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ADVICE TO ESMA

SMSG reply to the Call for evidence on the implementation of SRD2 provisions on proxy advisors and the investment chain

I. Executive summary

1. The SMSG welcomes the opportunity to respond to the call for evidence on certain provisions of SRD II and considers that the cross-border voting process should become simple, cost effective, and efficient.

2. In view of the SMSG, the shareholder identification process has not significantly improved, as the term 'shareholder' continues to be defined by applicable national corporate law, which makes shareholder identification incomplete. The SMSG therefore considers that the definition of the 'shareholder' should be harmonized and aim at capturing the end-investor.

3. Moreover, the option provided by SRD II to limit the scope of shareholder identification to holdings exceeding a given threshold should be repealed and be made at the level of the first intermediary, not at each intermediary in the holding chain to ensure that shareholdings are captured correctly.

4. The SMSG also considers that the transmission of information along the intermediaries' chain remains not fully satisfactory and may have had an impact on the flow of information between issuers and investors around a general meeting. The main reasons for this are:

   - **the late implementation:** Not all Member States had transposed SRD II into national law by 3 September 2022.

   - **the lack of 'same language' format:** The format to achieve a "same language" purpose, ISO 20022, originally foreseen for 22 November 2021, had been postponed and 'go live' is now planned for November 2023. The reason for the delay is unclear and will hamper the communication between issuers and shareholders for a further general meeting season (2023).

   - **the late enforcement:** Neither shareholders nor issuers, have any valid means to accelerate the harmonisation process nor do (national) regulators often have the option yet to enforce the rules of SRD II and its Implementing Regulation which are being delayed by the late ISO 20022 implementation effectively at least until four years after transposition. The SMSG sees a need to review the regulatory oversight of general meeting-related processes to ensure that shareholder rights become enforceable in all Member States.

- **the market structure**: While information regarding corporate action processes are flowing smoothly through the intermediaries' chain, for general meeting processes, omnibus accounts still create obstacles as they make it difficult to identify proprietary interests of beneficial owners. Moreover, in many systems, the separation of legal ownership and beneficial ownership creates additional difficulties. The SMSG calls on ESMA to assess whether the intermediated systems currently in place and current CSDR framework needs to be reassessed to ensure that omnibus accounts do no longer create (factual) obstacles to the processing of information between issuer and shareholder.

- **Costs and charges:** The SMSG notes that costs and charges for general meeting-related services continue to be a deterrent, especially for individual shareholders. While at national level, participating in and voting at general meetings is generally free of charge, it may become very costly when the same rights are to be exercised abroad. The SMSG suggests ESMA to undertake an in-depth analysis on general meeting-related costs and charges invoked by intermediaries considers important that fees are made transparent for investors in advance.

- **Lack of harmonised oversight:** Next to that, there is a lack of harmonised regulatory oversight of intermediaries' general meeting-related processes.

- **Neo brokers:** Certain provision deviating from the legal requirements of SRD II, i.e., to facilitate the transmission of information between issuers and investors could be found in some neo brokers' terms and conditions. The extent to which neo brokers comply with the legal requirements of SRD II should be further investigated in their involvement in the governance of the proposed issuers, also in relation to the business model on which they are based.

- **Simplification of documentation requirements:** As of today, shareholders have to provide various documentation (e.g., a proof of entitlement) to their last intermediary when wanting to exercise their shareholder rights at a general meeting. The SMSG considers that an EU wide form of proof of share ownership at record date accepted by any intermediary in the chain as well as any EU issuer could help to simplify processes and foster a straight-through processing (STP) as foreseen by the SRD II Implementing Regulation.

- **Direct communication between shareholders and issuers:** The SMSG recommends ESMA to investigate further whether the use of modern technology, could improve the information flow between issuers and investors while taking into account potential risks for investor protection as both direct and intermediated communication channels between issuers and shareholders have equal footing.

5. Whilst Proxy advisors are not subject to mandatory regulation beyond the requirements laid down in Article 3j of SRD II, the Best Practice Principles (BPP) were formed to establish voluntary best practice principles. The SMSG considers that the latter's impact on the three principles (services quality, conflicts of interests and communication with issuers) remains unsatisfactory.

