

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

Reference | ESMA/2012/212

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1 Introduction

1.1 Manifest Information Services

Manifest provides global coverage in a range of services to responsible global institutional investors including:

- Corporate governance research and analysis;
- Proxy research, analysis and surveys;
- Customised voting recommendations;
- Proxy vote execution administration services and systems;
- Vote reporting and analysis;
- Engagement support;
- Governance training; and
- News and analysis.

Our coverage encompasses over 90 markets around the world both within and beyond EU jurisdictions, with over 4,000 companies on our database and trillions of pounds of assets under advice.

Manifest was founded in 1995 and since then has remained an independently owned company, offering an integrated suite of services to offer comprehensive facilitation of stewardship management to our customers. It is our philosophy that investors should be empowered to retain control of their voting processes, not only in terms of vote confirmations but also in terms of voting policy development by offering custom voting policy templates. We pioneered custom templates since the mid 1990's and count amongst our customers leading institutional investors for whom applying their own policy is important.

Manifest is a UK based company with customers in the UK, continental Europe, Scandinavia and the USA. We are particularly sensitive to serving the needs of institutional investors with custom voting policy management.

1.2 Structure of our response

We have responded to all of the questions in the original discussion paper, however our response answers question 12 first because, in fact, we consider this to be the most important and pertinent question.

Whilst the published Opinion of the Securities and Markets Stakeholder Group (SMSG) was not formally part of the discussion paper, it clearly informs aspects of ESMA's own processes which merit attention and response. We have therefore included in our comments references to both the ESMA Discussion Paper of the 22nd March and the Opinion Paper of the SMSG of the 26th April.

2 General Comments

We have grouped our general comments into three sections:

- 1) Concerns with the regulatory process;
- 2) Definitions and terminology; and
- 3) Conceptual misapprehensions which seem apparent from ESMA's documents.

2.1 Concerns with the Regulatory Process

We would like to say that from the outset, Manifest welcomes the opportunity to discuss the very real problems that exist with cross-border voting in Europe. However, we have serious reservations about the manner in which the notion of regulating the proxy advisory industry is being considered. This section outlines our concerns.

2.1.1 Regulatory Authority & Competence

We question the regulatory competence under which ESMA has taken it upon itself to investigate this issue. We are unaware of a specific mandate being given by the European Commission ('the Commission').

We note that in July 2011 ESMA stated that regulation of accountability regarding institutional investor voting activity is not necessary. In ESMA's own comment letter to the European Commission in reply to the Green Paper on Corporate Governance¹, ESMA specifically identified that 'it is not clear that additional laws are required' in the field of transparency relating to (*inter alia*) the exercise of voting rights by investors. ESMA cites UCITS IV as an existing mechanism under which investors must develop and elaborate strategies for the exercise of voting rights and must report to their clients as to how this is done.

Furthermore, even if ESMA had been given a specific mandate by the Commission to suggest action, Securities Markets Regulators in Member States do not have jurisdiction over the provision of proxy research and advice with which to apply any standards the current process may conclude. There is a significant gap in the assessment of the current regulatory landscape which, in the absence of a mandate, ESMA may struggle to identify the resources to carry out.

For example, some proxy advisors (PAs) are indeed already authorised as investment advisors. This means that ESMA's concerns are therefore somewhat redundant, because there is already a regulatory regime in place to which advisors which wish to make investment-specific voting advice must submit themselves. If this regime is not present across the EU, then this should be a maximum first step to ensure that (for example) German proxy advisors who are giving investment-sensitive proxy voting advice are subject to the same regulatory authorisation as their UK counterparts.

Furthermore, the two largest global proxy advisor parent companies are not headquartered in the EU. In order for any potential regulation of the proxy advisory market to be effective, it would have to ensure that it included the activities of proxy advisors incorporated outside the EU. It would therefore be more effective to amend existing regulation which applies to users of PAs (i.e. institutional investors) which are based and registered in the EU, rather than to introduce new regulations which could only apply to just EU-based PAs which would in turn harm the EU PA market compared to the dominant US providers.

¹ http://www.esma.europa.eu/system/files/2011_219.pdf, 20th July 2011

We are aware of a number of other specific mandates with which ESMA has been tasked by the Commission, which, understandably, are already stretching the limited resources ESMA has available. We are therefore unclear why ESMA has chosen to pursue the regulation of proxy advisors when so many other elements of abuse in the proxy vote execution process remain unresolved and unaddressed, despite ample proof of the significant market failures and anti-competitive behaviour which is undermining shareholders' rights.

2.1.2 Discussion Paper or Blue-print for Regulation?

While the paper inviting comments is termed a 'Discussion Paper', at the same time it appears to be a blueprint for regulation laying out a series of possible options.

We are not complacent about ensuring high levels of professionalism and probity in proxy governance research, however we are deeply concerned that a less than fair and robust process is being pursued. At a time when there is so little confidence in the wider financial services industry, and with banking and audit in particular, ESMA's approach to proxy advisors is notably out of step with wider regulatory reform approaches.

2.1.3 Evidence

We are very concerned to note a lack of credible evidence for assertions that ESMA takes as a suitable basis for justifying further regulation. Furthermore, the paper does not state whether the problems referred to are, or if there has already been a market 'failure' or simply feels there is potential for a market 'failure'. Indeed, ESMA does not even explain what market failures might be, such as a failure of securities markets, investment markets, markets for research, markets for access to issuers and so on (we contend that there is a market failure in vote agency, but this is beyond the scope of ESMA's considerations at present).

In relation to the question of correlation between proxy advice and investor voting behaviour, there seems to be an assumption that correlation means causality. There is currently no empirical evidence to support this assertion; more information on this question is vital to understand the degree to which any PA influence may in fact be at play.

Regulators are duty bound to properly investigate the nature of the 'problem' before choosing to regulate, and the assumption that there is a significant influence by PAs on voting outcomes in question 2b) pre-judges the answers to the prior question to the point where respondents are effectively recommended to conclude that there is significant influence at play.

Objective academic evidence² is needed to shed light on the specific question of whether influence between advice and outcomes exists. Some interesting work in this direction has recently been published by the IRRIC Institute, albeit in the US context³. Further expansion of the questions, especially in relation to both asset owners and the European context, is vital to understanding the proxy advisory market in Europe.

ESMA would also be well advised to familiarise itself with the UN PRI Reports on Progress, which are published on an annual basis, charting the development of responsible investment activities by signatories, including (*inter alia*), the nature of their voting

² The SSRN working papers cited by ESMA, while interesting, do not constitute "Academic Literature" in the understood sense. This is because the papers have not gone through a robust peer review process to eliminate bias etc.

³ "Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers", Robyn Bew and Richard Fields, June 2012. www.irrcinstitute.org

decision-making processes and the way in which they use proxy advisory services. This is sound, empirical evidence regarding how proxy advisors are actually used by investors, rather than anecdotal perceptions and assumptions about the influence of proxy advisors made by non-investors.

2.1.4 Policy Priorities - Vote Agency Is a Bigger Problem than Voting Advice

Naturally, we contend that shareholder voting is an important investment-related activity. Proxy research, analysis and recommendations are therefore also important. We make the point later that proxy advisors are actually only as influential in terms of voting decision-making as institutional investors allow them to be. However, this itself is only in respect of those shares it is possible to vote.

The market for vote agency is characterised by incumbents preventing market competition which could improve standards of vote agency which would in turn greatly improve shareholder democracy.

For example, despite the fact that Europe has had a 'European Shareholder Rights Directive' for 5 years, there are still countries within Europe where it is prohibitively difficult to vote. The voting services through which custodians force their customer's votes to be processed are unfit for purpose yet investors are prevented from using any other means. Custodians sometimes impose prohibitive charges for shareholders to discharge their rights and through the enforced use of pooled nominee accounts jeopardise the security of client assets for the benefit of their own profit.

With ever-increasing diversification and internationalisation of shareholder register, combined with persisting cross-border voting problems, turnout figures are suffering. Some major large cap companies in Europe only ever see a minority of their shareholders vote at all. Furthermore, investors who wish to engage with companies across borders are hindered from doing so by the difficulty of identifying themselves through the chain of intermediaries.

ESMA should view these issues as much more serious in terms of damaging shareholder democracy, participation and transparency, and should be addressing them first before turning attention to the role that third party research might play in informing those votes that are actually cast. We are confident that investors, issuers and proxy advisors alike are all in agreement that the cross-border voting system itself is not fit for purpose.

2.1.5 Nature of ESMA's Questions

Whilst we appreciate that the discussion paper is itself an information gathering exercise, the leading nature of some of the questions is in our view highly unlikely to obtain an objective result. We are not suggesting that ESMA should not obtain factual evidence; on the contrary, we would wholeheartedly welcome an open inquiry into the functioning and relevance of the proxy advisory and shareholder voting market.

In light of our observations about a need for empirical evidence, the overwhelming majority of the questions in the ESMA Discussion Paper are exploring opinion and fall short of soliciting factual analysis. In the preparation of a potential regulation, a regulator is surely duty-bound to not just include factual analysis but make it the foundation of any regulatory proposal? Not only has ESMA not obtained facts, the questions ESMA poses are unlikely to procure factual information with which to base a judgement about any regulatory action that might be deemed appropriate.

For example, the questions relating to voting policies are framed so as to assume that PAs are duty bound to apply local market conditions. Whilst we agree that, from our business model at least, an important part of providing accurate proxy research is to understand the context, it is incorrect to assume that this is what investors must demand. This is a

straightforward matter of culture, consumer choice and free market economics. Furthermore, it is contradictory to demand that proxy advisors should work to a single global norm when we are also expected to accept that issuers should be protected from global investor preferences. Furthermore, to suggest that only local market proxy advisors are capable or qualified to offer advice would appear to be proposing that proxy advisors ignore the Services Directive which is designed to eliminate cross-border barriers.

In our experience, it is far more common for investors to wish to retain their right as shareholders to object to certain questions (for example the separation of chairman/CEO or pre-emption rights) regardless of the local context; others equally prefer to support management regardless of infringement of local standards.

