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Regulating the proxy advisory industry in Europe: the European Commission's Directive Proposal

1. The proxy advisory industry. Its rise, value and flaws

While their early origins date back to the 1980s in the US, where they soon developed into a well-established industry, only later did proxy advisory firms begin to spread across Europe, where they are a relatively new but rapidly consolidating phenomenon. The rise of proxy advisors, and concerns regarding their (supposedly) strong influence on European listed companies, drove the European Commission to take steps towards regulating the industry, based on the assumption that proxy advisors are part of the broader problem of an insufficient and inadequate level of shareholders' engagement with European issuers, which the Commission is willing to address, along with other shortcomings of the corporate governance framework, by means of a Directive amending Directive 2007/36/EC, whose Proposal was published on 9 April 2014[1].

The reasons for the increasing importance of proxy advisors within the so-called corporate governance industry[2] are well known, as are the benefits provid-

[1] European Commission, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EU as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement*, Brussels, 9 April 2014, COM/2014/0213 final - 2014/0121 (COD).

[2] Paul Rose, *The Corporate Governance Industry*, 32 J. Corp. L., 887 (2007).

ed by them to investors making use of voting recommendations and of other proxy agency and (in some cases) engagement services sold by them.

Proxy advisors simply represent a cost-effective solution to voting shares worldwide, and primarily within a narrow period of time, for institutional investors, fund managers and investment advisers holding or managing portofolio securities in listed companies and who are unwilling or unable to gather and process the information required for these purposes on their own. Proxy advisors foster the willingness of investors to vote by filling information and knowledge gaps, and by relieving their clients from the cost and time-intensive work required by an informed voting decision. Not every investor is ready to bear this burden, primarily due to the small size of economic interests in single investee companies, the investment strategies used[3], and the uncertain returns expected from exercising governance rights in terms of stock price performance[4].

Proxy advisory services do not flourish only in environments where certain kinds of institutional investors are (or *believe to be*[5]) subject to a fiduciary duty to vote every share (in the best interest of end-investors), which is typically the case for US-based pension plans, mutual funds and investment advisers. Even in countries where this duty is clearly not required by regulation, as in most European jurisdictions, investors still make use of voting recommendations, and in some cases of proxy agency or engagement services, provided by the industry. As far as European domestic investors are concerned, such a result may be partly explained by existing local stewardship or corporate governance codes' provisions, which although non-binding in nature, exert pressure to take over stewardship responsibilities, *inter alia* by voting shares, disclosing voting policies and votes actually cast, and thus monitoring investee companies. Undoubtedly, however, the growing number of stakes held in issuers listed in Europe by foreign, international and especially by US, investors making use of transnational investment and voting strategies, are conditions beneficial to the outgrowth of proxy advisors in Europe[6].

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[3] *See* Serdar Çelik and Mats Isaksson, *Institutional Investors as Owners: Who Are They and What Do They Do?* OECD Gorporate Governance Working Papers No. 11, 22 f (2013), at http://dx.doi.org/10.1787/5k3v1dvmfk-42-en.

[4] However, empirical studies indicate that mutual funds actually devolving resources to analysis and research for assuming informed voting decisions perform better than passive funds (the latter being generally smaller and having a higher investment turnover): Peter Iliev and Michelle Lowry, *Are Mutual Funds Active Voters?,* 3 April 2013, at 4, at http://ssrn.com/abstract=2145398. *See further* Reena Aggarwal, Pedro A.C. Saffi, and Jason Sturgess, *The role of institutional investors in voting: evidence from the securities lending market* (2012), at http://ssrn.com/abstract=1688993, finding that a number of institutional investors restrict or call back their loaned shares prior to a vote, giving up revenue from lending securities, in order to exercise voting rights, ad therefore recognise the importance (in economic terms) of voting shares; and Sylko Winkler, *Institutionelle Anleger in Deutschland und den USA, DAJV Newsletter,* 99 (2008).

[5] Although US federal regulation does not expressly lay down such an obligation, recipients, also induced by further materials provided by federal agencies, have in fact interpreted regulatory provisions as requiring them to vote every share: *see ultra,* note 7 and para V.

[6] According to the European Commission, *Explanatory Memorandum. Proposal* COM/2014/0213 final, 2014/0121 (COD), at 3, non-national shareholders – most of which are institutional investors and asset managers – hold some 44% of the shares issued by EU listed companies. More generally, *see* OECD, *The Role of Institutional Investors in Promoting Good Corporate Governance,* 26 ff (2011), at http://www.oecd.org/daf/ca/49081553.pdf.

Furthermore, both in the US[7] and in Europe the regulatory environment has evolved in the last decades in a way favourable to proxy advisors. European rules strengthening shareholders' rights, removing legal obstacles to transnational voting, tightening the duties associated with institutional investors, encouraging engagement, and supporting stewardship responsibilities and managers' accountability, accordingly render proxy advisory services useful, if not essential, both for managing voting rights and for regulatory compliance.

In fact, such developments of the law, together with the availability of proxy advisory services, appear to be part of an explanation for the increase in shareholder activism that many jurisdictions are experiencing[8], including contexts of concentrated ownership structure[9]. Indeed, proxy advisors can have a positive effect on activism because voting recommendations reduce monitoring costs associated with shareholders and increase the value of voice options, in relation to exit options, thus limiting investors' apathy while (aside from inhibitions deriving from European rules on acting in concert[10]) providing a means for facing collective actions problems that are inherent in coordinated institutional shareholder action[11].

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[7] Regulatory factors that have fueled the proxy advisory industry in the US broadly include both measures aimed at increasing shareholders' power [primarily: *Rule* 14a-8 under the Exchange Act (proxy access), which although at last not extended in scope as originally intended by the SEC (SEC, *Facilitating Shareholder Director Nominations.* Release 33-9136; 34-62764; IC-29384 (file S7-10-09), 75 Federal Register, No. 179 of 16 September 2011, at 56668: *Rule* 14a-11 subsequently adopted under the Exhange Act was invalidated by Business Roundtable and Chamber of Commerce *v*. SEC, 647 F.3d 1144 (D.C. Cir. 2011): *see* Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 Emory L.J., 440 (2012), and *Ead.*, *The Long Road Back:* Business Roundtable *and The Future of SEC Rulemaking*, 36 Seattle U. L. Rev., 695 (2013)), still contributed to gradually reducing plurality voting and staggered boards, and rules on say-on-pay advisory votes on executive compensation, as enhanced by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act], and measures relevant on the investor-side, sharpening their fiduciary obligations to end-investors as to voting proxies [primarily: SEC 2003 rules on mutual fund voting disclosure and on investment advisers exercising voting authority over funds' portfolios; pension fund voting requirements under the Employee Retirement Income Security Act of 1974 (ERISA), as interpreted in 1998 by the Department of Labor – on these issues *see ultra*, para V), as well as restricting the NYSE broker voting rules following sec. 957 of the Dodd-Frank Act].

[8] *See* J.P. Morgan, *Knocking at the door – Shareholder activism in Europe: Five things you need to know*, August 2014, available at https://www.jpmorgan.com/cm/BlobServer/mabriefing_activism_july2014.pdf. Referred to the US context *see* PricewaterhouseCoopers, *Shareholder activism.* Who, what, when, and how?, March 2015, at https://www.pwc.com/us/en/corporate-governance/publications/assets/pwc-shareholder-activism-full-report.pdf.

[9] *See* Massimo Belcredi and Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: the Case of Italy*, ECGI Law Working Paper No. 225/2013, March 2014, at http://ssrn.com/abstract_id=2325421.

[10] However, *see* the "White List" of cooperation activities beneficial to shareholders' engagement identified by the ESMA as a safe harbour from the mandatory bid under Article 5.1 of Directive 2004/24/EC: ESMA, *Information on shareholder cooperation and acting in concert under the Takeover Bids Directive*, 12 November 2013, ESMA/2013/1642, and updates thereof: *Ead*., *Information on shareholder cooperation and acting in concert under the Takeover Bids Directive – 1st update*, 20 June 2014, ESMA/2014/677.

[11] *See* Philip Schwarz, *Institutionelle Stimmrechtsberatung*, Berlin, 2013, 149 ff, 182 f.

However, investors have poor incentives to effectively monitor the quality of proxy analysis reports and of voting recommendations, given that costs associated with a thorough and permanent monitoring of the work and outputs of proxy advisors can economically neutralise the very rationale of mandating them[12]. This in turn may lead to an over-reliance on the advice of their agents, or cause investors to virtually outsource their voting decisions.

Following voting recommendations more or less blindly, gives rise to concerns about the influence proxy advisors may *de facto* unduly exert on votes cast on fundamental governance and financial decisions affecting both other shareholders and the issuers, to whom proxy advisors owe no fiduciary duties because they typically do not hold a stake therein nor bear the economic risk of corporate decisions[13].

As a matter of fact, this may lead to a phenomenon roughly comparable to empty voting[14], which is relevant to the decision-making process in companies open to the public, given that proxy advisors are indeed not free from conflicts of interest when making voting recommendations.

Further flaws in the industry are deemed to derive from the adoption of a highly criticised one-size-fits-all approach to proxy analysis when applying proprietary proxy advisor voting policies, and from poor qualification on the part of firm analysts. Taken together, these circumstances determine voting recommendations that insufficiently or inadequately take into account, in some cases, both company-specific and local legal and business conditions.

In conclusion, while proxy advisors help reduce agency costs in the relationship between minority and majority shareholders and managers[15], they give rise to a

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[12] *See* Lars Klöhn and Philip Schwarz, *Die Regulierung institutioneller Stimmrechtsberater*, ZIP, 152 (2012).

[13] *See* Holger Fleischer, *Zur Rolle und Regulierung von Stimmrechtsberatern* (Proxy Advisors) *im deutschen und europäischen Aktien-und Kapitalmarktrecht*, AG, 4 (2012); Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 Stan. J.L. Bus. & Fin., 422 f (2008-2009).

[14] *See* SEC, *Concept Release on the U.S. Proxy System.* Releases 34-62495; IC-3052; IC-29340 (file S7-14-10) [so-called Proxy Plumbing], 75 Federal Register, No. 140 of 22 July 2010, at 43008; Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 Del. J. Corp., 673, 688 (2005); Tamara C. Belinfanti, *The Proxy Advisory*, 406 f; Jodi Slaght, *What happened to the Prudent Man? The Case for Limiting the Influence of Proxy Advisors Through Fiduciary Duty Law*, 9 Rutgers Bus. L. Rev., 20 (2012); Philip Schwarz, *Institutionelle*, 188, 208 f; Holger Fleischer, *Zur Rolle*, 4; Lars Klöhn and Philip Schwarz, *The regulation of proxy advisors*, 8 Capital Markets L.J., 95 (2013); Peter Böckli, *Proxy Advisors: Risikolose Stimmenmacht mit Checklisten*, SZW/RSDA, 210, 221 (2015); Dieter Gericke and Olivier Baum, *Corporate Governance: Wer ist der Governor?*, SZW/RSDA, 348 (2014); Jaap Winter, *Persistent Concerns in Corporate Governance*, in ISS, *25for25. Observations on the Past, Present and Future of Corporate Governance*, 11 (2011), at http://www.shareholderforum.com/emtg/Library/20110200_ISS.pdf; *Id*., *Shareholder Engagement and Stewardship. The Realities and illusions of institutional share ownership*, 10 (2011), at http://ssrn.com/abstract=1867564.

