, those proxy advisors that serve both investors and the issuers generally are insufficiently transparent regarding any potential conflicts of interest. While there may, in fact, be safeguards in place which prevent any conflict of interest, the lack of transparency does not allow for any confidence in the assessment of this. Such

potential conflicts are not limited to service provision, they are also present in terms of ownership.

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?

In PIRC's view conflicts which impact on voting recommendations are the most significant. However conflicts can arise in relation to :

- Issuer services
- Staff shareholdings
- Ownership of a PRA and
- Dominant investor clients.

b) Have in place appropriate conflict mitigation measures?

The major advisor, ISS, claims to have safeguards in place to ensure the independence of their voting advice from their consulting services. It might be appropriate for anyone who is not formally regulated already to at the very least commission and publish some kind of external verification of the adequacy of these safeguards and the disclosure of such issuer revenues may also be appropriate.

c) Do you consider that these conflicts lead to impaired advice?

There is no way to externally verify that such potential conflict has lead to impaired advice but the fact that a firm provides guidance on how to meet it's own standards and so obtain a positive voting recommendation, may lead to concerns that the advisor is more interested in maximising revenues than providing recommendations that will lead to improved corporate governance which is the goal of the advisory clients. At the very least these conflicts lead to a loss of confidence amongst wider stakeholders that advice might be impaired – which is often nearly as serious.

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?

European corporate governance best practice has in the main developed through the used of codes of best practice. (cf Tabaksblat, Cadbury, Crommer etc). In these cases the focus and extent of guidelines and voting policies often reflect such codes, which in themselves become established in particular markets as a result of achieving consensus between governments, market regulators, standard setters, issuers and investor representatives.

Virtually all proxy advisors take local market practice into account in formulating their voting policies. That being said, some markets have situations which are heavily skewed to favour one group of investors, usually the state or a majority owner over the interests of minority shareholders. Proxy advisors attempt to provide a more

level playing field for all investors in terms of research and analysis and to move a market towards practices which treat all shareholders equitably.

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

Proxy advisers who publish voting guidelines usually review them annually. PIRC does this for developed markets and updates regularly where major policy changes are required, perhaps as a result of new legislation.

In terms of public dialogue over guidelines content, PIRC provides for a period of comment from clients before final publication. In terms of public comment from other interested parties, including issuers, PIRC is concerned that its own independent judgement may be impaired if it enables issuers to influence and amend its voting guidance. As an independent proxy advisor regulated by the Financial Services Authority, PIRC believes that its fiduciary responsibility is to provide its clients with its best advice. This may be unduly influenced if issuers were to seek to influence and constrain its independently arrived at voting recommendations or policy.

However having said this, where voting guidelines are developed and published in public it might be more useful if issuer trade associations rather than individual issuers responded. Individual issuers can and do raise points about specific aspects of their operations or can comment on many if not all individual voting recommendations from a factual point of view. We provide specific opportunities for issuers to participate in formal PIRC briefings/seminars as well as independently organised conferences where voting guidelines are presented and debated openly, and it participates in a broad range of industry platforms where voting policies are also debated.

PIRC's voting policies are not determined on a whim or out of some prejudice but are heavily influenced by the investors who use the recommendations. PIRC recognises that the interests of issuers may not always be those of the investors, and this reflects that fact that there is a fundamental principal/agent problem in modern corporations, where often directors/management seek more of the economic rents that would otherwise flow to the owners.

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?

Most proxy advisors provide some form of their voting guidelines to the public. That being said, some of this information is proprietary and may be inappropriate for firms to share. Also, proxy advice is not a simple matter of following a recipe and there is a constant need to interpret voting guidance based on sometimes complex company disclosures. In PIRC's view individual voting recommendations should either demonstrate the application of the guidelines used or state clearly when deviation from those guidelines has been necessary and why.

b) the dialogue with issuers when drafting voting recommendations?

Best practice would be to permit issuers to have a limited time to review the advice prior to publication. PIRC endeavours to provide issuers with its draft reports for UK companies 48 hours in advance of despatch to clients. This is not always possible due to problems of communication with companies and restrictive deadlines. In many other markets in Europe and around the world however, issuers often fail to provide information in sufficient time to permit this, especially given the voting timeframes imposed on investors by custody or sub-custody practices for voting in various European and other markets.

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

PIRC as a regulated firm is directed and managed by FSA Approved Persons who must meet threshold conditions and capabilities. PIRC's staff are sanctioned and can be held accountable by FSA at any time. In addition PIRC is required to meet key rules regarding the capabilities of its staff as specified in FSA rules specifically:

'SYSC 5.1.1

A *firm* must employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.