The central point is that ESMA does not invite opinion from investors as to what they think about the importance of making ‘concessions’ to local market practice. Instead, ESMA appears to assume that local market practice must be adhered to by PAs in order to leverage the influence of PA recommendations thereby ensuring that investors bend to local practices/preferences as well, regardless of whether the investors are actually comfortable with them.

2.1.6 Basis for Regulation

We are extremely concerned at the lack of empirical evidence for concluding that regulation is needed at all. Of even greater concern is the fact that the SMSG paper seems to make presumptions for which no evidence is offered whatsoever.

For example, on p4 of the SMSG paper, there is an accusation that PAs have perpetrated market abuse (i.e. manipulation of financial markets), yet there is no evidence posited in support of such an assertion other than ‘the opinion of the majority of the SMSG’. This is a serious allegation as market abuse is criminal act. Furthermore, on the same page, the SMSG paper supports a conclusion about the need for regulation at a Union level with the phrase ‘it is reasonable to assume’. This is a distinctly unsound and insufficient basis on which to make decisions about regulation. If there are concerns that criminal acts are suspected these should be reported to the relevant competent authority so that impartial due process can take place. Indeed, such action would also serve to underline our point that existing regulation is sufficient to manage the issues which the Discussion Paper and Opinion Paper refer to.

Similarly, paragraph 46 of the ESMA discussion paper talks about ‘reflecting’ on ‘perceptions’ of the proxy advisory industry. This is no more than inviting hearsay rather than empirical evidence, which, given the context of the document, is hardly likely to be objective in its nature. Again, this does not suggest that ESMA intends to take a sufficiently robust and balanced approach to the question of the need for, let alone the nature of, regulation of proxy advisors.

2.1.7 Timing

The timing of ESMA’s consultation is, to say the least, ill-chosen.

Firstly, proxy advisory is possibly one of the most unbalanced industries in the world in terms of the spread of annual workload. Typically, 80% of the annual workload is squeezed into 20% of the year. It is therefore most unwelcome that ESMA should hold a consultation period on this industry which falls over this peak season. It is akin to holding a consultation of the provision of Christmas postal services in December.

Secondly, the increase in commitment on the part of investors to the practice of ‘Stewardship’ is one of the key drivers for the most recent developments in proxy advisory

services. However, the world's first stewardship code explicitly for institutional investors⁴, published by the UK Financial Reporting Council, is barely two years old and it is too soon to undertake a fair, balanced analysis of its impact on the way in which proxy advisory services are used within stewardship activity. Similar initiatives in other key European markets are yet younger, and their impact even less mature. It is therefore simply too soon for ESMA to be able to judge the impact of such stewardship codes of practice which will without doubt be major determinants in the role that voting decisions (and how they are arrived at) play in investment processes.

The timing of this consultation is therefore ill-chosen on two fronts: one, in terms of the peak voting season itself; and secondly, in terms of the immaturity of understanding of the impact of various stewardship codes, when such assessment must form an important backdrop to any assessment of the need for further regulatory activity in the field.

2.2 Definitions

We note that the discussion paper is in need of some careful definition of terminology and concepts in order to be clear about precisely what is being discussed. This section highlights those which in our view require more careful definition in order to ensure better clarity.

2.2.1 Proxy Advisors

Remarkably for a discussion paper on the subject of regulation for proxy advisors, there is no actual definition of what a 'Proxy Advisor' is, despite some attempt to characterise the activities of a PA. Understanding of the PA market requires an understanding of what a PA is. The context of the ESMA paper centres upon the notion of influencing the votes of (institutional) investors. This means that the range of organisations goes well beyond the traditional term 'proxy advisor'.

We propose that a Proxy Advisor, almost without exception⁵, should be defined as any person or entity which offers a service whereby research, information advice or direction as to how to vote shares is provided.

Specifically, this encompasses the following entities:

- Entities which provide a research service, analysing meeting business and giving advice on how to vote shares at a meeting by means of provision of a report (or reports) to their customers.
- Entities who offer research and/or engagement as a spin-off service which is non-core to the organisation's prime function.
- Entities who provide an engagement service whereby target companies are engaged in year-round dialogue, including through the use of voting rights at the discretion of the engagement provider.
- Entities who offer discretionary voting as part of a wider set of investment-related services, such as custody or even asset management itself.

⁴ Manifest is a signatory to the UK's Stewardship Code.

⁵ Technically this definition also includes issuers, as management normally provides a recommendation as to how shareholders should vote. In the USA this is called a "Proxy Solicitation". We do not seriously intend to include issuers as proxy advisors for the purposes of this discussion response, though the observation does introduce an angle of consideration which is worth exploring.

The above list therefore includes custodian banks, engagement overlay service providers and trade organisations in addition to pure PAs, because they are all entities which may be given the discretion to exercise votes or enter into dialogue on behalf of the investor.

We would encourage ESMA familiarise itself with the work of the UN PRI in identifying different types of actor in this space and the different roles they play.

2.2.2 Investors

The role of investors is central to investment decision-making, and should be central in vote decision-making. Therefore it is solely in the interests of investors that PAs should be acting. Logic would suggest therefore that regulatory action might be framed by creating healthy demand from the customers of PAs. However, we are far from clear that ESMA has a consistent understanding of what bearing the different types of investors has on the way in which the market for proxy advisory services operates.

Asset Owners: For the purposes of a professional investment process, an asset owner might be a pension fund or pension provider, a sovereign wealth fund, a retail fund manager, a pooled investment vehicle manager, a hedge fund manager, a foundation, a charity or an insurance company. The key consideration is that they all bear responsibility for determining how the investment process is to be structured in respect of the assets for which they are responsible, including discretion over the exercise of voting rights. Some asset owners manage their own money on an in-house basis, others use external asset managers.

Asset Managers: Asset owners may use third party specialist providers of asset management services for managing the investment of the assets. Discretion over voting rights may or may not form an explicit part of the contractual relationship between the asset owner and the asset manager. An asset manager may have a variety of concurrent investment products and services which are managed under a similar variety of different regulatory frameworks.

Asset Owners are ultimately influential in determining the role of proxy advisors, as it is they who determine the investment process. Some may appoint (and follow) proxy advisors directly, in order to ensure that they may more closely determine the way in which voting rights are exercised, even where the fund management function is outsourced to an external asset manager. Others may direct their fund managers to follow the voting advice of a specified voting advisor or trade association. In both cases, the choices of the asset owner are critical in determining the role of the voting advisor in the decision-making process. This has considerable ramifications for ESMA when considering regulatory questions in this field, as the regulatory landscape for asset owners is very different (and in many ways entirely separate) from that of asset managers.

ESMA notes that there is a no regulatory framework specifically for PAs. When considering indirect regulation, especially regarding the scope of existing regulation and whether it may be used to implement additional regulation in relation to the perceived problems of the market for PA services, a key consideration is the array of differing regulations that apply to specific types of investor.

For example, some, but not all, fund managers may be subject to the UCITS Directives. Others may be subject to the AIFM Directive. But, other than a requirement to be authorised as an investment advisor (which in any case is managed by regulators at Member State level), there is no framework for managing the specific question of discretion over voting rights in the context of segregated investment mandates as often exist between asset owners and their appointed asset managers. This is because the votes are a characteristic of an asset already bought and not an investment asset in their own right. They are a property right inextricably linked to the ownership of the shares

themselves - for example, when shares are lent, the votes go with the shares. Nor is there a single regulatory framework for the myriad of different types of asset owners through which to develop and append regulatory requirements relating to discretion over voting rights.

In order to propose an effective indirect regulatory strategy on the PA industry, it is extremely important to consider the scope and structure of existing regulation to ensure that all institutional investors who procure proxy advisory services are covered.

2.2.3 'Reliance' Upon Voting Advice

ESMA refers regularly to the notion of investors 'relying' on the voting advice they receive. This lies at the heart of the debate about the influence of proxy advisors on meeting outcomes. It goes without saying that, to the extent investors rely on voting advice, the providers of that voting advice are effectively empowered to determine how the shares concerned are voted.

Realistically, investors 'rely' on all sorts of products and services in their investment processes. Financial information is relied upon. Third party financial analysis also relies upon financial information and then in turn is used by investors (and, in quant terms, is also relied upon) but there is no obligation to rely on financial analysis. Proxy Advisors rely upon the accuracy of the information they obtain. Investors rely upon proxy research for information about the issues at hand but there is no obligation for investors to rely upon any advice they receive in relation to the investment process. Indeed, if investors relied upon third party financial analysis and third party voting advice for all of their decisions, what would there be left for them to do? It is not clear from the discussion paper why proxy advice is singled out for particular focus and whether there is an understanding of what is meant by 'rely'. Do critics mean that shareholders vote on auto-pilot without looking at the issues or do they mean that shareholders rely on proxy advisors to manage the logistics of the information and analysis process in order to streamline a labour intensive process?

It is assumed that the influence of PAs is deemed, at best, a threat, at worst a serious market failure. As a policy strategy, ESMA has two choices. One is to manage the symptom (PA influence), the other is to treat the cause. ESMA can go some way towards treating the cause by focusing the debate upon proxy research rather than proxy advice. This would emphasise the significance of the substance of research rather than the conclusion. However ESMA has not concluded that there has either been a market failure or a potential market failure, nor has it outlined the implications for that failure in terms of investor harm.

2.2.4 Vote 'Execution'

There is often confusion about the term 'Proxy Voting Agency' and what that role entails. The ESMA paper and the SMSG response also perpetuate the myth of custodian bank responsibility for proxy vote execution. This is not correct as proxy voting is not defined as Administration in The Financial Services & Markets Act (in the UK context⁶)

Manifest uses the term vote agency to mean, as in the context of stock broking, acting on the explicit instructions of the owner to obtain 'best (vote) execution'. This, in Manifest's terms, means that we deliver the votes directly to the vote tabulator and obtain a confirmation.

⁶ Source: <http://www.legislation.gov.uk/ukxi/2001/544/part/II/chapter/VIII/made>

There are also Voting Principals who act for the shareholder at their own discretion and act under fully delegated fiduciary authority.