[15] Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, and Chester S. Spatt, *The Role of Advisory Services in Proxy Voting*, 6, NBER Working Paper No. 15143 (July 2009), available at http://www.nber.org/papers/w15143.

further agency relationship[16] that is potentially – if not monitored – detrimental to the wealth of shareholders[17].

2. Conflicts of interest undermining the independence of proxy advisors

Conflicted voting recommendations may stem from the proprietary structure of a proxy advisory firm. As in some cases the shareholders of proxy advisory firms are themselves participants of the wider financial community[18], conflicts may arise where a firms' controlling shareholders, or related parties thereof, hold relevant business ties with companies subject to proxy analysis[19], or, being themselves shareholders of listed companies, intend to promote their own governance views or particular interests in investee companies[20]. One such example relates to making voting proposals based on which the proxy advisor owned by them is expected to give voting recommendations for a number of other investors, clients of the same. Similar risks relating to the impartiality of voting recommendations arise where managers of a proxy advisory firm hold stakes or further economic interests in, or serve in the board of, issuers being analysed.

Other types of conflicts of interest are associated with the very nature of the business, and are therefore inherent to any proxy advisor, depending on its relationship with major clients[21]. Because with regard to single companies under analysis an advisor sells voting recommendations to many investors, the proxy advisor finds itself in a position of conflict whenever evaluating any voting proposal made by one of its major investor-clients, being reasonably influenced to favour its client's voting preferences, or whenever one of its major clients is itself a listed company.

Further risks relating to conflicted voting recommendations arise when a proxy advisor, while delivering voting recommendations to investors, also sells governance rating and advisory services to issuers subject to proxy analysis ("corporate

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[16] By hiring proxy advisors, investors delegate the monitoring on managers (their agents) to a second agent (the proxy advisor): on this issue generally *see* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev., 850 ff, 854 (1992); specifically referring to proxy advisors *see* Tamara C. Belinfanti, *The Proxy Advisory*, 386, 406 f.

[17] *See* Philip Schwarz, *Institutionelle*, 211; Peter Böckli, *Proxy Advisors*, 211.

[18] *E.g.* Glass, Lewis & Co. (the second player wordwide) is entirely controlled by two major Canadian activist public pension plans (Ontario Teachers' Pension Plan Board; Alberta Investment Management Corp.), which are also Glass Lewis' clients. Formerly owned by MSCI, Inc, Institutional Shareholder Services, Inc (ISS), the major proxy advisor globally, was acquired by Vestar Capital Partners, a US-based middle market private equity firm, in 2014.

[19] US Government Accountability Office (GAO), *Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*, GAO-07-765, at 11 (2007), available at http://www.gao.gov/cgi-bin/getrpt?GAO-07-765; ESMA, *An overview of the Proxy Advisory Industry. Considerations on Possible Policy Options.* Discussion Paper, 22 March 2012, ESMA/2012/212, No. 66, at 2.

[20] *See* e.g. James K. Glassman and Hester Peirce, *How Proxy Advisory Services Became so Powerful.* Mercatus on Policy (June 2014), at 2, available at http://www.mercatus.org; Tom Quaadman (U.S. Chamber of Commerce's Center for Capital Market Competitiveness), Letter to the SEC of 30 May 2012, in *Examining the Market Power and Impact of Proxy Advisory Firms. Hearing before the Subcommittee on Capital markets and Government Sponsored Enterprises of the Committee on Financial Service U.S. House of Representatives*, 5 June 2013, Serial No. 113-27, 201 f, available at www.gpo.gov.

[21] *See* ESMA, *An overview*, No. 67, 21; GAO, *Issues*, 12.

services")[22]. On the investor services side, a possible dependency of a proxy advisor from corporate clients, due to the size of the economic interests involved in the contract[23], can lead to non-independent judgement, as may be the case for say-on-pay voting proposals regarding compensation plans counselled by a proxy advisor on the side of the issuer[24]. Furthermore, issuers subject to proxy analysis have an incentive to buy governance services offered by proxy advisors in order to take advantage of the dual position of the advisor and obtain both voting recommendations aligned with board proposals, as well as favourable governance ratings. With regard to former experiences with auditors and credit rating agencies, as to non-audit and financial products structuring services offered by them, doubts relating to the efficacy of firewalls and other measures intended to ensure separation between corporate and proxy advisory services[25] indeed appear to be well-founded[26].

3. Methodological and organisational weaknesses of proxy advisors' research and analysis

[22] This is typically the case for the main player globally (ISS), although some commentators do not exclude that other proxy advisors too may offer corporate advisory services indirectly, *i.e*. through partnerships with other firms: *see* Darla C. Stuckey (Society of Corporate Secretaries and Governance Professionals), *Written Testimony*, in *Examining*, at 231. The same kind of conflicts of interest has been reported with regard to the german proxy advisor IVOX GmbH (before it was acquired by Glass Lewis in June 2015): *see* Gesamtverband der Deutschen Versicherungswirtschaft e.V. (GDV), *Position Paper. An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options*, Berlin, 22 June 2012, at 4, available at http://www.gdv.de/2012/06/mehr-transparenz-fuer-stimmrechtsberater/. Both the issuers and investors are highly critical on this issue: *see* Kenneth L. Altman and James F. Burke, *Proxy Advisory Firms: The Debate Over Changing the Regulatory Framework. An Analysis of Comments Submitted to the SEC in Response to the Concept Release on the U.S. Proxy System*, 1 March 2011, at 27, available at http://astfundsolutions.com/pdf/TAGSpecRptProxyAdv.pdf. Likewise ESMA, *An overview*, No. 65, 21.

[23] As for 2011 Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisory Industry.* ECGI Finance Working Paper No. 389/2013, 12 November 2013, at18, available at http://ssrn.com/abstract=2287196, finds approximately 21% of ISS' revenue deriving from ICS, its entirely owned subsidiary offering corporate services to listed companies, which in turn gets most of its revenue from companies making use of its compensation model and buying advisory services for elaborating compensation policies and plans.

[24] *See* Joerg-Markus Hitz and Nico Lehmann, *Does proxy voting advisory matter in a European Context? Empirical evidence from German annual general meetings*, December 2014, available at http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2015-Amsterdam/papers/EFMA2015_0125_fullpaper.pdf, finding (as to the German market) that ISS' recommendations significantly correlate with ISS' commercial corporate governance ratings (GRId).

[25] Measures adopted by ISS for separating and maintaining the separacy of corporate and proxy advisory services do not seem to have put an end to its independence critics, because the risk of opportunistic conduct is considered inherent in its dual business model. *See* SEC, *In the Matter of Institutional Shareholder Services, Inc.*, Administrative Proceeding File No. 3-15331, 23 May 2013, especially No. 13 ff, available at http://www.sec.gov/litigati-on/admin/2013/ia-3611.pdf. Similarly, European Company Law Experts (ECLE), *Response to the European Commission's Green Paper "The EU Corporate Governance Framework"*, 22 July 2011, at Question 19, at http://ec.europa.eu/internal_market/consultations/2011/corporate-governance-framework/individual-replies/ecle_en.pdf.

[26] *See* Lars Klöhn and Philip Schwarz, *The regulation*, 98.

The impact of conflicts of interest associated with proxy advisors is enhanced by opaque information provided to investors about their origin and relevance. The lack of an adequate level of disclosure regarding existing conflicts of interest is generally reported in the relevant literature drawing attention to the non-specific nature of information contained on this issue in reports delivered to clients, and on measures internally adopted for the managing thereof, which does not allow them to form a clear and case-specific opinion on the influence such particular interests may have had on voting recommendations[27].

An insufficient level of transparency also concerns methodologies used to analyse information relevant to voting decisions and to make voting recommendations[28]. Analytical tools used by proxy advisors are in many cases considered to be primarily based on rigid and uniform governance metrics and standards, regardless of variables relating to specific country, legal, company or business conditions, and on a box-ticking approach underlying the application of house voting policies, which, as noticed earlier, does not allow for accurately assessing the company-specific circumstances or local legal and business conditions, and may lead to inappropriate or misleading recommendations still capable of influencing voting outcomes[29]. Furthermore, governance metrics used artificially lead to the standardisation of governance practices and structures and constrain the necessary flexibility required in this context[30]. In this respect proxy advisors are frequently referred to as self-legitimated *de facto* international standard setters in governance matters, not subject to independent review or control mechanisms[31]. Moreover, boards sometimes tend to *ex ante* align their voting proposals with proxy advisors'

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[27] *See* SEC, *Concept Release*, 43012, note 280, at 43011, and note 270, at 43013. Examples of insufficient transparency on conflicts of interests are given by Nicholas O'Keefe, *Will Proxy Advisors Be Reined In By the SEC? Takeaways from the SEC's Roundtable*, 22 The Corporate Governance Advisor, 13 and 18, note 29 (2014).

[28] Tamara C. Belinfanti, *The Proxy Advisory*, 418 ff; David F. Larcker, Allan L. McCall, and Brian Tayan, *And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?* Stanford Closer Look Series, 25 February 2013, 2 f, at http://www.gsb.stanford.edu; ESMA, *Final report. Feedback statement on the consultation regarding the role of the proxy advisory industry*, 19 February 2013, ESMA 2013/84, at 18.

[29] *Inter alia* SEC, *Concept Release*, 43012; Charles M. Nathan and Parul Mehta, *The Parallel Universes of Institutional Investing and Institutional Voting*, 2 April 2010, at 2, available at http://ssrn.com/abstract=1583507; Lucian A. Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance?*, 22 Rev. Fin. Studies, 787 (2009); Sanjai Bhagat, Brian Bolton, and Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 Colum. L. Rev., 1803 ff (2008); Lucian A. Bebchuck and Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Penn. L. Rev., 1265 ff (2009); PricewaterhouseCoopers, *Trends shaping governance and the board of the future***.** PwC's 2014 Annual Corporate Directors Survey, at 9, available at https://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/assets/annual-corporate-directors-survey-full-report-pwc.pdf.

