

EFAMA REPLY TO THE PUBLIC CONSULTATION ON BEST PRACTICE PRINCIPLES FOR GOVERNANCE RESEARCH PROVIDERS

EFAMA¹ appreciates the opportunity to respond to the public consultation organised by The Best Practice Principles for Governance Research Providers Group on “Best Practice Principles for governance research providers”.

EXECUTIVE SUMMARY

While we are generally speaking in favour of this first effort to provide Best Practice Principles, we are concerned that the issues raised have not yet been optimally addressed. Our main reservations can be summarised as follows:

- Some instances have seen the scope of the proposal extended beyond the remit of the ESMA’s “Guidance for a proxy advisory industry code of conduct” which could potentially cover any activities provided to their institutional clients, therefore discharging them of their engagement responsibilities. Setting the scope too wide and defining terms such as “governance research services” too broadly risk applying the code of conduct to asset managers which carry out activities which are totally different from those of proxy advisory firms. The aim of the code of conduct should not be to maximize the number of signatories, but to profoundly mitigate the specific risks to which proxy advisors’ clients are exposed in the context of a proxy advice provided to them. Therefore, we strongly advise that **the Principles should adopt a more targeted approach**, which addresses proxy advisory-like risks which are genuinely significant to the voting process.
- Whilst we generally support the use of the comply-or-explain framework, we are concerned that the Principles consists of just three high-level principles and some guidance on each of them. This is a different and less robust structure to that of the many corporate

¹ EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 60 corporate members about EUR 15 trillion in assets under management of which EUR 9.5 trillion managed by 55,000 investment funds at end September 2013. Just over 35,500 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

governance codes in the EU which contain principles for listed companies and with much more detailed provisions that they must either comply with, or explain. We caution that there is a danger that the Principles become an exercise of finding the lowest common denominator: if the scope is too broadly defined and/or Principles are so easy to become meaningless, then the draft Principles become a piece of self-regulation that does not improve standards within the proxy advisory industry, nor remove the desire of some to introduce binding rules. Therefore, we would advise to **make changes to the draft Principles' structure to ensure that a strong foundation to the Principles**. This means that the Principles should:

- contain Principles, elaborated in the form of specific best practice provisions,
- operate on a comply-or-explain basis,
- require proxy advisers to state publicly whether or not they apply the best practice provisions.
- Partly as a result of the wide scope, the draft Code seem not to be fully comprehensive and **lacks precision in areas such as “avoiding conflicts of interests” and “ensuring the accuracy and reliability of the advices”**. We would strongly suggest that serious consideration is to be given to include in the Principles at least the Principles regarding the Proxy Advisory Industry derived from ESMA's analysis as formulated in the 19 February 2013 ESMA Feedback Statement. We would like to see best practice provisions on:
 - how the proxy advisor seeks to reflect the views of its clients and how it seeks to ensure accuracy;
 - its approach to dialogue with issuers;
 - whether it shows issuers copies of its voting analyses before publication, its approach to corrections;
 - the resources it applies to its research, the role of senior executives in adjudicating difficult judgements;
 - the nature of conflicts it faces, and how these are managed; and
 - whether it has a contact point for companies and clients wishing to raise concerns.
- The Code should **not impose standards of conduct** for the following reasons:
 - Investment management companies are already regulated thoroughly under various regulations (i.e. MiFID, UCITS, MAD, and Transparency Directive). They are – inter alia – required to implement conflict of interests' policies and strategies to execute voting rights including a requirement to decide on whether and how execute voting rights.
 - Other regulated institutional investors are obliged to comply with similar or slightly different requirements compared to investment management companies.
 - The Principles should stay focused on one addressee which already is difficult enough given the fact that the business models differ widely.

GENERAL COMMENTS

As asset managers act as fiduciaries for their clients, all EFAMA members agree that exerting voting rights bound to shares held in managed portfolios is of crucial importance to enhance issuer-shareholder dialogue and engagement in order to create long-term value for the asset managers' clients.