Advisors which rely on a third party for the communication/transmission of votes to the meeting are not providing vote execution or vote agency but are strictly-speaking 'proxy voting administrators'.

When providing vote agency services, it is our experience that the deep market knowledge brought about by providing research ensures a service which is fit for purpose. Vote agency is about more than simply passing information from pillar to post without checking it; otherwise it adds no value to the process and sometimes actually harms the effective voting of shares through a lack of understanding of the significance of the instruction being communicated.

We have many examples of this, all of which could be avoided by combining research with vote agency, such as:

- Lazily labelling the process of registration of shares for voting as share blocking;
- Converging registration with vote instruction deadlines for administrative convenience;
- Not facilitating the voting of counter proposals;
- Not facilitating dual-incorporated securities' agendas
- Not processing votes because they have not been told about a meeting by a specific counterparty, regardless of the general availability of the meeting materials;
- Not processing votes for a meeting because the issuer has not hired the vote service provider to solicit votes for them;
- Erroneously presenting the format of resolutions so that only one may be voted for; and
- Voting deadlines which are not provided until the day of the deadline.

This list is far from exhaustive and we would be happy to share with ESMA in more detail our experiences and observations of problems presented by providers of vote agency services that do not provide research.

We would, in particular, draw your attention to the UK's legal requirement for custodians to *'make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the firm's insolvency, and to prevent the use of safe custody assets belonging to a client on the firm's own account, except with the client's express consent.'*

Regrettably, despite proof of the use of clients' assets without their express consent in the voting context by custodians and their mandated service providers, regulators have seen fit to ignore this abuse. While we understand the pressures that issuers must face in wanting to ensure a positive result at their AGM and the desire to reach out to investors to engage in dialogue, buying advanced confidential data which has been warehoused at the custodian's vote service provider due to unfeasibly early deadlines is not the way to accomplish that objective and simply perpetuates the market inefficiencies.

2.3 Conceptual Problems

2.3.1 Accountability

Proxy advisors are commercial information intermediaries in EU terms they are a 'knowledge-based service to business'. They work for, and are paid by, investors in the main. They are primarily accountable under contract to their clients for their proxy advice. The introduction of formal accountability to issuers would undermine the purpose of our function, which is to give objective and independent assistance to investors. Proxy advice which has been vetted or approved by issuers is less likely to be independent than

proxy advice for which the advisor takes individual professional responsibility. After the collapse of Enron in particular, the issue of analyst objectivity and investor dependence on analyst recommendations and the role of the “sell-side” research community was widely debated and it was determined that issuer interference in the research process leads to sub-optimal advice.⁷

We would agree that if investors are not ensuring sufficient independence or competence of their PAs either when procuring or using their services, this is indeed a market failure which ESMA should investigate.

2.3.2 Comparison with Other Types of Advisor

The proxy advisory industry is in fact already regulated, to the extent that regulators have already deemed that proxy advice does not constitute investment advice.

In the EU and elsewhere financial analysts and investment advisors are required to be formally regulated. Those activities which must be registered with financial regulators are fundamentally regulated because they are market activities i.e. they involve recommendations for the sale or purchase of securities on regulated markets or investment management. In the UK context, advising on, administering and managing investments is covered by The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.⁸

Proxy advisors and proxy voting agency activities are specifically exempted by that legislation because they do not constitute investment activities. Market observers may feel that is a significant failing and that some kind of oversight would confer a higher status on the activity through formal recognition. However the purpose of good regulation is to protect consumers, not confer status on the market operators. ESMA has not offered any evidence that consumers are being harmed by their service providers.

Proxy advisors are not alone in the lack of regulation in the financial services segment. There are many other agency support services which are influential but, like proxy advisors, they are auxiliary to the investment process, rather than central to it. However, none of the other similar auxiliary services may be deemed to have no influence over the investment process - indeed, one could not justify their relevance to the investment industry unless they were fundamentally useful to the investment process.

These include data vendors which provide editorial opinion such as Bloomberg or Thomson-Reuters. Data vendors who offer quant investment models (on a black-box basis such as I/B/E/S) are also unregulated, as are ESG research providers whose data and insight is increasingly used for investment decisions and indeed instigating high profile lobbying campaigns against certain types of investor behaviour. Even the general financial press are influential in terms of the opinion they express, yet they are also unregulated by financial regulators. All of these providers work for investors on a subscription basis, all of them influential by some measure, yet appear to be of no concern to issuers. What they all have in common is the notion that they are not offering investment advice. Those that do deem themselves to be offering investment advice (including many proxy advisors) register themselves as such with their local financial services regulator.

⁷ Kolasinski, Adam C. and Kothari, S.P., Investment Banking and Analyst Objectivity: Evidence from Analysts Affiliated With M&A Advisors. *Journal of Financial and Quantitative Analysis (JFQA)*, Vol. 43, No. 4, 2008; MIT Sloan School Working Paper No. 4575-06. Available at SSRN: <http://ssrn.com/abstract=499068>

⁸ <http://www.legislation.gov.uk/ukxi/2001/544/part/II/chapter/XII/made>

The only reason we can see for singling out proxy advisors is that it is relatively easier for issuers to jump to conclusions about links between proxy advice and shareholder behaviour by correlating negative voting advice with negative voting results.

Does this mean that regulators should not re-visit their legal powers from time to time as possible market or consumer threats appear? No, of course not, however the process would be based on more than assumptions and selective action.

2.3.3 More investors use ESG research in buying and selling shares than to vote them.

It is anomalous to single out proxy advisors as agents of influence that require regulation in isolation from providers of other types of extra-financial research⁹. Whilst we promote the notion that general meeting resolutions are material in their impact (most of them are, after all, important enough in the life of a corporate entity to be mandated by law), there are plenty of other extra-financial considerations which, although they may not feature directly on a corporate meeting agenda, are nevertheless the subject of analysis and opinion which is used by investors to make investment decisions at other points in the investment cycle.

Many investors use ESG research when making investment decisions and/or constructing portfolios. The 2011 UN PRI Report on Progress¹⁰ showed that 95% of investment managers integrate ESG considerations when making investment decisions, meaning they either use ESG research for the positive or negative screening of companies, or ESG research has at least some bearing on the investment analysis.

The proportion of investors (asset owners and managers) who make use of their voting rights on at least some part of their portfolio is 88%. Whilst still high, these figures show that it is anomalous to focus upon voting (which is comparatively rarely an activity which is used to determine a buying or selling situation, other than a takeover), without equally focussing on ESG research providers, whose services are used even more widely than PAs and whose materials are used to directly influence investment decisions.

We question whether issuers would be as concerned about the perceived influence of proxy advisors compared to ESG research providers if they understood the extent to which 'exclusion lists' bar fund managers from buying their shares.

In actual fact, ESG research is comparatively more influential on the liquidity of a company because of the direct effect that the use of ESG research in investment screening and decision-making has upon its desirability in the market. Quite aside from the debate as to what degree proxy advisors might be influential over voting decisions, in terms of share price sensitivity, research that directly influences investors buying and selling decisions is, almost by definition, more price sensitive than research which is used to help inform the use of on-going ownership rights.

We suspect that the reason proxy advice is being singled out is that investor stewardship has become higher profile in recent years, not just at the investment advisor level but also through the professional and popular media. Voting recommendations are relatively easy to find out about for an issuer. Voting advice thus becomes an easy target for issuers who object to the idea that investment professionals may not automatically endorse every aspect of the way their company is run and managed.

⁹ Whilst we consider the term 'extra-financial' a misleading term because ES and G issues all bring to bear some degree of materiality, we use it here to mean analysis of information which is non-financial in nature. We do not mean to infer that such information is non-financial in impact.

¹⁰ http://www.unpri.org/publications/2011_report_on_progress.pdf

In 2009 the American Accounting Association Journal “The Accounting Review”¹¹ highlighted that corporate management has ‘an incentive to portray a self-serving assessment of past corporate performance and future outlook.’ It demonstrated that negative interpretation of key corporate information posed significant risks for companies. It is therefore entirely reasonable to expect them to attempt to seek to control their message as far as possible. There is also strong evidence that objective, independent research and commentary suffers significantly fewer agency problems and has stronger credibility in terms of uncovering negative corporate activity.

2.3.4 Over-Emphasis on Voting Recommendations Rather Than Research Quality

As judged by the many references to recommendations throughout the discussion paper it is clear that there is an assumption that the role of a proxy advisor is simply to make voting recommendations. This is factually inaccurate and demonstrates poor research and analysis by ESMA and the Stakeholder Group.

It is a free market choice for a PA to offer recommendations of any description or not. Furthermore it is a free market choice for PAs to determine how they arrive at their decisions. This does not mean that they should be done badly or inaccurately, but if a PA’s client’s due diligence processes satisfy them that that model is appropriate for them as investors, then that too, in principal, is their choice. In our experience as providers of proxy advisory services, the prime concern that issuers express to us is regarding the recommendations we are likely to issue, and in particular the negative or non-management supportive recommendations.

ESMA also seems to be applying a narrow focus upon the activities of PAs by placing a similar over-emphasis on the importance of voting recommendations, rather than seeking to address the more fundamental concern about the quality of research. The Discussion Paper makes 49 references to voting recommendations, and only two references to research quality.

Manifest’s core research product does not make ‘House Recommendations’. Instead each client has their own customised voting recommendations to inform their judgements. The research reports clearly signal problematic areas but it is a central tenet of ‘good research practice’ that you don’t pre-judge the material with any particular outcome in mind, i.e. we don’t tailor the data or research process to fit a desired outcome or answer.

The Manifest Voting Template model ensures robust, transparent and consistent voting advice to act as a flag against stated investor and regulatory concerns or preferences. Some of those outcomes are ‘case-by-case’, and market activity related decisions are always referred to the investor.

Shareholder voting is about more than outcomes; rather, it is a formal expression of the wider relationship between a company and its owners. If the influence of PAs is to be addressed, then the application of research must surely be front and centre of ESMA’s approach i.e. how investors make their final voting decisions.

