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ESMA CONSULTATION CONCERNING THE PROXY ADVISORY INDUSTRY

AND CONSIDERATIONS ON POSSIBLE POLICY OPTIONS

AFEP answer

The purpose of AFEP is to present the views of large French companies to the European Institutions and the French authorities, mainly with regard to the drafting of non-sectoral legislation (on the economy, taxation, company law, financial information, competition, intellectual property rights, consumer affairs, social regulations, employment legislation, environment, financial and accounting information, etc.).

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IV.II. Correlation between proxy advice and investor voting behavior

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

2) To what extent:

a) do you consider that proxy advisors have a significant influence on voting outcomes?

b) would you consider this influence as appropriate?

Proxy advisors obviously influence a substantial majority of investors wherever they are located. This was confirmed directly by investors who do rely on one or more proxy advisors when evaluating shareholder proposals. Depending on the investor, the proxy advisor's position may simply be taken into consideration as part of a larger analysis, it may be applied mechanically, or it may be used as a "default position" with some possibility to deviate. Many investors who profess to have adopted the "default position" approach are in practice reluctant to deviate on account of the administrative burden imposed on the investment or compliance manager who must document and justify such deviations under internal procedures.

Issuers have gained evidence of this correlation between proxy advice and investor's behaviour. This concerns a large majority of institutional investors who follow proxy advisors' recommendations. The influence of proxy advisors will be more important in case of widely-held corporations without controlling shareholders represented within the Board of Directors, and whose shareholding base is composed mainly of institutional investors. According to a study carried out by the AFG in 2011[1], 60 % of the asset management companies monitored in the study use proxy advisors to analyse French issuers 'resolutions. The percentage rises to 80 % when it comes to analysing foreign issuer's resolutions (in that case they indicate referring to ISS, ECGS and Glass-Lewis). When management companies vote by correspondence in advance of the general meeting, it is relatively easy for issuers to determine those who follow proxy advisors' recommendations and those who deviate. This can be explained by the fact that the vote is cast immediately after the investors receive the proxy advisors' recommendations.

The high correlation between proxy advice and voting outcomes derives also from the use of a voting platform by proxy advisors on behalf of their clients (who are investors). Proxy advisors send reports with voting recommendations to their clients together with the ballot paper which is already filled according to the voting policy, which is a questionable practice. Another practice, which goes further, consists in offering within the voting platform a "quick vote" option: when pressing a single button, investors cast a vote that follows the proxy voting recommendations. Issuers have noticed a clear link between the reception of a voting report by the investors and the votes they cast immediately after.

We cannot deny the proxy advisors' role in facilitating the monitoring of corporate proposals, as mentioned in the discussion paper. In the meantime, it is important that institutional investors do not refer blindly to voting recommendations without exercising any control and contact the issuer, as soon as they have concerns about the company's governance or its strategy. In this respect, it is interesting to note that a recent study on the role of the proxy advisors in France and in Japan underlined the fact that *"a previous CEO of ISS admitted that up to 20 % of the clients were using the automatic vote service which means their proxy are automatically voting according to ISS recommendations".*[2]

One of the factors which may explain the increase of the proxy advisers' influence is connected to the fiduciary duties of the mutual funds that were recognised under legislations, which may have encouraged investors to outsource their votes.

Then, major institutional investors should be encouraged to set up dedicated teams to analyse resolutions and in the alternative, to retain several proxy advisory firms in order to compare the analysis.

[1] Source : AFG website (Association Française de la Gestion Financière): « Exercice des droits de vote par les sociétés de gestion en 2011 ».

[2] Edouard Dubois, SHAREHOLDERS' GENERAL MEETINGS AND THE ROLE OF PROXY ADVISORS IN FRANCE AND JAPAN, issue 04-2011, Journal of International Legal Studies –Kyushu University (page 93).

Issuers acknowledge that establishing a dialogue with shareholders, particularly institutional investors, is key. When issuers have the opportunity to engage into such a dialogue and organise meetings where corporate governance issues are fully explained and discussed, it appears that these meetings are fruitful in clarifying the issues and foster better understanding with investors. However, for practical reasons, it is impossible for large listed companies to meet individually with all their shareholders. Therefore the scope for discussion is limited to the main shareholders.

The dialogue between investors and an issuer is not always possible, because investors do not have the resources to discuss proposals when the issuer represents only small scale investments. In such cases, the responsibility of proxy advisors is all the more important and justifies that their activities be regulated for the interest of all parties.