6. In the area of ESG services, the SMSG considers it important that any future legislative or regulatory actions on proxy advisors are coordinated with the upcoming review on ESG rating providers.

7. Also, the SMSG considers it important to ensure that a structured dialogue procedure, proper and transparent engagement is put in place by proxy advisors; so that factual errors in the report can be corrected by proxy advisors after a dialogue with issuers before the voting deadline.

8. The SMSG sees a need for more disclosure to ensure that the methodology and procedures put into place to ensure that voting recommendations are of appropriate quality and are not deviated from in case of services for both issuers and investors.

9. In addition, the SMSG further sees a need to clarify how voting recommendations and policies are being developed and reviewed, whether an investor/stakeholder consultation process been established, and what the main features of the process justifying revisions of the voting policy are.

10. The SMSG considers that conflicts of interest should be avoided by any circumstances and that proxy advisor should not offer consulting advice to analysed companies in particular on topics that are part of the general meeting agenda and should inform their clients individually about any actual or potential conflicts before or at the same time as the voting recommendations are made available to clients.

11. The SMSG furthermore would consider it helpful if any review of the proxy advisory market would look into the de facto duopoly in this market preventing smaller, local service providers to compete with the existing market players.

12. The SMSG notes that SRD II did not achieve more transparency when it comes to proxy advisors, or at least only marginally. When reviewing SRD II, the SMSG therefore would favour a reinforced voluntary approach, based on the "comply or explain" principle with the NCAs being in charge of the supervision.

I. General remarks

1. The SMSG welcomes the opportunity to respond to the call for evidence on certain provisions of SRD II. SRD II was intended to improve the processes of shareholder identification as well as the transmission of information and facilitation of the exercise of shareholder rights. Also, it was supposed to improve transparency of proxy advisors. The SRD II Implementing Regulation (IR) offers minimum standards in that respect. It also was intended to enable a direct communication between investors and issuers.

2. As stakeholder group, the SMSG would like to provide high-level feedback on how market participants perceive the appropriateness of the scope and the effectiveness of the SRD2 provisions, and the difficulties faced by market participants.

3. The SMSG considers that the cross-border voting process should become simple, effective, and efficient. The easier and cheaper it is for shareholders to vote at the general meetings of their companies on a cross-border basis, the more they will exercise their voting rights also abroad.

II. Shareholder identification

4. **Definition of shareholder:** In view of the SMSG, the shareholder identification process has not significantly improved since the introduction of SRD II. The main reason for this being that the term 'shareholder' continues to be defined by applicable corporate law, meaning that the determination of the shareholder depends on the Member State of the issuance (as defined by national laws). This results in varying 'shareholder' concepts which cause an uneven level playing field, and thus makes shareholder identification incomplete as well as more complex and costly.[1]

5. It enables, for example, a practice followed by intermediaries in some Member States (e.g., Denmark) to register a shareholder only upon request for general meeting participation in a company register and to automatically replace the name of the shareholder by their own once shareholder rights have been exercised ("re-registration") - even when shareholders have not disposed of their shares. This unravels the concept under which SRD II intended to enable the direct communication between issuer and shareholder and thus lead to a situation where company registers do not reflect properly the owner base and

[1] UNIDROIT has identified five models of intermediated securities systems based on the ownership of securities in the chain undefined These are: i) the trust model; ii) the security entitlement model; iii) the co-ownership model; iv) the individual ownership model, and; v) the contractual model.

where shareholders have to pay charges to their intermediary for being included in the company register.

6. The SMSG therefore considers that a harmonization of the 'shareholder' definition, as recommended by the HLF CMU[2] and as taken on board by the EU Commission in its Action Plan[3] (Action 12) is necessary. Any such definition should take into account as shareholder the 'legal or natural person having invested his/her own money directly into a share, bears the financial risk and is entitled to the dividends/corporate actions'. This definition aims at capturing the end investor investing into shares. In addition, the SMSG considers that the Implementing Regulation needs to be strengthened in its language to ensure that the information flow does not end at nominee level but that the end investor, i.e. the 'final' shareholder receives the information from the issuers through the chain of intermediaries and is able to exercise his/her rights flowing from the shares.