¹¹ Kothari, S.P., Li, Xu and Short, James E., The Effect of Disclosures by Management, Analysts, and Business Press on Cost of Capital, Return Volatility, and Analyst Forecasts: A Study Using Content Analysis (September 2009). Available at [https://www.nd.edu/~carecob/April2010Conference/Kothari%20Li%20Short%20\(2009\).pdf](https://www.nd.edu/~carecob/April2010Conference/Kothari%20Li%20Short%20(2009).pdf)

We should also accept that it is entirely possible that some investors just don't want control of their votes, are not remotely interested in the process of Stewardship at an intellectual level and so will do the minimum that is required to be seen to be doing the right thing. That is not an issue of PA influence but of investor behaviour. That behaviour may itself be driven by regulation (e.g. mandatory voting¹) and facilitated by regulation of investors and proxy advisors which encourages the investor to engage the proxy advisor to act as a fiduciary.

Quality of research is, in our view, key to ensuring quality of decisions. The more control investors have over their decisions, the more influence they can have over their voting decisions. Some measures which ESMA may wish to consider relating to research and decision quality include the following.

The timing of meetings: Around 80% of Europe's AGMs happen within the same 15% of the year, during April and May. Such a high concentration of work in such a short space of time inevitably means the entire process is stressed. This is a phenomenon not just for PAs and investors, but also for the critically important function of audit and issuer reporting. ESMA should carefully consider measures which have the effect of spreading the intensity of the peak meeting season, which would enable more meaningful dialogue between investors and companies and less time pressure on important proxy research and analysis. The time pressures are made worse by custodian-bank enforced proxy voting intermediaries who add unnecessary padding to vote deadlines, make the process unnecessarily convoluted and refuse to unbundle service offerings.

The relationship between cost and quality: Where investors undertake a more formal procurement or market testing process cost is invariably placed near the top of the selection criteria, sometimes even without a minimum quality threshold. Indeed, ESMA's own discussion paper reveals that 'proxy advisors' fees for the provision of their services are most likely a crucial factor when it comes to the selection of a proxy advisor'. This is an interesting phenomenon as we have noted very little diversity in portfolio management fees which tend to be standardised basis points charges on AUM.

For as long as this is investors' approach, competition in the PA market will be largely defined by costs and economies of scale at the expense of quality and innovation.

For as long as investors do not mind this, issuers must also accept that large proxy advisors will retain their level of influence, come what may.

2.3.5 'Good' v 'Bad' advice

ESMA refers to the notion of 'Good' and 'Bad' advice as if to ignore the fact that advice is based on opinion which is necessarily subjective and probably the most 'black box' part of the final decision process because it involves the human mind. To make the obvious point, any recommendation to vote against management may seem to management to be a 'bad' piece of advice, whereas to an investor it may seem reasonable. Similarly, where there is a proxy fight or a contested resolution over which a proxy advisor must make a choice to support or not, inevitably one party will disagree with the advice given.

This relates back to our point about an over-emphasis on voting recommendations. It is much easier to objectively determine a good piece of research than it is to determine a good piece of advice. ESMA refers to the notion of 'accurate' recommendations, which is a subjective notion based on the observer's perspective. Outcomes can be based on accurate or inaccurate data - the 'Garbage In-Garbage Out' principle. If the data and observations fail to meet an investor's test of acceptability then clearly the recommendation or advice is accurate. Data can be bad for many reasons - some may be processing related and that is a PA's responsibility to manage properly. Issuers themselves can be responsible for bad data by poorly laid out, inconsistent or sparse documentation.

In pursuing or giving recognition to the idea of ‘bad voting decisions’ we hope that ESMA would not also be suggesting that voters at general elections which elect the ‘wrong party’ have made bad election choices and so therefore the newspapers that influenced their thinking must be brought into line or that citizens’ franchise must be curtailed in any way.

In relation to our previous observation that empirical evidence is required to better understand the questions ESMA is exploring, it would be pertinent to survey alleged instances of ‘bad’ advice to determine what proportion of them were resolutions where the recommendation was to oppose management. We suspect that ESMA would find that the notion of accurate recommendations actually derives from issuers objecting to advisors making recommendations they don’t agree with. It is worth noting that, according to Manifest’s analysis of vote outcomes, the average level of total dissent at shareholder meetings across resolutions is, on average, under 5%. Put another way, investors support management 95% of the time. Are issuers suggesting that those 95% support decisions are also wrong because they too are based on proxy advisor input?

The ‘Voting Recommendations’ section in the ‘Key Issues’ chapter of the ESMA Discussion Paper would seem to support our suspicion that the majority of issues and concerns have come from issuers. This is borne out by the strong suggestion that issuers should become an integral part of the research process to an extent that would be alien and unethical to financial analysts or business journalists.

2.3.6 Engagement & Dialogue

The discussion paper regularly refers to and promotes the practice of PAs undertaking engagement with companies in the research process. We respect the right of PAs to construct their research techniques and methods in whatever manner they wish. If PAs clients object to their practices then clients have the choice to change their service provider.

However, ESMA should seek to better familiarise itself with the effect of multiple participants in the same process undertaking engagement, and how engagement by PAs actually serves to harness their influence over issuers, making the issuers captive to PA concerns at the expense of those of investors.

Engagement is a time-consuming, labour-intensive process which demands a considerable investment in resources from both parties. From an issuer and investor perspective, we are sympathetic to the view that requiring an issuer to engage with a PA on an issue, only to then have to engage with investors who are clients of the PA on the same issue creates additional work and blurs transparency in terms of understanding spheres of influence and, fundamentally, who to actually listen to (co-incidentally, it is also frustrating for the issuer to engage with fund managers on an issue only to find different decisions are subsequently taken by a separate governance or back office colleague).

For example, if the PA claims to represent a larger proportion of an issuer’s shareholder base than will actually follow the PA’s advice, then the PA is actually mis-representing its authority. If an investor customer of the PA then engages directly with the company on the same issue but asking for a different outcome, the issuer is then faced with a difficult choice: adhere to the PA’s preferences, knowing the ‘influence’ they might have over some of their shareholders, or listen to actual shareholders who have taken the time to make direct contact with them.

Arguably if a PA is acting as a fiduciary under explicitly delegated authority then it is entirely reasonable for the issuer to engage with them directly. How explicit are PAs in the presentation of their role and influence? Should asset managers or owners allow such delegation? Are asset owners even aware that their asset managers have delegated this fiduciary act?

Furthermore, ESMA should investigate the extent to which investors which buy into a PA service which explicitly includes engagement understand and accept the notion that this potentially distances them from the companies in which they are invested.

ESMA should seek to understand whether issuers are selectively briefing some PAs but not others - is this acceptable in Market Abuse or Competition Directive terms? Does this constitute Concert Party behaviour? If there is selective briefing then this is the fault of the issuers and not the proxy advisors as it is the issuers that chose to be selective, we are not aware that any PA demands exclusive access to management.

ESMA should also seek to gain a fuller understanding of the potential for multiple engagement functions within an ownership chain. For example, where an asset owner hires an Engagement Service Provider (ESP), which in turn uses a PA, there may be conflicting representation of that same shareholder by two agents in the same process. Although the ESP may be mandated to engage with companies, their PA may also be engaging with the same companies on the same issues. The end result is the issuer is presented with a cacophony of preferences and demands, none of which emanate directly from their shareholders.

We suspect that if ESMA were to investigate the question, issuers would express some element of frustration with the situation. It is one which is shared by investors too, as evidenced by the letter that Larry Fink, Chief Executive of Blackrock, wrote to the 600 largest equity holdings in BlackRock's portfolios, encouraging them to talk to BlackRock before they speak to proxy advisors. Mr Fink is absolutely correct. A PA is not the owner, it is an information intermediary.¹²

Investors should be encouraged to adopt genuine procurement practices, and in so doing they should place a considered focus on genuine quality of research and how the research can support the investor's own processes, rather than focusing on voting advice to such a great extent. Similarly, issuers (and their advisors) must have the discipline to move away from focusing on what the proxy advisors say and towards what their investors are saying, even though it may be a simpler task to talk to a few PAs compared to a larger number of investors. ESMA is well positioned to play a constructive role in encouraging this. Indeed this discussion paper will have served a useful purpose in helping to realign industry knowledge by dismantling myths.

2.3.7 Fiduciary Responsibility of Investors

There is a fundamental difference between US and much EU law relating to the ability to delegate fiduciary acts. In the US, the full delegation of a fiduciary act to a PA is possible where it is regulated as an investment advisor. It is this possibility in the US that has let to the dominance of the US model of advice-driven research. Investors in the largest investment market in the world were legitimized overnight into literally devolving their entire voting process - decisions, administration, reporting and all - to their proxy advisor.

¹² Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, The Power of Proxy Advisors: Myth or Reality?. Emory Law Journal, Vol. 59, p. 869, 2010; University of Penn, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: <http://ssrn.com/abstract=1694535>

This regulatory approach served to create the very problem that ESMA is seeking to resolve - namely, the undue influence of proxy advisors over voting decisions. It is an unintended consequence that the SEC now has to work to address, incidentally through the introduction of guidelines for the use of proxy advisors rather than by the regulation of proxy advisors themselves, recognizing the very important fact that proxy advisors are accountable to their clients¹³.

In the UK, and in many European countries, responsibility for a fiduciary act cannot be devolved in the same way as the US. That means that no matter to what degree discretion over voting of shares is given to a PA, legal responsibility for those decisions rests with the investor, not the PA.

If ESMA is seeking to reduce or manage the influence of proxy advisors in Europe, then the creation of a regulatory regime which legitimises the practice of investor reliance on proxy advice will clearly be counter-productive to ESMA's aims. This again points to the most effective course of regulatory action which would be the enforcement of current regulations which define the behaviour of investors and issuers rather than proxy advisors.