IV.III. Investor responsibilities

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

As it is recalled in Directive 2007/36/EC of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, *"effective shareholder control is a prerequisite to sound corporate governance and should, therefore, be facilitated and encouraged".* Shareholder control is mainly exercised through their voting rights which give them the opportunity to influence and take part in the decision making of the company. However, when votes are cast by applying mechanically proxy advisors' recommendations, effective shareholder control is put into question. The following paradox arises: voting decisions over resolutions are based on the advice of persons who are not shareholders. Proxy advisors thus have a political influence on the decision making of the company without bearing any economic risk. By contrast with shareholders, they do not hold any investment in the company and they do not bear the economic consequences of the votes cast during the general meeting. This situation is comparable to stock lending where the borrower of securities may influence the outcome of the General Meeting without bearing any market exposure (empty voting).

In addition, attention should be paid to the business model of the proxy advisors, itself, which requires more and more demanding voting policies. When the voting policy requirements do not take into consideration the specificities of the local legal system or the local market practices or, when the benefit of a new corporate governance standard is not clearly demonstrated, the proxy advisor may be seen as an illegitimate actor influencing the votes of investors.

V.I. Conflicts of interest

4) To what extent do you consider proxy advisors:

a) to be subject to conflicts of interest in practice?

b) have in place appropriate conflict mitigation measures?

c) to be sufficiently transparent regarding conflicts of interest they face?

5) If you consider there are conflicts of interest within proxy advisors which have not been appropriately mitigated:

a) which conflicts of interest are most important?

b) do you consider that these conflicts lead to impaired advice?

Proxy advisors should be discouraged from developing consulting services at the same time as they offer voting recommendations, in the European market. This practice which is common in the US and less so in the EU should be regulated with strict rules. We may also encounter situations where the proxy advisor offers other services and sells reports, concerning for example issues relating to executive directors' remunerations or an analysis of the outcomes of the last AGM season. Issuers may rightly feel that they are at a disadvantage if they do not subscribe to these consulting services or do not buy these reports. The mere disclosure of potential conflicts of interests would not be enough and services of voting recommendations provided by proxy advisors should be exercised by a legal structure clearly separated from other consulting services.

Another problem may derive from the links between a proxy advisor and a management company of investment funds which is active in proxy fights and has the opportunity to table resolutions. Proxy advisors should disclose such links and should be prevented from tabling resolutions and making voting recommendations on the same resolutions.

Lastly, it should be noted that some proxy advisors are at the same time proxy collectors which can be subject of conflicts of interest.

V.II. Voting policies and guidelines

6) To what extent and how do you consider that could be improvement:

a) for taking into account local market conditions in voting policies?

b) on dialogue between proxy advisors and third parties (issuers and investors) on the development of voting policies and guidelines?

Voting policy should involve issuers and take into account the legal framework of the relevant market

On the whole, issuers are not involved in the establishment of the general benchmark policies. ISS distinguishes itself from the other proxy advisors in this respect by seeking issuer input through its annual policy survey and by holding its draft benchmark policies open for comment. However, the survey provides only for the possibility to answer "yes" or "no" to questions without giving the opportunity to add nuances and comments, or to explain the specificities of the local legal framework of the relevant market. In addition, ISS has highlighted in its recent correspondence with the AMF that ISS considered that its duty is to the investors who use its services and not to the issuers who are the subject of ISS reports. The outcome of the consultation does not mention issuers' opinion.

The main problem as regard the establishment of voting policy derives from the fact that:

i) Voting policies are each year more and more demanding

Each year, proxy advisors add in their voting policies new governance practices to be respected by issuers in order to obtain a favourable vote on precise items such as: election of directors, related party transactions, allocation of stock options or bonus shares, caps for issuances requests, percentage of dilution for equity based compensation plans etc. It appears that this race for self-proclaimed good corporate governance is a never ending process. It appears to be quite questionable that proxy advisors should, by themselves, establish new corporate governance standards which go beyond existing legal framework and recognised governance codes without any scrutiny or debate about the added value of the relevant rules.

ii) Voting policies are not always clear and precise enough

It would be in the investors' interest to have clear and precise voting policies, where the concepts used are strictly defined. For instance, ISS does not give certainty as to their expectations as regards performance criteria for bonus shares. In addition, it should be possible to ask proxy advisors to justify how appropriate their recommendations are, with precise and objective explanations; in particular when the recommendations are not consistent with the local legal framework.