7. The way some Member States have transposed the option provided by SRD II to limit the scope of shareholder identification to holdings exceeding a given threshold is questionable and should be repealed as it would help avoiding fragmentation of the market and has not proven to work in practice. If being kept and Member States apply the option, determination of the holdings exceeding the threshold should solely be made at the level of the first intermediary, not at that of each intermediary in the holding chain as interpreted by some Member States in order to ensure that shareholdings are captured correctly.

III. Transmission of information and facilitation of the exercise of shareholder rights

8. In view of the SMSG, the transmission of information along the intermediaries' chain remains not fully satisfactory since the entry into application of SRD II and its Implementing Regulation on 3 September 2020. A recent survey among shareholders and shareholder associations4 found that only in 37% of cross-border voting attempts during the AGM season 2022, shareholders received the meeting notice either through the intermediaries' chain, i.e., from their deposit bank/broker, or directly from the issuer. In 63% of all cases, the shareholder did not receive this information unsolicited from the deposit bank/broker or found it through his/her own means. This is a deteriorating trend compared to findings in similar research from 2021[5] where 41% of respondents received the information either from the deposit bank/broker or directly from the company. 45% of all cross-border voting attempts failed (2021: 66%).[6]

9. The SMSG considers the following reasons may have had an impact on the flow of information between issuers and investors around a general meeting:

10. **Late implementation:** Not all Member States had transposed SRD II into national law by 3 September 2022, among them Spain, Croatia, Slovenia, or Iceland. Consequently, full regulatory clarity was outstanding but also where transpositions did take place on time, they were not harmonised on key definitions and requirements.

11. **Lack of 'same language' format:** Updates to SWIFT connectivity and status of messaging on holdings were delayed. The format to achieve a "same language" purpose, ISO 20022, originally foreseen for 22 November 2021, had been postponed and 'go live' is now planned for November 2023.[7] Market participants, especially intermediaries expect this ISO format to be significantly improving the general meeting-related communication between intermediaries.

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[2] https://finance.ec.europa.eu/system/files/2020-06/200610-cmu-high-level-forum-final-report_en.pdf
[3] https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan/action-12-facilitating-shareholder-engagement_en
[4] https://betterfinance.eu/publication/barriers-to-shareholder-engagement-srd-ii-revisited/
[5] https://betterfinance.eu/wp-content/uploads/publications/FINAL_Barriers_to_Shareholder_Engagement.pdf
[6] Ibid.
[7] https://www.clearstream.com/clearstream-en/products-and-services/asset-services/c22002-2922248

12. While the original implementing timetable had been foreseen for November 2021, i.e., already more than one year after the entry into application of SRD II and its Implementing Regulation,[8] the postponement will hamper for a further general meeting season (2023) the communication between issuers and shareholders. The reason for the delay is unclear but may have to do with the market infrastructure's complexity (voting processes built on legacy systems are not fit for purpose), a lack of financial motivation for harmonisation or a lack of enforcement. Also, local specificities have been detected as a reason for the delay. For example, as part of the vote-reception process, in certain cases local law allows issuers the possibility to request a certification from the custodian bank, or client identification requirements which exceed the basic requirements. In the absence of harmonisation of legal requirements, standard formats and operational processes are not a silver bullet.

13. **Late enforcement:** Neither shareholders nor issuers, though, have any valid means to accelerate this harmonisation process nor do (national) regulators often have the option yet to enforce the rules of SRD II and its Implementing Regulation which are being delayed by the late ISO 20022 implementation effectively at least until four years after transposition. The SMSG therefore sees a need to review the regulatory oversight of general meeting-related processes to ensure that shareholder rights become enforceable in all Member States.

14. **Market structure:** Omnibus accounts reduce costs for intermediaries and streamline processes. They are the predominant account model used in Europe. [9] While information regarding corporate action processes (e.g., dividend payments or capital measure announcements) are flowing smoothly through the intermediaries' chain, for general meeting processes these omnibus accounts – combined with the notion of "nominee" and of the separation of legal ownership and beneficial ownership - still create obstacles as they make it difficult to identify proprietary interests of beneficial owners. Moreover, in many systems, the separation of legal ownership and beneficial ownership creates additional difficulties.

