Ascensión Gallego Córcoles
Lecturer of Commerical Law
PhD in Law (with international Mention)
University of Castilla-La Mancha
Albacete Law School,
Plaza de la Universidad, 1 | 02071, Albacete (Spain)

Mr. Brent J. Fields,
Secretary Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

via SEC internet submission form

Re: File No. 4-725 - SEC Staff Roundtable on the Proxy Process

Dear Mr. Fields,

I am Lecturer of Commercial Law at the University of Castilla-La Mancha in Spain [PhD in Law (with international Mention)]. Part of my research has focused on the voting process at general meetings with particular attention to the role of proxy advisors in the corporate governance. In fact, I am the author of some publications on this topic (including a monograph).

As the role of proxy advisory firms is one of the topics proposed for discussion at the Roundtable on 15th November 2018, I really do welcome the initiative of hosting a Roundtable by the Securities Exchange Commission and, particularly, the opportunity granted to investors, issuers, and other market participants to contribute to the discussion on the proxy process and rules. Therefore, I am pleased to submit a comment and to provide my view as a member of the academic community.

The following are some of the findings of my research with regard to some of the questions posed for discussion by the SEC:

- *Stimulating factors for the proxy advisory industry*. It has been argued that the duties relating to the exercise of voting rights imposed on some institutional investors are stimulating factors for the proxy advisory industry. A distinction should be made among these duties. On the one hand, the importance of the mandatory exercise of voting rights should be deemed relative, as institutional investors are not generally required to vote on every proxy item. Besides, when voting is mandatory, institutional investors may refrain from voting under some circumstances when it is not economically efficient. On the other hand, both the disclosure duties on the voting policy and the disclosure duties on the way the voting rights have been exercised help to stimulate the exercise of voting rights (or, at least, to take such exercise into consideration) and thus constitute incentives to demand for the services of proxy advisors. The post-vote service some proxy advisors provide by facilitating information on the outcome of the

vote appears to be very useful in order to fulfil the disclosure duties on the way the voting rights have been exercised.

Morevoer, as ESMA pointed out[1], proxy advisors may play an important role for institutional investors, as proxy advisors help to obtain, to filter or even to translate information from various issuers (which is seen of special value when investing in foreign securities).

As an additional factor it could be mentioned the two SEC letters on the voting rights by investment advisors with discretionary voting authority on behalf of their clients [Institutional Shareholder Services, Inc. SEC Staff Letter (Sept. 15, 2004); Egan-Jones Proxy Services, SEC Staff Letter (May 27, 2004) and SEC *Rule* 206(4)-6 *Investment Advisers Act* 1940]. Also some situations leading to a separation between the investment‘s ownership and the decision-making power (as tenure of shares “in street name” or as the issuance of ADSs) contribute to the rise of the proxy advisory industry.

- *Conflicts of interests.* Some conflicts of interests are giving rise to concerns on the impartiality of proxy advisors’ recommendations. In the literature, the attention has been paid mainly to the provision of consulting services to issuers and shareholders at the same time. Together with this one, it is possible that the holders of the control of the proxy advisor or its employees have links with (or particular interests in) the issuers, the members of the board of the issuers or the issuers’ shareholders. These are just some examples.

  The best way to deal with conflicts of interests is transparency. Thus, once the investors have been warned of the situation, they should assess whether the provision of the service in such conditions is likely to affect the impartiality and usefulness of the advice. The information should be given *before* hiring the services of the adviser and it should not depend on a previous request from the client. To this purpose, it is certainly insufficient to use a *boilerplate* language in any communication with the clients just warning them of the mere *possibility* of the existence of links that may give rise to conflicts of interests, without providing specific data whether or not it is in fact the case.

- *Regulatory framework.* It is necessary to strike a balance between some aspects that should be subject to regulation (conflicts of interests and the establishment of supervisory mechanisms) and others that should be subject to market governance practices. The registration of proxy advisors and their submission to supervision, with the disclosure of certain identifying features of the service provider and the transparency with regard to conflicts of interests are necessary to provide a minimum of legal certainty and trust in the market and to prevent future market failures.

[1] ESMA, Discussion Paper ‘An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options’, March 22, 2012, p. 10.

The guidelines released in June 2014 by the Divisions of Investment Management and of Corporate Finance of the SEC constitute small steps in the right direction, but their scope is very narrow as they just apply to very specific cases. Besides, they are not a rule or regulation, but just interpretation and application criteria on existing US federal law.

For further details, I attach one of my papers on this topic, where I analyse the role of proxy advisors in the voting context and I put forward some considerations for future regulation.

Sincerely,

Ascensión Gallego

Proxy Advisors in the Voting Process: Some Considerations for Future Regulation in Europe

by

Ascensión Gallego Córcoles*

The role of proxy advisors and their possible regulation has become a matter of particular interest since the European Commission released the Green Book on Corporate Governance in April 2011 and the ESMA began its analysis and consultation that summer In the last year, the industry has developed its own code of conduct as recommended by ESMA and the European Commission has decided to slightly approach to them by incorporating some proposals in the context of the revision of the Shareholder Rights Directive. Despite these steps, there is still a lack of regulation on this field. ESMA has recently launched a Call for Evidence to assess the impact of the code of conduct.

Just as has happened to other service providers, the lack of regulation on proxy advisors contrasts with the power they in fact hold. This power is exercised not only in the determination of the way voting rights are cast at general meetings worldwide, but also, which is even more striking, in the board's preparation of proposals for general meeting resolutions.

The scarcity of literature on this highly topical question endows this paper with particular interest. It aims to reflect on the role of proxy advisors in the corporate governance of listed companies. In fact, together with the high concentration of the industry, one of the new challenges to be faced by this sector is the overcoming of the problems associated with the provision of proxy advisory services. In this context, the paper addresses the major questions raised with respect to the performance of proxy advisors, and proposes a framework of possible alternatives for future regulatory intervention.