Proxy advisors are not necessarily consistent in the way they apply their voting policies from one issuer to another, in particular when the voting policy is not sufficiently clear (eg the representation of employee shareholders at the Board) or when the policy leaves too much room for interpretation. This creates a high level of uncertainty for issuers and does not allow them to anticipate possible discussion topics with investors.

iii) Voting policies are applied mechanically

Voting policies generally declare operating on case by case basis. However, in practice the voting exercise is often operated automatically without taking into account specific circumstances.

iv) Voting policies do not always take into account the specificities of the national market

Proxy advisors – through their voting policies which are updated each year – adopt new rules which, to some extent, exceed or are in opposition with national legal regulations, corporate governance codes and even corporate governance practices. In particular, they make a mix of common law and civil law corporate governance structures and select what they believe are the best corporate governance rules from each system without looking at each system globally. This is for instance the case on the question of splitting the function of chairman and CEO. The French system offers an option between the unitary and the dual system. Under the unitary system, companies may choose between combining or separating the offices of Chairman and CEO. This principle has been embedded in law. It is up to the board, once the bylaws of a company have been amended, to determine the organization best suited to the company and not to shareholders. The AFEP-MEDEF code states that *"The statute does not favor either formula and allows the Board of Directors to choose between the two forms of exercise of executive management. It is up to the board of each corporation to decide on the basis of its own specific constraints".* Despite this rule, ISS recommends, in a mechanical way, to vote against the renewal of an executive director if the functions of chairman and CEO are combined. This piece of advice gives ISS' clients the wrong idea that they have a right as shareholders to decide on the corporate governance structure of the Company. However voting against such renewal does not solve the issue of combined role since it cannot be decided by shareholders in France to have combined or separate roles. Instead of supporting rules that create confusion between different legal systems by trying to apply broad general principles of governance worldwide, it could be worthwhile for proxy advisors to focus on local regulations which provide shareholders with adequate leverage.

Once again, the French legal framework should be mentioned as essential background in any proxy advisor recommendation, should there be a recommendation to vote against the renewal of a combined chairman and CEO board of director mandate.

Others examples concern:

- the recommendation to vote against the (re)election of censors, by-laws amendments to authorize the appointment of censors, or to extend the maximum number of censors to the board;
- the recommendation to vote against related party transactions if the report of the external auditors is not submitted to a shareholder vote.

This is not supported by the law, or the AFEP-MEDEF code.

v) The retaliation procedure should be put into question when applying voting policies

As mentioned above, when a proxy advisor cannot issue a negative recommendation because, according to the French legal framework, it is not an issue decided by shareholders, they retaliate and recommend a negative vote concerning another resolution: for instance the renewal of a director or even more significant, the approval of the accounts. This practice is questionable and would result in a prejudice to the issuer if a resolution is not adopted. For instance, a proxy recommended a negative vote concerning the approval of the accounts because it considered that the corporate governance report was not complete and that it did not provide enough explanations for when the company departs from the AFEP-MEDEF code. This assertion was not in fact true, which the proxy advisor admitted later.

We may also refer to the example of related-party transactions. ISS considers that where a transaction is deemed problematic, it may recommend to vote against the election of the director involved in the related-party transaction or the full board.

Proxy advisors should be prevented from retaliating and recommending a negative vote concerning another resolution which has nothing to do with the point raised by the proxy.

V.III. Voting recommendations

7) To what extent do you consider that there could be improvement, also as regards to transparency, in:

a) the methodology applied by proxy advisors to provide reliable and independent voting recommendations?

b) the dialogue with issuers when drafting voting recommendations?

c) the standards of skill and experience among proxy advisor staff?

Transparency is important in order to regulate the relations between proxy advisors and issuers. Therefore we consider that:

i) Voting policy should be disclosed

In principle, publicly-available proxy voting policies can benefit issuers insofar as they help professionalize the discussions on corporate industry governance and facilitate interactions with investors by creating identifiable frames of reference. At the same time, proxy voting policies may degrade the voting environment by encouraging investors to apply an arbitrarily chosen set of standards sometimes in contradiction with the local legal framework, rather than reflecting on individual resolutions, and by encouraging one-size-fits-all solutions.

Proxy voting policies should be disclosed under a consolidated format and should be detailed enough to allow issuers to anticipate as much as possible the position of the proxy advisors on the resolutions proposed to the shareholder's meeting. Updates of some recommendations should be disclosed with the full text of the proxy voting policies tracking the changes. Failing that, it would be debatable whether some recommendations are still in force or not and issuers would not have a clear view of the global voting policies.