15. Literature in that respect suggests that omnibus accounts may even lead to issuers' registrars having to disregard votes because there is no means to ascertain that votes had been validly cast,[10] as an accurate reconciliation of holdings to votes in omnibus accounts may be close to impossible.

16. Also, shareholders with shares being held on an omnibus account at the CSD wanting to vote their shares for example in a Finnish company have to re-register for a general meeting, a procedure that is connected to costs and is cumbersome, especially for individual investors. The reason for this being one the one hand the lack of a common definition of 'shareholder' and the contractual arrangements between intermediaries.

17. The SMSG notes recital 11 of CSDR stating that 'Immobilisation and dematerialisation should not imply any loss of rights for the holders of securities and should be achieved in a way that ensures that holders of securities can verify their rights.' The SMSG calls on ESMA to assess whether the intermediated systems currently in place adhere to this statement and whether the current CSDR framework needs to be reassessed to ensure that omnibus accounts do no longer create (factual) obstacles to the processing of information between issuer and shareholder.

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[8] In several Member States, the national regulator (in Germany, for example, the national regulator BaFin), is not competent for enforcing general meeting-related processes as these have been implemented in national company law (AktG). In case of non-compliance, shareholders therefore must seek legal recourse from their intermediary in court which is ineffective to accelerate for example the introduction of a harmonised intermediaries' language or to force an intermediary to comply with the obligations defined in SRD II.

[9] In 2019, the Greek ATHEXCSD was the only EU CSD providing for a beneficial ownership account for domestic participants whereas six CSDs (the Belgian Euroclear Bank, the Swiss SIX SIS, the Italian Monte Titoli, the Luxembourgish LuxCSD, the Portuguese Interbolsa and the Austrian OeKB CSD) provided mostly omnibus accounts even to domestic participants. EU CSDs annually process around 448m delivery instructions representing 1.46q EUR. ECSDA, CSD Fact book, https://ecsda.eu/wp-content/uploads/2021/01/2019_European_CSD_Industry_Factbook.pdf.

[10] Eva Micheler, Building a Capital Markets Union: Improving the Market Infrastructure, https://www.researchgate.net/publication/295562915_Building_a_Capital_Markets_Union_Improving_the_Market_Infrastructure

18. **Costs and charges:** SRD II states that the discrimination between the charges levied for the exercise of shareholder rights domestically and on a cross-border basis is a deterrent to cross-border investments and the efficient functioning of the internal market and should be prohibited. Any difference between the charges levied for the domestic and the cross-border exercise of shareholder rights should be allowed only if they are duly justified and reflect the variation in actual costs incurred for delivering the services by intermediaries.

19. The SMSG notes that costs and charges for general meeting-related services continue to be a deterrent, especially for individual shareholders. While at national level, participating in and voting at general meetings is generally free of charge, the heavier operational burden for intermediaries resulting from outdated IT systems, a lack of a common language format (see IV.4. of this advice) and non-aligned national specifics means that it may become very costly when the same rights are to be exercised abroad.

20. Exemplary custody tariffs from selected intermediaries suggest that intermediaries still adapt their fee structures to different Member States, invoke significant amounts of fees for general meeting-related processes or even restrict shareholders to proxy voting only, and thereby do not facilitate physical general meeting attendances abroad. [11]

21. Issuers also perceive a lack of transparency regarding fees for services provided to them by intermediaries. Not only is the fee calculation not always fully transparent, also there is no clarity to whom the task of invoicing should be attributed to (the CSD or a separate intermediary service provider).

22. The SMSG therefore suggests ESMA to undertake an in-depth analysis of whether general meeting-related costs and charges invoked by intermediaries are indeed duly justified and reflect the variation in actual costs incurred for delivering their services.

23. The SMSG also considers it important that, like for other banking services, where fees are charged by intermediaries for general meeting-related services these are made transparent for investors in advance. There is still a low level of transparency for shareholders with regard to costs that intermediaries charge for providing general meeting-related services, plus the cost information is neither easily accessible, on-demand only or nor comparable.