* Lecturer of Commercial Law (Universidad de Castilla La Mancha, Spain). The author is simultaneously publishing a monograph in this area, on which this paper is substantially based [A. Gallego Córcoles, Asesores de voto (proxy advisors) y el ejercicio del derecho de voto en las sociedades cotizadas, Thomson-Reuters Aranzadi (2014)]. She expresses her gratitude to Prof. Dr. Theodor Baums, Director of the Institute for Law and Finance (Goethe-Universität Frankfurt am Main) for the kind reception at the Institute and, above all, for their indications and insightful comments. Her appreciation extends also to Mrs. Jella Benner-Heinacher, Chief Managing Director at Deutsche Schutzvereinigung für Wertpapierbesitz e. V. (DSW) and Chairman of the European Corporate Governance Institute Limited (ECGI), to Mr. Alexander Juschus, founder of IVOX, to Mr. Hans-Christoph Hirt, Executive Director at Hermes Equity Ownership Services Limited and to Mr. Nicolas Huber, Managing Director at Deutsche Asset & Wealth Management Investment GmbH (DWS Investments), for the enriching information they have provided her in the development of her research on the proxy advisory industry.

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I. Introduction: The increasing importance of proxy advisors

Since the European Commission released the Green Book on Corporate Governance in April 2011 and the ESMA began its analysis and consultation that summer, the role of proxy advisors and their possible regulation has become a matter of particular interest. Not only the European and Member State authorities and institutions have paid attention to them, but also the *Securities and Exchange Commission* (SEC) in the US and the *Canadian Securities Administrators* (CAS) in Canada. The OCDE had previously filed for more scrutiny of their activity.

Similar to what has happened to other service providers, the lack of regulation of the proxy advisory industry contrasts with the power they in fact hold. This power is exercised both in the determination of the manner in which votes will be cast at general meetings worldwide, and – which is even more relevant – over the proposals for general meeting resolutions drafted by the board.

Yet, such control over the sense in which votes will be cast should be made relativize. In fact, as ESMA has warned[1] and is frequently pointed out by the proxy advisory industry, the ultimate responsibility for the exercise of voting rights lays in the investors to whom proxy advisors render advisory services. Indeed, it is the investor who decides freely and autonomously whether to follow *blindly* what has been recommended by those who are supposed to be qualified and impartial professionals (at least on a theoretical level). As has been pointed out in the context of investment advice, *rendering advice should not be identified with "deciding for someone else", but with counseling someone who will later decide by himself*[2].

The problem is that the proxy advisory business is subject neither to specific rules that guarantee professionalism and impartiality in the service provider, nor to the control of supervisory authorities. Furthermore, it appears quite difficult to hold a proxy advisor liable either toward the listed company or toward the investor. The lack of a link with the first has led it to be considered mainly in terms of tort[3]. However, the difficulties in proving the damages and the cause-effect relationship are almost insurmountable. It could even be argued that the proxy advisor's reports are just opinions protected by the freedom of expression[4], in which case the offensive criticism of the issuer would not be protected[5]. With regard to the liability toward investors (their custom-

1 European Securities and Market Authority (ESMA), Discussion paper. An overview of the Proxy Advisory Industry. Considerations on Possible Policy Options, (March 22, 2012).

2 SAP Baleares, núm. 83/2013, March 5, 2013.

3 See, among others, A. Omaggio, 'Faut-il encadrer l'activité des agences de conseil en vote (*proxy advisors*)?', 46 La Semaine Juridique-Edition Entreprise et Affaires (2009) 29, 33. On the contrary side, based on the existence of a contract with protective effects for third parties (in this case, the issuers), see C.F. Vaupel, 'Ansprüche von Aktiengesellschaften gegen Stimmrechtsempfehlungen institutioneller Stimmrechtsberater', 3 AG (2011) 63, in particular, 66 to 69.

4 It recalls the debate regarding the credit rating agencies, with respect to which the EU has reinforced their accountability as ratings are not just simple opinions. See Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No. 1060/2009 on credit rating agencies.

5 Given the international nature of the situation, any requirement of liability for harm would also require considerations from a Private International Law point of view. An example of this is the case *LVMH vs. Morgan Stanley* settled by l'Arrêt Cour d'Appel of Paris on June 30, 2006.

ers), the existence of damage for an incorrect recommendation would probably be more questionable than in the case of rating agencies, the latter issuing ratings with a *regulatory use* and with a *direct* influence on economic decisions.

In any case, although the reference to the increasing recourse to these service providers by institutional investors is common in literature, it is difficult to ascertain their concrete level of influence[6]. Anyway, the fact is that it seems that their influence has been evident in some cases with certain public impact, not only in the United States (such as the case of the *HP- Compaq* merger in 2002), but also in European countries like Germany (such as the controversial appointment of the Chairman of the supervisory board of *Infineon Technologies AG* at the 2010 general meeting). Besides, their concrete level of influence appears particularly difficult to determine in the case of cross-border securities holdings, where the additional risk of losing track of the vote along the chain of intermediaries arises[7].

In the particular case of Spain, the influence of proxy advisors does not seem to be extremely high, given the concentrated structure of corporate ownership and the reduced presence of institutional investors in the Spanish listed companies' capital holding, as it was marked by the Group of Experts selected by the *Comisión Nacional del Mercado de Valores* (CNMV) to assess the impact of proxy advisors on Spanish issuers (April 2012). Nonetheless, the Group noticed the increasing influence of proxy advisors and that it is stronger on issuers with a higher level of free float[8].

In fact, the difficulties to estimate the influence of proxy advisors on Spanish issuers do not mean that proxy advisors have no influence at all. The studies that have been undertaken show that, even if their voting recommendations against a proposal do not usually lead to its rejection, they do result in a

6 This influence is encrypted by some authors between13.6% and 20.6%, while for others it amounts to 6–10%. See the references in Canadian Securities Administrators (CSA), 'Consultation Paper 25–401 – Potential Regulation of Proxy Advisory Firms' (2012), at 4 and 5; T. Belinfanti, 'The Proxy Advisory and Corporate Governance Industry: the Case for Increased Oversight and Control', Stan. J. L. Bus & Fin. (2008–2009) 384, 386; U. Schneider and H. Anziger, 'Institutionelle Stimmrechtsberatung und Stimmrechtsvertretung – A quiet guru's enormous clout', 10 NZG (2007) 88, 90; E. Atzler, 'Die Aktionärsflüsterer?', Financial Times Deutschland on Januar 27, 2010.