In addition, proxy voting policies should be available free of charge and sufficiently ahead of the meeting to allow issuers to be in a position to fine-tune the resolutions they intend to submit to the shareholders' vote. The suitable date should be set up at the latest in November for companies exercise ending in December.

Proxy advisors' websites should be reorganized in order to make the relevant information more accessible. For instance, it is rather difficult to find the consolidated updates voting policy of ISS on its website and issuers need to request the direct link.

ii) Company-specific recommendations should be submitted to issuers' review before communication to investors

Proxy advisors should be transparent with respect to the positions they are taking and available to enter into a dialogue with issuers. We consider that proxy advisors such as Glass Lewis which do not publish their benchmark policies and company-specific recommendations, are forfeiting an opportunity to influence corporate behaviour and are doing a disservice to all parties concerned. If issuers are informed of the reasons behind negative votes on shareholder proposals, they can reflect on the wisdom of future changes. This is the positive dynamic recognized by the UK Stewardship Code applicable to institutional investors. Without knowing the reasoning behind negative votes, issuers cannot engage constructively with their shareholder base.

There is also a public interest in issuers being able to respond to the positions taken by the proxy advisors, which in many cases may be based on incorrect facts, misunderstanding of French corporate governance legal framework or debatable governance positions. If the issuers are not informed of the positions taken by the proxy advisors, there can be no such critical debate. Most of the proxy advisors' clients will not independently research and challenge the advisors' positions, because if they had the resources to do so they would not need to use the advisor in the first place. This however should go along with regulation of proxy advisors' activity to ensure the highest possible quality of their work; issuers should not be required to bear responsibility for the accuracy of the proxy advisors' product.

Finally, the rationale behind ISS's refusal to send its draft report to the issuer where the agenda includes a resolution tabled by shareholders and not approved by the Board should be explained.

iii) Standards of skill among proxy advisors staff should be disclosed

The companies' resolutions reflect the complexity of company law and their writing imply a paramount work involving the legal and financial departments with the regular assistance of external experts. However despite this complexity, proxy advisors are not required neither by a regulation or a code of conduct to employ sufficiently qualified staff. On the contrary, we have found that, in order to save costs, some proxy advisors are understaffed and hire trainees for the AGM season. As it is mentioned in the ESMA consultation report, recruiting temporary staff increases the risk of inexperienced people.

As it is the case for others professionals such as lawyers or external auditors, proxy advisors should be required to justify their skills. This should avoid the risk for issuers to be submitted to negative recommendations due to a misunderstanding of the legal framework or an erroneous reasoning. Therefore, proxy advisors should be required to disclose the number of analysts dedicated to each market and their qualifications.

VI.IV. Policy options

8) Which policy option do you support, if any? Please explain your choice and your preferred way of pursing a particular approach within that option, if any.

9) Which other approaches do you deem useful to consider as an alternative to the presented policy options? Please explain your suggestion.

Proxy advisory firms are unregulated and non-transparent bodies which are highly concentrated on the market and which disclose analysis which have a real impact on decisions taken by investors without being accountable of their behaviour.

Proxy advisors raise competitiveness issues given their unregulated influence. This is all the more problematic for smaller issuers, which do not have the necessary means to overcome the influence of proxy advisor's recommendation (either through adequate internal resources or through hiring the services of professional proxy solicitation firms to help entertain constructive discussions with institutional investors).

Issuers consider that the activity of proxy advisory firms should be regulated as has been the case for CRAs. AFEP favour option 3, because this matter is of European-wide concern. The drawing up of guidelines or recommendations applicable to proxy advisors should be one of ESMA's tasks as suggested by the discussion paper and by AMF[3]. AFEP also considers that the development of standards addressed directly to proxy advisors should be underpinned by new legislation with a requirement for proxy advisors to apply the "comply or explain" principle.

[3] *« Given that various firms provide proxy advisory services in several different countries, the AMF would like to see the initiative it has taken through this recommendation matched by a similar initiative within Europe and at a broader international level"* (AMF recommendation n° 2011-06 of 18 March 2011 on proxy advisory firms).

This principle will introduce the necessary flexibility which permits proxy advisors to adapt from one market to another. AFEP shares the views of the Securities and Markets Stakeholder Group (SMSG) according to which *"national competent authorities should register proxy advisor and this information should be communicated to ESMA and made available by ESMA to allow continued monitoring and transparency of the industry at a Union level".*

The question of the liability of the proxy advisors should also be considered.

10) If you support EU-level intervention, which key issues, both from section IV and V, but also other issues not reflected upon in this paper, should be covered? Please explain your answer.