[30] Paul Rose, *The Corporate*, 917; David F. Larcker and Brian Tayan, *Do ISS Voting Recommendations Create Shareholder Value?*, Stanford Closer Look Series, 19 April 2011, at 1; as to Canada *see* Yvan Allaire, *The Troubling Case of Proxy Advisors: Some policy recommendations*, Igopp Policy Paper No. 7, January 2013, 12, at http://www.iasquebec.com/, and Bryce C. Tingle, *Bad Company! The Assumptions behind Proxy Advisors' Voting Recommendations*, 37 Dalhousie L.J., 738 ff (2014).

[31] Yvan Allaire, *The Troubling Case*, 12; U.S. Chamber of Commerce, *Statement*, in *Examining*, at 189; Paul Rose, *The Corporate*, 889; Deutscher Anwaltverein (DAV), *Stellungnahme Nr. 64/2014*, December 2014, No. 37 at 17 f, available at http://www.anwaltverein.de.

voting policies in order to prevent predictable negative voting recommendations: a conduct found to be even triggering negative stock market reactions to changes to compensations programs prior to the vote[32].

Routine standardised and automated analysis potentially also finds an explanation in organisational deficiencies of proxy advisory firms, especially when hiring insufficiently qualified personnel, as is the case at least with temporary analysts employed to tackle seasonal business peaks necessitated by the concentration of shareholders' meetings in a narrow period of time at a world-wide level, entrusted with issues characterised by high-complexity such as compensation plans or extraordinary transactions[33].

Incoherencies and errors that subsequently occur in voting recommendations are finally very unlikely to be detected and (possibly) corrected in a timely manner. Based on a particularly widespread standpoint within the issuers' community, proxy advisors, although normally entering into dialogues with companies, are not ready, or not sufficiently ready, to provide issuers subject to proxy analysis the opportunity to reply[34] and to signal possible miscomprehensions that may lead to a review of voting recommendations before these are delivered to clients[35].

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[32] With reference to SOP votes David F. Larcker, Allan L. Mc Call, and Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 13 June 2014. Rock Center for Corporate Governance at Stanford University Working Paper No. 119; Stanford University Graduate School of Business Research Paper No. 14-27, at http://ssrn.com/abstract=2101453, find a significant number of changes to compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favoured by proxy advisory firms, and a negative stock market reaction to these changes; *see further* David F. Larcker and Brian Tayan, *Institutional Shareholder Services: The Uninvited Guest at the Equity Table*. *Stanford Closer Look Series*, 17 May 2010, 2 and 5, and Robyn Bew and Richard Fields, *Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers*, June 2012, 12, at http://irrcinstitute.org/wp-content/uploads/2015/09/Voting_Decisions_at-US_Mutual_Funds1.pdf

[33] Examples of subsequent inaccuracies and/or errors in voting recommendations are reported as to the European context by Albert F. Verdam, *An Exploration of the Role of Proxy Advisors in Proxy Voting*, December 2006, 6, at http://ssrn.com/abstract=978835; Dutch Corporate Governance Code Monitoring Committee (DCGCMC), *Third Report on Compliance with the Dutch Corporate Governance Code*, December 2011, 13, at www.commissiecorporategovernanve.nl.; *Id*., *Fourth report on compliance with Dutch Corporate Governance Code*, December 2012, at 44, *ibid.*; Peter Böckli, *Proxy Advisors*, 216 ff; Dieter Gericke and Olivier Baum, *Corporate Governance*, 346 and note 3; in general terms *see also* European Commission, *Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies*, COM/2012/0740 final, Strasbourg, 12 December 2012, at 10; ESMA, *An overview*, No. 86, at 25; *Ead*., *Final Report*, 16, 19. With regard to the US and to Canada *see i.a*. Daniel M. Gallagher, *Outsized Power& Influence: The Role of Proxy Advisors*, Washington Legal Foundation. Critical Legal Issues Working Paper Series No. 187, August 2014, 9 f, at http://www.wlf.org/publishing/publication_de tail.asp?id=2448; Center on Executive Compensation, *A Call for Change in the Proxy Advisory Industry Status Quo. The Case for Greater Accountability and Oversight*, January 2011, at 113 f, in *Examining*; Nicholas O'Keefe, *Will Proxy Advisors*, 14; Yvan Allaire, *The Troubling Case*, 13; David F. Larcker and Brian Tayan, *Do ISS*, 1; Kenneth L. Altman and James F. Burke, *Proxy Advisory Firms*, 18.

[34] ESMA, *An overview*, No. 43, 14. However, some proxy advisors, like *e.g.* Glass Lewis, have a clear policy of not dialoguing with issuers to avoid being lobbied, being influenced, or potentially receiving inside information.

[35] *See i.a.* Albert F. Verdam, *An Exploration*, 13.

4. The case for (cautiously) regulating proxy advisors at the European level

As a number of empirical studies appear to indicate, based on the evidence of a more or less strong association between the recommendations provided by proxy advisors and the votes cast by investors[36], the matter of over-reliance on poor-quality and potentially conflicted voting recommendations has turned out to be a problematic issue, especially in the case of non-activist, smaller investors, who are less equipped both organisationally and economically to conduct their own research and analysis[37]. While most of the studies available refer to the US context, proxy advisors' influence on voting outcomes is held to be a problematic issue also within Europe[38]. Furthermore, foreign investors tend to be comparatively more

[36] In fact, while the literature agrees that voting recommendations move at least some fraction of the votes cast, the extent to which proxy advisors influence shareholder votes still remains unclear. Referred to the US context, ISS is found to be moving 19% of the votes in directors' elections according to Jie Cai, Jaqueline L. Garner, and Ralph A. Walking, *Electing Directors*, 64 J. of Finance, 2417 (2009), or a percentage of votes between 6 and 10% according to Stephen Choi, Jill Fisch, and Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 Emory L.J., 906 (2010). Depending on the item to be voted on, ISS' power varies between 13,6 and 20,6% of the votes according to Jennifer E. Bethel and Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 Financial Management, at 30, 46 (4/2002). In contested elections Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, and Chester S. Spatt, *Interim News and the Role of Proxy Voting Advice*, 23 Rev. Fin. Studies, 4439 ff (2010) find ISS' recommendations shifting on average 14% of the votes. Fabrizio Ferri and David Oesch, *Management influence on investors: evidence from shareholder votes on the frequency of say on pay*, Columbia Business School Research Paper No. 13-17, 25 Ocotber 2013, at 6 (available at http://ssrn.com/abstract=2238999), find that ISS influences ¼ of SOP non-binding votes: a finding consistent with Tao Li, *Outsourcing*, who sees an association between positive voting recommendations from ISS [from Glass Lewis] and an increase of 23,8% [of 12,6%] of the votes cast in the same direction. On the same subject *see further* Yonca Eritmur, Fabrizio Ferri, and David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 2013, at 20, available at http://ssrn.com/abstract=2019239; James F. Cotter, Alan R. Palmiter, and Randall S. Thomas, *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 Geo. Wash. L. Rev., 982 (2013). Finally, Nadya Malenko and Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, November 2015, at http://ssrn.com/abstract=2526799, find that a negative ISS recommendation on a SOP proposal leads to a 25% reduction in voting support for the proposal.

[37] Bigger investors seem instead to use proxy advisors' voting recommendations as a basis for their own analysis and voting decisions. *See* Stephen J. Choi, Jill E. Fisch and Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 Harvard Bus. L. Rev., 67 (2013); GAO, *Issues*, 15 f; Timothy J. Bartl (Center on Executive Compensation), *A Case*, 39 f, in *Examining*. As for the Dutch market *see* DCGCMC, *Third report*, 13, 42, 44 f.

[38] *See* European Comission, *Green Paper. The EU corporate governance framework*, Brussels, 5 April 2011, COM (2011) 164 final, at 14; *Ead*., *Explanatory Memorandum*, 5; ESMA, *An Overview*, 17, stating the existence of a "strong" correlation between proxy advisors' voting recommendations and the votes cast; *Ead*., *Final report*, at 12. As to France *see* Autorité des Marchés Financiers (AMF), *Agences de conseil de vote. Recommandation* No. 2011-06, para 7, at 2. As to Italy *see* Assonime, *Response* to the Commission's 2011 Green Paper, Riv. soc., 1276 (2011). According to the DCGCMC, *Second report on compliance with the Dutch Corporate Governance Code*, December 2010, at 58, proxy advisory firms are considered by institutional investors to be more influential than lobbying organisations and other institutional investors; further, investors that used proxy advisory services indicated that they disregarded the advice only in a very limited number of cases. Moreover, the extent of the influence of ISS' and Glass Lewis' voting recommendations seems to be greater at companies with a widespread shareholdership and with relatively small percentages, mainly held by foreign institutional investors, which tend to be guided by other foreign best practices that are not in all cases generally accepted best practices: *Id*.,

reliant on the advice of proxy advisors when voting in companies based outside their own homeland, due to their corresponding poorer understanding of the local business and legal environment. This point is important especially with regard to companies listed in the European Union, where major foreign investors with highly diversified portfolios have lately been, and still are, increasing their presence and stakes[39]. According to the ESMA, US proxy advisors tend to rely more on their own voting policies, whereas European ones generally tend not to develop their own guidelines but follow client's policies, and investors with diversified portfolios seem to prefer worldwide voting solutions, therefore hiring proxy advisors offering 'global coverage'[40]. Taken together, these circumstances raise special concerns about the effects that major US-based proxy advisory firms active in Member States may have on European issuers. Significantly, referred to say-on-pay advisory votes, the Italian supervisory Authority noticed that the effect of proxy advisors on institutional investors' voting in Italy "is at least as strong as (and probably stronger than) that observed in the US", consistent with the weight of non-domestic institutions, and with the features of listed companies, which may be classified as small/medium cap firms on a comparative basis[41].

Due to the growing importance of the industry in Europe[42], to the lack of a satisfactory level and quality of disclosure of conflicts of interest, as well as the lack

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Fourth report, at 44. As to the German market, Joerg-Markus Hitz and Nico Lehmann, *Does proxy voting*, find that negative voting recommendations from ISS significantly correlate with 8.5% less supportive shareholder votes – a measure more pronounced for issuers with high free float (-11,44%), low voting turnout (-11,78%), and high ISS client base (-11,21%). For similar findings referred to the Swiss market *see* Alexander F. Wagner and Christoph Wenk Bernasconi, *Aktionäre und Stimmrechtsberater im Jahr 1 nach der Minder-Initiative*, Schweizer Treuhänder, 1148 f (12/2014).