2.3.8 Proxy Advice vs. Investment Advice

Throughout the Discussion Paper, and especially the SMSG paper, we are unconvinced that there is sufficient understanding of the differences and overlap between proxy advice and investment advice. Specifically, it is not possible to refer to proxy advice as entirely distinct and separate from investment advice.

Put very simply, investment advice is related to buying and selling decisions, in particular focussing upon financial considerations. These are market or trading decisions. Proxy advice relates specifically to resolutions at company meetings on which shareholders are invited to vote. These are company law or ownership decisions. Although they are both property rights, from a regulatory perspective they are entirely different.

Most voteable resolution topics are principally (though rarely exclusively) governance considerations, and some are principally financial considerations. This is not the appropriate point to enter into a discussion about the financial investment sensitivity of governance considerations, other than to point out that there is general agreement that governance does bear some relevance as an investment-related consideration.

Our central point here is that, even if we were to agree that governance considerations have no securities markets implications whatsoever, most AGM agendas include at least one resolution which is an investment decision, which means that proxy advice on such agendas may encompass investment advice too. Those PAs that have registered as investment advisors have done so partly because of this very consideration.

However, in our experience, users of PA services (institutional investors) do not always understand this distinction, and do not engage and make use of the services of PAs in the same way they would buy or sell-side research and advice. Specifically, they rely more heavily on proxy advice from a single provider than they might on investment research. In terms of the way that they pay for sell-side research, interestingly fund managers do not (generally) use hard cash to pay for it in the same way they do for proxy research as sell-side research is subsidised by brokerage commissions. Although brokerage commissions must be disclosed to clients and fund managers will have codes of conduct for allocation of commission, commission itself is not a P&L item.

¹³ <http://blogs.wsj.com/cfo/2012/06/07/sec-plans-new-guidance-on-proxy-advisers>

It is therefore not entirely true to say that, as ESMA claims in the Discussion Paper, proxy advice 'is generally not relied upon by the market for investment decision-making purposes' (paragraph 107). To the extent that investors follow the proxy advice they are given, as well as the extent to which that voting decisions are in fact straight investment calls, the market does indeed rely on proxy advice for some investment decision-making purposes.

However some PAs (and Manifest is one) will advise on the governance aspects of the market-related resolutions (principally takeovers), but specifically do not recommend on the appropriateness or otherwise of such resolutions.

3 Correlation Between Proxy Advice & Investor Voting Behaviour

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

We offer a number of explanations for a high correlation between proxy advice and voting outcomes, all of them alternative to the dominant (unproven) perception that significant numbers of investors blindly follow the advice of their proxy advisor.

3.1.1 Proxy advisors understand the issues

There is one obvious initial observation in answer to this question which is that expert proxy advisory services by and large ‘get things right’. By that we mean that they use an evidence-based approach to their research process in terms of identifying the issues that investors subsequently express concern about in their voting. However, proxy advice is about more than accurate research.

A governance or stewardship strategy is about translating that research into a judgement or opinion on what that research means for voting and engagement strategy which many then follow. It is this aspect to which ESMA should pay particular attention. For example, ESMA may wish to target a study on how specific investors have voted where two or more proxy advisors arrive at different recommendations for the same resolution, in order to throw more light on this question.

3.1.2 Proxy Advisors with Whom Investors Disagree Should Lose Business

Additionally, proxy advisors which make voting recommendations would not, in principle, be able to retain business if they produced research or made recommendations with which their customers routinely disagreed. In this sense, the question becomes something of a circular one.

ESMA may wish to examine two questions which we believe lie behind the question at hand: ‘what are the reasons for choosing a proxy advisory service provider?’ (the supposed ‘quality’ of voting recommendations is likely to be high up the list (though behind cost)); and ‘to what extent do proxy advisors influence the voting policy-making process for their customers, and how do they do it?’ (this is likely to be down to the use of prescriptive presentation sessions, customer surveys from which the ‘general consensus’ is aggregated, and occasionally the imposition of the providers own views and opinions where these are particularly strong).

There is a counter-argument to this particular view, which is that investors actually are reluctant to change from a proxy advisor if they perceive the advisor to be allied to, or synonymous with, reputational safety. This might be because the proxy advisor is appointed by, or has some official or commercial link to, a trade body or market organisation, thereby having the effect of an endorsement which is a powerful testimony to consumers. Reluctance to change advisor might even be simply because of the size of an advisor - ‘you never got sacked for buying IBM’.

3.1.3 There Are Only Three Options to Choose From

A voting decision is not an open-ended one. It is one of three choices between ‘For’, ‘Abstain’ and ‘Against’. Many investors use proxy advice not to decide how to vote but as one of a number of means of identifying potential issues of concern, if indeed they choose to vote at all.

The resultant correlation between the voting advice and the investor voting decision is therefore not an empowerment of the proxy advisor, but an agreement by the investor that the issue is indeed one over which management should be opposed. If such agreement occurs, there is a 50% chance that the investor will choose the same voting option as the voting advisor, which therefore serves to exaggerate the perception that there is causality when it is actually statistical co-incidence.

3.1.4 Compliance & Voting

ESMA's introduction of the term 'compliance' into the debate about voting advice is distinctly unwelcome. US history (for example, through the ERISA principles) has shown that the more voting is made a compliance-driven activity, the more reliance there is upon voting advice together with wholesale outsourcing of the entire voting activity creating a divide with the rest of the investment process. As the US experience shows, this inevitably encourages an approach to voting which deflects attention away from the importance to the voting decision and towards simply ensuring that shares are seen to be voted. This further exacerbates the reliance upon voting advice or in extreme cases, complete outsourcing of the process rather than administrative outsourcing.

Furthermore, from the investor perspective, once an expert outsourced provider has been appointed, the compliance burden is much greater for the investor to justify going against the advice they receive from the advisor than it is to justify using them in the first place. Until there is a balance in terms of the compliance demands of monitoring and justifying agreement with external advice as well as justifying disagreement with it, there will always be an imbalance which favours an implicit shift of power in favour of the proxy advisor, because there will always be greater implicit incentive to vote in line with the advice received.

For this reason, from a 'compliance' perspective it is far better practice for an investor to receive custom voting advice to follow than it is to follow third party advice.

In short, compliance should not be associated with the decision to vote or not, nor should it be associated with following someone else's opinion. If it is to be associated with voting at all, it should be applied to the investor being able to demonstrate a link between their investment preferences and the voting decisions made in respect of the assets they are responsible for.

If there is any compliance to consider it is compliance with the investment mandate given by the underlying owner.

3.2 To what extent: do you consider that proxy advisors have a significant influence on voting outcomes?

This question is arguably a very leading one, because it seems to pre-suppose that proxy advisors have a measurable influence, rather than initially asking if respondents actually agree with the notion itself.

The extent to which investors choose to allow their proxy advisors to determine how their shares are voted is exactly the extent to which proxy advisors have influence on the voting outcomes. Proxy Advisors can only be deemed to have a significant influence on voting outcomes if the investor does not monitor the voting decisions proposed by the PA.

3.2.1 2011 figures show PAs control, at most, 5% of votes

The annual UN PRI Report on Progress¹⁴ helps shed some light on this question. In 2011, 88% of asset owners report they vote shares, of which on average 93% of their votable assets are voted - so 82% of shares overall. Of these, only 12% do not monitor the voting decisions of their third party manager, demonstrating that the proportion of shares which are actually potentially being 'influenced' in this way is less than 10% of shares overall. Therefore, over 90% of share voting decisions are in fact being monitored by asset owners in the PRI sample.

Of the 10% that are not being monitored, some decisions are outsourced to voting advisory companies, others are the responsibility of an appointed asset manager. Of the asset managers in the PRI survey to whom part of this 10% of unmonitored voting is delegated, only 15% leave the voting decisions (custom or otherwise) to their outside providers. Of that 15%, half of them closely monitor the voting decisions being made (and therefore by implication will intervene in the event of voting decisions they are not comfortable with). Therefore, in fact, barely 5% of all share voting reported by UN PRI signatories is left at the discretion of PAs unchecked. Whilst a small handful of resolutions may be close enough for such a proportion to theoretically make a difference to whether a resolution passes or fails, such an event would be in the context of 45% of independently minded shareholders also opposing the resolution, indicating that the proxy advisors views are in line with a significant number of other investors.

But what exactly does ESMA mean by 'influence'. Does it mean coercion or dogma or informed insight? A weather forecast may influence the decision to carry an umbrella or not, through insight and interpretation of data but they can hardly be said to influence the weather.

3.2.2 Different types of influence could be at play, but none of them definitive

Such influence obviously exists in cases where the investor has a 'standing order' to the proxy advisor, under which the advisor is authorised to vote all resolutions in line with the proxy advisor's own recommendations, with little or no oversight of the instructions to be sent on a meeting-by-meeting basis. This is also the case where an investor, whose fund management is outsourced to a professional investment manager (for example a pension fund who uses an investment management company for the management of their investments), instructs their fund manager to vote the shares in line with advice from a specified proxy advisor or the advice of the nominated advisor of a trade association.

Potential influence can occur even where an investor commissions custom voting advice from their proxy advisor, where customised voting advice is not sufficiently explained and rationalised for the investor to be able to understand how their custom policy has been applied. It is potential influence in the sense that it becomes difficult for the investor to evaluate whether or not the advisor has correctly interpreted the custom policy, or whether they have applied some element of their own evaluation instead, however, in such cases investors are arguably less likely to follow advice they are sceptical about and don't understand (especially if it is not in favour of management) than to follow it blindly.

¹⁴ <http://www.unpri.org/reporting/result.php>

Another area of potential influence can occur where an entity is producing proxy voting advice as a 'secondary service' (i.e. someone for whom proxy advisory services are not the only or main business function). The provision of proxy advice is a resource-intensive activity. Therefore any entity which is large enough to offer proxy advisory services as a 'free' auxiliary service is likely to easily be big enough to exercise influence over most issuers, even if proxy advisory services may not be a strategically significant business priority for the entity. This is a particularly unhealthy context for such potential influence to exist.