We believe that proxy advisors provide a useful service to investors in the context of the functioning of the voting system as a whole. They provide important services to those who intend to vote on items on the agenda of the listed companies' general meetings. In particular, large institutional investors who – for reasons of diversification – invest in many listed companies seated in various countries can benefit from proxy advisors' voting advices and proxy voting services. At the same time, their influence should not be overstated².

We agree with ESMA's statement in February of this year that the ultimate decision and the voting responsibility are on the side of the investor. The use of a proxy voting advisors or other third-party services cannot be regarded as a substitute for the institutional investor's own responsibility to vote in an informed and responsible manner.

A number of concerns regarding proxy advisors have been identified in both the European Commission's Action Plan³ and ESMA's analysis (e.g. potential conflicts of interests, the accuracy and reliability of advices, lack of sufficient resources). Similar points of criticism have been raised by investors and issuers in the past. These issues demand serious attention and need to be properly addressed. We concur with ESMA's view that the preferable approach is the introduction of a pan-European industry code of conduct rather than putting in place formal regulatory measures.

DETAILED COMMENTS

Background to The Principles

Q1. What are your views about the Principles development process?

EFAMA would like to remark in a more general manner that the role of proxy advisors and the development process of the Principles is only one of many facets to enable and encourage shareholders to effectively fulfil their role as owners of investee companies.

² In a 2010 study regarding US listed companies it was estimated that overall, an ISS recommendation shifts 6–10% of shareholder votes (Choi , Fisch and Kahan: The Power of Proxy Advisors: Myth of Reality?, Emory Law Journal, Vol. 59, p. 869, 2010, University of Penn, Institute for Law & Economics Research Paper No. 10-24). According to the Dutch Corporate Governance Code Monitoring Committee 2010 Survey 50% of the institutional investors investing in Dutch listed companies do not use any of the services of proxy voting advisors.

³ European Commission's European company law and corporate governance Action Plan of 12 December 2012 (COM(2012) 740 final).

While the on-going discussion on Best Practice Principles (BPP) for the proxy advisory industry is certainly helpful, we believe that the public discussion should not stall at this one particular point in an entire chain which enables the exercise of ownership rights. Other important issues are the existing legal and operational barriers to smoothly exercising voting rights.

Furthermore, some questions could be also raised whether the committee in its current form is representative of the industry. We regret there is no further information, as to how the committee was formed and according to which criteria its members were selected. Since there is also no inclusion of clients' representatives and target companies, it cannot be ascertained that the views expressed by the Committee fully reflect the opinion of all the practitioners (such as asset managers, target companies, advisory companies, etc.).

Q2. Respondents are welcome to express their expectations regarding the review and monitoring of the Principles. As the ongoing governance of the Principles has yet to be determined, the Committee particularly welcomes suggestions by stakeholders as to how a representative feedback mechanism can be implemented.

We support the idea to develop Principles for Governance Research Providers, but would like to raise some concerns. Since ESMA's work focused mainly on the voting services of proxy advisors, it is very surprising that this topic was excluded from the scope of the Principles. While we understand that the business models vary widely, therefore making it more difficult to cover all services offered, we believe that best practices should also address the particularities of vote agency and engagement services

We also believe that the effectiveness of the Principles could benefit from establishing an independent body that monitors the Principles on a regular basis and publicly reports on the monitoring outcomes. We believe that the Principles should be reviewed periodically in a formal manner with consultation on particular aspects that may have emerged over time.

One further suggestion would be to organise regular meetings with main stakeholders, such as representatives of the asset management sector in addition to representatives of wealth managers and target companies.

Comply or Explain

Q3. Please share your views on the practicality of a comply-or-explain approach to the Principles.

We fully agree with a classical comply-or-explain approach as there is no other practicable approach. This approach appropriately reflects the fact that institutional clients are primarily responsible to hold proxy voting agencies to account, while offering enough flexibility to proxy advisors to use higher standards in their own policies rather than a one-size-fits-all approach or the obligation through regulatory measures.