7 As an example see the press release published by Manifest with regard to the general meeting of *Lagardère* SCA on April 27, 2010, available at: http://blog.manifest.co.uk/2011/05/5015.html.

8 Grupo de Expertos, *Documento elaborado por el Grupo de Expertos para evaluar la actividad de los "proxy advisors" en relación con los emisores españoles (respuesta al DP-ESMA),* April 16, 2012, pp. 9 and 10. Available at: http://www.cnmv.es/DocPortal/Publicaciones/Grupo/InformeProxyAdvisors.pdf.

diminishment of shareholders' support[9]. The results regarding the Repsol, SA general meeting in 2014 are striking in that sense: all items on the general meeting's agenda got a support between 91,08 % and 99,88% of the capital attending the general meeting, with the exception of the item with regard to which proxy advisors had recommended to vote against. The proposal got in this case a support of 61, 75% and a rejection of 38, 2%[10]. Following the voting recommendations, some foreign institutional investors voted against[11].

Besides, the circumstance of being scrutinized by proxy advisors has an obvious *indirect* impact on the board (at least, by *forcing* the members of the board to take extra efforts -on the very eve of the general meeting- to justify their proposals and to convince shareholders of their virtues, when they deviate from proxy advisors' voting recommendations and when the members of the board have had somehow access to them). As an example, despite the ISS' recommendation of voting against the reelection of the Chairman and Chief Executive Officer of Iberdrola, SA at the general meeting held in 2015, he was reelected with 86,44 % of the support. The rest of the items on the general meeting's agenda got a support between 98, 65% and 99,

9 See R. Casado, 'Los grandes fondos meten presión a las empresas españolas', in *Expansion.com,* on October 10, 2014. Available at: http://www.expansion.com/2014/10/13/empresas/1413218225.html. According to the survey carried out by Funds People, Georgeson y Cuatrecasas, Gonçalves Pereira regarding the 2014 proxy season in Spain, the vote against the proposals submitted to the general meeting increased 9.72 points in 2014 when there had been a negative recommendation. However, there was a decrease of 3.67 points with regard to the abstaining percentage in 2013. On the other hand, when there had been a positive recommendation, the votes against decreased 0.18 points and the abstentions arose only 0.06 points. See Georgeson y Cuatrecasas, Gonçalves Pereira 'El gobierno corporativo y los inversores institucionales', p. 46, 2015 edition, available at http://www.georgeson.it.

10 See the information published by the issuer at http://www.repsol.com/es_es/corporacion/accionistas-inversores/gobierno-corporativo/junta-general-de-accionistas/jga2014/desarrollo-acuerdos14.aspx.

11 See the press release at *Expansion.com* quoted at note 9 and the one titled 'Un grupo de grandes fondos votará contra el blindaje de los negocios de Repsol' on March 28, 2014 at www.consensodelmercado.com. It is important to note that they were foreign institutional investors: as it results from the survey carried out in 2013 by Funds People, Georgeson y Cuatrecasas, Gonçalves Pereira in Spain, with a sample of 15 institutional investors (13 of them Spanish), 14% of domestic investors did not know what a proxy advisor was and just 7% of them declared that they had taken into consideration proxy advisors' reports when deciding on how to vote both in Spain and abroad. Anyway, 64 % of investors noted that they had not taken into consideration voting recommendations for the 2012 proxy season. (62% in 2011). See Georgeson y Cuatrecasas, Gonçalves Pereira, 'El gobierno corporativo y los inversores institucionales', p. 37, 2013 edition, available at http://www.cuatrecasas.com/media_repository/docs/esp/el_gobierno_corporativo_2013_956.pdf.

96%[12]. The sense of the ISS' voting recommendations on the items on the agenda was announced days before the general meeting[13]. The recommendation against was based on the need to split the roles of Chairman and Chief Executive Officer, which is inconsistent with the corporate governance model used by ISS. Nonetheless, this concentration of roles has been traditional in Spain to the extreme that the Spanish Corporate Governance Code released in 2015 by CNMV lets Spanish issuers decide at their best convenience on this point[14].

Overcoming the problems associated with the provision of proxy advice and the high concentration of the industry are some of the new challenges for corporate governance. This paper aims to provide a description of the main features of the industry and some key issues in relation to their activity. We also intend to reflect on the role of proxy advisors in the corporate governance of listed companies and to propose a framework of possible alternatives for future regulatory intervention.

II. Possible business actions of proxy advisors in the market

1. Services provided by proxy advisors in the market

Even if proxy advisors usually provide other services, the core activity that qualifies their business activity is proxy advice, which is generally defined as the provision of a remunerated service consisting in the issue of recommendations on how to cast voting rights in relation to the items set on the agenda of the general meetings with regard to the companies whose shares are part of the investor's portfolio.

Consisting in the analysis of different proposals to the general meeting and in the issuance of recommendations on how to vote on the items analyzed (*proxy advising services*), this "intellectual" service is not usually delivered alone, but combined with the provision of a set of "logistic" services comprising the collection and transmission of information and the facilitation of support of

12 See the information published by the issuer at https://www.iberdrola.es/accionistas-inversores/gobierno-corporativo/junta-general-accionistas/2015/.

13 See the press release by J. Navas titled 'El principal 'proxy advisor' se opone a la reelección de Galán al frente de Iberdrola' published in *El Confidencial*, on March 24, 2015. Available at: http://www.elconfidencial.com/empresas/2015-03-24/el-proxy-advisor-iss-se-opone-a-la-reeleccion-de-ignacio-galan-como-presidente-ejecutivo_733406/.

14 See CNMV, 'Good Governance Code of Listed Companies', February 2015, pp. 30 and 31 available at http://www.cnmv.es/DocPortal/Publicaciones/CodigoGov/Good_Governanceen.pdf.

the voting process[15], including the contact with custodian banks. Such a combination makes these proxy voting services, provided through electronic platforms[16], of particular interest in the cross-border context. Additionally, under the "logistic service" category, some proxy advisors may provide a post-vote service, by facilitating information on the outcome of the vote once the general meeting is held. This additional service appears to be very useful in order to fulfil the fiduciary duties imposed on institutional investors' managers in some jurisdictions.

