

ESMA's Discussion Paper on Proxy Advisory

Deutsches Aktieninstitut's response

25 June, 2012

Correlation between proxy advice and investor voting behaviour (IV.II.)

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

As it is the core of the business model of proxy advisors (PAs) to assist institutional investors in exercising their voting rights in general meetings, it is not surprising that there is a high correlation between proxy advice and voting outcomes. It would rather be surprising, if there was no significant correlation.

2) To what extent:

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

Unfortunately, there is no reliable empirical evidence on the influence PAs have in average. This is also due to the fact that there are different channels of influence working together in harmonising voting behaviour of institutional investors:

- Institutional investors may first perform their own analysis and then take the PAs' recommendations in order to make plausibility checks.
- Institutional investors may take the PAs' voting recommendations as a basis for their own analysis.
- PAs' voting recommendation's are „followed to the dot” by institutional investors without deviation and without own analysis.
- To a smaller extent PAs do not only give voting advice but offer to exercise the voting rights of the investor by using the depositary banking chain.

Anecdotal evidence that has come to the knowledge of Deutsches Aktieninstitut over the past two or three years indicates that the influence of PAs differs substantially between the companies. In terms of votes influenced or represented by proxy advisors in the general meetings there was a range from apparently no influence to influence on significantly more than 50 percent of the AGM presence. Concrete evidence is rather indirect in nature. One issuer for example reported that that rate of disapproval regarding the system of manager's remuneration increased from 1.7 percent to over 10 percent after Glass Lewis had changed its voting policy on this issue. Even if this change in

voting behaviour may have different reasons, it may also be an indicator for the influence of PAs.

In general Deutsches Aktieninstitut would expect the influence to be higher in companies with a) high percentage of foreign shareholders (in particular from the USA), b) high free float and c) a highly dispersed ownership.

While influence tends to have increased over the past decade on average because more institutional investors seek to exercise their votes actively and the shareholder base has become more international, in more recent years a number of institutional investors have developed their own voting guidelines that may or may not be stricter from PA's voting policies. Thus the relative influence of PAs has come down a bit – at least according to the observation of some issuers.

b) would you consider this influence as appropriate?

As stated in our response to ESMA's call for evidence on this issue last summer the emergence of proxy advisors has benefits as well as potential drawbacks from the issuers' point of view. Basically it is to the benefit of issuers that proxy advisors lower the transaction costs of voting for investors (in particular for foreign investors) and thus increase the participation rates in general meetings as well as improve the understanding of investors' expectations and the predictability of investors' behaviour. Also issuers are well aware that PAs are the agents of investors (they pay for the PAs' services), so that it is basically up to the investors to evaluate the quality of PAs' advice and to decide whether to pay for it and whether and to what extent to follow it.

But issuers have also raised the concern that PAs may develop into powerful market participants and de facto standard setters, because investors may lack resources and willingness to check the appropriateness of PA's voting recommendations for individual companies and issuers. This concern is backed by the impression of many issuers that in particular foreign institutional investors de facto follow the recommendations of PAs without undertaking own analysis of the individual situation of the company in question.

Investor responsibilities (IV.III.)

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

If any, a shift of investor responsibility may only take place de facto if investors contract a PA in order to comply with a particular regulatory voting recommendation but are in fact uninterested in the concrete voting policy and/or in casting votes on informed basis. In this situation, uninformed box ticking may occur.

However, from an economic point of view the responsibility of investors to decide whether to attend AGMs and how to vote will be untouched even in this situation. Investors are always free to engage a PA or to cast votes under own responsibility. From this perspective the engagement of PAs is simply a division of labour that saves transactions costs for the investors.

Conflicts of interest (V.I.)

4) To what extent do you consider proxy advisors:

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

b) have in place appropriate conflict mitigation measures?

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

See answer to Q5.

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

a) which conflicts of interest are most important?

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

From Deutsches Aktieninstitut point of view a conflict of interest arises when proxy advisors offer voting recommendations or prepare general corporate governance rankings combined with the offer of advisory services on corporate governance topics to issuers at the same time. In theory, offering services for both investors and issuers, may create the risk of impaired advice.

However, Deutsches Aktieninstitut doubts that the potential conflicts are serious enough to have de facto influence on the preparation of voting recommendations. Also, there is no empirical evidence that such additional services have an impact on the voting recommendations. Against this background we would welcome transparency on potentially conflicting activities, which will help to assess, if there are potential conflicts and whether they already properly addressed by PAs.