24. **Lack of harmonised oversight:** Next to that, there is a lack of harmonised oversight of intermediaries' general meeting-related processes. In view of the SMSG, there is a need for the EU Commission to review regulatory oversight of costs and charges connected to general meeting-related processes and harmonise it. In a first step a central point of intermediaries' custody service fee schedules could be established at European level, for example at EBA.

25. **Neo brokers:** A desk research[12] among neo brokers found that several neo brokers, according to their terms and conditions, do not always comply with the legal requirements of SRD II, i.e., to facilitate the transmission of information between issuers and investors. Certain deviating provision could be found in some neo brokers' terms and conditions. This is contradicting the requirements of the Shareholder Rights Directive II (SRD II) and its Implementing Regulation on the obligation to transmit the necessary information to the shareholders (Article 4) and to enhance the execution of shareholders' voting rights (Article 5 & 6). In the absence of any indication to the contrary (in their disclaimer or terms of services),

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[11] https://betterfinance.eu/publication/barriers-to-shareholder-engagement-srd-ii-revisited/
Exemplary custody tariffs to support this assessment can be found at: https://www.bil.com/Documents/brochures/tarifs-en.pdf, https://sebgroup.com/legal-and-regulatory-information/legal-notice/shareholders-rights-directive-srd2-fee-disclosure, https://cdn0.erstegroup.com/content/dam/at/spk-erstebank/konditionenaushang/2.800_-_2.803.pdf, https://www.deutsche-bank.de/dam/deutschebank/de/shared/pdf/List-of-Prices-and-Services-Deutsche-Bank-AG.pdf, https://danskebank.dk/-/media/pdf/danske-bank/dk/investeringsprodukter/charges-for-custody-accounts.pdf?rev=c5f2f8810bb3463b8be89fe2c95e746c&hash=C3EEB0F7C52FCF99E1B457544BA84F15 or https://www.degiro.co.uk/helpdesk/documents/fee-schedule/fee-schedule-custody https://www.degiro.co.no/helpdesk/trading-platform/how-can-i-participate-shareholders-meeting https://www.justtrade.com/fileadmin/Formulare/Preis-und-Leistungsverzeichnis.pdf

[12] https://betterfinance.eu/publication/barriers-to-shareholder-engagement-2-0-srd-ii-implementation-study/

however, it remains unclear whether some neo-brokers grant themselves the right to execute voting rights on behalf – or instead – of the client (quid of a securities lending business model, for instance). The SMSG therefore recommends to further investigate the involvement of neo-brokers in the governance of the proposed issuers, also in relation to the business model on which they are based.

26. **Simplification of documentation requirements:** As of today, shareholders have to provide various documentation (e.g., a proof of entitlement) to their last intermediary when wanting to exercise their shareholder rights at a general meeting. Sometimes, a shareholder identification number is required. In other cases, the ownership needs to be proven by providing an ID card or a proof of ownership from the last intermediary. Sometimes, documentation needs to be provided as hard copy or legalised document. [13] From a shareholder perspective it is unclear who does require certain information, the issuer or (any) intermediary in the chain. While different documentation requirements may result from the nature of the share (registered vs. bearer share) and national laws, from a shareholder perspective they are confusing and lead to a manual and time-consuming process instead of one that should be as simple as possible.

27. The SMSG considers that an EU wide form of proof of share ownership at record date that needs to be accepted by any intermediary in the chain as well as any EU issuer could help to simplify processes and foster a straight-through processing (STP) as foreseen by the SRD II Implementing Regulation.

28. **Blocking of communication:** On a separate issue, regardless of how investors hold their shares, there is a broader concern about de facto blocking of communication between the issuer and investors in the holding chain, preventing information from passing down to the shareholder, especially in instances where the record date is close to the meeting date. While in such cases it can frequently occur that instructions arrive too late to be successfully processed in time for the cut-off date, intermediaries should be mindful not to breach their obligations to pass on information and facilitate the exercise of shareholders rights.

29. **Direct communication between shareholders and issuers:** Generally, there is a need to spell out more clearly in the SRD II Implementing Regulation that both direct and intermediated communication channels between issuers and shareholders have equal footing. A case in point is the confirmation of entitlement that could be sent directly to issuers and/or their agents. Academic research finds that the 'permissioned blockchain solution' may offer shareholders 'real-time transmission of the information and direct communication between issuers and shareholders' as it would make it 'possible to remove all intermediaries (like Broadridge) involved in the proxy votes collection and instructions process if all ownership information from different tiers is uploaded to the distributed ledger'.[14] The SMSG recommends ESMA to investigate further whether the use of modern technology could improve the information flow between issuers and investors while taking into account potential risks for investor protection.