As an observation on the quality of the debate currently taking place on the role of proxy advisors, if part of the perceived problem in this area is the over-influence of proxy advisors, it would be helpful if ESMA promoted the notion of buying proxy research and analysis rather than proxy recommendations. This would underline the importance of investor ownership of the decision-making process, without undermining recognition of the investors' need for research assistance in making those decisions.

3.3 To what extent would you consider this influence as appropriate?

3.3.1 Voting outcomes

It is not appropriate at all for a proxy advisor to exercise influence over a voting outcome, because not all proxy advisors bear the economic consequences of the vote outcomes. A proxy advisor might go as far as helping their investor customers influence issuers, but only to the extent that they have specific mandate to do so.

Proxy advisors do not bear the ultimate fiduciary responsibility or investment consequence of the voting outcomes. They should therefore inform but should not determine voting outcomes. Investors which are able to assume intellectual ownership of their voting decisions, through oversight of individual decisions and the use of custom voting policies, can demonstrate with more clarity than others their ownership of influence over the companies in their portfolio. Those who simply sign up to a third party's voting policy are less able to demonstrate ownership of their fiduciary responsibility.

3.3.2 The proxy advisory market suffers from a lack of healthy competition

The market for proxy advisory services suffers from a lack of genuine competition. ESMA does not seem to understand the different competitive dynamics which exist between providers of global proxy advisory services and those which are local in focus.

It is not true to say that there is plenty of competition in the provision of the proxy advisory services regarding investors in European companies. Foreign investors tend not to use local advisors, they will use global ones. So the more issuer share registers are characterized by foreign shareholders, the more influence global proxy advisors could potentially exercise, especially given that investors are more likely to rely more heavily on advice for companies with which they are less familiar.

Of the global providers, ISS is the dominant provider. Their growth, especially in Europe, has been far from organic and has included anti-competitive commercial arrangements with trade associations and takeovers of local providers. Together this has given them a dominant commercial advantage in positioning themselves as the most influential provider.

The proportion of shareholders they are able to purport to represent is sufficient to force issuers to negotiate with them when recommendations are being drafted. It also enables them to underline the relevance of their corporate advisory services. Corporate advisors regularly refer to 'compliance' with ISS policies and the importance of obtaining a favourable recommendation. ISS' market share enables them to claim that their in-house policy draws upon the views of more investors than anyone else (a spurious argument given that the overwhelming majority of investor policies are in the public domain).

Issuers respond to ISS in public, thereby further enhancing the profile of ISS' viewpoint, at the expense of all others, including those of their own shareholders. Sometimes, issuers will also free-ride a positive ISS recommendation in order to strengthen their hand towards investors. In fact, the desire to be able to do so arguably creates an incentive to negotiate with ISS instead of with investors.

The overall effect is that ISS has a commercial and reputational advantage and interest in promoting their influence over the entire process. They can claim to issuers that more investors use their research and recommendations than anyone else in order to promote their corporate advisory services and to ensure a seat at the negotiating table. Likewise, many institutional investors (especially smaller ones with comparatively fewer resources) see ISS as a 'safe haven' to enable them to 'fit in with the crowd' or because it is the recommended provider of their affinity trade association. Even large institutional investors feel a necessity to use ISS because their research is used so widely that to not have access to it might be seen as 'missing out' on the debate.

The degree of dominance that ISS exerts in the market for proxy advisory services should be a matter for the Directorate General for Competition (DGComp) to investigate, because there is a correlation between the growth in the nature and extent of ISS' market dominance and the growth of concerns about the influence of proxy advisors.

4 Investor Responsibilities

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

Again, this question suggests a presupposition that using a proxy advisor inevitably shifts investor responsibility and weakens their prerogatives. Respondents are not encouraged to comment on whether they deem this to be true in the first instance.

Asking investors about whether using a proxy advisory service is an insurance against liability was an excellent but doomed question. Just as lawyers don't reveal their costs, they disclose their fees, investors would not admit to the degree that in practice their votes are authorised with little or no oversight of many agenda items. This is precisely why ESMA finds that 'Most respondents see the use of a proxy advisor as a practical way of implementing voting across a diversified portfolio' - in other words, investors rely on proxy advice where they don't use internal resources to decide for themselves. It is quite legitimate to select a business partner to manage and inform the process of voting, cutting corners on the control and oversight of the actual decisions is another issue.

Investors will always underline that they have the ability to override the advice they get (though it seems this question has only been posed to asset managers - ESMA should look into the degree to which asset managers perceive they are instructed by an asset owner customer to vote in line with the recommendations of a proxy advisor, specified or not).

The extent to which the use of proxy advisors induces a risk of shifting the investor responsibility and weakening the owner's prerogatives is exactly the extent to which the voting decision is taken by the proxy advisor rather than the investor. The extent is related not the use of proxy advice in itself, but the nature of the use of such advice.

ESMA's SMSG group noted that 'proxy advice is ... an efficient way of ensuring that a diversified investment strategy does not become a passive investment strategy'. The SMSG discussion paper does not seem to reflect the marked difference between provision of scrutiny of agendas and offering of explicit voting advice on the agenda items. Furthermore, purely putting voting into practice does not make an investor 'active' as opposed to 'passive'. Voting can be carried out on a passive basis just as much as an investment strategy can be passive. A passive investment strategy means that the buying or selling decision is not taken by the investor, but by a third party (for example, an index provider). A passive voting strategy would be where the voting decision is not taken by the investor, but by a third party (a PA).

The essence here is that even where an investor has made arrangements for their shares to be voted, those arrangements may still amount to a 'passive' approach. It is from this very practice that the notion of 'relying on proxy advice' derives, to which the SMSG refers so frequently. Voting does not necessarily denote an 'active' voter. Only considered voting, which proves demonstrable investor control of the actual decision making process, may be described as 'active'.

It is firmly the relationship between the proxy advice and the decision-making role played by the investor which determines the passivity or otherwise of a voting strategy.

5 Conflicts of Interest

5.1 To what extent do you consider proxy advisors to be subject to conflicts of interest in practice?

There are numerous potential conflicts of interest applicable to a proxy advisor. The extent to which they apply varies according to the specific circumstances of the individual proxy advisor. It is not possible or appropriate to generalize about the extent to which proxy advisors are subject to conflicts of interest, other than to say that conflicts of interest are, as in all walks of life, inevitable and cannot completely be avoided. The identification of appropriate ways to manage them transparently is the key to ensuring they do not interfere with research output.

5.1.1 Governance advisory services to issuers

The most widely discussed conflict of interest is related to whether or not governance consulting services are sold to the issuers at the same time that the advisor is selling voting advice to investors. There is an obvious conflict in terms of the objectivity applied in proxy advisors making voting recommendations on a company that the proxy advisor has given corporate governance advice to.

5.1.2 Ownership

Proxy Advisors can also be subject to conflicts of interest through their ownership structures. If they are part of a publicly listed company themselves, or are owned by an institutional investor, for example, then there are potential conflicts of interest to be managed between the views of their owners and the advice they give their investor customers.

5.1.3 Provision of in-house voting recommendations

There is also potential for both an economic and reputational conflict of interest where a proxy advisor produces and promotes its own (in-house) policy and recommendations.

The economic conflict is between achieving greater economies of scale by encouraging their customers to use the generic voting advice and providing customized voting advice tailored to the needs of the investor. Custom voting advice is by definition more complex to provide when the advisor's business model is founded upon in-house voting advice.

The reputational conflict is through the desire to be seen by investors to be influential towards issuers. This is mainly a function of the US model of proxy advisory services, whereby to an extent proxy advisors compete with one another purely on the basis of their policy and the nature of their recommendations. It is also at least in part caused by investors who include in their selection processes an assessment of the degree of influence a proxy advisor can demonstrate.

5.1.4 Significant commercial relationships

Conflict of interest can also occur where a proxy advisor has a significant commercial relationship with one particular customer which is influential on the nature of the advice the proxy advisor may give. This can only be possible in cases where the advisor makes in-house recommendations.

An example might be where a proxy advisor is engaged to provide advice for the members of a trade association or investor group, where either the size of the contract for the advisor represents a significant portion of their overall income, or where the reputational benefit of being seen to be aligned with the trade association could be deemed to be significant enough to compromise objectivity.

5.2 To what extent do you consider proxy advisors have in place appropriate conflict mitigation measures?

Disclosure of potential conflicts of interest is fundamentally important, for customers to be able to make judgments about the extent to which the conflicts are themselves successfully mitigated.

Most of the potential conflicts of interest that exist are well-known enough for each proxy advisor to have some explanation available to mitigate concerns over any perceived conflicts of interest they might be subject to. Evaluation of the explanations and mitigation measures should be a matter of due diligence in the procurement process.

5.3 To what extent do you consider proxy advisors to be sufficiently transparent regarding conflicts of interest they face?

Given the small size of the proxy advisory market, any potential conflicts of interest are well-known and the arguments well rehearsed. It is practically impossible for a proxy advisor to conceal or deflect attention away from a potential conflict of interest.

Additionally, it is not clear from the discussion paper that ESMA, or for that matter critics of proxy advisors have analysed PA conflict disclosures and having read them, found them wanting.

5.4 If you consider there are conflicts of interest within proxy advisors which have not been appropriately mitigated: which conflicts of interest are most important?

Mitigation of conflicts of interest is an on-going process rather than a one-off fix. For example, it forms a part of Manifest's ongoing Quality Assurance Management System¹⁵. Any conflict of interest which could potentially compromise the objectivity of a voting recommendation is serious.

However, in terms of our perception of the degree to which different conflicts of interest could sway the objectivity of advice, the conflicts listed in section 5.1 above are listed in descending order of seriousness, with the most serious first.

¹⁵ Manifest operates an [ISO 9001:2008](#) Quality Management System for the provision of stewardship support services. The ISO quality framework provides a tried and tested framework for taking a systematic approach to managing an organisation's processes so that products and services consistently meet customers' expectations. Manifest was first externally assessed and approved as an ISO9001 registered firm in March 1998. Our system was re-accredited by [Lloyds Register Quality Assurance](#) in March 2012.