[39] *See* European Commission, *Green Paper 2011*, 14 f; *Ead*., *Summary of the informal discussions concerning the initiative on shareholders engagement*, Brussels, 17 April 2013, at 5; ESMA, *An overview*, No. 58, at 19; DCGCMC, *Third report*, table 19 at 45; Michael C. Schouten, *Do Institutional Investors Follow Proxy Advice Blindly?*, January 2012, 22 f, available at http://ssrn.com/abstract=1978343; as to Switzerland *see* Peter Böckli, *Proxy Advisors*, 212 f; as to Italy *see* Simone Alvaro and Bendetta Lupini, *Le linee di azione della Commissione europea in materia di* corporate governance *e i riflessi sull'ordinamento italiano*, Quaderni giuridici Consob, No. 3, April 2013, available at http://www.consob.it/main/consob/pubblicazioni/studi_analisi/quaderni_giuridici/qg3.html.

[40] ESMA, *An overview*, No. 37, at 13, and No. 49 and 51, at 17.

[41] Massimo Belcredi, Stefano Bozzi, Angela Ciavarella, and Valerio Novembre, *Proxy advisors and shareholder engagement. Evidence from Italian say-on-pay*, Quaderni di finanza Consob, No. 81, April 2015, at 26 ff, available at http://www.consob.it/main/consob/pubblicazioni/studi_analisi/quaderni_finanza/qdf81.html, finding, however, investors seemingly not to blindly follow voting recommendations, but to consider the specific reasons of concern referred to in proxy analysis reports.

[42] *See* ESMA, *An overview*, 9, 16; Massimo Belcredi and Luca Enriques, *Institutional Investor Activism pagina?*; Mats Isaksson and Serdar Çelik, *Who Cares? Corporate Governance in Today's Equity Markets*. OECD Corporate Governance Working Papers No. 8, 19 April 2013, at 44, available at http://dx.doi.org/10.1787/5k47zw5kdnmp-en; Pavlos. E. Masouros, *Is the EU Taking Shareholder Rights Seriously? An Essay on the Impotence of Shareholdership in Corporate Europe*, 7 European Company Law, 199 (2010); Albert F. Verdam, *An Exploration*, 6; Holger Fleischer, *Zur Rolle*, 3; Uwe H. Schneider, *Abgestimmtes Verhalten durch institutionelle Anleger: Gute Corporate Governance oder rechtspolitische Herausforderung?*, ZGR, 520, 526 (2012); Lars Klöhn and Philip Schwarz, *Die Regulierung*, 150; Hans-Ulrich Wilsing, *Corporate Governance in Deutschland und Europa. Die Rolle der institutionellen Investoren, der Proxy Advisors und die*

of competition in the market for proxy advisory services, problems deriving from the influence of proxy advisors on shareholders' meetings are enhanced. The European market is in fact dominated, as it is in the US, by two major and well-known US-based proxy advisors, whose market power is not effectively constrained by smaller local competitors due to existing barriers to entry and economies of scale, to substitution costs, network effects and first-movers' advantages[43].

The absence of an adequate control on proxy advisors by investor-clients as well as the market, means that mechanisms intended to reduce the relevance of the private incentives associated with proxy advisors are insufficient, and that limitations exist that are not negligible with regard to the independence and impartiality of voting recommendations potentially affecting shareholders' voting behaviour.

According to the European Commission, the case for regulating the industry results from these findings, and from recognising that the existing regulatory framework is not capable to specifically address these drawbacks with regard to both investors and issuers subject to proxy analysis, and to provide for an acceptable discipline[44]. In fact, except primarily for rules regarding market abuse, as far as selective disclosure of price sensitive information to proxy advisors may be concerned, other existing norms apply to proxy advisors not on a general basis, but rather in particular cases or under special circumstances only, *e.g.* when proxy agency occurs on a discretionary basis, possibily causing rules on shareholdings' transparency to apply.

Initially, the European policy position on proxy advisors seemed to focus exclusively on a self-regulation option. Relying on the feedback from the market to its Discussion Paper of 22 March 2012, the ESMA found no clear evidence of a failure of the proxy advisory market to justify the introduction of binding measures, but encouraged the development of an industry specific Code of Conduct by setting key-principles for addressing critical issues to serve as a guidance therefore[45]. The Best Practice Principles Group (BPPG), which was soon after

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der Aktionäre, ZGR, 296 (2012); Klaus Ulrich Schmolke, *Institutionelle Anleger und Corporate Governance – Traditionelle institutionelle Investoren vs. Hedgefonds*, ZGR, 714 (2007); Ulrich Seibert, *Corporate Governance: The Next Phase – Die Corporate Governance Debatte schreitet weiter zu den Pflichten der Eigentümer und ihrer Helfer*, in Gerd Krieger, Marcus Lutter, and Karsten Schmidt (*Eds.*), *Festschrift für Michael Hoffmann-Becking*, München, 2013, 1112 f; Carine Girard and Stephan Gates, *The professionalization of Shareholder Activism in France*, 3 *Director Notes*, February 2011, at http://ssrn.com/abstract=1843330.

[43] *See* Tamara C. Belinfanti, *The Proxy Advisory*, 411 ff; as to the European proxy advisory market *see* European Commission, *Action Plan 2012*, at No. 3.3, ESMA, *An overview*, 10, 17, and Philip Schwarz, *Institutionelle*, 61ff. ISS is the major global player, followed by Glass Lewis; taken together, these two firms are considered to hold roughly a 90% market share in the US, and likewise in Canada: *see inter alia* James K. Glassman and J.W. Verret, *How to Fix Our Broken Proxy Advisory System*, Mercatus Center, George Mason University, 6, 8 (2013), available at http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf; Canadian Securities Administrators (CSA-ACVM), *Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms*, 21 June 2012, at 3, available at www.osc.gov.on.ca. European local firms do not seem to seriously jeopardize ISS' and Glass Lewis' market power, due to their smaller size, and to their mainly selling proxy advisory services to domestic investors.

[44] European Commission, *Action Plan* 2012, at 10. As to the US *see* Tamara C. Belinfanti, *The Proxy Advisory*, at 385.

[45] ESMA, *Final Report*, 6, 8 ff.

founded by industry members under the independent presidency of Professor Dirk Zetzsche, published such a Code in March 2014 in the form of Best Practice Principles for Providers of Shareholder Voting Research & Analysis (BPP)[46]. These Principles have been adopted by a number of proxy advisors active in Europe.

However, well before the expiration of the deadline scheduled by the ESMA for an assessment of the application of the Code, and for a possible review of its initial policy option[47], following the responses received both to its 2011 Green Paper on the EU corporate governance framework and to its 2012 Consultation on the future of European company law[48], and its subsequent Action Plan of 12 December 2012, the European Commission chose instead to provide for a regulation of proxy advisors by proceeding with its 2014 Proposal for a Directive amending the so-called Shareholders' Rights Directive of 2007.

Various attempts formerly undertaken to provide for a (not legally binding) regulatory framework of proxy advisors through supervisory authorities or self-regulation[49], and the willingness to arrange for a common basis for a (binding) regulation[50], also designed to prevent asymmetric legislative measures from being potentially taken in this context by Member States, are at the basis of the Commission's Proposal, along with awareness of the steps taken forward overseas on the same subject by the SEC and by the Canadian Securities Administrators[51].

Given that the (ordinary) legislative procedure for the adoption of the Directive proposed is still on going, and that various amendments to the Commission's Proposal have been adopted both by the Council of the European Union and by the

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[46] Best Practice Principles Group (BPPG), *Best Practice Principles for Providers of Shareholder Voting Research & Analysis*, March 2104, at www.bppgrp.info. The founding industry members are Glass Lewis, ISS, IVOX (later acquired by Glass Lewis), Manifest Information Services Ltd.; PIRC Ltd., Proxinvest sàrl.

[47] ESMA, *Final Report*, 11. The results of ESMA's planned review via its *Call for Evidence. Impact of the Best Practice Principles for Providers of Shareholder Voting and Research Analysis*, 8 June 2015, ESMA/2015/920, have been published on 19 December 2015: *see* ESMA, *Follow-up on the development of the Best Practice Principles for Providers of Shareholder Voting and Research Analysis*, 18 December 2015, ESMA/2015/1887.

[48] European Commission, *Feedback statement. Summary of responses to the Commission green paper on the EU corporate governance framework*, Brussels, 15 November 2011, at 14, Question No. 18; *Ead*., *Consultation on the future of European Company Law*, 23 December 2012.

[49] *See* Autorité des Marchés Financiers (AMF), *Recommandation* No. 2011-06. The UK 2012 Stewardship Code, while "directed in the first instance to institutional investors", also applies "by extension, to service providers, such as proxy advisors and investment consultants": *see* Application of the Code, No. 2, and further Application No. 11. Service providers adopting the Code are listed at https://www.frc.org.uk: these include a number of proxy advisors, *e.g*. Expert Corporate Governance Service (ECGS); Glass Lewis & Co; Manifest Information Services Ltd; PIRC Ltd.

[50] European Commission, *Explanatory Memorandum*, at 3.

[51] SEC, *Concept Release*, 43008 (for further developments thereof *see ultra*, para V); CSA-ACVM, *Consultation Paper 25-401*. On April 2015 the Canadian Securities Administrators adopted National Policy 25-201 *Guidance for Proxy Advisory Firms* (available at https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150430_25-201-proxy-advisory.htm), providing guidance on (non prescriptive but) recommended practices and disclosure for proxy advisory firms, that addresses identification, management and mitigation of actual or potential conflicts of interest; transparency and accuracy of vote recommendations; development of proxy voting guidelines; communications with clients, market participants, other stakeholders, the media and the public.

European Parliament[52], the following, and necessarily preliminary remarks are based on a comparison between the Proposal, the Council mandate (so-called Coreper of 25 March 2015) and the European Parliament's position as of 8 July 2015, as complied with the Council on 28 July 2015[53].

Still, before commenting on the drafted provisions, special attention needs to be given to arguments made in defence of proxy advisors. In fact, the impact of some of the industry's shortcomings, as previously described, may turn out to be over-estimated in light of both the results of further studies downsizing the actual impact of proxy advisors on voting outcomes, as well as the counter-arguments to be considered when discussing criticisms concerning the independence of proxy advisors. This is not to say that there is no need for any European regulation of proxy advisors. Rather, a thorough comprehension of the manner in which the industry functions in the European context and of its developments, which are indeed steadily progressing, is needed in order to assess the appropriateness and effectiveness of the rules under discussion at the European level.

4.1. Why transparency rules for proxy advisors are preferable. The uncertain reach of the actual impact of proxy advisors on investors and issuers

First of all, the existing correlation between the voting recommendations made by proxy advisors and the votes cast does not *per se* imply a cause-and-effect relationship. On the sole basis of such an association it cannot be said that investors are over-reliant on voting recommendations, or blindly follow them, outsourcing voting decisions to third parties.