IV. Proxy advisors

30. Due to costs involved in underlying due diligence and considerable economies of scale, many asset managers retain the services of one of the few proxy advisory firms. Their impact on the voting market is illustrated by a recent assessment of the SEC which found that 114 institutional investors voted in lockstep alignment (robovoting) with either ISS or Glass Lewis in 2020: 86% of robovoting investors used ISS and 14% used Glass Lewis, reflecting the dominant market position of ISS. Robovoting institutional investors managed collectively more than $5 trillion in assets.[15]

31. Proxy advisors which have arisen due to market failures underlying voting and the broader system of corporate governance, are not subject to mandatory regulation beyond the requirements laid down in Article 3j of SRD II. The Best Practice Principles (BPP) had been formed by proxy advisors, among

[13] https://betterfinance.eu/publication/barriers-to-shareholder-engagement-srd-ii-revisited/
[14] Lafarre/van der Elst: Shareholder Voice in complex intermediated proxy systems: Blockchain technology as a solution? https://biblio.ugent.be/publication/8698523/file/8698524.pdf
[15] https://corpgov.law.harvard.edu/2021/05/27/proxy-advisors-and-market-power-a-review-of-institutional-investor-robovoting/

them the two dominant players in this market, ISS and Glass Lewis, to establish voluntary best practice principles for proxy advisors, tailor-made to them. Their initiative came in response to a call by ESMA for more openness from governance research providers and proxy voting advisors about their decision-making processes. The BPP are non-binding and self-established market practice. Only since 2019, this voluntary code of conduct is overseen by an independent Oversight Committee which provides an annual independent review of the monitoring of the BPP and an annual independent review of the public reporting of each BPP Signatory.

32. Generally, while welcoming the progress made since the BPP's update in 2019, the SMSG considers that the latter's impact on the three principles (services quality, conflicts of interests and communication with issuers) remains unsatisfactory.

33. **BPP coverage:** The updated BPP only provide the bare minimum referred to in SRD II. The principles remain ambiguous, notably in the area of conflicts of interest identification and prevention. One of the major areas of concern for issuers is ancillary or overlay services, such as voting platform services provided to investor clients, ESG services and ratings offered provided to investor clients and issuers. These services, on which some of the most important proxy advisors on the market seem to capitalize, de facto have remained outside the scope of BPP, often leading to conflicts of interests.

34. Especially in the area of ESG services, the SMSG considers it important that any future legislative or regulatory actions on proxy advisors are coordinated with the upcoming review on ESG rating providers.

35. **Accuracy of information:** A further concern relates to the accuracy of the information included in the reports to clients which may lead, in some instances, to misleading information to investor clients. To cope with this fundamental problem of inaccurate and even misleading information, the BPP should improve the possibility for issuers to comment on drafts voting reports and ensure that, where reports are factually wrong, their comments be passed on to investors to help them making informed investment decisions.

36. **Disclosure of methodology and procedures:** Proxy advisory firms now essentially making their voting policy available ahead of the general meeting season. The SMSG however sees a need to ensure that the procedures put into place to ensure that voting recommendations are of appropriate quality and are not deviated from in case of services for both issuers and investors. The SMSG further sees a need to clarify how voting recommendations and policies are being developed and reviewed, whether an investor/stakeholder consultation process been established, and what the main features of the process justifying revisions of the voting policy are.

37. **Engagement with issuers/stakeholders:** Also, more clarity is needed to understand if and how proxy advisors engage with issuers and other stakeholders, which source of information they use to ensure that the information about the issuer and each particular matter is complete, and if and how they take into account the issuer's views and comments in an efficient and timely manner.

38. **Factual report mistakes/errors:** Where issuers observe errors or seriously misleading information appearing in the voting reports which affect the quality of the reports and in some more serious cases may lead to misleading information communicated to the investor client, the SMSG considers it important to ensure that a structured dialogue procedure must be put in place by proxy advisors so that factual errors in the report can be corrected by proxy advisors after a dialogue with issuers before the voting deadline.