5.5 If you consider there are conflicts of interest within proxy advisors which have not been appropriately mitigated: do you consider that these conflicts lead to impaired advice?

Conflicts of interest are far from the only factor which may affect accuracy, independence and reliability. However, we have reservations again here about the nature of ESMA's question, without explaining what is meant by the term impaired advice. Is ESMA suggesting, for example, that issuers have bought good recommendations to avoid a ballot conflict with shareholders? Our response to this question should therefore be read in conjunction with section 2.3.5 above on the notion of 'good' versus 'bad' advice.

This is not an easy question to answer from our perspective as a proxy advisor as we do not have easy access to perceptions as to how our competitors manage conflicts of interest.

However, this question is one which it is critical ESMA for to explore with statistically significant empirical research, as this question lies at the heart of the debate as to whether regulation is to be deemed necessary. We suggest that a comprehensive survey of institutional investors would be necessary to answer this question with any degree of statistical significance or certainty.

6 Voting Policies and Guidelines

6.1 To what extent and how do you consider that there could be improvement for taking into account local market conditions in voting policies?

The question suggests that proxy advisors do not take account of local issues. What evidence does ESMA have that local issues are not considered? Even if they are not considered, the extent to which a proxy advisor takes into account local considerations is a commercial decision. If it is true that a proxy advisor's reputation and its intellectual capital strength are vital assets to its business, then local considerations will naturally follow as a pre-requisite for service provision *if investor clients make it a significant factor in selection*.

However, local considerations are sometimes only a part of the full picture. Issuers and investors alike may actually deem the global perspective a more relevant one for large multi-national companies. Writing in the FT on the 6th June 2012, Sir Martin Sorrell, CEO of WPP plc expressed objection that certain proxy advisors¹⁶ *'compare our US-based competition with companies such as Time Warner, Viacom and CBS, and do not include WPP ... they compare us only with UK companies, although less than 10 per cent of our revenues and profits originate in the UK and all WPP's big competitors, including those with pay schemes that are very generous by comparison, are excluded from these analyses'*. ESMA should therefore be cautious about promoting the notion that local market conditions are paramount in governance and voting considerations. As it happens, Manifest did not only compare WPP to local market participants but used global benchmarks to assess WPP's remuneration report resolution.

Manifest believes that it is important to ensure a balance between local considerations and global best practice, which is what issuers themselves do in the operation of their businesses. Inevitably this makes the research process more nuanced and potentially more expensive. The ability of some proxy advisors to deliver sufficiently locally nuanced research is a direct function of the willingness of investors to pay for it. The natural corollary of the fact that investors know their home market well is that their knowledge of foreign markets may not be so good to be able to know if their proxy advisor is applying local considerations appropriately in the research and advice. Conversely, because investors rely rather less on their proxy advisors for advice in their home market, they pay less attention to the accuracy of the proxy advisors research. As a consequence, many investors do not hold their advisors sufficiently to account on this question, either because they do not have the expertise or inclination, or they do not rely so much on use of the research in their home market.

ESMA is also in great danger of perpetuating a myth that it is only possible to analyse or service a market from within the territorial boundaries of that market. The principles of the EU are that it is a single market for services, financial or otherwise. The territoriality of vendor is therefore not a legally valid consideration.

Unfortunately, the primary demand in the proxy advisory services market is for low prices, placing an overwhelming emphasis on cost reduction rather than quality of service. Our own anecdotal evidence from the past year in invitations to tender is that price forms between 40% and 50% of a buying decision, making price by far the biggest single consideration, important over all others.

¹⁶ Of which Manifest was not one

Unfortunately, ESMA also seems to have been placing emphasis on the cost-cutting benefits of proxy advisors, rather than the importance of quality - paragraph 50 of the consultation paper re-iterates that 'proxy advisors' fees for the provision of their services are most likely a crucial factor when it comes to the selection of a proxy advisor'. Whilst proxy research and advice does indeed bring a cost benefit to an investor compared to managing all aspects of research and voting in-house, one of the market deficiencies in the proxy advisory market in recent years has been highly predatory pricing pressures, brought about especially through the two largest proxy advisors in the market, ISS and Glass Lewis.

ESMA and the SMSG must decide whether its priority is to encourage quality research or cheap research, whilst maintaining an understanding that there is obviously and inevitably an inverse relationship between the two. ESMA may find it helpful to investigate the pricing structures of other investment-related research disciplines to better understand the unique economic dynamics of the proxy advisory market.

6.2 To what extent and how do you consider that there could be improvement on dialogue between proxy advisors and third parties (issuers and investors) on the development of voting policies and guidelines?

There are various ways in which dialogue between investors and proxy advisors as well as between proxy advisors and issuers could be improved. Fundamentally, if the degree of influence of proxy advisors is an issue of concern, the industry must move the debate away from the notion that proxy advisors should be the first and central dialogue point for issuers or investors for defining policy. However, PAs can, should and do provide helpful empirical evidence to inform voting decision-making processes.

6.2.1 Proxy Advisor - Investor Dialogue

The extent to which proxy advisors engage with their investor customers about the development of their voting policies and guidelines is an easy measure that investors can use in assessing whether their proxy advisor is working in the interests of investors or themselves. The more proxy advisors consult with, and offer flexibility to, investors in developing and applying a policy which is best for each customer, the more it can be demonstrably shown that the investor's interests are being served.

This depends to an extent on the degree to which investors require control of the voting policy making process, and the transparency of policy implementation.

This is critical because, as the SMSG rightly notes, 'proxy advice should facilitate investor engagement and stewardship' because 'investors should engage with the company in which they invest'.

So proxy advisor dialogue with investors about policy development and implementation is vital to be able to capture the needs and requirements of the investor.

6.2.2 Proxy Advisor - Issuer Dialogue

The nature of dialogue initiated by proxy advisors is driven by the engagement and recommendations style of the proxy advisor involved. Where the proxy advisor is planning to make explicit in-house voting recommendations, they may feel more of an incentive to undertake their own engagement with issuers in the preparation of voting advice.

The nature of engagement between issuers and proxy advisors is almost completely geared towards a perception that issuers must pre-empt what proxy advisors are going to say about them, and the importance of securing a 'favourable' voting recommendation.

This mentality completes the vicious circle of influence by proxy advisors over issuers. Investors use 'influence over issuers' as one selection criterion for the proxy advisor of their choice. Proxy advisors then purport to represent large proportions of an issuers' shareholder base, creating the impression that they must be engaged with because of their potential influence over the issuer in question. Issuers then seek to obtain a positive voting outcome by reference to voting advice, rather than by reference to their investor base. Proxy advisors can then demonstrate a positive correlation between 'positive' change at issuers and higher levels of support from investors towards the advisors point of view, thereby enhancing the perception that the proxy advisor is influential.

This vicious circle must be deconstructed, which requires better direct communication and understanding between issuers and investors. Investors in their procurement practices should place a greater focus on genuine quality of research and how the research can support the investor's own processes, rather than focusing on voting advice to such a great extent. Similarly, issuers (and their advisors) must have the discipline to move away from focusing on what the proxy advisors say and towards what their investors are saying.

There is some evidence that investors wish this too. The BlackRock Letter (see page 17) demonstrates investor commitment to the principle that all shareholders should have information at the same time. Selective briefing (especially selective briefing of proxy advisors) should be avoided. If an issuer needs to selectively brief investors or proxy advisors then it is likely that its disclosures are deficient. We are aware that investors will choose to become 'insiders' and they are entirely within their rights to do so under prevailing regulation.

The principal difference between the US and EU market is that the former is 'privatized' and the latter 'socialized' in terms of governance policies. By that we mean that in the EU, voting guidelines such as The UK Governance Code, The Viennot Code etc are in the public domain and have had widespread, open consultation and are generally owned by a public interest entity. In the US governance codes and policies are generally commercial and are owned by the relevant vendor. That said there is also a great deal of academic and cross-cultural policy mingling through bodies such as ICGN, OECD, UNPRI etc.

7 Voting Recommendations

7.1 To what extent do you consider that there could be improvement, also as regards to transparency, in the methodology applied by proxy advisors to provide reliable and independent voting recommendations?

Yet again ESMA is focused exclusively on recommendations and not on research and analysis. The black box argument the discussion paper refers to is a circular one. If issuers want more transparency about how recommendations are produced to the extent that they can be sure about what recommendations an advisor may make about their forthcoming meeting, then the only way to precisely deliver that level of transparency is with a box-ticking approach.

It is clear that issuers do not want a tick-box approach applied to the assessment of their meeting business, yet it is also clear that issuers wish to know with relative certainty how an advisor is likely to recommend. These two notions are mutually exclusive.

This is only a relevant concern at all if the proxy advisor produces in-house recommendations, and then only where investors are relying on them.

Transparency towards investors on the part of proxy advisors is important but is again inevitably a function of commercial demand. If such transparency is important enough for investors to want it, then proxy advisors will be incentivised to provide it in order to meet their client demands. Recent developments such as the UK Stewardship Code, which require reporting of voting activity and (occasionally) explanation of voting decisions, have served to increase demand for transparency of voting advice.

However, it must be noted that the sheer volume of meetings and research reports which investors have to deal with during the peak meeting season (quarter 2 of the calendar year) means that there is a finite ability on the part of investors to process information relating to voting advice transparency. The degree to which such transparency is useful to investors is therefore proportionate to the time available for the evaluation of meeting business.

7.2 To what extent do you consider that there could be improvement, also as regards to transparency, in the dialogue with issuers when drafting voting recommendations?

The tone of this question again suggests a basic assumption that shareholders need spoon-feeding with explicit in-house voting advice and as such is the only business model in the proxy advisory industry. This betrays an obsession with voting recommendations and advice rather than research quality and objectivity which is unhelpful. Furthermore, it implies the notion that the greater the level of dialogue, the greater the chance of mitigating and avoiding the possibility of negative voting recommendations.

Advisor dialogue with issuers may be important to ensure understanding of the governance of the company, the issues to be voted upon and the disclosures the company has made available to shareholders and the market (the normal source materials for proxy advisors). This is all critical to research; but this is entirely separate from the preparation of voting recommendations.

