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The Best Practice Principles Group for Shareholder Voting Research
2017 Consultation Steering Group
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Dear Mr Hodge,

I very much welcome the opportunity to participate, in my capacity as an interested party in the regulatory framework of proxy advisors, in the consultation process that aims to gather evidence on the implementation of the Best Practices Principles for Shareholder Voting Research and Analysis (BPP). I will not answer all questions included in this Consultation as I will focus on matters directly related to my academic expertise and to my ongoing research in the area of proxy advisors that I hope will be useful for your purposes.

Short Biography

Dr Konstantinos Sergakis holds an LL.B from the National and Kapodistrian University of Athens, an LL.M in International Business Law from University College London and a PhD from the University Paris 1 Panthéon-Sorbonne. He joined the University of Glasgow as Senior Lecturer in Law in 2015, where he has convened the LLM in Corporate & Financial Law since 2016 and he has been acting as School International Lead since 2017. He is a Fellow of the Higher Education Academy (2014) and a qualified Advocate, a member of the Athens Bar Association since 2004. In 2017 he was elected as a member of the Executive Board of the International Association of Economic Law (AIDE). He is the author of *The Transparency of Listed Companies in EU Law* (Sorbonne - IRJS Editions 2013) and of *The Law of Capital Markets in the EU* (Palgrave Macmillan 2018). His research interests are related to Corporate Law, EU Capital Markets Law and Corporate Governance.

Introductory Comments

The importance of proxy advisors in capital markets and their influence on institutional investors has triggered the need for the introduction of disclosure obligations in order to provide the necessary information to existing and potential clients on how they intend to exercise their activities and therefore allow these clients, as well as other market participants and regulators, to better understand proxy advisors' role and evaluate them in an adequate way. Although the proxy services provided in this framework are unquestionably legitimate, the overall way in which they are provided must be addressed transparently at the EU and international level.

The choice for a Code of Conduct at the EU level and the preparation of the Best Practice Principles for Shareholder Voting Research by an industry committee testify to the need for maximum flexibility in the area of proxy advisory services. Nevertheless, the new EU regulatory framework (Shareholder Rights Directive (EU) 2017/828) is still unclear and its future relationship with the BPP needs further examination.

Various national frameworks currently in place (for example, the UK and French ones)¹ provide different disclosure spectrums and show the reason why flexibility may need to be maintained in the proxy advisory industry's disclosure obligations. The argument for more flexibility focuses mainly on the fact that proxy advisory firms have not previously been subject to any disclosure obligations at the EU level, including in some EU Member States. It would therefore be only utopic to assume that the revised Shareholder Rights Directive will – on its own – secure a uniform and widely applicable regulatory approach and bring substantial results in terms of transparency and comparability between different practices experienced at the EU level. BPP can function as an important auxiliary reference to the emerging EU regulatory framework and offer a non-binding useful informational framework for both proxy advisors and interested parties in this type of information.

Consultation Questions

Question 11: No. It is preferable to consolidate the informational *acquis* based on the three principles that already cover a broad range of issues (especially in the light of the useful guidance).

If the Best Practice Principles Group decides to broaden the scope of the Principles, 'Governance engagement services' could be included but with the safeguard (and relevant provision) that such services are neither always feasible nor adaptable to all proxy advisors or other market actors. This will enable more meaningful disclosure and management of the expectations of the recipients of such information.

As far as the current Principle Two is concerned (conflicts of interest management), attention could be given to the new provision of the Shareholder Rights Directive (Article 3(j)(3)) that also requires disclosure to clients of 'the *actions* [proxy advisors] *have undertaken* to

¹ The UK Stewardship Code includes the proxy advisory industry in a general way in its spectrum, expecting such firms to become voluntary signatories and to abide by its principles. Conversely, the French competent authority (*Autorité des Marchés Financiers*, hereinafter AMF) adopted in 2011 a recommendation that, although it does not have binding force, takes a rather stricter approach than the UK one: for a more detailed analysis, see K. Sergakis, 'Deconstruction and Reconstruction of the "Comply or Explain" Principle in EU Capital Markets' (2015) 5(3) *Accounting, Economics and Law: A Convivium* 233, 249, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2516741.

eliminate, mitigate or manage the actual or potential conflicts of interests’ (emphasis added). This could be a useful addition to Principle Two to better align its informational content with the revised Shareholder Rights Directive and become more informative on this issue.