However, for this approach to function properly, we consider that the comply-or-explain standards used need to be of sufficiently high quality. We are currently not convinced that they are. It also needs to be considered if the comply-or-explain mechanism could break down without investor clients to whom the explanations are directed and who take into consideration the provided explanations, engage with proxy advisors to better understand them and, if applicable, suggest their own views.

Q4. Could the effectiveness of the Principles be further enhanced? Please elaborate and provide specific examples and/or suggestions.

In our opinion, the effectiveness and application of the Principles should remain at the level of the signatory and govern the relationship between the different signatories and their clients. Indeed, the variety of hypotheses, constraints and situations is so broad that it is not possible to regulate and foresee each case. Taking this into account, besides our suggestions to Q1 we believe that certain amendments could be made to the Principles in order to render them more effective:

- (a) As a minimum requirement there should be no dilution of the Principles, as set out in the ESMA statement;
- (b) Proxy advisors should inform their clients about any changes in their initial advice(s), as a result of the issuer's input;
- (c) Essential terms in the Principles should be clarified and – if necessary – defined or better explained. These terms include “conflicts of interest”, “material conflicts” and “investor-client influence”.

Application of the Principles

Q5. Do you believe the Principles and/or supporting Guidance conflict with obligations under legislation or other best practice Principles? If yes, please elaborate and provide specific examples and/or suggestions.

We are concerned that the European Commission's has recently voiced their intention to propose a revision to the Shareholders' Right Directive in February 2014. Since proxy voting agencies have been named as one area of possible future regulation, we are concerned that the industry's self-regulation could prove futile in case the European legislators upend the suggested Principles.

Q6. Please share your views on the procedures for registering as a signatory, describing and disclosing how Principles and related Guidance are being applied, and for disclosing the Statement of Compliance.

We agree with the idea of publishing the Statement of Compliance on the independent Committee's website and on the ESMA website. However, we think publication of the policy on how to manage conflict of interests is also of the upmost importance and should also be published.

Q7. What should the regional scope of the Principles be, in terms of signatories and services provided? For example, do you think that the Principles should be global?

We are of the opinion that the Principles should first be developed and tested at European level and then extended at global level, in close dialogue with local players. Should Principles only exist in Europe, then this situation would result in an uneven playing field between actors from different regions of the world. This would definitely not result in an open and fair competition and equivalent protection of clients.

Q8. For additional potential signatories only: Are there factors that generally would keep you from becoming a signatory to the Principles? If yes, please elaborate and provide specific examples and/or suggestions.

EFAMA has no specific comments to this question.

Q9. For additional potential signatories only: What are your views on the Guidance for subscription, adoption and ongoing compliance from an organisational point of view? Do you think the ongoing management of the Principles could be improved? If yes, please elaborate and provide specific examples and/or suggestions.

EFAMA has no specific comments to this question.

Scope & Definitions

Q10. Do you agree with the definition of “governance research services”? Is the scope of the definition adequate? If not, please elaborate and provide specific suggestions.

We agree with the proposed definition, but we have some doubt as to whether ratings should be included in the scope of Governance Research Services.

EFAMA members are not aware of service providers using “ratings” and cannot determine what elements these ratings would cover. In addition, we remind the Committee of the potential dangers of relying on sole ratings, especially in a field such as governance especially due to recent experiences of investors with rating agencies and the current efforts by the EU to create a regulatory framework for benchmark users and providers.

Q11. Are the definitions of “vote agency services” and “engagement and governance overlay services” and their distinction from “governance research services” sufficiently clear and accurate? If not, please elaborate.

While some of our members are content with the definitions, others object and argue that concept such as “governance research services” are slightly artificial and are neither clearly defined nor can be substantially distinguished from (other) “vote agency services” and “engagement and governance overlay services”.

Instead of using the current three definitions, a suggestion brought forward was to introduce a clear and single definition of proxy advisors in order to clarify the scope of the Principles:

Firms, other than asset managers or institutional investor representing organisations, who provide commercial based services that consists of analysing the proposals for general meetings, providing voting recommendations, either based on the proxy advisor's own voting policy or on the investor's customised voting policy and/or providing services to execute voting rights.