Different findings offer other explanations for this correlation. The expectations of investors and main preferences concerning corporate governance structures are found to be consistently convergent with the views of proxy advisors on the same subject[54], due to a variety of reasons which mainly refer *i)* to public mainstream opinion, as mirrored in the media[55]; *ii)* to the consolidating practice on the part of proxy advisors to launch policy surveys on governance developments, aimed at collecting feedback from market participants as a means for annually reviewing their voting policies[56]; *iii)* to the growing incidence of client-

[52] Council of the European Union, *Preparation of an informal trilogue*, 7315/15, Brussels, 20 March 2015 (following Presidency compromise texts No. 13758/14 of 10 November 2014; No. 15647/14 of 5 December 2014; No. 5215/15 of 14 January 2015); European Parliament, *Long-term shareholder engagement and corporate governance statement*, T8-0257/2015, Strasbourg, 8 July 2015 (following earlier Committee on Legal Affairs' Report and the Opinion of the Committee on Economic and Monetary Affairs, both in European Parliament, A8-0158/2015 of 12 May 2015).

[53] Council of the European Union, 11243/15, Brussels, 28 July 2015, available at http://data.consilium.europa.eu/doc/document/ST-11243-2015-INIT/en/pdf.

[54] *See* Stephen J. Choi, Jill E. Fisch and Marcel Kahan, *The Power*, 879, 881, 883; *Id*., *Director Elections and the Role of Proxy Advisors*, 82 S. Cal. L. Rev., 696 f (2009); *Id*., *How Powerful id ISS? Less – and in Different Ways – than Most People Think*, 19 Corp. Advisor, 7 and 10 (2011); GAO, *Issues*, 17; ESMA, *Final report*, No. 30, at 12.

[55] *See* Reena Aggarwal, Isil Erel, and Laura Starks, *Influence of Public Opinion on Investor Voting and Proxy Advisors*, April 2014, at http://ssrn.com/abstract=2447012.

[56] Policy surveys' results are often publicly available on proxy advisors' websites. As to ISS' policy updates for 2016 *see* http://www.issgovernance.com/policy-gateway.

specific, tailored voting policies as a basis for proxy analysis[57], which contradicts the view assuming a prevailing occurrence of a one-size-fits-all approach on the part of proxy advisors, and that contractually constraints advisors' own discretionary judgement when making recommendations[58]; *iv)* to a significant degree of heterogeneity in the analytical approaches (and policies) used by proxy advisors[59], that enables investors to comparatively choose the advisor that best fits their interests and governance expectations.

Second of all, further studies suggest that at least when it comes to major investors, the outputs generated by proxy advisors are neither the unique, nor the conclusive support for voting decisions, but an informative source used together with many others for analysis and evaluation purposes. This appears to be particularly true for investors holding relatively consistent stakes, voting on matters capable of significantly impacting on portfolio values, and of issuers under analysis that are poorly performing[60]. In spite of voting recommendations becoming gradually less hostile to board proposals, the voting behavior of investors appears to be taking an increasingly independent stance with respect to the advice of their agents[61].

With regard to criticisms related to the impartiality of proxy advisors, scholars emphasise proxy advisors' own interest of limiting, and adequately managing, conflicts of interest. In fact, conflicts of interest may undermine a proxy advisor's reputation and, as the business is largely based on the consideration of the market, cause clients to move to a competitor, and to potentially compromise the economic integrity of the firm. Furthermore, the ability of the market and of investors to

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[57] According to Dirk Zetzsche and Christina Preiner, *Der Verhaltenskodex für Stimmberater zwischen Vertrags- und Wettbewerbsrecht*, AG, 689 and notes 57 and 58 (2014), the majority of voting recommendations, and virtually all voting recommendations delivered to major investors, are nowadays based on client custom voting policies; *see also* George W. Dent Jr., *A Defense of Proxy Advisors*, Mich. St. L. Rev., 1301, 1316 (2014); GAO, *Issues*, 16; Sagiv Edelman, *Proxy Advisory Firms: a Guide for Regulatory Reform*, 62 Emory L.J., 1389, 1391 f, 1400 (2012-2013).

[58] *See also* Dirk Zetzsche and Christina Preiner, *Der Verhaltenskodex*, at 690.

[59] Again, Stephen J. Choi, Jill E. Fisch and Marcel Kahan, *Director Elections*, 696, finding differences between proxy advisors as far as variables underlying their voting recommendations and the weighing thereof are concerned; Yonca Eritmur, Fabrizio Ferri, and David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. Accounting Research, 953 (2013), figuring out proxy advisors' evaluation methods of compensation plans subject to say-on-pay respective of company-specific circumstances. A quantitative analysis of differences between US voting policies from different proxy advisors is set out by Colin Diamond and Irina Yevmenenko, *Who is Overseeing the Proxy Advisors?*, 3 Bloomberg Corp. L.J., 609 ff (2008).

[60] *See retro*, note 37; *see also* Peter Iliev and Michelle Lowry, *Are Mutual Funds*, 3 f, finding highly diversified mutual funds with lower investment turnover voting independently from proxy advisors' recommendations. For this type of investors benefits expected from voting shares outweigh costs associated with research and analysis of the relevant information. *See further* Joseph A. McCahery, Zacharias Sautner, and Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 7 (October 2014), available at http://ssrn.com/abstract=1571046, and, with respect to the European context, Michael C. Schouten, *Do Institutional Investors*, 4.

[61] *See* Reena Aggarwal, Isil Erel, and Laura Starks, *Influence*, 4 f, 13 f.

scrutinise proxy advisors and cause conflicts of interest to emerge should not be under estimated[62].

Even the impact of the possible dependence of a proxy advisor on services sold to issuers may partly be counterbalanced by competition from other advisors not offering corporate services, and making of it their strong differential feature to divert clients[63]. Also, the availability on the market of advisors perceived as less subject to conflicts of interest, whose market share is in fact slowly growing, are deemed to indirectly produce a monitoring effect on competitors selling services both to investors and to issuers. Such an effect is inferred from findings showing an association between a reduction of the number of voting recommendations favourable to the boards' proposals given by ISS and the insurgence of its main competitor, and by the growth of its market share[64].

These findings demonstrate the extent of uncertainties still surrounding a clear understanding of the market, and of the industry's problematic impact on the interests of investors as well as issuers. Although not reasonably eliminating the need for (soft) regulation, a somehow questionable understanding of the *status quo* of the proxy advisory market and of its functioning in Europe requires, with regard to the choice of regulatory techniques, an adequate balancing of benefits and costs associated to regulation, permitting to avoid, or at least to keep within acceptable limits, possible negative effects in terms of efficacy. Potential risks of a proxy advisory regulation not based on a sufficiently accurate informational background have been described in terms of expectations gaps too[65].

In this respect, the Commission's orientation to address conflicts of interest associated with proxy advisors, and their corresponding incentive to extract private benefits, essentially through transparency rules, rather then by imposing more restrictive measures – *e.g.* by putting in place registration requirements within Europe, or prohibiting the sale of advisory services to investors and to issuers –, is to be supported at the present stage. Enhanced transparency on the side of proxy advisors allows market mechanisms to strengthen without constraining their necessary flexibility [66].

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[62] Sagiv Edelman, *Proxy Advisory*, 1386, 1388 f, considering concerns on proxy advisors' independence to be exaggerated.

[63] George W. Dent Jr., *A Defense*, 1324 f.

[64] According to Tao Li, *Outsourcing*, 5, 25 f., 27 f, Glass Lewis' 2003 entry in the proxy advisory market has caused a discipline effect on ISS, bringing about more "sincere" ISS voting recommendations, especially in cases of clients buying both ISS' and Glass Lewis' proxy advisory services.

[65] Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 21 July 2014, at http://ssrn.com/abstract=2469158.

[66] An opinion indeed widely shared among scholars*: see* Uwe H. Schneider and Heribert M. Anzinger, *Institutionelle Stimmrechtsberatung*, 96; Holger Flesicher, *Zur Rolle*, 11; *Id*., *Zukunftsfragen der Corporate Governance in Deutschland und Europa: Aufsichtsräte, institutionelle Investoren*, Proxy Advisors *und* Whistleblowers, ZGR, 173 (2011); Lars Klöhn and Philip Schwarz, *Die Regulierung*, 158; Katja Langenbucher, *Stimmrechtsberater*, in Gerd Krieger, Marcus Lutter, and Karsten Schmidt (Eds.), *Festschrift für Michael Hoffmann-Becking*, München, 2013, at 745. For broader remarks on the advantages of transparency as a means of regulation in the corporate governance field *see* Klaus J. Hopt, *Corporate Governance in Europe. A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance*, ECGI Law Working Paper No. 296/2015, August 2015, at 49, available at

For the very same reasons, a pertinent approach to issues being considered in the Proposal is adopted by the Council's amendments to Article 3i(4), requiring the Commission, in close cooperation with the ESMA and by four years from the expiry of the transposition period, to submit a report to the European Parliament and to the Council on the implementation of the proxy advisors' regulation, "including the appropriateness of its scope of application and its effectiveness and the assessment of the need for establishing regulatory requirements for proxy advisors, taking into account relevant EU and international market developments", and to be "accompanied, if appropriate, by legislative proposals". By creating a commitment to verify the adequacy of the regulatory framework associated with proxy advisors within a reasonable time after its first application, on the basis of relevant developments, this approach acknowledges the need for a deeper understanding of the issues being identified as problematic and for monitoring on-going developments in the market, while also providing an incentive to compliance on the side of market participants concerned (or a warning focused on how to prevent more severe measures from potentially being introduced in the future).

4.2. The Draft Directive's provisions on proxy advisors: An overview

Rules under discussion are intended to provide for both a direct as well as an indirect transparency regulation of proxy advisors operating in the EU, as a means, along with further measures, to ultimately encourage long-term shareholder engagement.

On the one hand, the provisions of Article 3i, directly regarding proxy advisors, are intended to "ensure reliability and quality of advice of proxy advisors" [67], in order to permit shareholders to make (correctly) informed voting decisions. These provisions require proxy advisors: *i)* to publicly disclose reference to a code of conduct which they apply and to report on its application, or to explain the reasons for not applying such a code (a measure considered in paragraph 1 both by the Council and the Parliament, while ignored by the Commission, which does not take self-regulation into any account), and *ii)* to publicly disclose certain key information related to the preparation of their voting recommendations (paragraph 2), as well as *iii)* to timely inform clients (and issuers concerned too, according however only to the Commission's Proposal), on any actual or potential conflict of interest or business relationship that may affect voting recommendations, and on measures correspondingly adopted to manage it (paragraph 3).

According to the Council's and the Parliament's changes to the Commission's Draft Directive, transparency rules on proxy advisors would therefore take into account two layers. While not willing to disclaim the industry's recent self-regulatory efforts, they demonstrate a tendency to scarcely rely on the sole comply-or-explain rule under Article 3i(1) to efficacely, or at least comprehensively, discipline proxy advisors, and therefore lay down transparency rules applicable to any player, regardless of it adopting a code of conduct. In this respect, the Council's amendments to Article 3i(2) appropriately state that information referred to in the same paragraph does not need to be disclosed where the same is already

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http://ssrn.com/abstract=2644156; Holger Fleischer, *Corporate Governance in Europa als Mehrebenensystem*, ZGR, 184 f. (2012).