Question 12: BPP cover a considerable range of issues that, if combined with the related guidance, give the market the chance to receive a considerable amount of information on proxy advisory firms. The structure is clear and appropriate. The ‘comply or explain’ principle provides the necessary flexibility in this framework. In order to better understand the future relationship between BPP and the revised Shareholder Rights Directive and, more specifically, to assess the clarity and appropriateness of BPP’s structure, it is useful to examine all these issues under the revised Shareholder Rights Directive spectrum. I will then proceed with our assessment of the BPP’s usefulness and future presence and role in this evolving EU regulatory framework.

As analysed in our study ‘Deconstruction and Reconstruction of the “Comply or Explain” Principle in EU Capital Markets’ (see footnote 1), the ‘comply or explain’ principle is vital for disclosure obligations that are still at a relatively recent stage (given that a minimum and binding informational framework for proxy advisory firms was introduced by the revised Shareholder Rights Directive in 2017).

The Shareholder Rights Directive has shaped disclosure obligations applicable to proxy advisors in the following fashion:

a) firstly, Member States shall ensure that proxy advisors disclose publicly a reference to a code of conduct that they apply and also need to report on the application of that code. The ‘comply or explain’ principle has now been introduced so as to allow them to explain why they have chosen not to apply a code of conduct or they have decided to depart from some of its parts (if they apply one). The information provided needs to be updated on an annual basis and made publicly available.² The reference to a code of conduct in the Shareholder Rights Directive, accompanied by the ‘comply or explain’ principle, testify to a discreet approximation of the EU regulatory framework to the proxy advisory industry and its efforts to promote its own principles and norms (BPP being the most notable initiative).

b) secondly, Member States shall ensure that proxy advisors disclose publicly on an annual basis at least the following information in relation to their research, advice and voting recommendations:

- the essential features of applied methodologies and models
- the main information sources used
- the applicable procedures for the safeguard of the quality of research, advice and recommendations as well as the qualifications of the involved staff
- whether and, if so, how do market, legal, regulatory and company-specific conditions are taken into account
- the essential elements of voting policies for each market
- whether dialogue with companies, falling within their activities’ spectrum, as well as with the stakeholders of the company takes place and, if so, their extent and nature and, lastly,
- the applicable policies for the prevention and management of potential conflicts of interests.³

It should also be noted that such disclosure obligations are publicly disclosed but meant to inform adequately proxy advisors’ clients about the accuracy and reliability of their activities. The emphasis upon these firms’ clients aims to highlight the conceptual mindset

² Article 3(j)(1), Directive (EU) 2017/828.

³ Article 3(j)(2), Directive (EU) 2017/828.

within which such disclosure needs to take place and will inevitably influence the informational content provided to the public.

c) Thirdly, Member States shall ensure that proxy advisors identify and disclose to their clients any actual or potential conflicts of interest (or business relationships) that may exert an influence on their services, as well as the actions that they have taken to eliminate, mitigate or manage this type of conflict.⁴

The first impression from the Directive's framework is that it creates a rather unusual framework in combination with the current version of BPP. This is due to the fact that, while very flexible, the BPP cover a considerable range of issues that, if combined with the related guidance, gives the market the chance to receive a considerable amount of information on proxy advisory firms. On the contrary, the Commission seems to have opted for disclosure of a minimum of issues in a more binding framework. This is, to a certain extent, understandable since the objective of the revised Shareholder Rights Directive is to frame disclosure in this area to an agreed minimum across the EU, while allowing private actors to engage additionally with their own Principles (BPP). Moreover, the 'comply or explain' principle is used for reference to a code of conduct, under 3(j)(1), but sits rather uncomfortably with the other hard law disclosure requirements under 3(j)(2) and (3).⁵

Therefore, I firmly believe that BPP should maintain its current operational mode and informational framework (with some minor amendments, as suggested at Question 11 above). Guidance notes are undoubtedly a very useful tool to enable proxy advisory firms to continue to provide their clients and the public at large with a wider spectrum of information. This flexibility offers important educational advantages to all market actors interested in proxy advisory services since it allows for a wider engagement platform amongst actors. Confining BPP to the new provisions of the revised Shareholder Rights Directive only would compromise such educational and dialogue potential and would transform disclosure in this area into a simplistic compliance exercise.

BPP can therefore work as a preparatory exercise for all proxy advisory firms as to their compliance with the Shareholder Rights Directive, while giving them the opportunity to disclose information related to additional matters.

Question 36: The BPP Group's intention to introduce an independent element into the monitoring arrangements is a welcome one. From the proposed features in this Consultation, the creation of an oversight body including members independent of the sector would be the most preferable option. Nevertheless, other monitoring schemes could prove to be even more useful (analysed further at Question 37 below).