The usual combination of both activities (logistic and intellectual) implies that the recommendation on how to vote, as part of services described as "intellectual", appears automatically predisposed on the electronic platforms which are made available to the customer as part of the "logistic" activity undertaken by the proxy advisor. So the institutional investor needs just a couple of easy steps to *cast* his votes, especially if he agrees with what has been recommended. If not, he is free to separate from the recommendations appearing as default on the voting platforms and to vote otherwise[17]. Complementarily, proxy advisors offer the possibility to cast proxy statement votes on their client's behalf[18].

However, the market shows that the majority of proxy advisors do not only provide services to investors. Together with some services rendered to custodian banks and to other intermediaries (usually instrumental regarding the logistic services described above), they also provide advice on corporate governance to listed companies (directors' compensation, mergers and acquisitions, etc.), offering the proxy advisor's particular view on good practices. In that sense, proxy advisors often apply their own standards of corporate gov-

15 For the description of the services, see Report working group AMF, 'Improving the exercise of shareholder voting rights at general meetings in France', September 2005, 24, 46 and 47.

16 Investors fill the voting form available on the interface provided by the proxy advisor. Such instructions are then sent to the custodian bank either by the investor (once printed and signed) or directly by the service provider. The proxy advisor usually waits for a deadline before sending the corresponding faxes, thus enabling the investor to change the vote if deemed appropriate. Especially in cross-border situations, in most cases custodians confirm the reception and vote to proxy advisors.

17 These platforms also offer the opportunity to quickly complete the voting form, as the investor can automatically select all the items "in favour of the proposals of the board"; "Against the proposals of the board"; "In the sense recommended by the proxy advisor" or "abstention".

18 T. Belinfanti, 'The Proxy Advisory and Corporate Governance Industry: the Case for Increased Oversight and Control', Stan. J. L. Bus & Fin. (2008–2009), 384, 386, even strikes that a 15–20% of US mutual funds have authorized ISS to automatically vote their shares however it sees fit.

ernance, not necessarily consistent with each other[19], when delivering their services. The use of such standards enables the proxy advisor to classify each issuer in accordance to their level of observance. In turn, the disclosure of such classification arouses the obvious interest of listed issuers in being in the best ranking positions[20]. Hence the possibility of being classified in a good position is considered by some proxy advisors as one of the attractive features of the advisory services on corporate governance they offer to listed companies[21].

2. *Proxy advising service: typology of potential customers*

The proxy advising service described above is likely to be delivered in different situations that reveal the heterogeneity of those who could be customers from the proxy advising side. In general, proxy advisors offer their services to those in charge of making the decisions on the exercising of voting rights. This may correspond to those who support risk-bearing capital[22], to those who are registered as holders of shares, or even to those who neither bear the economic risk of the shares nor are registered as holders of shares but are vested with authority to exercise voting rights and to decide on them.

Beyond the case of institutional investment (where those who bear the risk associated with the securities in the institutional investors' portfolio are actually the ultimate beneficiaries), it is quite common in some markets, that investment in listed companies leads to the recognition of autonomy to vote to individuals other than those who actually bear the risks of the investment. So intermediary holders of shares "in street name"[23], investment advisors with

19 S. Arpin, 'Proxy Advisory Firms' Beefed-Up Role In Exec Pay', Employee Benefits and Executive Compensation Group, 23rd August 2010 at 4.

20 A. Perdices Huetos, 'Las agencias de calificación crediticia y los *proxy advisors*', 9 Cuadernos de Derecho para ingenieros (2011) 143, pp.152 and 153.

21 See in A. Verdam, 'An exploration of the role of Proxy Advisors in Proxy Voting', December 2006, 14, the reference to the Aetna case. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=978835.

22 This is common both in domestic situations and in the case of cross-border securities holding. In this case, once the beneficial owner determines (after obtaining a proxy advice, if demanded) how to vote, it shall instruct the nominee. This notwithstanding the fact that, for various reasons (the lack of control over how the votes are cast or the lack of instructions, etc.), the praxis has shown that the nominee exercise sometimes voting rights however it sees fit.

23 The holding of shares by a broker-dealer or custodian bank "in street name" is common in the United States (§ 8, Part Five, US Uniform Commercial Code). Being a broker-dealer, the NYSE Rule 452 recognizes his autonomy to vote the proxies attached to the shares held "in street name" on behalf of their customers (beneficial owners) for "routine" matters if the broker-dealer has not received instructions from customers in advance. See NYSE Rule 452, paragraph 10 (*When member organization May vote with-*

discretionary voting authority on clients' behalf[24] or custodian banks of ADSs under the terms of the ADS contract, may be entitled to vote as deemed appropriate (especially if they have not received instructions from the holders of entitlements).

These circumstances can lead to other possibilities for the decision-making process regarding the exercise of voting rights and show how, without being the holder of the investment, the nominee, or even who acts as a representative, may be authorized to exercise the voting rights and to decide on how to do so. Depending on the circumstances of each situation, all these possible individuals are likely to request the proxy advising service.

III. Stimulating factors for the proxy advisory industry

1. Duties relating to the exercise of voting rights imposed on some institutional investors

Given the duties related to the exercise of voting rights imposed on institutional investors' managers, the proxy advisors appear as the perfect allies to ease part of the pressure of their fulfillment. Particularly where the portfolio is quite diversified, it makes it difficult to decide on how to vote in terms of time and effort (general meetings are held on similar dates worldwide). Thus, following the advice of the professional provides the institutional investors'

out customer instructions). It is included in Section 402.08 of the Listed Company Manual (New York Stock Exchange). See also M. Kahan and E. Rock, 'The Hanging Chads of Corporate Voting', 96 Georgetown Law Journal (2008) 1227, 1250.