39. Despite some improvement, each European company's unique set of local and legal conditions (regarding notably corporate governance) are not always adequately taken into account and weighted by certain proxy advisory firms. One reason for this being that there is a dominance by two globally acting proxy advisory firms in the market, which is not open to competition due to the sheer dominance of the two main proxy advisors preventing local providers to emerge due to a lack of economies of scale. Moreover, the same governance practice (e.g., the combination or separation of the Chairman and CEO offices) gives rise to a diverging voting policy in Europe and in the US. Generally, there is a strong trend

by some proxy advisory firms to recommend sanctioning directors, when their office is up for renewal, who have assumed or approved a company-specific policy (e.g., on executive remuneration) differing from the proxy voting policy.

40. **Conflicts of interest:** Conflicts of interest within the terms of SRD II should be prevented. At least, they need to be clearly identified and disclosed to clients, together with the actions proxy advisors undertake to prevent, avoid, eliminate, mitigate or manage them.

41. One of the major potential or existing conflict of interest may arise when a proxy advisory firm provides voting recommendations to investors on corporate governance matters for which the same firm offers provided consulting services to the issuers, for example on executive remuneration policies. This potential for conflict of interest is not even mentioned in the updated BPP and cannot be inferred from the description of the proposed services.

42. We note that the BPP did not prevent one of the signatories from developing consulting services to issuers in parallel to its proxy activities, another signatory just launched a ESG data service both for issuers and investors.

43. Particularly relevant in this respect, are the two services marketed by ICS, a subsidiary of ISS, who, despite claiming it has set up appropriate so called “Chinese Walls”, is still systematically offering services to issuers aimed at improving their "QualityScore" or "PayForPerformance".[16] In our opinion, Chinese Walls between proxy voting teams and consulting teams are not an effective response to distortions caused by conflicts of interest. Furthermore, we believe that “comply or explain” rules are not strong enough to solve all the problems generated by conflicts of interest. Despite any Chinese Walls, analysts can easily identify the listed companies using the researcher's advisory services. On the other hand, listed companies may decide to purchase the advisory services of the researcher to increase the possibilities of a favourable voting recommendation.

44. A further case is that proxy advisors also commonly provide electronic vote management systems through which asset managers can access not only their voting advice, but also voting ballots pre-populated with the proxy advisor’s voting recommendations, ready for submission to be counted; even if the investor has the possibility of "deactivating" this pre-programming when he casts his vote, in practice, investors with a small stake in the capital of a listed company will not take the time to study the documentation published by the company and implement their own voting policy. Hence a rate of influence of ISS recommendations estimated at 25% of voting results in listed companies with dispersed capital.

45. Ideally, proxy advisory should not offer consultancy services to issuers when being already mandated by investors to carry out research on the same companies, especially where services offered amount to compulsory sales (e.g. ISS QualityScore and PayforPerformance). This major conflict of interest is however not yet addressed by the BPP. The only reference in the BPP is that “issuer-client influence” is considered as a possible conflict for consideration.[17] The SMSG considers that this conflict of interest should be avoided by any circumstances. Additionally, the proxy advisory firms should be recommended to confirm the non-material character of the ancillary services offered to the relevant issuers from a revenue standpoint.

46. Other professional activities such as the audit profession have been regulated to avoid incompatible mandate. Indeed, an audit firm cannot keep the books of its audited client. The SMSG considers that

[16] A troubling 54% of companies reported being approached by ISS Corporate Solutions during the same year in which the company received a negative vote recommendation. https://www.centerforcapitalmarkets.com/wp-content/uploads/2020/10/CCMC_Nasdaq_ProxySeasonSurvey2020.pdf

[17] https://bppgrp.info/wp-content/uploads/2019/07/2019-Best-Practice-Principles-for-Shareholder-Voting-Research-Analysis.pdf

the same should apply in the proxy voting business where proxy advisor should not offer consulting advice to analysed companies in particular on topics that are part of the general meeting agenda.