Question 37: The monitoring framework could take one of the following forms:

- Oversight body including members independent of the sector

Such a solution could imitate the already-existing example in France: a private body (The High Committee in charge of monitoring the implementation of the code) (*Haut Comité de suivi de l'application du code AFEP-MEDEF*) composed of four personalities with

⁴ Article 3(j)(3), *ibid.*

⁵ It should be also borne in mind that the use of 'whether' in two of these hard law informational requirements may create further confusion as to their nature and content, creating a multi-layered legal order (semi-hard and hard) and differentiation amongst proxy advisor statements: Article 3(j)(2), *ibid.*

recognised experience from international groups and three personalities from other sectors (investors, personalities selected for their competence in legal/ deontological issues) has assumed the role of monitoring the application of the principles contained in the Afep–Medef corporate governance code as well as proposing updates to the code. The members of the Committee are nominated and appointed by Afep (the French Association of Private Enterprises) and Medef (the French Business Confederation) for a period of three years, renewable once, and they also have to declare their directorships in listed companies. The chairman of the Committee is selected amongst the four personalities of the corporate sector and the committee has to produce an activity report on an annual basis. The committee may receive companies’ questions on corporate governance code interpretation issues but also retains the right to contact companies and ask for more information in the absence of meaningful explanation. It should also be noted that companies that choose not to follow the recommendations of the Committee must mention this fact in their annual report/reference document and explain why they have adopted this position.

Some elements of this structure could be interesting for the purposes of this Consultation but need to be enriched with institutional safeguards to ensure its success and credibility. Indeed, the potential introduction of such an Oversight body related to the monitoring of the implementation and impact of the BPP may, in the long term, sit uncomfortably with the role that national competent authorities will be called to play in this field (under the revised Shareholder Rights Directive). It should be also borne in mind that the Shareholder Rights Directive provides, in article 14b, the *eventual* imposition of administrative sanctions/measures at the national level in the case of infringements. Therefore, in order to safeguard the legitimacy and the usefulness of such a body, it is important to enable its fruitful cooperation with other market actors and stakeholders by ensuring their presence in its Monitoring Committee. This will also enhance its credibility across market actors. Moreover, such an Oversight body may cooperate efficiently with national competent authorities in the future (depending on the role they will assume in this area) by offering its ‘know-how’ when needed or *eventually* requested.

- Review Panel with ‘institutionalised dialogue’ spectrum

Another option, inspired – to a certain extent – by the one we have fully explored in our study (see Sergakis (2015), footnote 1), relates to the introduction of a soft monitoring process exercised by a Review Panel that would provide a ‘dialogue framework’ amongst market participants and proxy advisors and would also include in its role the receipt and management of complaints (similar to the ‘complaints’ procedure that is currently provided by the BPPG).

Composition of the Panel: For the Review Panel’s activity to be efficient and legitimate, its composition and the spectrum of its authority must be clearly identified and delineated. The composition of the Panel should be as diverse as possible in order to gain acceptance by all market participants as well as to spark interest in participating in its activities. Company directors (executive and non-executive), institutional investors and proxy advisors should be eligible to be elected members of the Panel, for a maximum period of 3 years. Membership should also be open to other stakeholder groups under the condition that they have developed considerable experience in interacting with market participants. The “considerable experience” criterion would further strengthen the useful character of the discussions taking place in this framework as well as the quality of the dialogue developed in these discussions. The members’ mandate should not be renewable to avoid increased familiarity with recurrent cases and, more generally, to maintain the merits of rotation in terms of independence and

diversity of Panel composition, allowing more representatives from the same sector a chance to serve on the Panel.

Role of the Panel: with regard to potential cases being launched under this scheme, an interested party could ask for the Panel's intervention due to a proxy advisor statement that does not – in its view – comply with the application and implementation of BPP.

It would also be necessary to define clear criteria for a Review Panel to be able to allow a request to be put forward and trigger a more active dialogue with the proxy advisor whose disclosure practices are questioned. Generally speaking, these criteria could be:

- a) a detailed explanation of the disclosure-related issue, as well as the implications of the supposed informational deficiency for the claimant party's affairs
- b) Moreover, the claimant party should provide proof that communication had already been sought, as well as a reasonable explanation as to why the party considers that the outcome of this initiative did not prove fruitful, namely in the case that the party concerned did not cooperate or its cooperation did not meet the expectations of the claimant party.
- c) Provided that the request for further examination is well argued and sound, the Review Panel would be in a position to invite the party concerned to attend a meeting for further discussion of the subject, which could entail failure to update the "compliance" statement or the disclosure of perfunctory "non-compliance" explanations. Confidential information should also be protected in this framework, and the relevant rules applicable to the Panel's functioning should clearly allow parties not to disclose any information for which they have a legitimate interest to maintain confidentiality. Secrecy needs to be included for some delicate matters that, although they may be able to trigger a more fruitful dialogue, may compromise the position of one of the parties involved and have negative repercussions on a larger scale.