[67] European Commission, *Explanatory Memorandum*, at 2.

available as part of the disclosure on the application of a code of conduct, thereby avoiding dysfunctional informative duplications, that may especially occur in the case of BPP signatories[68], given that key information subject to transparency according to Article 3i(2) significantly overlaps with disclosure requirements set out in the 2014 BPP.

Specifically, as far as processing information and developing voting recommendations are concerned, disclosure is due, via a proxy advisor's website, on a series of circumstances relevant for assessing its research, analysis and outputs. Public disclosure requested from proxy advisors by Article 3i(2) concerns: the essential features of the methodologies and models applied; the main sources of information used; whether and, if so, how national market, legal, regulatory and company-specific circumstances are taken into account; dialogues held with companies subject to analysis, and the extent and nature thereof. Amendments adopted both by the Council and by the Parliament also include information on the essential features of voting policies applied for each market, and on the policy regarding prevention and management of potential conflicts of interest. Contrary to the Commission and to the Parliament, the Council excludes information pertaining both to the total number of voting recommendations provided in the last year, and the total number and qualifications of the staff involved in preparing such recommendations, implicitly deferring the matter to self-regulation only[69]. Furthermore, the Council considers disclosure on procedures put in place to ensure the quality of research, whereas the Commission and the Parliament establish instead a general principle in Article 3i(1) requiring voting recommendations to be "accurate and reliable", based on a "thorough analysis" of all the information available to them.

The Parliament's only Draft also expressly lays down a principle according to which recommendations are to be developed in the sole interest of clients. Serving as a general rule of conduct for proxy advisors, similar to MiFID, such a principle, likewise underlying the BPP[70], establishes an interpretative guideline for all detail provisions of Article 3i. Nonetheless, given that these very provisions implicitly make reference to the same principle[71], as a means of ultimately avoiding conflicts of interest, the lack of an explicit statement in this regard in the law should not hinder the recognition of its existence.

On the other hand, while more broadly aimed at increasing "the level and quality of engagement of asset owners and asset managers with their investee companies"[72], provisions of Articles 3f and 3h regarding institutional investors

[68] BBP signatories' statements of compliance are available at http://.bbbpgrp.info, according to which, as per December 2015, signatories *de facto* coincide with the six Drafting Committee Members [ISS, Glass Lewis, Ivox (starting from 11 June 2015, as a subsidiary of Glass Lewis Europe), Manifest, Pirc; Proxinvest].

[69] *See* Guidance supporting Best Practice Principle One (Service Quality), specifically referring to employee qualification and training.

[70] As generally stated by the BPP with regard to voting research and analysis, at 9, "Unless otherwise stated or disclosed signatories do not act on behalf of any particular shareholder or group of shareholders that is trying to influence hor other shareholders vote. Similarly, signatories do not act on behalf of an issuer that is trying to secure votes from its shareholders".

[71] *See* DAV, *Stellungnahme*, No. 36 at 17.

[72] European Commission, *Explanatory Memorandum*, at 2.

and asset managers are also intended to render them accountable to end-investors and to issuers concerned for the use they make, if any, of proxy advisory services. In fact, requesting - on a comply or explain basis - institutional investors and asset managers to develop an engagement policy *inter alia* considering if and how proxy advisory services are used by them, to publicly disclose the policy, and to report on its implementation and on the results thereof on an annual basis, is clearly directed at providing an incentive for a client to carry out a minimum level of monitoring on its proxy advisors, causing it to responsibly use voting recommendations, *i.e.* to control their appropriateness instead of blindly following them.

Moreover, considering that shareholders' engagement, as defined in Article 2(h), includes exercising voting rights, the further requirement laid out for institutional investors and asset managers in Article 3f, to publicly disclose and to provide an explanation within their annual report on the implementation of the engagement policy and of its results, if and how they cast their votes in shareholders' meetings, this factor should further strengthen proxy advisors' clients monitoring incentives[73].

5. Possible (unintended) effects on the proxy advisory market associated with the Draft Directive's regulation of institutional investors and asset managers

Disclosure requirements for institutional investors and asset managers regarding votes cast in shareholders' meetings, and the use made by them of proxy advisory services, are not new to regulation at an international level. Requirements similar (although not identical) to those considered under Article 3f of the Draft Directive are provided for by stewardship codes already adopted in some European States[74], and likewise especially by rules adopted by the SEC under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

[73] Measures directed to increase institutional investors' information duties in these areas were envisaged by the Commission since its 2003 Acion Plan: *see* Commission of the European Communities, *Communication from the Commissione to the Council and the Euopean Parliament. Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, Brussels, 21 May 2003, COM (2003) 284 final, at 13.

[74] *See* Application No. 5 and Guidance to Principle No. 6 of the 2012 UK Stewardship Code, prompting institutional investors to publicly disclose voting records and the use made, if any, of proxy voting or other voting advisory services, by describing the scope of such services, identifying the providers and disclosing the extent to which they follow, rely upon or use recommendations made by such services. *See also* the Best practice Recommendation relating to Principle n. 1 of EFAMA's 2011 Code for External Governance. Transparency regarding investors' voting policies and the implementation thereof, albeit without reference to the use made of proxy advisory services, are laid down by Article L533-22 *Code monétaire et financier* and by Articles 314-100 to 314-104, 319-21 and 319-5 of the AMF's *règlement général*, especially requiring management companies to explain to funds' shareholders the reasons for deciding not to cast votes relating to funds' portfolio securities. Likewise, Article 23 of the Swiss Federal Council's law of 20 November 2013 «against excessive compensation in listed companies» (*VegüV*), requires pension plans to vote [under a (not unconditional) *Stimmpflicht* set down in Article 22] on governance issues and on related changes of the articles of association.

Specifically, two companion SEC releases of 2003 require registered management investment companies[75], on the one hand, to disclose to their shareholders how they vote proxies relating to portfolio securities they hold, and to disclose the policies and procedures used to determine how to vote proxies[76]. On the other hand, registered investment advisers exercising voting authority over client proxies (as is typically the case for proxy voting relating to mutual fund portfolio securities) are required to adopt policies and procedures designed to reasonably ensure that the adviser votes proxies in the best interest of clients, to disclose to clients information about those policies and procedures, how to obtain information relating to how the adviser voted their proxies, and to maintain records relating to proxy voting[77]. Disclosure as a means of informing fund shareholders how the fund, or its adviser (delegated by the former), voted proxies, includes the extent to which the fund, or its adviser, delegates its proxy voting decisions to its investment adviser, *or to another third party* (typically a proxy advisor), *or relies on the recommendations of a third party*[78].

As a matter of fact, rule 206(4)-6 consequently adopted by the SEC under the Advisers Act (so-called Proxy Voting Rule), stating an investment adviser's fiduciary duty to its clients (the funds) to vote their proxies in the clients' best interests, and requiring them to adopt and implement written policies adequate to fulfil such fiduciary obligations, has prompted investment advisers to increasingly hire proxy advisors as a means of complying with the rule[79]. Further SEC material explicitly recognised that voting advice from proxy advisors can serve to demonstrate appropriate due diligence, and the absence of conflicts of interest, on the part of investment advisers in voting clients' proxies[80], and was further interpreted as requesting investment advisers to vote on all matters, *i.e*. to vote *every* proxy. Taken together, these circumstances – along with previous rulings adopted by the US Department of Labor, likewise prompting ERISA pension plan fiduciaries to

[75] Being for simplicity referred to in the release cited in the following footnote as "mutual funds" (comprising open- and closed-ended management investment companies, as well as insurance companies' separate accounts organized as management investment companies that offer variable annuity contracts).

[76] SEC, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* [Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02], 31 January 2003, 68 Federal Register, No. 26, 7 February 2003, 6564 ff, also available at http://www.sec.gov/rules.

[77] SEC, *Proxy Voting by Investment Advisers* [Release No. IA-2106; File S7-38-02], 31 January 2003, 68 Federal Register, No. 26, 7 February 2003, 6586 ff, also available at http://www.sec.gov/rules.

[78] SEC, *Disclosure*, at 6567.

[79] *See inter alia* Stephen J. Choi, Jill E. Fisch and Marcel Kahan, *Director Elections*, at 655; Daniel M. Gallagher, *Outsized Power*, 2 ff.

[80] *See* SEC's no-action letters to Egan-Jones Proxy Services of 27 May 2004, available at https://www.sec.gov/divisions/investment/noaction/egan052704.htm, and to ISS on 15 September 2004, at https://www.sec.gov/divisions/investment/noaction/iss091504.htm, stating that votes based upon the recommendations of an independent third party can serve investment advisers to fulfill their fiduciary obligation under rule 206(4)-6. *See* also Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, and Chester S. Spatt, *Interim News*, at 4423, note 8 (2010).

vote the plan's shares on the basis of a similar analysis[81] – are considered to have led to an increase in the demand for proxy advisors, to over-reliance on them and to outsourcing the voting responsibilities of investors to these firms[82].

In order to tackle these unintended consequences, on 30 June 2014 the SEC Divisions of Corporate Finance and Investment Management released new guidance regarding the responsibilities of investment advisers concerning proxy voting and their reliance upon proxy advisory firms, requiring them to take an active role on behalf of their clients, particularly in evaluating and overseeing on an on going basis any proxy advisory firm they engage[83]. Staff Legal Bulletin 20 (SLB 20) is therefore intended to fine-tune the SEC's previous Proxy Voting Rule by urging investment advisers buying proxy advisory services, to ascertain the firm's "capacity and competency to adequately analyse proxy issues." In addition, investment advisers are requested to consider the appropriateness of the proxy advisory firm's policies and procedures for both ensuring that voting recommendations are based on accurate information, and identifying and addressing conflicts of interest affecting the nature and quality of the services provided. If a voting recommendation is found to be based on inaccurate information, the investment adviser should investigate the oversight and determine whether such errors are being actively addressed by the proxy advisor. SLB 20 further requires investment advisors to periodically reassess their use of the proxy advisor, taking into consideration possible changes in the firm's business or conflict of interest related policies.