Q12. Do you agree that the Principles should not impose standards of conduct on investors? If not, please explain why.

We do agree that no standard of conduct should be imposed on investors for the following reasons:

- Investment management companies are already regulated by under various regulations (i.e. MiFID, UCITS, AIFMD, MAD, and Transparency Directive). They are – *inter alia* – required to implement conflict of interests' policies and strategies to execute voting rights including a requirement to decide on whether and how execute voting rights (see e.g. Directive 2010/43/EU). Therefore, from our perspective, investment management companies are already regulated sufficiently covered in this regard. Lastly, a large number of industry efforts in the form best practices codes (i.e. EFAMA Code for External Governance, UK Stewardship Code, national codes) already exist that also have to be taken into consideration as well.
- Other regulated institutional investors are obliged to comply with similar or slightly different requirements compared to investment management companies. Hence, it is very unlikely that the Principles could impose standards in a way which would not conflict with all mandatory law.
- The Principles should stay focused on one addressee which already is difficult enough given the fact that the business models differ widely.

One other issue should also be raised: investors may actually fall under the scope of the Principles in case they act as engaged owners, individually or collectively, on the basis of their own governance analyses investee companies. For an investor it is hard to engage successfully with a company without having conducted any governance research on the company. We believe that engagement practices and related research activities that institutional investors and their managers conduct on their own, individually or via collective vehicles, should be excluded from the scope. The Principles should therefore focus on third-party voting recommendations and the processes and issues related to that.

Principle One: Service Quality

Q13. Do you think that Principle One will help the market to better understand the different kinds of services and approaches that participants operate? If not, please explain.

Yes, we agree that the existence and disclosure of a research policy and “in-house” voting guidelines will help better understand the services provided. However, we think that the existence of the conflict-of-interest policy should be regarded as equally important as the other two policies. In our view existence and disclosure of policies are two separate considerations.

Q14. Do you see any issues of service quality that are not addressed in this section? If so, please provide examples and specific information on the purpose and merits of any additional disclosures.

One area we could think of relates to the resolution of disagreements between advisor and client. Additionally the liability of the advisor should be addressed in greater detail (i.e. Is there a professional liability insurance covering the adviser’s liability?).

Should an advisor provide erroneous information, issues of liability arise. As many advisors currently have no insurances relating to these services, this could lead to major difficulties.

Q15. Do you think the disclosure of the research policy, voting guidelines and research methodologies will enable stakeholders to determine how signatories consider local market conditions? If not, please provide reasons.

Yes, the disclosure of research policy, voting guidelines and research policies will enable stakeholders to determine how advisors consider local market conditions; however local peculiarities have to be disclosed for each market, if the stakeholders want to be properly informed and understand the direction of the voting recommendations. Most advisory firms work with local subsidiaries providing them with the necessary information (legal/regulatory in addition to corporate information).

Q16. Please express your views on the scope and content of the proposed research-related disclosure under this principle with respect, to: (a) research policy; (b) voting guidelines and (c) research methodologies

EFAMA has no specific comments on the scope and content.

Q17. For additional potential signatories only: Does the Guidance provide you with the information necessary to properly apply Principle One? If not, would you prefer further Guidance? Please explain.

EFAMA has no specific comments to this question.

Principle Two: Conflicts of Interest Management

Q18. Does Principle Two address the relevant issues or considerations relating to potential conflicts of interest in the provision of governance research? If not, please explain.

Yes, we agree that Principle Two addresses the relevant issues and considerations relating to potential conflicts of interest.

Q19. Do you agree with the proposed conflict management and mitigation procedures? If not, please explain why and what additional measures you would propose.

Conflicts of interest are in particular relevant in situations when other considerations than the best interest of the client may affect the recommendations. Examples of potential conflicts of interest situation are when a proxy advisor:

- has an asset manager as client who is part of a larger financial group with a stock market listing;
- provides services to both institutional investors and issuers;
- allows issuers not only to check the draft advice's accuracy before submitting it to issuers but also allow them to comment on the actual content of the advice.