Based on past difficulties, these guidelines or recommendations should in particular address the following key issues:

1- Voting policies

- The rationale and the expected benefits of the updates on voting policies should be clearly explained and documented in the specific context of the relevant market (country by country in the euro-zone).
- improved wording: voting policies should be clear and precise, taking into account the specificities of the relevant market and communicated to the national regulator.
- timely availabilities of voting policies: updates on voting policies should be formulated and made public in a way that allow issuers to take them into consideration and maintain a constructive dialogue for the upcoming shareholders meetings season. In addition, voting policies should be made available on the proxy advisor's website on a consolidated format.

2- Standards of practice

- Proxy advisors should employ an adequate number of employees which have to be sufficiently qualified, with a solid knowledge of the market practice and legislative framework of the relevant market.
- Proxy advisors should commit themselves to providing accurate, complete and precise information in their analysis report. They should undertake to correct any error that might be identified through dialogue with an issuer.
- Proxy advisor should make available a Charter of Ethics or Code of Conduct specifying procedures to be followed when multiple activities are involved (advising issuers, providing a voting platform, proxy solicitation, etc.) and describing the resources allocated to the proxy advisors activities on a country by country basis (structures of the proxy services, qualification of staff and number of staff dedicated for each market, description of the internal control procedures to be followed).

– Proxy advisor shall publish on its website its adopted rules on communication with companies, particularly rules on submitting the draft analysis report.

3- Proxy dialogue with issuers

– Proxy advisors should contact the issuer as early as possible prior to the date of the AGM on issues that are subject to difficulties on the occasion of the upcoming AGM. Proxy advisors have a strong influence and therefore should commit to a minimum standard of availability for issuers.

– Issuers should be offered the possibility to review the content of proxy recommendations at least 48 hours before they are sent to the proxy clients, allowing the issuer to correct mistakes and exchange views with the proxy advisory firms if necessary. For issuers who make their documents available far in advance of the AGM (for instance D-50), the delay to review the content of the recommendations should be extended, and an anticipated timeframe communicated.

– The company should be allowed to insert in the report a "dissenting opinion" before it is sent to clients.

– The proxy advisor should include in the report, when applicable, the frequency of meetings or discussions with the issuer.

– The proxy advisor's terms-of-use should allow its investor clients to quote the content of the report to the issuer so that positions can actually be discussed.

– Copies of the final report should be made available by the proxy advisor to the issuer at the same time as it is sent to clients.

4- Avoiding conflicts of interests[4]

– Proxy advisors should be required to disclose capitalistic or personal links with the issuer or its main shareholders as well as information on their own shareholder structure.

– Consulting services provided to issuers and voting services should clearly be separated from voting advisory services.

– When a shareholder appoints a proxy advisor as a proxy holder to attend and vote at a general meeting in his name, the number of votes cast should be disclosed.

– The "quick vote" approach should be avoided.

5- "Comply or explain" principle

– Proxy advisors should be required to either comply with the relevant guidelines or recommendations, or explain why they are deviating from those.

[4] The rules concerning conflicts of interest could be inspired from the requirements set out in section A and B of Annex I of the Regulation n° 1060/2009 concerning credit rating agencies.

In addition, some recommendations should be made to investors:

It should be recalled that investors have a fiduciary duty to monitor investee companies and exercise efficient governance responsibility.

It could be useful for investors to disclose the proxy advisors which they use including information on how they are used as is required by the UK stewardship code.

11) What would be the potential impact of policy intervention on proxy advisors, for example, as regards:

a) barriers to entry and competition;

b) inducing a risk of shifting the investor responsibility and weakening the owner's prerogatives; and/or

c) any other areas?

Please explain your answer on: (i) EU-level; (ii) national level.

A policy intervention on proxy advisors will be very beneficial for the functioning of the market. We do not see any drawback in regulating this activity and making it more transparent.

12) Do you have any other comments that we should take into account for the purposes of this Discussion Paper?

Proxy advice, while not a voting trust as such, does represent an attempt to increase concerted shareholder action on subjects of fundamental importance to the functioning and control of a listed corporation including notably director nominations. While proxy advisors may claim that their advice is of a "take it or leave it" nature, in practice it is widely followed. In many cases these firms are mandated to cast votes in accordance with their benchmark policy and they act as a proxy holder. It could be worth considering whether existing rules requiring disclosure of shareholder co

ncertation and control groups or notification of holding of voting rights when a threshold provided by the Transparency Directive is reached, should not be expanded to cover certain activities of proxy advisors.

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