It is important to note that, while recent SEC guidelines, issued for the specific purpose of providing an indirect regulatory framework of proxy advisors within the federal securities regulation scheme[84], emphasise the quality control role played by investors, affecting the duties of investment advisers related to their internal controls, the European Directive Drafts do not explicitly provide for carrying out any form of critical and standing "review" on the proxy advisor services on the part of client investors. In the European regulations currently under discussion, forms of control concerning the adequacy and quality of proxy advisory services on the part of investors remain therefore primarily subject to self-regulation: in particular, to the provisions (possibly) contained in stewardship or corporate

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[81] *See* Department of Labor - Employee Benefits Security Administration (DOL-EBSA), *Interpretative Bulletin relating to written statements of investment policy, including proxy voting policy or guidelines,* 29 CFR 2509.94-2, at https://www.gpo.gov/fdsys/granule/CFR-2007-title29-vol9/CFR-2007-title29-vol9-sec2509-94-2, later partly amendend in 2008: *Id*., *Interpretative Bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines,* 29 CFR 2509.08-2, available at https://www.gpo.gov/fdsys/pkg/CFR-2011-title29-vol9/pdf/CFR-2011-title29-vol9-sec2509-08-2.pdf.

[82] An overview of such developments is *ex multis* provided by Daniel M. Gallagher, *Outsized Power*, 2 ff.

[83] SEC-Staff Legal Bulletin No. 20 (IM/CF), *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Avbailability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, 30 June 2014, at http://www.sec.gov/interps/legal/cfslb20.htm#_ftn1.

[84] SLB 20 also directly adresses proxy advisory firms, to the extent these are subject to the federal proxy rules because they engage in a solicitation. While proxy advisoring generally constitutes a solicitation subject to the information and filing requirements, SLB 20 clarifies the conditions under which the exemptions rules 14a-2(b)(1) and 14a-2(b)(3) under the Securities Exchange Act of 1934 apply to proxy advisors.

governance codes, concerning the "responsibilities" that in this specific context refer to institutional investors' duties in exercising their voting rights[85], and on information provided by proxy advisors, via self-regulation and Article 3i, that helps investor-clients to carry out quality controls[86]. While this set of circumstances may not yield a sufficent level of monitoring of proxy advisors, especially when it comes to their smaller clients, the discipline drafted at the European level may still be preferable at the present stage, considering that a more comprehensive approach, as that followed by the SEC, may render compliance excessively burdensome for smaller investors[87].

Nonetheless, concern can still be expressed regarding the possible effects on the European market of proxy advisory services, of an indirect regulatory framework that, while based on a so-called soft law (comply or explain), requires - to a very broad circle of recipients - that relatively detailed information is regularly disseminated concerning the voting conduct and the corresponding reasons. Although the measures under consideration would certainly not impose an obligation on the part of the investor to vote at the shareholders' meetings (a decision which, of course, remains within the discretion of the shareholder), these would still induce increased pressure to exercise voting rights, and could adversely affect the quality of the engagement with respect to investee companies, contrary to the intentions put forward by EU legislators.

What is therefore important to emphasise is that the possible perception of the existence of a sort of "almost-duty" to vote could induce, especially among investors with less commitment towards shareholder activism, a formalistic stance to the fulfilment of the rule proposed under Article 3f[88], promoting the slavish application of the voting recommendations put forward by the proxy advisors, and - as it happened in the United States - an over-reliance on advisory services. In the event that such circumstances materialise, the competitive structure of the proxy advisory market, predominantly involving two major players, contributes to increasing the risk that these forms of voting decisions outsourcing may give rise to herding phenomena in the process of exercising voting rights and lead to potentially suboptimal voting decisions[89], given the concerns regarding the qualitative performance of proxy advisory services already highlighted: a risk that the foreseen European regulation is willing to counterbalance primarily by means of the duties of transparency that would be imposed on proxy advisors in this respect.

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[85] *See e.g.* the Best Practice provision No. IV, 4.5 of the Dutch Corporate Governance Code, according to which the shareholder that makes use of third parties' voting recommendations «is expected to form his own judgment on the voting policy of this adviser and the voting advice provided by him», as well as Principle No. 3(4) of the Swiss *Richtlinien für Institutionelle Investoren zur Ausübung der Mitwirkungsrechte* of 21 January 2013.

[86] *See* the 2014 BPP, at 12 ff, requiring disclosure regarding the quality of the service provided and the proxy advisory firms' organisation.

[87] *See* Peter Böckli, *Proxy Advisors*, at 215.

[88] *See* ECLE, *Shareholder Engagement and Identification*, February 2005, 3 f., available at http://ssrn.com/abstract=2568741, recommending engagement policy rules to be adopted rather within a Commission's recommendation than through a legal comply or explain rule, and Klaus J. Hopt, *Europäisches Gesellschaftsrecht im Lichte des Aktionsplans der Europäischen Kommission vom Dezembrer 2012*, ZGR, 208 (2013).

[89] *See* Mats Isaksson and Serdar Çelik, *Who Cares?*, 52.

Overall, the Council's approach should therefore be favoured, requiring from institutional investors and asset managers public disclosure of voting records only with respect to single investee companies in which they hold at least 1% of the voting rights (Article 3f (1) (b))**.** For holdings underneath this threshold, "a general description of their voting behavior" (and of their use of the services of proxy advisors) would sufficiently enough serve end-investors need for information, while not (excessively) disincentivizing (informed) voting. Contrary to the Commission's and the Parlament's Drafts, which require disclosure on all votes cast in a generally undifferentiated way[90], the Council mandate at least partly counterbalances the risk of voting outsourcing for compliance reasons [91], and demonstrates to take into account that considerations exist, that indeed can differently drive investors to engage with investee companies[92].

6. Potential drawbacks associated with the effectiveness of the Draft Directive's direct regulation of proxy advisors

A code of conduct, basically founded on information, primarily aims at efficiently positioning the agency relationship between investor-clients and signatory proxy advisors, to the benefit of the market's efficiency overall. A comply or explain requirement, as set down by Article 3i of the Council's and the Parliament's Drafts, strengthens the reach of self-regulation in a para-legal sense. Such a rule aims, first, at realizing transparency as to how proxy advisory firms active in Europe position themselves with respect to self-regulation. Second, and strictly related, at urging signatories to behave consistently with their statement of compliance, given that a conduct *de facto* divergent from compliance statements may be enforced via market reputation mechanisms, as well as through possibile (although not easy) investor damage claims. Third, more generally, at exercising pressure on market participants to comply with the code[93].

Comply or explain requirements set by the law with reference to codes of conduct do not normally run parallel to further legal rules requiring disclosure on is-

[90] According to Article 1 (2) (f) and (g) of the Commission's Proposal, Chapter 1 B, and therefore rules requiring disclosure of voting records, would apply to EU life assurance undertakings and EU occupational retirement institutions ('institutional investors'), as well as to AIFMs, UCITS management companies and investment firms providing portfolio management services in accordance with the MiFID, thus extending the categories of recipients already subject to voting policies disclosure requirements (limited at present to management companies subject to AIFM and UCITS regulation). Overlappings between the rules under discussion and the AIFMD as well as the UCITS rules are criticised by EFAMA, *EFAMA's Views on the European Commissions' legislative proposal for a Directive amending Directive 2007/36/EC*, October 2014, 3 f and annex, available at https://www.efama.org/Publications/Public/Corporate_Governance/14-4068_FinalPositionPaperSRDII_290914.pdf.

[91] *See also* No. 11 (a) of the Council mandate of 25 March 2015.

[92] Specifically, these considerations include informal engagement, the type of investor, the ownership structure of the issuer concerned, the number of holding lines in investors' portfolios, and the lack of an adequate protection of investors involved in an engagement policy against the negative consequences of their actions in terms of acting in concert and receinving privileged information: *see* ECLE, *Shareholder*, 2 f.

[93] *See likewise* Peter Sester, *§ 161*, in Gerald Spindler and Eberhard Stilz (*Eds*.), *Kommentar zum Aktiengesetz*, 2nd Ed., vol. 2, München, 2010, No. 8-9, at 29 (referring to the comply or explain provision of para 161 *Aktiengesetz* with regard to the German Corporate Governance Code).

sues significantly overlapping with those considered by self-regulation itself. Instead, legal rules of this kind more frequently follow an insufficient or not satisfactory acceptance of, or compliance with, self-regulation, and thus derive therefrom. For this very reason, the double-layer direct draft regulation of proxy advisors arranged by the Council and by the Parliament may somehow surprise. However, one should consider that signatories to the BPP – reasonably the prevailing self-regulatory framework for proxy advisors – appear at present not to include a number of smaller proxy advisors based in single Member States[94]. Therefore, relying on the sole comply or explain rule could result in asymmetric transparency effects. If this is the case, then it remains questionable whether or not the Commission's Proposal, laying down transparency rules applicable to any player, while overseeing self-regulation, would finally better serve the scope of providing a discipline generally applicable to proxy advisors operating in Europe.

Among the most immediate issues regarding the rules proposed, directly applicable to proxy advisors, that relating to the territorial scope of application is of prime relevance, given that proxy advisors incorporated outside the European Union are the major players within the domestic market. An essential condition to the effectiveness of the rules under discussion is therefore that third-country proxy advisors would be subject to[95]. Otherwise, the regulation of the preponderant part of a business that has effect on European issuers would remain subject, and on a voluntary basis only, to self-regulation, penalising local and smaller businesses in terms of competition.

In the Commission's proposal (and of the European Parliament) the competence of Member States to regulate proxy advisors pursuant to Chapter 1B is identified on the basis of the title related to the place of registration of the issuer under analysis[96], favouring the protection of the specific domestic market where the voting recommendations are of actual importance, regardless of the registered office of the proxy advisor and of that of the investor hiring it. A more measured approach is endorsed by the Council, adding a subparagraph to Article 1 (2) of Directive 2007/36/EC which identifies the competent Member State as that "in which the proxy advisor has a registered office or a head office, or where the proxy advisor has no registered office or head office in a Member State, (that) in which the proxy advisor has an establishment" [97].

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[94] Not by chance does the ESMA find that the number of signatories to the BPP is less satisfactory then the width of the Principles' impact in terms of size of the signatories and their geographical coverage: ESMA, *Follow-up*, at 14.

[95] *See* No. 14a of the Council mandate, stating "In order to ensure that this Directive has an impact on practices of third-country proxy advisors which provide analysis with respect to EU companies, proxy advisors having their registered office or their head office outside the Union which carry out their activities through an establishment located in a Member State should be subject to this Directive, regardless of the form of this establishment".

[96] The Commision's and the Parliament's Drafts do not see any amendment to Article 1 of the SRD of 2007.

[97] Article 1 (aa) (ii) of the Council mandate. *See further* No. 14 (a), Article 3i (4a), and Council of the European Union, *Opinion of the legal service. Extension of the territorial scope of the proposed Directive to thirdcountry intermediaries and to thirdcountry proxy advisors*, Brussels, 16 December 2014, 16979/14, No. 28, note 22, at 10, and No. 25, at 9, identifying in such an establishment, *regardless of its form* (a branch, an office, etc.), the relevant territorial link for exercising jurisdiction over third-country proxy advisors operating inside the Union.