24 US investment advisers usually have voting authority to vote client proxies. In that case *Rule* 206(4)–6 *Investment Advisers Act* 1940 applies. It requires the investment adviser to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of its clients. To that extent, an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party. Recently, the Division of Investment Management has pointed out that compliance could be demonstrated by periodically sampling proxy votes (including those that relate to certain proposals that may require more analysis) to review whether they complied with the investment adviser's proxy voting policy and procedures. In addition, as part of an investment adviser's ongoing compliance program, it should review, no less frequently than annually, the adequacy of its proxy voting policies and procedures to make sure they have been implemented effectively, including whether these policies and procedures continue to be reasonably designed to ensure that proxies are voted in the best interests of its clients. See Division of Investment Management and Division of Corporation Finance (SEC), 'Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms', Staff Legal Bulletin No. 20 (IM/CF), June 2014.

managers with a preventive protection against any claim or penalty with respect to the observance of their fiduciary duties[25]. Actually, it has been argued that the rise of proxy advisors turns out to be a side effect of the rules imposing fiduciary duties on institutional investors[26]

Nevertheless, the importance of the mandatory exercise of voting rights on institutional investors as a stimulating factor for the proxy advisory industry should be considered relative. Note that such duties have neither spread to the same extent on all kinds of institutional investors, nor are referred to all securities in the portfolio. They are usually conditioned to a given volume of ownership in the capital of the participated company or, in particular, to its nationality. In any case, even where the duty exists, institutional investors are not generally required to vote on every proxy item, as they may refrain from voting under some circumstances[27].

Thus, in some cases the duty to vote is solely imposed with regard to domestic institutional investors relating to domestic issuers[28]. Indeed, it is often considered that the difficulties and costs of issuing a vote on foreign securities justify (and even make it advisable) the non-exercise of voting rights. For example, art. 314-100 2 of *Réglement l'AMF Géneral* (which is development of L. 533-22 *Code monétaire et Financiere*), expressly contemplates the nationality of the issuer as one criteria, among others, to include in the voting policy of the OPCVM *(organismes de placement collectif en valeurs mobiliares)*. Traditionally, it has been likewise under Spanish law on investment companies and mutual funds in the case of both the voting and the disclosure duties (art. 81.1.i *Reglamento de la Ley de Instituciones de Inversión Colectiva* dated in 2005). Anyway, the new *Reglamento de la Ley de Instituciones de Inversión Colectiva* dated 2012 (art. 115.1.i) no longer contains reference to the *Spanish issuer* with regard to the *disclosure duty* contained in the former (art. 81.1.i.

25 L. Strine, 'The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face', 30 Delaware Journal of Corporations Law (2005) 673, 688.

26 E. Dubois, 'Shareholders' General Meetings and the Role of Proxy Advisors in France and Japan', 4 Kyushu Journal of International Legal Studies (2011) 56, 86; H. Fleischer, 'Zur Rolle und Regulierung von Stimmrechtsberatern (*Proxy Advisors*) im deutschen und europäischen Aktien- un Kapitalmarktrecht', 1–2 AG (2012) 2, 3; J. Carney, 'Why Should you be worried about Proxy Advisory Firms?', NetNet, 26. 10. 2010, available at: http://www.cnbc.com/id/39795662, among others.

27 See, Latham And Watkins LLP, Proxy Advisory Business: Apotheosis or Apogee?', Corporate Governance Commentary (2011), p. 8. Available at: http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

28 With regard to Spanish Law, see A. Roncero Sánchez, 'El deber de ejercicio de los derechos inherentes a los valores integrados en la cartera de un inversor institucional', 283 Noticias de la Unión Europea (2008) 101, pp. 107 and 108.

Reglamento 2005). Also under Spanish Law it is imposed solely on mutual funds when the shareholding ownership meets or exceed 1% of the issuer's capital during 12 months [art. 46 1 d) *Ley de Instituciones de Inversión Colectiva* and 115.1 i *Reglamento 2012*]. It contrasts with self-regulation, where it is often advised to vote *every* proxy in the portfolio investment (see explanation of the sixth principle of the UK Stewardship Code).

But, rather than a duty to vote, it is common that institutional investors' managers meet the duty to act in the best interests of their ultimate beneficiaries when assessing whether and how to exercise the voting rights and to report on them [art. L.533-22 *Code Monetaire et Financier*; art. 40.2 *Testo Unico della Finanza* y art. 46 1 d) *Ley de Instituciones de Inversión Colectiva*]. The aim is to impose, not a duty to vote, but a standard of behavior on the institutional investors' manager as a fiduciary. Institutional investors would thus be required to vote only when the exercise of voting rights would be in the best interests of their beneficiaries. It usually leads to a decision regarding cost-benefit terms.

So, given the high presence of foreign institutional investment (especially coming from the US) in the capital of European issuers, and given that these are mostly proxy advisors' potential customers, to these effects it is crucial to find out if their respective jurisdictions impose voting and disclosure duties on institutional investors with regard to the foreign securities included in their investment portfolios[29]. To this end, in the United States, only private pension funds' managers meet the regulated duty to vote proxies. Anyway, in literature and case law precedents such a duty has been derived in other institutional investors from the fiduciary position of their managers. But it does not imply, however, a duty to vote every proxy, but only when it is economically efficient[30]. Therefore, given the additional costs attached to the cross-border exercise of voting rights, it seems simple to argue the general absence of a voting requirement in such cases.

Apart from the duty to vote are the disclosure duties on the voting policy (*ex ante*) and on the way the voting rights have been exercised (*ex post*), respectively, not confined to the nationality of the issuer. In our opinion, insofar as they help to stimulate the exercise of voting rights (or, at least, to take such exercise into

29 As an example, with regard to private pension funds, the US Department of Labor has considered that the costs of issuing a vote on foreign securities justifies that voting rights are not exercised. See US Department of Labor, 'Interpretive bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines', with regard to sections 402, 403 y 404 *Employee Retirement Income Security Act* 1974 (ERISA), 2008, 29 CFR 2509.08-2.