Voting policies and guidelines (V.II.)

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

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

Taking local market conditions into account has surely improved over the past years.

However, issuers still make the experience that PAs do not fully reflect the local legal conditions in their voting guidelines, which may have both significant consequences for the issuers in question and lead to an unequal treatment between issuers from different jurisdictions.

- For example, some German issuers reported that the German legal environment with regard to capital increases is not completely understood or at least not accepted by some PAs. For example the ISS guideline defined a limit of 20 percent for issuance requests without preemptive rights which is more restrictive than the 50 percent limit of the German law. GlassLewis goes even further in setting the limit at 5 percent. Additionally, issues of new shares that are performed under the regime of art. 186 III 4 of the German Stock Corporation Law (*Aktiengesetz*) are included in the calculation of the ISS limits. Art. 186 allows a so-called „*erleichterter Bezugsrechtsausschluss*“ (simplified way to issue new shares without pre-

emptive rights) under the conditions (i) that a maximum of 10 percent of new shares is issued and (ii) that the price of the newly issued shares is close to the current market price. Thus, this particular kind of capital increase is economically equivalent to issue with rights, as an investor who likes to avoid any dilution effect is free to buy shares in the market after the issue has taken place at a market price that is nearly unaffected by the newly issued shares. Nevertheless ISS treats this particular form of capital increase the same way as usual capital increases without rights issues, which appears not to correctly reflect the economics and reduces the ability of issuers to flexible raise capital if it is necessary.

- With regard to corporate governance there is also the general impression that PAs' advices often tend to rather reflect the anglo-saxonian understanding and institutions of corporate governance. For example, the division of labour in the German two-tier-system (with a separated supervisory board and a management board) is not always well understood as is the system of co-determination. For example ISS guidelines with respect to the independence of the supervisory board only partly reflect the fact that there are representatives of employees in the supervisory board. Concretely, the ISS guideline for Germany states the one third of the complete (supervisory) board has to be independent. Compared to other jurisdictions where the quota is 50 percent this appears more generous on the first look. In fact the guideline for Germany is stricter, because the general meeting in Germany can only determine the representatives of the shareholders and half of the board consists of unindependend employee representatives.

These two examples demonstrate that PAs' recommendations can have significant consequences for issuers and/or issuers' corporate governance. Many issuers therefore would prefer that voting recommendations better reflect local legal conditions so that issuers from different countries are treated equally.

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

ESMA is right in its analysis that there is no general rule how guidelines are developed and to what extent issuers can participate. Currently, the process varies from PA to PA.

Only ISS has set up a more formal process of amending its guidelines, which involves investors and – at least to some extent- also issuers. Other PAs are sceptic with regard to a dialogue with issuers, in general, or collect the views rather occasionally and informally.

Furthermore, there is the general impression that the openness to take the issuers' into account is rather limited on the level of the voting guidelines, while there is more flexibility with respect to specific voting recommendations.

Against this background, it would be preferable that guidelines are open for comment also for issuers before they are issued. At the minimum, voting guidelines of proxy advisors should be made transparent to the general public in due time so that the issuers may consider to adjust their AGM proposals

accordingly (as this seems already the case in many, but not all circumstances) or know in advance that they have to undertake more efforts to convince their shareholders of the issuer's view.

Voting recommendations (V.III.)

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

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

We do not have more knowledge than the explanations in ESMA's Discussion Paper, which shows that there might be a certain lack of transparency on which information the voting recommendations are based on.

However, this would not be a problem if a dialogue with the issuer took place where he could comment on the recommendation in advance and could highlight possible serious factual errors (see below).

b) the dialogue with issuers when drafting voting recommendations?

To our knowledge there is no general rule if, when and how a dialogue between issuers and proxy advisor takes place as this depends on both the respective proxy advisor and the individual analyst at the proxy advisor.

Looking at the individual voting recommendation, it is basically up to the issuer to contact the PA in order to enter into discussion. From the issuers' perspective such a dialogue is necessary for at least the following reasons:

- Issuers have reported that there are huge differences with respect to the accuracy and completeness of reports of the proxy advisors so that the dialogue may improve the quality of reports.
- Whenever a particular recommendations do not properly reflect the individual situation of the issuer (see above), issuers wish to engage in a closer discussion, even if advices are often not changed afterwards.