Jurisdiction criteria related to the place of registration of the issuer, and therefore requiring the application of specific transparency standards (and a corresponding system of sanctions) set by each Member State, would hold proxy advisors to a set of non-coincidental schemes of regulatory compliance, with fragmentation effects contradictory with respect to the purpose of EU intervention, to ensure a uniform level playing field. Instead, anchoring the discipline to an organisation (of whatever form) of the proxy advisor located in the domestic market would be preferable when it comes to the costs associated with regulation. The comparatively lower regulation cost for recipients would not be accompanied by a reduced level of protection of domestic markets in which proxy advisors operate without establishing local establishments. In fact, whatever the national market towards which voting recommendations are directed may be, information consistent with EU requirements would be required, even if subject to the law of a different Member State.

From another standpoint, European regulation that has been drafted is completely lacking in provisions concerning the exchange of information between the issuer under analysis and the proxy advisor. Contrary to what is recommended by the AMF and despite criticism in this regard expressed by several parties[98], the Draft Directive dos not consider an opportunity for the company to receive prior information on the (draft of) voting recommendations, and to liaise with the advisor if it considers any of the recommendations misleading. A monitoring concerning the accuracy of the voting recommendations (and of the underlying assumptions and verifications) and their consistency with the corporate and local framework, would then be left (in the Council document) primarily to the information periodically provided by the proxy advisor, and to investor-clients' controls, or (according to the Commission and the European Parliament documents) could possibly fall within the scope of decisions made by the Member States in the transposition of the first paragraph of Article 3i[99]. This last solution, however, could lead to the possible adoption of heterogeneous measures between Member States.

Although, in the absence of a practice focused on prior discussion and dialogue with issuers, a company may of course choose to issue a statement explaining the

[98] The AMF's recommendation No. 2011-06 requires proxy advisors to allow issuers for commenting on voting recommendations, in order to permit possible corrections thereof; where no such dialogue practice is put in place, proxy advisors are requested to explicitly explain the reasons why in their proxy anlysis report to clients. A similar approach is favoured by Deutsches Aktieninstitut, *Vorschlag mit Nebenwirkungen: EU Kommission fördert (unintendiert) Geschäftsmodell von Hedge Funds*, November 2014, at 13 ff, available at https://www.dai.de/files/dai_usercontent/dokumente/positionspapiere/2014-11 06%20Stellungnahme%20DAI%20Aktionaersrechterichlinie%20FINAL.pdf, considering an issuers' review of voting recommendations provided by proxy advisors to be a fundamental part of a regulation of proxy advisory firms. *See also* Bryce C. Tingle, *Bad Company!*, 748; Regierungskommission Deutscher Corporate Governance Kodex, *Stellungnahme zum Vorschlag für eine Richtlinie des Europäischen Parlaments und des Rates zur Änderung der Richtlinie 2007/36/EG*, 30 Jaunuary 2015, 7, at http://www.dcgk.de/de/kommission/die-kommission-im-dialog, as well as Peter Böckli, *Proxy Advisors*, at 221.

[99] Requiring Member States to ensure that proxy advisors adopt and implement adequate measures to ensure that voting recommendations are accurate and reliable, based on a thorough analysis of all the information that is available to them.

reasons for inconsistencies it finds relating to voting recommendations that have already been expressed[100], the European position to not regulate this aspect in any way is certainly open to criticism. These concerns, however, can be scaled down, considering that any entitlement of the issuer to the prior discussion of voting recommendations could further complicate the compliance with the statutory deadlines established for the provision of information prior to general meetings (particularly with regard to the submission of information documents intended to be submitted to the general meeting), or delay the delivery of the proxy analysis report to the shareholder-client too close to the meeting date, limiting the time available for subsequent voting evaluations, without taking into account the dysfunctional effects of possible "disputes" between the advisor and the company[101]. Furthermore, recognising an issuer's right to exchange information with the proxy advisor could provide a broader basis for litigation (difficult but still configurable) for issuers claiming a proxy advisors' liability for breach of negative duties to not damage the interests of the issuer. A consequence of this kind might appear incongruent with the regulatory plan proposed at the European level, which at least at an initial stage aims to directly impact only in terms of information transparency.

But the very nature, apparently quite generic, of the information subject to transparency on the part of proxy advisors, raises questions concerning the efficacy of the discipline. Because accessing information is important as long as it serves investor-clients' decision-making as to how to vote, disclosure requirements are important as long as they are able to effectively support the decision-making process. This much depends, first, on the information subject to discolure according to the law, and, second, on the actual quality of information subsequently disclosed. Information regarding the "essential features" of "methodologies and models" applied, as well as the "main information sources" used, could easily justify a disclosure formally consistent with the corresponding requirements under Article 3i (2), but which in essence does not allow the shareholder-client a significantly deeper appreciation of what is already possible today. Most of the information regarding proxy analysis and research, which European Drafts deal with, is in fact generally already available to the shareholder-client today[102].

On the other hand, one should recognise that defining transparency requirements of a more specific nature, for achieving more effective information, cannot be separated from the search of a suitable point of equilibrium with the opposite need to not violate the legitimate expectation of proxy advisory firms to maintaining confidentiality on information, whose disclosure could negatively affect know-how gradually gained with regard to the methods and procedures used,

[100] Which appears to be not uncommon, given that voting recommendations are often made publicly available (while the underlying report is provided only to subscribers): *see* for the US context Colin Diamond and Irina Yevmenenko, *Who is Overseeing*, 606 and note 3.

[101] *See* for a similar view GeorgeW. Dent Jr., *A Defense*, 1316, Dirk Zetzsche and Christina Preiner, *Der Verhaltenskodex*, at 693, drawing attention to potentially acute conflicts of interest deriving from pressures possibly exerted on proxy advisors during dialogues held prior to shareholders' meeting from the issuer's lawyers, and Holger Fleischer, *Zur Rolle*, at 9.

[102] *See* likewise Philip Schwarz, *Institutionelle*, 325 f.

which in fact constitutes for the firms one of the main factors of competitive advantage[103].

Information concerning the "essential features of the voting policies applied for each market" and the manner in which a proxy advisor takes into account the national market, legal and regulatory conditions, could be just as limited in scope, if not provided within a more detailed context[104]. As far as considering local market conditions is concerned, requiring information that only concerns variations from specific provisions (of corporate governance codes and further self-regulatory framework), and the reasons for these variations, would better facilitate a more immediate appreciation of proxy analysis[105]. More generally, the efficacy of a disclosure requirement regarding voting policies could further be limited by the fact that transparency can only refer to an advisor's house voting policies, while the majority of proxy advisors' voting recommendations appear in fact to be now based on clients' custom voting policies that are in principle confidential[106].

Questions arise also regarding the enforcement of the regulation. Given that there is actually neither a specific standing review body which covers the industry to monitor the signatories' compliance to the BPP, nor a public enforcer, if a comply or explain rule on the adherence to best practice codes were confirmed, it might be appropriate to also provide a form of legal legitimacy of private supervisory bodies (still to be created) regarding the compliance with self-regulatory provisions. It could be possible, for example, to recognise by law the authority of these organisms to publish, in case of repeated non-cooperation of the parties involved, its position by making known the identity of the non-compliant firm[107].

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[103] *Id*., at 326.

[104] For example, the ESMA significantly finds that there is room for improvement in the BPP in the area concerning disclosure on how voting policies are applied to produce voting recommendations, and that, subsequently, signatories' compliance statements generally contain limited information on this issue: ESMA, *Follow-up*, at 22, and at 26, No. 81.

[105] *See* DAV, *Stellungnahme*, No. 37 at 17. *See further* ESMA, *Follow-up*, at 26, No. 83, finding that most statements of BPP signatories "do not make clear if clients will be informed of *how* such conditions are taken into account".

[106] *See* note 57.

[107] According to the compliance monitoring model identified by the BPPG (*see* Proxy Research Providers Announce Feedback & Monitoring Mechanisms of 10 February 2015, available at http://bppgrp.info/wp-content/uploads/2014/03/150210-BPP-Group-Consultation-Press-Release-Monitoring.pdf), signatories are requested to provide their disclosures in a format that allows for a comparison showing if and how each signatory has implemented the Principles and related Guidance (the template of the comparative framework, expected to be published on the BPPG website in early Q4 2015, is apparently not yet available on the BPPG's website by 7 January 2016). The comparison will be disclosed on the BPPG's website for review by other stakeholders, who are given the possibility for a feedback. While the former Chair considers that the Committee can decide to make a stakeholder's grievance public together with a statement of disapproval regarding the signatory's non-compliance, the Committee has not decided on the procedures regarding the feedback mechanism: *see* Dirk Zetzsche, *Report of the Chairman of the Best Practice Principles Group developing the Best Practice Principles for Shareholder Voting Research & Analysis*, 12 May 2014, 18 f, available at: http://ssrn.com/abstract=2436066. *See also* Securities and Markets Stakeholder Group, *ESMA Call for Evidence on the Impact of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis. Opinion of the SMSG*, 14 September 2015, ESMA/2015/SMSG/026, at 5, and further ESMA, *Follow*-up, at 35 ff,

The possible anticompetitive effects of the proposed regulation are worth final consideration. Transparency obligations may be penalising in particular for smaller proxy advisory firms[108], possibly causing them to withdraw from the market or resulting in their acquisition by leading firms, with further concentration of the market and a corresponding strengthening of the barriers to entry. However, creating an exemption for smaller advisory firms would not be justified. One should also consider that smaller firms without financial industry affiliates, not selling services to issuers and not using house voting policies, are likely to have few potential conflicts of interest relevant to proxy advisoring. In this case, procedures to be maintained could be simplified, and compliance with the rules under discussion overall less burdensome.

Finally, because unlike statutory audits, proxy advisory services are not mandatory, it cannot be excluded that a possible increase in advisory rates, due to higher costs incurred as a result of regulation, could cause investors who (due to the limited opportunities to invest in dedicated internal resources or to entrust more than one proxy advisor) seem to rely more heavily on voting recommendations, and who are more exposed to the corresponding weaknesses of the system[109], to renounce the use of the service. This could in turn increase the risk of formalistic engagement, with an outcome opposite to that which European lawmakers intend to achieve.

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both recognising the need for strengthening independent monitoring on the implementation of the Principles by the Committee.

[108] *See likewise* Deutsches Aktieninstitut, *Vorschlag*, 16, and, referred to SLB 20 of June 2014, George W. Dent Jr., *A Defense*, 1308 f., Sagiv Edelman, *Proxy Advisory*, 1405. For this very same reason, even the BPP were built up on a comply or explain principle: *see* Dirk Zetzsche and Christina Preiner, *Der Verhaltenskodex*, 688.

[109] *See also* Hans-UlrichWilsing, *Corporate Governance*, at 306; Sagiv Edelman, *Proxy Advisory*, 1404.