30 See, Latham And Watkins LLP, Proxy Advisory Business: Apotheosis or Apogee?', Corporate Governance Commentary (2011), p. 8. Available at: http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

consideration), they constitute incentives to the proxy advisory industry. These are, for example, the duty of managers of French OPCVM to report on the exercise of voting rights or to explain the reasons for not exercising them, contained in art. L.533 -22 *Code monétaire et financier* in France or the duty to make public its voting policy and to report on the exercise of voting rights met since 2003 by investment companies in the US[31]. Similar information duties are also regulated under Spanish law on investment companies and funds [arts. 46 d) *in fine Ley de Instituciones de Inversión Colectiva* and 115.1.i *Reglamento de la Ley de Instituciones de Inversión Colectiva*) and on pension funds (art. 69.6 *Reglamento de Planes y Fondos de Pensiones*). In any case, the absence of regulation in some significant jurisdictions like Germany is remarkable both with regard to the exercise of voting rights and to the information related to them[32]. Indeed, the European Commission has announced its proposal to revise the Shareholder Rights Directive in order to include stronger transparency requirements for institutional investors and asset managers on their investment and engagement policies regarding the companies in which they invest, as well as a framework to make it easier to identify shareholders so they can more easily exercise their rights (in particular in cross-border situations)[33].

Furthermore, regardless of whether it is normatively imposed or not, it is clear that institutional investors could always opt to voluntarily assume these duties toward their beneficiaries. Thus, to the extent that the application of the UK Stewardship Code is intended for any institutional investor with participation in UK listed companies, it would also extend to foreign investors, whose voluntary submission have been encouraged by the Financial Reporting Council (FRC) as, in fact occurs[34]. Similarly, the UK Stewardship Code encourages British investors who opt to comply with the Code to act accordingly with regard to foreign securities (application of the Code, item 9). Principles 6 and 7 require the institutional investor to report on how and according to what policy the voting rights are exercised. But beyond that, Principle 6 of

31 See SEC, 'Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies', January 31, 2003. See. SEC Rule 30b1–4 (codified § 270.30b1–4 Title 17 CFR).

32 For an interesting reflection on this matter, see H. Fleischer and C. Strothotte, 'Ein Stewardship Code für institutionelle Investoren Wohlverhaltensregeln und Offenlegung der Abstimmungspolitik als Vorbild für Deutschland und Europa?', 7 AG (2011) 221 et *seqq*.

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

34 Financial Reporting Council, 'Consultation on a Stewarship Code for Institutional investors', January 2010, pp. 12 and 13. The list of signatories is available at: http://www.frc.org.uk.

the UK Stewardship Code includes another transparency measure when it requires disclosure as to what extent the institutional investor has hired proxy advisory services.

In fact, the duty to report on the use of proxy advisory services is different from the duties to disclose the general voting policy and to report on how the voting rights have been exercised. While both are in general transparency measures, only the second one is transcendent when considering the development of the proxy advisory industry. From this point of view, it is clear that the duty to disclose the general voting policy and/or to report on the exercise of voting rights is an incentive to the proxy advisory industry insofar as it involves an indirect stimulus to the exercise of such rights (or, at least, to the taking such exercise into consideration). Information on whether any proxy advisor has been engaged in the course of that process seeks a market disclosure of whom is contributing to the formation of the decision making power in listed companies (thus a transparency measure), and especially to deter institutional investors' managers from following *blindly* what the proxy advisor has recommended. But to the extent that it does not seem to enhance the exercise of voting rights, it could not be considered a stimulating factor for the proxy advisory industry.

2. *Other possible factors*

The growing diversification of the portfolio (either as a consequence of an investment decision or as required in most jurisdictions), the increasing presence of foreign securities in most institutional investors' portfolios and the sophistication of the items on the general meeting's agenda are pushing institutional investors to seek the help of professionals (proxy advisors) to manage the process of obtaining and handling all the information needed to cast a conscious and informed vote (or, at least, to make a decision on the exercise of voting rights). The lack of skills on corporate decisions, the lack of personnel and even the absence of a real interest in doing so have come to enhance the development of the industry of proxy advisors. For institutional investment managers, it also serves as a mechanism of preventive protection against possible sanctions and criticism of their management. A separate and troubling question is whether, in a context of significant competition among institutional investors to attract savings from the public, the spending of economic resources on hiring the services of one (or even two) proxy advisors, is justified, or at least advisable, especially when it is noted that, generally, institutional investors are not required to vote every proxy with respect to all securities in their portfolios[35].

35 Similarly, Latham And Watkins LLP, Proxy Advisory Business: Apotheosis or Apogee?', Corporate Governance Commentary (2011) wonders if rethinking the view that

In the US market, there appear additionally some particularities inherent to the services provided by investment advisers with discretionary voting authority on behalf of their clients [SEC *Rule* 206(4)–6 *Investment Advisers Act* 1940)], the characteristics of tenure of shares "in street name", or the issuance of ADSs, that lead to a separation between the investment's ownership and the decision-making power. These factors have contributed to the rise of the proxy advisory industry and are likely to predict a further expansion in the future.

IV. The role of proxy advisors in the corporate governance of listed companies

1. The proxy advice as a tool serving institutional investors and corporate governance

Generally, it is entirely reasonable (and even considered as good corporate governance practice[36]), that institutional investors' managers seek the help of professionals to provide them with the virtues and drawbacks of the proposals for general meeting resolutions regarding the securities in their portfolios and to explain to them what is probably in the best interests of their beneficiaries.

But besides that, prior to the issuance of the votes, the role of proxy advisors as information agents is also relevant for the institutional investors[37]. Apart from the fact that such a service could be followed by a proxy advice, which is usual, proxy advisors constitute a way of obtaining and pre-processing information from various issuers. Indeed, in the case of investment in foreign securities, proxy advisors are called to play a valuable role in the translation of the information from the issuer[38]. In that sense, it has been noted that some institutional investors really value the services provided by proxy advisors, not with regard to the voting recommendations they issue, but with regard to their consideration as agents providing information with which they will subsequently make the voting decisions[39].

the investment advisors' fiduciary duty requires the adviser to vote all portfolio shares on all ballot issues would lead to the apotheosis, rather than to the apogee of proxy advisors. Available at: http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

36 OECD Principles of corporate governance, 2004, pp. 56 and 57.

37 S. Choi, J. Fisch and M. Kahan, 'The power of proxy advisors myth or reality?', 59 Emory Law Journal (2009) 869, in particular, pp. 879 and 881.

38 ESMA, Discussion Paper 'An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options', March 22, 2012, p. 10.

39 S. Choi, J. Fisch and M. Kahan, 'Director elections and the influence of proxy advisors', NYU Law and Economics Research Paper No. 08–22, May 2008, p. 47; EFAMA, Reply to the ESMA Discussion Paper An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options, June 2012, p. 2.