However, if the party does not wish to attend the meeting or attends but without showing a real willingness to cooperate and improve its practices, the Review Panel would have the right to publish a statement summarising the position adopted by this party or outcomes of the meeting. The Review Panel would therefore remain completely neutral on the persuasiveness of the arguments presented by the party and would only make public its guidance, the dialogue that took place, and the overall outcome of the procedure.

The invited party would be given the chance to express its views on the disputed matter, present its own version of the alleged facts as presented by the claimant party, and possibly show that steps have been taken to remediate this situation or even improve the informational context in the future. Under this assumption, the Review Panel would be expected to provide guidance on further actions to ensure that improvement will occur. Guidance should remain always neutral and should focus on general recommendations that could correspond to already existing guidance notes of various soft law texts currently applicable at the national level.

Maintaining the Panel's neutrality is the key to the success of such a proposed monitoring mechanism, since the Panel will only offer the chance to the concerned parties to express their views and explain their respective arguments further. The Panel will provide the necessary guidance to ensure that the context BPP is broadly respected given the individual circumstances of the examined case.

I thus believe that the introduction of such an “institutionalised dialogue spectrum” will transmit the message to the market that the existence of a Review Panel ensuring transparency over complaints about the quality of information provided is widely applicable and therefore may have the potential to encourage market actors to cooperate further with the Panel and have a chance to justify their positions. The absence of legal sanctions will preserve the incentive for market actors to be more open and will make the Panel seem less intimidating.

Regarding the other options envisaged at Question 36 by the Consultation document, third party certification could weaken the educational and dialogue benefits proposed under this scheme since it could be perceived as ‘indirect authorisation’ of implementation methods by a third party. Surveys of market participants could be useful in this framework but would not necessarily allow space for a centralised dialogue space as analysed in our proposal. If the BBPG decides to proceed with such surveys, a good idea would be to organise them at pre-determined periods and for the same issues every year (with some degree of flexibility if new challenges arise) so as to offer a consistent, comparable and easily accessible informational framework for the recipients of such information.

Question 40: No.

Question 42: I firmly believe that it is essential to avoid confusion and inconsistencies between different sources of rulemaking both at the national and EU levels (Shareholder Rights Directive, BPP among others).

The main concern about the revised Shareholder Directive’s framework is that, by leaving it to Member States to require proxy advisors to disclose information on a specific series of issues, national frameworks will inevitably move towards this informational minimum without necessarily making the effort to trigger further reforms and create a more sophisticated and elaborate informational spectrum for the benefit of the rest of the market. At the same time, the BPP issued by BBPG will continue to exist at the EU level as a private-sector initiative that offers a broader informational spectrum and, as a non-binding document, which invites proxy advisory firms to become signatories and follow its principles.

The rather unfortunate result might therefore be that proxy advisory firms will be required to follow a minimum of binding disclosure requirements at the national level, with variable outcomes, while maintaining the discretion to adhere to a broader non-binding set of principles at the BPP level. The main concern about this potential inconsistency is that it may become rather burdensome for the rest of the market to understand the information disclosed according to the regulatory framework at both the national and EU levels. Although it is rather premature to predict the outcomes of these different regulatory initiatives, the EU agenda needs to take into serious consideration potential sources of informational inconsistency and confusion that will make the overall disclosure exercise somewhat burdensome and – ultimately – of little use to market participants.⁶ This and other national specificities will inevitably create discrepancies amongst Member States and will impede transparency in this area for the recipients of information.

⁶ A pertinent example in this sense is that the French framework is the only one in the EU that currently provides rules for the relationship between proxy advisory firms and issuers: for more details, see Sergakis (2015) 251.

It is hoped that the review of BPP may bring the private and the public sectors even closer to the creation of a more coordinated disclosure framework. This result will benefit both proxy advisory firms, who will avoid extra compliance costs, and investors as well as stakeholders who will be able to find the information they need in a more concentrated and useful manner.

I hope the comments provided in this letter are of interest for the Consultation's purposes.

Shall you need any further information on the points raised above, please do not hesitate to contact me at Konstantinos.Sergakis@glasgow.ac.uk.

Yours sincerely,

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