Although we generally believe that the mitigation measures proposed are appropriate, there is a need for at least more specific disclosures about actual conflicts of interest. Accordingly, we make reference to our answer on Q20 below.

Q20. Do you agree with the proposed approach on disclosure of material conflicts? If not, please explain.

We agree on the fact material conflicts have to be disclosed but we are not content with the fact that the Principles allow disclosures only at the time of the delivery of the service. We think material conflicts have to be disclosed as soon as possible and in any case before any service is provided.

Furthermore, with regard to voting recommendations, we believe that conflicts that arise from (i) offering both services to investors and issuers and/or from (ii) issuers trying influence the content of voting advice rather than just checking accuracy are most important in terms of negatively affecting the advisors independency and reliability. In addition, for reasons of integrity and to avoid any doubt on conflicting interests within the same group, we would also generally support restrictions for proxy advisors to provide consulting services to investee companies.

Q21. For potential additional signatories only: Does the Guidance provide you the information necessary to properly apply Principle Two? If not, what additional Guidance do you need?

EFAMA has no specific comments to this question.

Principle Three: Communications Policy

Q22. Please express your views on the scope and content of the proposed policy disclosure under this principle with respect to: (a) Issuers; and (b) media and the public

We have no reservation to engage into dialogues with issuers. However, we believe contacts with media and the public are a very delicate topic relating to the advisor's liability. Indeed, disclosure of information can be dangerous, should the information be confidential, wrong, inaccurate, and prejudicial to the target company or out of timing. In any case, we think the advisor should not engage in such contacts without the client's prior agreement. The client should at least agree on a methodology concerning this type of dialogue.

Q23. Are there any other aspects of issuer-related dialogue that should be taken into account? If yes, please elaborate and provide specific examples and/or suggestions.

Firstly and in addition to what is already set out in the draft Principles, we believe that proxy advisors should always inform their clients about any changes in their initial advices as a result of the issuer's input.

Secondly, the advisor should always ensure that the contact person of the target company is duly authorised and that the information received is adequate and correct and that it can be disclosed. The timing and use of information have to be adequate and not prejudicial to the target company's interest. Class actions for misrepresentation are becoming a trendy juridical activity these days so we are of the view that those aspects should be a central point in this dialogue.

Q24. Are there any other aspects of issuer-related dialogue that should be taken into account? If yes, please elaborate and provide specific examples and/or suggestions.

We have no further comments to aspects of issuer-related dialogues, but please refer to our answers to Q22 and Q23.

Q25. Are there any other aspects of media and the public dialogue that should take into account? If yes, please elaborate and provide specific examples and/or suggestions.

EFAMA has no specific comments to this question.

Q26. For additional potential signatories only: Does the Guidance provide you with the information you need to properly apply Principle Three? If not, where would you prefer further Guidance?

EFAMA has no specific comments to this question.

General Features of The Principles

Q27. In addition to comments on the specific questions addressed in the remainder of this Consultation Document, views are invited on the general approach taken by the Committee and the general features of the Principles.

Please refer to our answer to Q2. Furthermore, we have no additional comments except for the fact we regret that no more stakeholders were included during the drafting process of the Principles.

Q28. Do you feel that the Principles meet the policy Principles set forth in ESMA's Final Report? If not please explain.

Yes, we agree that the proposed Principles are in line with the Principles ESMA set forth in its Final Report dated 19 February 2013. All three Principles proposed by ESMA and their sub-Principles seem well encompassed by the proposal of the Committee.

Q29. Do you have any other comments that the Committee should take into account when finalising the Principles?

We believe more efforts should be committed to the area of reporting. More transparency should be provided regarding compliance with instructions from clients and some EFAMA members are clearly in favour of exhaustive reporting automatically provided to clients. These members see potential problems when several clients make use of the proxy voting service of an advisor: was the vote correctly casted and in proportion to the different voting instructions coming from different clients?

Brussels, 17 December 2013

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