Now, this positive assessment of the service provided by proxy advisors requires it to be customized to the client's own interests. Note that the term "advice" stands for a task of processing of information in relation to the particular needs and profile of a customer, who is provided with selected information and customized recommendations[40]. Despite the continuous warnings that the ultimate recommendation will depend on each circumstance, the tight deadlines for preparing recommendations on thousands of general meetings under which proxy advisors have to render their services, does not eliminate the doubt about whether the advice ends up being the result of the automatic application of the general voting guidelines, without any other consideration (box-ticking) and, obviously, without taking into consideration the customer's portfolio from a global perspective (a one-size-fits-all approach). In any case, if some proxy advisors distinguish between standardized and customized proxy advice when they offer their services, this is because their voting recommendations are not always suitable to the particular interests or situation of their customers.

Along with the possibility to provide valuable services to institutional investors aimed at an informed exercise of voting rights, and with the ability to contribute to the improvement of good corporate governance practices (through the exercise of voting rights), proxy advisors also act as *de facto* regulators[41]. Experience has shown that it is not enough for managers of listed companies (or for shareholders who wish to submit a shareholder proposal) to comply with regulation and the rules contained in codes of corporate governance, as they also feel *forced* to adapt their proposals to the standards of corporate governance handled by the proxy advisor who is expected to deliver services to their shareholders. In any case, the fact is that this *pressure* for the proxy advisor's scrutiny can lead to an improvement of good governance practices. Operating as an additional tool for disciplining managers and directors, they would feel *obliged* to take efforts to justify every proposal of a general meeting resolution that deviates from the criteria managed by the adviser when they are not fully aligned with the interests of the company and, therefore, to justify it as consistent with the issuer's best interests.

In short, the role of proxy advisors is likely to facilitate the flow of information from issuers to institutional investors, contributing in this way to a better understanding of the proposals put forward at the general meeting and, therefore, to an informed exercise of voting rights, as well as to the enhancement of corporate governance practices.

40 A. Perdices Huetos, 'Las agencias de calificación crediticia y los *proxy advisors*', 9 Cuadernos de Derecho para ingenieros (2011)143, 146.

41 P. Rose, 'On the role and regulation of proxy advisors', 109 Michigan Law Review First Impressions (2011) 62, 68.

2. *Ongoing communication between issuers and proxy advisors, with particular reference to Spanish listed companies*

a) *Dialogue as a tool aimed at the (correct) provision of proxy advice*

From the proxy advisory perspective, it is clear that the collection of data from market operators, including issuers, is an invaluable tool at the expense of the advisory service offered to institutional investors. Ultimately, the use of accurate information contributes to the quality of their voting recommendations and enriches the underlying analysis.

According to the information available on the proxy advisors' websites, there are several possible occasions when proxy advisors could contemplate the potential contact with issuers as a part of the advisory services they offer. On the one hand, a first contact may occur as part of the annual process of preparing and updating proxy advisor's voting guidelines. When this occurs (as is the case of ISS, but not of Glass Lewis & Co., the latter being less transparent than the first on this point)[42], it happens at an earlier stage before the general meeting is called. On the other hand, a second contact may occur during the process of drafting and delivering voting recommendations, once the proposals to the general meeting are known.

Along with these two occasions, there are other possible contacts between proxy advisors and issuers whose contours could not be so clearly defined. We refer to road shows and to one-on-one meetings that may occur both during the proxy season and at any time during the year. They could consist in the discussion of good corporate governance practices, the disclosure of the issuer's particular situation and business strategy, or the exchange of views on certain specific transactions or proposals at the general meeting.

Depending on the purpose of such contacts, they would sometimes be aimed at the establishment, in *abstract*, of *general principles* to serve as the basis for the elaboration of voting guidelines (which would consist in the transmission and collection of good governance practices, particularities of local jurisdictions, etc. for the subsequent draft of voting guidelines), while in other cases they would focus on the *particular circumstances* of each issuer and its business policy in the context of the issuance of current or potential voting recommendations with regard to the holding of a *precise* general meeting. Referring to specific proposals at the general meeting, the latter could consists both in the explanation and justification of such proposals in the issuer's particular circumstances (either

42 D.F. Larcker, A.L. McCall and B. Tayan, 'And Then A Miracle Happens! How Do Proxy Advisory Firms Develop Their Voting Recommendations?', Standford Closer Look Series, February 2013, 1 to 3.

before their draft and disclosure along with the general meeting's agenda or even after that moment) and in the mere amendment of factual errors.

While the dialogue with issuers in the first area does not appear to pose highlighted problems from the points of view of the relationship between the company and its shareholders and the rules on disclosure and trade of inside information (basically, not being information of precise nature relating to the issuer), could not be concluded the same regarding the second frame of contacts. Precisely, the second one is confined to aspects related to the particular situation of the company (information of a *precise* nature relating to the issuer), which is sometimes disclosed on the eve of the holding of a general meeting of shareholders.

From the first perspective *(general principles)*, such contacts would ensure that the national standards of corporate governance and the peculiarities of local jurisdictions and markets would be taken into consideration by the proxy advisor (adapted later to its customers' profile)[43], thus dampening one of the problems linked to the activity of proxy advisors which usually stands out.

Regarding the second area, the dialogue between proxy advisors and issuers about the specific voting recommendations raises first, the question of the various ways in which that dialogue could take place. One of them is to facilitate a draft of the report containing the voting recommendations before its final delivery to the customer. This could have the purpose of facilitating the issuers' comments on voting recommendations or simply of enabling the correction of mere material or factual errors[44]. In this context, the French AMF *Recommandation* on proxy advisors must be brought up[45]. With respect to the correction of mistakes, it has been noted that its value would be limited in practice, as discussions between proxy advisors and board members already take place leading up to general meetings, so issuers already have the opportunity to review and correct any errors[46]. Hence, apparently more interesting

43 In the same sense, the *Deutsches Aktieninstitut*, Reply to ESMA Discussion Paper, June 2012, p. 4. Beyond that, it has been stated that it would be more useful if issuer trade associations rather than individual issuers responded. See PIRC Reply to ESMA Discussion Paper, June 2012, p. 9.

