GLOBAL NETWORK OF DIRECTOR INSTITUTES

19 December 2013

The Best Practice Principles for Governance Research Providers Group

Email: consultation@bppgrp.info

Dear Sir/ Madam,

Public Consultation on Best Practice Principles for Governance Research Providers

Thank you for providing us with the opportunity to comment on the draft Best Practice Principles for Governance Research Providers (the Principles).

The Global Network of Director Institutes (GNDI) was founded in 2012. It brings together member-based director associations from around the world with the aim of furthering good corporate governance. It is an international network among leading membership organisations for directors in Australia, Brazil, Canada, Europe, Malaysia, New Zealand, South Africa, the United Kingdom, and the United States. The following membership organisations are members of GNDI and collectively represent more than 100,000 corporate directors worldwide:

- Australian Institute of Company Directors;
- Brazilian Institute of Corporate Governance (IBGC) in Brazil;
- European Confederation of Directors Associations (ecoDa);
- Institute of Corporate Directors (ICD) in Canada;
- Institute of Directors in New Zealand (IoDNZ);
- Institute of Directors in Southern Africa (IoDSA);
- Institute of Directors (IoD) in the United Kingdom;
- Malaysian Alliance of Corporate Directors (MACD); and
- National Association of Corporate Directors (NACD) in the United States.

We have attached a copy of the global perspective of GNDI in relation to **Board-Shareholder Communications** and hope that this will be of assistance when considering submissions on the draft Principles.

Additionally, while we do not intend to comment specifically on all of the issues raised in the Public Consultation, GNDI[1] would like to take this opportunity to make some general comments regarding the issues that the Best Practice Principles for Governance Research Providers Group (the Group) is seeking views on.

General comments

We agree that it is important for proxy advisors to be governed by a set of "good practice" principles and guidance. The exercise of voting rights by shareholders is a critical component of corporate governance and proxy advisory firms play an important role in this. In order for shareholders to make informed voting decisions, the information that they are provided with must be accurate and not misleading, whether the information is provided by the issuer, its directors or from some other intermediary, such as proxy advisory firms.

[1] While great care is taken to ensure that the comments provided in this submission are consistent with the approved policy positions of all GNDI member organisations, this is not always possible. To the extent of any inconsistencies, the comments of the GNDI in this submission do not alter or otherwise override any express, approved policy positions of GNDI's member organisations.

Despite proxy advisory firms playing such an important role and, in our view, exerting significant influence over their clients with respect to the exercise of voting rights, they are currently not held to any standard with respect to the communications that they make to shareholders. This is to be compared with the obligations of issuers and their directors who, in most jurisdictions, must comply with a number of regulations with respect to shareholder communications, and have potential liability in the event the materials that they send to shareholders contain inaccuracies, misrepresentations and/ or misleading statements.

There is clearly a disconnect between the influence and accountability of proxy advisory firms. We believe that this disconnect undermines the exercise of voting rights by shareholders and impacts on the integrity of capital markets. In our view, this disconnect needs to be addressed. While the draft Principles represent a useful step towards this, there are still a number of areas of concern that have not, in our view, been adequately addressed under the Principles. These are set out in more detail below.

ESMA guidance on a Code of Conduct for the proxy advisory industry

The Principles have been prepared in response to the *Final Report and Feedback Statement on the consultation regarding the role of the proxy advisory industry* that was released by the European Securities and Markets Authority (ESMA) in February 2013 (Final Report). In the Final Report, ESMA concluded that it was appropriate for the proxy advisory industry to develop its own Code of Conduct. It also suggested five principles to help guide the industry in developing this code.

While the Public Consultation document for the Principles notes that the Group took the views of the ESMA as expressed in the Final Report into account in the formulation of the Principles, in our view **the draft Principles do not adequately address the five guiding principles as set out in ESMA's final report**.