But it should not be assumed that dialogue is necessary in the preparation of voting advice. Voting advice essentially involves the application of an opinion, to which any individual is entitled.

As stated earlier, the degree to which proxy advisors engage with issuers may be determined by a number of varying factors including the research methodology used, objectivity standards¹⁷, the method employed for the provision of voting advice and the desire of the underlying investors to prefer to have dialogue.

It is worth considering that if an investor cannot make a voting decision based on the information presented in the annual report then the annual report is at fault and 'dialogue' will only perpetuate low quality disclosures on the basis that selective dialogue and disclosure on an as needed basis avoids the tricky challenge of higher quality reporting. This is grossly unfair to smaller shareholders who may not be able to command the attention of issuers, especially retail shareholders or overseas professional investors whose voting rights are already unnecessarily constrained by the nominee system.

7.3 To what extent do you consider that there could be improvement, also as regards to transparency, in the standards of skill and experience among proxy advisor staff?

We absolutely agree that a Proxy Advisor must have sufficient understanding of the legal (soft and hard law) context within which a company operates in order to give nuanced analysis. Proxy Advisors should have sufficient quality systems in place to manage this, but we are unclear why ESMA believes it is necessary to suggest a regulatory requirement when it is not proven that research quality is poor or dangerous to customers or that standard business practices have failed.

The implication of the SMSG statement that 'The PA must have sufficient qualifications to offer proxy advice and its employees must hold the necessary qualifications to perform their function within the PA' is that analysts must all have a specific type of qualification. SMSG does not state what it think are 'the sufficient necessary qualifications'. Our experience has proved that insistence on prescriptive qualifications to be counterproductive to the encouragement of vibrant research and innovation of research perspective. Frankly, legal minds write dry reports, which investors do not find valuable and equally, mathematical minds may produce elaborate and complex reports which are impenetrable.

Reliance upon the knowledge of the individual is also not a sound basis on which to base a research service which it is required must be consistent in its application, and would also represent too high a risk in terms of intellectual capital.

Understanding of the skill sets within the proxy advisory organization should be an important part of the due diligence an investor should make when appointing a proxy advisor. They should satisfy themselves that the proxy advisor has the appropriate level of knowledge, systems, skills and personnel to deliver the services being rendered. The over-emphasis on price and size used by investors in procurement has prevented objective skills considerations and obscured focus on the quality of research outputs. This is how market dominance acts as a barrier to service quality, reducing 'competition' to a numbers game which is ultimately at the expense of investors and issuers alike.

¹⁷ Manifest conforms to the CFA Institute's Research Objectivity Standards which include specific, measurable standards for managing objectivity and independence in research reports and disclosing conflicts of interest (<http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n2.4006>).

We should be mindful that those who provide proxy advice on a professional basis do so to professional investors. We would hope that the SMSG and ESMA is not suggesting that professional investors are incapable of undertaking sufficient due diligence to ensure that the providers they appoint uphold sufficient standards. If it is ESMA and the SMSG's view that professional investors are incapable of applying basic due diligence in their buying decisions, ESMA and the SMSG would do better to address the problem directly by offering professional investors assistance in understanding basic due diligence processes and their importance rather than in doing it for them through regulation by trying to be prescriptive in the information proxy advisors must provide to the open market.

8 Policy Options

It is commendable that ESMA has proactively sought market participant's views on the importance of corporate governance and proxy voting. However we do not see that ESMA has solicited objective evidence to use as a basis for any recommendations for regulatory activity let alone to be able to define its scope or determine its effect on the proxy advisory market. For that reason we have chosen not to answer the section on policy options. The entire essence of this section would seem to be leading respondents to accept that regulation of proxy advisors is necessary and/or desirable or that the options presented are the only options that can be considered, which is not the case.

While it may be desirable for segments of the market which find the proxy scrutiny process uncomfortable to see their critics regulated, that does not constitute sufficient reason to regulate proxy advisors.

Does this mean that Manifest believes that ESMA or the European Commission should not act to protect investors? No. On the contrary, Manifest believes that ESMA's overriding priority is to ensure that investors are capable of playing their fiduciary roles without unnecessary operational difficulty. Therefore prior to any work being carried out on the nature of proxy advice, it is essential to ensure that investors are able to vote effectively across borders.

9 Conclusions

Some readers of this paper may assume a degree of complacency on our part about the need for proxy advisor regulation and that we are blind to any notions of improving standards. Those readers that know Manifest would know how far from the truth such an assumption would be. When it comes to issues of analyst objectivity, independence and, most importantly, investor protection, Manifest has been a staunch advocate for reform for over 15 years.

But what are ESMA's priorities in protecting markets and shareholders? Can the regulation of a selective sub-set of market data vendors be justified at this point in time, especially given a lack of evidence of market failures, a clear view of what the potential for market harm might be and the early stage of development of soft regulation encouraging better stewardship practices on the part of investors?

We believe that ESMA and the European Commission needed a clearer understanding of how and why investors make proxy voting and stewardship decisions to be able to understand the dynamics of the market incentives which determine proxy advisor behaviours. Existing regulations as they affect proxy advisors, investors and issuers, the way intermediaries are used by investors should all be mapped, understood and enforced before additional regulation can be considered.

When it comes to the integrity of financial markets and the role of corporate governance, ESMA has a far wider choice of options open to it than has been presented. There are existing mechanisms in place to use investor behaviour to great effect in terms of addressing the issuer concerns of which ESMA has been made all too volubly aware.

Market Abuse

If there are suspicions of Market Abuse then ESMA must act promptly and use the existing regulatory frameworks to ensure that any such abuse is dealt with. To not respond to such allegations would, we believe send the markets entirely the wrong message.

Cross-border Voting

To date, the problems of cross border voting in Europe have not been addressed and existing regulations regarding the conduct of intermediaries has been weakly enforced, despite overwhelming evidence and knowledge of the need to act.

The effectiveness of the Shareholders Rights Directive was greatly compromised by an inability to address the problems of cross border voting and any attempt to regulate investor decision-making on voting will be equally futile until cross-border voting is rendered efficient and effective by genuine competition and innovation.

Investor Use & Application of Proxy Advice

Fund managers are currently regulated in their role as investment fiduciaries. In the UK context (many of the Financial Services Authority's rules are based on MIFID) there are specific rules in relation to both the investment management as well as the administrative functions in relation to managing investments have specific duties including: the 'monitoring and processing corporate actions'¹⁸ (generally speaking proxy voting is seen as what is known as a 'voluntary corporate action'). If there is a suspicion that fund managers are not in compliance with their local market regulations then ESMA should be seeking enforcement of the existing regulations as they apply to the investment fiduciaries.

¹⁸ <http://fsahandbook.info/FSA/html/handbook/Glossary/A>

For example, if it is considered that a fund manager is voting by auto-pilot without oversight of the process or input is in breach of its fiduciary responsibility or client agreement then it is for regulators to investigate using the powers they already have.

Market Dominance Questions

There is, without doubt, a serious problem of lack of competition in the global proxy advisory and execution markets. This dominance affects the way in which the growing number of foreign voting shareholders cast their votes at European meetings. Consumers have suffered as a result of vested interests with strong economic reasons for forcing shareholders to use ineffective and inappropriate technologies for managing their voting.

If ESMA (or any other stakeholder) is using the term the dominance of proxy advisors as a verbal short-hand for the dominance of an individual market participant and there are genuine complaints about the effect of that dominance then ESMA is obliged to make a referral to DGComp.

Codes of Conduct

We are extremely sceptical of regulatory proposals which don't actually solve quantifiable problems and simply generate what the technology community calls 'shelfware'. Seeking to introduce soft regulations or codes of conduct would do nothing to address the underlying problems of market inefficiency which brought about market dominance issues.

In preparing this paper we were reminded that on 1st July 2000 Ken Lay announced Enron's new and improved 65 page Code of Ethics, stating that: "*Relations with the Company's many publics . . . will be conducted in honesty, candor, and fairness.*" So while codes of conduct set out very high minded principles their operational impact is sometimes very questionable.

We thank you for this opportunity to present our perspectives on the ESMA Discussion Paper. Generally speaking, in a fair or reasonable judicial process the protagonists are innocent until proven guilty. Regrettably, the ESMA Discussion Paper has turned that common law maxim on its head.

We look forward to continuing our engagement with the European Commission on the important issue of investor protection.

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10 End Note

ⁱ **The Avon Letter:** In 1988, the United States Department of Labor (DoL) issued a set of guidelines, now known as the "Avon Letter,"⁽¹⁾ directing Employee Retirement Income Security Act (ERISA) fund managers to vote proxies with the same diligence as making other fiduciary decisions.

On July 29, 1994, the DoL issued guidance with respect to the duties of employee benefit plan fiduciaries under sections 402, 403 and 404 of Title I of the Employee Retirement Income Security Act (ERISA) to vote the shares in companies held by their pension plans (29 CFR 2509.94-2). New guidance was set out in Interpretive Bulletin 08-2, which included clarifications of the earlier guidance, as well as interpretive positions issued by the DoL 1994 on shareholder activism and socially directed proxy voting initiatives.

The US Department of Labor takes the view that proxy voting is integral to the fiduciary act of managing plan assets, and can only be exercised by:

- (i) the plan trustee;
- (ii) a named fiduciary through instruction of the plan trustee, or
- (iii) the investment manager to which investment authority of the relevant asset has been delegated.

Named fiduciaries are obliged to monitor the proxy voting decisions of the plan's investment managers. Managers are therefore recommended to maintain written records of its voting procedures, the actions taken in individual proxy voting situations, and, where appropriate, cost-benefit analyses of situations where the manager refrained from voting on the basis that the cost of voting (including the cost of research) exceeded the likely economic benefits of voting.

Source: Federal Register /Vol. 73, No. 202 / Friday, October 17, 2008 /Rules and Regulations

(1) See letter from the Department of Labor to Helmut Fandl, Chairman of the Retirement Board of Avon Products, Inc., dated February 23, 1988.