47. The BPP foresee that proxy advisors should disclose a policy that describes their approach to addressing potential and existing conflicts of interests. The policy should explain which conflict exist or may arise, how and when these conflicts are disclosed to clients, how these conflicts are avoided, managed or mitigated and how their staff are trained on operating the policy. However, measures of avoidance, including the separation of activities and the establishment of information barriers, proved insufficient to prevent conflicts of interest.

48. In addition to the obligation to publish a conflicts of interest policy, have to disclose conflicts of interest to their clients. More concretely proxy advisors should be recommended by the BPP to inform their clients individually about any actual or potential conflicts before or at the same time as the voting recommendations are made available to clients.

49. Information already released in the conflicts of interest policy should not replace individual disclosure of conflicts that have appeared during the preparation of the voting recommendation. In particular, the general reference to a relationship with issuers in the policy should not be considered as an exempt from the obligation to indicate in the voting recommendation that the issuer covered in the report is also a client of the proxy advisor, which currently is far from being the case.

50. **Dialogue with issuers:** While making progress, there is still substantial room for improving dialogue with issuers. Proxy advisors' engagement policy with issuer often lacks transparency. Proxy advisors should disclose the main features of their engagement policy, which is currently not always the case. As recalled by ESMA,[18] they need to inform investors about their dialogue with issuers and the nature of that dialogue. This dialogue and its extent should be mentioned in the voting report provided to the investor client. When they do not engage with issuers, they should explain why. However, opening up such a dialogue should become compulsory, if so requested by the issuer, especially where contentious issues are at stake. Engagement throughout the year should be encouraged. More specific BPP guidance could be provided available in that respect.

51. Proxy advisors should promptly provide issuers (at least two weeks ahead of the GM) with the draft voting recommendations (at least two weeks ahead of the GM and before the draft is circulated to Investor clients) and give them sufficient time to comment (minimum two days, preferably three). The voting recommendation issued by the proxy advisor in such a context should be communicated simultaneously to the issuer so that it can make its position known to its investors. This position which can have a big influence on the results of the votes should even be made public.

52. **Ancillary services:** With the increasing involvement of some proxy advisory firms in M&A transactions, proxy contests, and other litigation matters, the case for increased transparency becomes all the more relevant and necessary. Noteworthy is the fact that proxy advisory firms, while agreeing to engage with issuers and send them their draft report, fail to give them advance notice of their voting recommendations whenever they relate to M&A transactions or contentious issues

53. Moreover, whenever proxy advisors get involved in takeover situations, they are recommending in effect that their institutional clients sell, or not sell, their shares to a would-be acquirer. In those circumstances, they should be subjected to the same regulations as financial advisers and investment bankers giving an "opinion" about a merger or acquisition transaction. This should be reflected in the BPP. In addition, proxy advisors should inform all parties concerned as to whether they have acted as consultant in any way for any of the parties involved in the transaction. It should be noted that many of the largest hedge funds are clients of ISS.

[18] www.esma.europa.eu/sites/default/files/library/2015/11/2012-212.pdf

54. Generally, speaking, complaints made by issuers are not seriously considered and examined in depth by proxy advisory firms. Moreover, the complaint procedures and the follow-up given therein are unknown and this situation very often discourage issuers from launching such a complaint. In terms of efficiency, issuers are of the opinion that the shortcomings observed should rather be subject to a procedure which could be initiated with a national regulator. Especially the complaints handling could be standardised and improved.

55. Proxy advisory firms should better explain in their reports to investors how they consider local and legal regulatory conditions or circumstances in their voting recommendations and how the same subject may lead to diverging recommendations in Europe and the US. The SMSG furthermore would consider it helpful if any review of the proxy advisory market would look into the de facto duopoly in this market preventing smaller, local service providers to compete with the existing market players.

56. Concluding, the SMSG notes that SRD II did not achieve more transparency when it comes to proxy advisors, or at least only marginally. When reviewing SRD II, the SMSG therefore would favour a reinforced voluntary approach, based on the "comply or explain" principle with the NCAs being in charge of the supervision.

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

Adopted on 25 November 2022

[signed]	[signed]	[signed]
Veerle Colaert Chair Securities and Markets Stakeholder Group	Christiane Hölz Rapporteur	Florence Bindelle Rapporteur