For example, with respect to conflicts of interest, ESMA's suggested principles state that:

> *"Proxy advisors should seek to avoid conflicts of interest with their clients. Where a conflict effectively or potentially arises the proxy advisor should adequately disclose this conflict and the steps which it has taken to mitigate the conflict in order that the client can make a properly informed assessment of the proxy advisor's advice.*"

This is to be compared with the Principles which merely require (on a comply or explain basis) that signatories have and publicly disclose a conflicts of interest policy. This clearly falls short of the ESMA's expectations with respect to the standards that the industry should be setting in the Principles with respect to conflict of interest management.

Similarly, while Principle One of the Principles only requires (again on a comply or explain basis) that signatories have and publicly disclose a research policy and, if applicable, "house" voting guidelines, the principles suggested by the ESMA go much further and require proxy advisors to:

- provide investors with information on the process used in making both general and specific recommendations, and any limitations or conditions to be taken into account;
- disclose, both publicly and to clients, the methodology and the nature of the specific information sources they use in making their voting recommendations and how voting policies and guidelines are applied to produce their voting recommendations;
- be aware of the local market and regulatory conditions to which issuers are subject, and disclose whether/ how these are taken into account in the proxy advisor's advice; and
- disclose their dialogue with issuers and the nature of that dialogue.

In our view, the Principles do not meet the ESMA's expectations and each of the Principles needs to be expanded significantly to take into account the principles set out in the Final Report.
While the Guidance to the Principles does make reference to some of these issues, these are requirements that proxy advisory firms should be expected to meet and therefore warrant inclusion in the actual Principles, with context and further detail being provided in the Guidance.

"Comply or Explain" approach

We do not agree that the Principles should apply on a "comply or explain" basis. While such an approach is appropriate for corporate governance matters where flexibility is necessary, a code of practices that is intended to govern the professional conduct of an industry (and on a voluntary basis) does not require similar flexibility as complying with such practices does not involve matters of judgement.

Currently, proxy advisory firms are unregulated, even though, as noted above, one of their key activities (ie shareholder communications) is subject to a number of regulations when undertaken by an issuer or its directors. While we do not necessarily think legislative intervention is required at this stage, we do think that signatories to the Principles should be required, at a minimum, to meet the standards set by the Principles (rather than having the option to simply disclose why they have chosen not to meet the standards).

If a "comply or explain" approach is to be taken (which we do not agree with), then the standards set out in the Principles need to be much stronger and set a higher standard than is currently provided for in the draft.

In the event that proxy advisory firms are unable or unwilling to hold themselves to appropriately robust standards of professional conduct, our view is that the proxy advisory industry should be regulated by an industry body that could set and enforce professional standards, investigate complaints and administer discipline to ensure the integrity of the services being provided by proxy advisory firms.

Service quality

Where proxy advisory firms provide clients with information that is intended to influence or assist in deciding how to exercise their voting entitlements, it is crucial that the information provided is meaningful, accurate and not misleading.

A number of the GNDI member organisations are aware of circumstances in their relevant jurisdictions where the voting recommendations of proxy advisory firms have contained mistakes and inaccuracies. This could be addressed by requiring that all voting recommendations be "fact checked" by the relevant issuer before the recommendation is finalised.

It is essential that proxy advisory staff are sufficiently experienced and have appropriate expertise and knowledge to understand the drivers of shareholder value creation in companies.
Globally, directors and issuers have expressed their concerns about the quality and inexperience of proxy advisory staff who are required to analyse and opine on complex subject matter but who are unable to form a proper understanding of the issues. This is particularly an issue where the recommendations relate to remuneration resolutions (for example, to approve a remuneration policy or to approve a director or executive's remuneration arrangements) as understanding these matters often requires a relatively high level of financial expertise and/or experience. In our experience, the proxy advisory staff who are analysing these issues do not necessarily possess this.

We do not think that the Guidance provided under Principle One goes far enough to address these concerns to provide assurance and accountability with respect to the quality of the services being provided by proxy advisory firms.