In sum, there could still be improvement regarding the dialogue with issuers and proxy advisors, even if some improvement has already taken place. In particular, it would be helpful if the proxy advisor sent a draft of the voting recommendation to the issuer before its finalisation and the passing on of voting recommendation to the investors, so that the issuer could comment on its completeness and accuracy in a certain (short) period of time. Factual errors discovered by the issuer then should be corrected by the proxy advisor. In case of dissent on a particular voting recommendation the proxy advisor should preferably also pass the dissenting opinion of the issuer together with his own recommendations to the investors.

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

Without doubt, the staff of the proxy advisors should be skilled and professional up to a high degree. However,, we do not think that it is appropriate to interfere with the recruitment practice of the proxy advisory agencies. We

prefer instead, that issuers get the chance to comment on drafted recommendations before they are sent out to the investors in order to avoid factual errors (see above) Also, having inexperienced personell should result in a lower quality of voting recommendations and thus fall back on the proxy advisor itself, so it is in its own interest to have qualified personnel and/or organisational measures to cope with potential errors

Policy options (VI.IV.)

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

From the issuers' point of view it is important that any possible regulation finds the right balance between enabling and improving the dialogue between issuers, PAs and the investors on the one hand and avoiding massive additional costs for investors and PAs on the other hand which would reduce the ability to provide PA services and/or to participate in the voting process.

Against this background we oppose a binding EU regulation (option 4) and would prefer some kind self regulatory standards instead. For example a code of conduct for proxy advisors combined with a duty to explain if they deviate from the recommendations of the code (comply or explain). This would give the proxy advisors some level of flexibility to consider its own specialities. Code of conducts and the comply or explain-principle are furthermore highly accepted with regard to the governance of listed companies, so that a similar regulatory principle with regard to the governance of the voting process appears to be preferable.

However, we have concerns with regard to ESMA being in the leading role in developing the code or even in monitoring its compliance, because we do not recommend a monitoring system by any national or international authority or a duty to register at this authority. From our point of view PAs' services are strongly related to corporate governance and company law issues. So the responsibility should rest with national legislators, the EU Commission or the industry itself. We, however, see the advantage in a harmonised EU approach with regard to this particular issue. The business of proxy advisors is by large a cross boarder activity so that it will be of advantage for all market participants if they have an EU wide set of standards.

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

No suggestion.

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

A code of conduct for PAs based in Recommendations by the EU Commissions should include the following elements:

- A duty to publish the voting policy in due time. Furthermore, these guidelines should be open for comment also for issuers before they are issued and the process of amendment should be transparent in terms of decisions taken.
- A duty to give the issuers the opportunity to check the draft of the voting recommendation on its completeness and accuracy in a certain (short) period of time before its finalisation. Factual errors then should be corrected by the proxy advisor. In case of dissent on a particular voting recommendation the proxy advisor should ideally also pass the dissenting opinion of the issuer together with the PA's voting recommendations to the investors.
- A duty to take into consideration local market conditions when establishing voting policies by at least giving the issuers' the option to comment on voting policies.
- A duty to publish possible conflicts of interest or at least to inform the client / investor about them when providing the voting recommendations.

The reasons for a need of non-binding rules in these areas you can find in the answers to questions 4 to 7.

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

a) barriers to entry and competition;

No comment. This should be left to the appraisal of the proxy advisory industry.

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

We believe that an EU wide harmonised code of conduct would help to strengthen the investor responsibility. Having the possibility to use voting recommendation which are commented (or even corrected with regard to facts) by issuers will also be helpful for the investors.

c) any other areas?

No comment.

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

We do not see a difference here on EU-level and national level.

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

As stated above, issuers welcome the role of proxy advisors as intermediaries of the voting process, in particular for foreign investors

Their main request is to make sure that the investor dialogue works as smoothly as possible. In particular, issuers are interested in a fair and transparent dialogue with proxy advisors including a fair chance that the issuers' point of view is properly understood and reflected in the voting guidelines and recommendations.

At the same time, issuers are not interested in a regulatory setting which would destroy or heavily disturb the business model of proxy advisors by for example limiting activities or making them extremely costly. Costs will be passed on to the PA's clients, i.e. the investors, which might lead to lower participation rates in general meetings and/or higher capital costs.