Including further FSA Guidance:

A *firm's* systems and controls should enable it to satisfy itself of the suitability of anyone who acts for it. This includes assessing an individual's honesty and competence. This assessment should normally be made at the point of recruitment.

Any assessment of an individual's suitability should take into account the level of responsibility that the individual will assume within the *firm*.'

As some staff may have multiple backgrounds, such as law and accounting, politics, even psychology or the humanities, these backgrounds may all provide different contributions to quality management systems in place at proxy advisors, and no one skill set is the appropriate one for all types of proxy research. Further, diversity of experience and viewpoints is useful in avoiding "groupthink".

Proxy advisors do market their services based on, amongst other things, the quality of their analysis and therefore the professionalism of their staff. This can and does include the background, experience and qualifications of their teams. The pressures of competition thus act as an effective challenge to maintain competence and quality amongst staff in the industry.

In summary, PIRC believes that the adequacy of staff capabilities relevant to their role and seniority, as well as integrity, must be capable of demonstration to regulators or with suitable confidentiality to other stakeholders. However, the rigidities

of a specific training and competency regime is not required and may prove counter productive.

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.

The most logical would be to allow for the further development of various standards within the EU: they would address any potential concerns that are identified as result of feedback to this discussion but also reflect individual business and regulatory environments in the EU. To ensure such standards are useful, investor's trade associations could be involved in the development of such standards. They might also be accompanied by an appropriate code of compliance with best practice standards for proxy advisers. PIRC therefore favours Option 3.

This approach seems the most appropriate for the nature of the business models followed by most proxy advisers operating in comply-or-explain market environments. Second, whilst the traditional approach of 'self-regulation' has failed across the board in European financial markets, codes of best practice have been successful, to the extent that there is now a broad consensus operating about corporate governance best practice between investors and issuers across the most developed markets in Europe.

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.

One EU intervention might be a requirement that all proxy advisors adopt a policy of not engaging in consulting with those companies on whom they also provide voting recommendations. This could be achieved by either a ban on such consulting or a clear disclosure of all consulting relationships.

Perhaps a better measure would be for an EU wide policy requirement for complete disclosure by investors of their voting records, the proxy advisors employed and their internal voting policies and procedures. This would allow the clients of the investors to evaluate the extent to which the institutions exercise their stewardship responsibilities effectively.

11) What would be the potential impact of policy intervention on proxy advisors, for example, as regards:

a) barriers to entry and competition;

Competition is already an issue within a market that is dominated by one or two major players which results in pressure on revenues, leading to reduced quality and

creating barriers both to entry and expansion by new players. In this regard the link up between trade associations and specific advisors has been one of the negative practices that has restricted competition (cf NAPF/ISS; Proxy Governance/US Business Roundtable).

The most significant barrier to entry in the market at EU level, is the fact the most investors require a firm to be able to provide research on a global portfolio of companies. This requirement forces any new firm to be able to offer such coverage which is costly both in terms of staff and other resources.

Market share and therefore considerable market muscle has been derived from the provision of electronic vote platform services to custodian banks wishing to outsource their vote processing responsibilities and is not necessarily related to the provision of proxy advice.

b) inducing a risk of shifting the investor responsibility and weakening the owner's prerogatives; and/or
c) any other areas

On one final point PIRC is of the view that more transparent procurement process by financial services firms contracting to PRAs might introduce a more level playing field for competition between US PRAs and European based PRAs.

In our view the ESMA intervention could clarify the responsibilities between participants and allow a practical approach to any liabilities which might properly arise.

Conclusion

In PIRC's view, proxy advisors are playing a constructive role in promoting wider ESMA objectives: voting has increased; investors have a real means of delivering desired stewardship; better stewardship promotes long-termism and challenges bad or secretive management - informed voting strengthens the ability of investors to enforce that kind of accountability. Congruence of voting and advice is an appropriate response as there are many non controversial issues to vote on, and the methodologies of the advisers have been agreed by their clients. If investors disagreed they would not pay for proxy advisory services.

Competition is an issue: the market is dominated by those who use the 'muscle' of market share to pressure other's revenues, reducing quality and creating barriers both to entry and expansion by new players. In this regard the link up between trade associations and specific advisors has been a negative and restrictive practice to open competition.

PIRC believes that the proxy advisory business is a serious business. It is appropriate that the PRAs methodology should be transparent and accountable, and thus regulated in some form. This will in our view lead to improved research and

analytical quality. PIRC is regulated by the FSA and this creates a framework for conflict management etc aligned with the investors. Proxy Advisors should be transparent with their methodology for all stakeholders but transparent on their capabilities only with clients.

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