At a minimum, the Guidance under Principle One should be expanded to include requirements that:

- in developing proxy voting guidelines, proxy advisory firms must provide an opportunity for consultation with the issuer and director communities so that the guidelines take into account the knowledge and perspectives of these key constituencies;

- before voting recommendations are finalised, that an opportunity be provided for them to be "fact checked" by the relevant issuer.
- proxy voting guidelines not be applied rigidly as a "one size fits all" by allowing flexibility to take into account the particular circumstances of the issuer where its corporate governance practices do not strictly conform with the guidelines;
- proxy advisory staff possess appropriate qualifications and experience to analyse or advise on the relevant issues. Details of the qualifications and experience of the staff should be disclosed, as well as the resources that the proxy advisory firm allocates to the analysis of meeting resolutions and outsourcing arrangements for the purposes of making voting recommendations; and
- sufficient time, resources and expertise must be allocated to analysing the issues necessary to make informed and accurate voting recommendations.

Conflicts of interest management

Having an appropriate conflicts of interest policy in place to manage potential and actual conflicts is essential to ensure the integrity of the advice that proxy advisory firms provide to their clients. It is also essential that proxy advisory firms publicly and comprehensively disclose all conflicts on any matter in respect of which they are issuing a voting recommendation. Proxy advisory firms should also set up "walls" and adopt other structural solutions to further reduce the likelihood of bias in the advice that they provide.

Principle Two does not go far enough to ensure that conflicts of interest will be appropriately dealt with. The principles recommended by the ESMA in its Final Report should be adopted and incorporated into Principle Two (as part of the Principle and not in Guidance). Also, where the management and disclosure of potential and actual conflicts will not be sufficient to ensure the integrity of the advice given, proxy advisory firms should refrain from providing the particular service. One such circumstance will be where a proxy advisory firm is asked by a client to make recommendations with respect to an issuer that it has provided consulting services to.

To address these issues and to strengthen the proposed conflicts of interest requirements under the Principles, at a minimum we believe that the Guidance under Principle Two should be expanded to include requirements that:

- proxy advisors seek to avoid conflicts of interest with their clients. The proxy advisor should adequately disclose any conflict and the steps which it has taken to mitigate the conflict in order that the client can make a properly informed assessment of the proxy advisor's advice;
- where a conflict effectively or potentially arises with respect to a voting recommendation that the proxy advisory firm will be issuing, the conflict must be publicly and comprehensively disclosed;
- "walls" and other appropriate structural solutions be adopted and set up to further reduce the risk of bias in the advice provided by the proxy advisory firms; and
- voting recommendations not be issued on matters where the proxy advisory firm has provided consulting services to the issuer or, if applicable, where the proxy advisory firm's owner or significant investor has a material interest.

Communications policy

We do not agree that it is appropriate for the Guidance to Principle Three to leave it to signatories to decide whether or not to engage with issuers.

Where the proxy advisory firm intends to issue a contrary voting recommendation, the firm should be required under the Principles to share its report with the issuer and discuss its proposed contrary recommendation **before** the recommendation is finalised and published. In the event that the proxy advisory firm still intends to recommend a contrary voting recommendation after this engagement, the

proxy advisory firm should be required to include the company's response to the firm's analysis and conclusions together with their voting recommendation.

In our view, by requiring this engagement and disclosure, the likelihood of contrary recommendations being made that are based on inaccuracies or are misleading will be greatly reduced. It will also mean that proxy advisory firms will be able to present a more fully considered view in their final recommendations and, importantly, that their clients will be able to make more informed voting decisions based on these recommendations.

Accordingly, as a minimum, we believe that the Guidance under Principle Three should be expanded to include requirements that:

- where a proxy advisory firm intends to issue a contrary voting recommendation with respect to an issuer, they must take active steps to engage with the issuer by sharing a copy of its draft report with the issuer and discussing the proposed contrary recommendation **before** the recommendation is finalised and published to voters; and
- if, following this engagement, the proxy advisory firm still intends to make a contrary recommendation, the issuer should be provided with sufficient time and opportunity to provide a response to the proxy advisory firm to be included as part of the analysis in the materials that is provided to the proxy advisory firm's client.

If you would like to discuss any aspect of our views please contact our Senior Policy Advisor, Gemma Morgan on (02) 8248 6600.

Yours sincerely,

John H C Colvin
Chairman

cc: International Organization of Securities Commissions
European Securities and Markets Authority