44 The rationale for this practice should not be that the issuer could communicate certain information or its particular view on the proxy advisor's position (or even refute it), but that the issuer provide input to the correction of factual inaccuracies. That way is pointed out at ISS website and is warned by EFAMA in the Reply to the ESMA Discussion Paper, June 2012, p. 5. It is however highly complicated to draw a line that clearly enables distinguishing among those concepts.

45 *Autorité Des Marchés Financiers*, AMF Recommendation 2011-06, Proxy Voting Advisory Firms (March 2011).

46 L. Klöhn, and P. Schwarz, 'The Regulation of Proxy Advisors', June 2002, pp. 17 y 19, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2079799.

might be the possibility that issuers would comment on the analysis made by the proxy advisor, by calling attention to some aspects included in the documents attached to the general meetings' call which could have gone unnoticed by the proxy advisor. The issuer (or the proponent shareholders) could also clarify the reasons for a specific proposal for resolution put forward at the general meeting and/or even express its disagreement with the proxy advisors' voting recommendation; dissident and general comments from the board, which have been suggested to be included by the proxy advisor in the final report delivered to the institutional investor[47]. Thus it appears that institutional investors would have the opportunity to review the different positions regarding the items on the general meeting's agenda.

That being so, it seems that this practice is not to prosper. Before all else, such contacts are almost impossible in the narrow time frame between the call and the celebration of the general meeting, which are reduced in practice in the case of cross-border securities holding[48]. This is diminished even more, the greater the percentage of capital held by institutional investors (proxy advisors' clients) and the number of proxy advisors. But in addition, this could be inconsistent with the current corporate rules in many jurisdictions. Primarily, in the most intense stage of the issuer's involvement (in which the issuer would include comments as a counter-argument to the proxy advisor's analysis and position), the institutionalization of this practice poses the risk of moving the debate out of the general meeting scenario and, above all, addressing it only to a part of shareholders; those who have hired proxy advisory services.

Even if it could be enriching for them[49], as it would *bring the company to its real owners* without having to assume excessive costs (although it would require, in any case, the institutional investor to have an interest in assimilating the information received), it is clear that, in addition to the fact that this debate would take place with some who are not shareholders (or their agents), it would deprive the other shareholders of much of the discussion. Note that these shareholders are also called to the general meeting and that they are entitled to the right to be part of the decision-making process at the general meeting. It seems that seeking to activate some shareholders at the expense of others is not consistent with the equal treatment principle among shareholders under many European company regulations (art. 520 *Ley de Sociedades de Capital* – LSC –, in the Spanish case). The fact of having hired proxy advisory

47 *Deutsches Aktieninstitut*, Reply to ESMA Discussion Paper, June 2012, p. 5.

48 See PIRC Reply to ESMA Discussion Paper, June 2012, pp. 2 and 3.

49 See, A. Omaggio, 'Faut-il encadrer l'activité des agences de conseil en vote (*proxy advisors*)?', 46 La Semaine Juridique-Edition Entreprise et Affaires (2009) 29, 33, who supports a close dialogue with issuers both before the proposals to the general meeting are made and before delivering the voting recommendations to the client.

services does not appear to be relevant enough for the purposes of considering that the shareholders are not in an equal position (art. 514 LSC). This is based on the premise that the equal treatment principle among shareholders would not only apply with respect to the *nominee shareholders* but also with regard to the *beneficial owners* (in any case, the prior are an extension of the latter). If so, hiring the services of a proxy advisor would ultimately ensure the shareholders more accurate information from the company and could end up in a greater reliance on proxy advisors[50]. In sum, in our opinion it is preferable that the board of directors strives to clarify as much as possible all the information publicly disclosed, to make such information easily available by electronic means and, above all, to justify the proposals put forward at the general meeting, rather than review and comment (to a greater or lesser extent), on the draft report containing the voting recommendations.

In another vein, the connection of the foregoing ideas with the shareholders' right to be informed on the occasion of the holding of the general meeting can raise the question of whether proxy advisors have enough information to elaborate their reports or, more specifically, whether they are, or should be, able to have access to the same information that any shareholder could obtain, prior to making the decision on how to vote, in the exercise of their rights. First, it could be hastily assumed that, if the right to be informed is functionally linked to the exercise of voting rights and, therefore, serves as a tool for analysis preceding the decision on how to vote, the proxy advisor should be then empowered with the right to be informed in similar terms. It appears, however, that this is not consistent with the rules setting the shareholders' right to be informed, at least as it is shaped under Spanish law, which is primarily recognized regarding the risk-bearing position assumed by shareholders (art. 93 LSC under Spanish Law), rather than with regard to the issuance of a subsequent vote. Even if a capital market perspective has come to make transparency a basic configuring principle of listed companies[51], the existence of a shareholders' right to be informed in the private-corporate sphere that coexists with a market transparency sphere, leads to a crucial difference. As risk-capital bearers, only shareholders are given the possibility to extend the information available to the general public in the course of the

50 The shareholders could always exercise their rights to obtain information or clarifications with regard to the holding of the general meeting (arts. 197 and 520 LSC under Spanish Law) but note that such information or clarifications would only be obtained upon request.

51 A. Alonso Ureba, 'Bases para una reforma del Derecho español de sociedades cotizadas en garantía del derecho de la sociedad emisora a conocer de modo permanente su estructura accionarial', in: Transparencia accionarial y buen gobierno corporativo (A. Alonso Ureba, F. Garcimartin Alférez, A. Perdices Huetos and I. Gómez-Sancha Trueba eds.) (2010) 82, in particular pp. 87 to 90.

exercise of a right accompanied by a correlative duty to inform[52]. As stated, this implies the power to require of the board of directors a given behaviour (insofar as the request is made in a manner provided by law), and the possibility to activate the protective mechanisms provided by law in the case of unreasonable refusal.

If there is a corporate information channel which is not available to proxy advisors because it is reserved for shareholders as risk-capital bearers, it should then be determined whether the provision of such information by the board to proxy advisors *on a voluntary basis* is considered to be a breach of the shareholders' rights. Ultimately, the answer to such a question is part of the debate about the existence of market information flows exceeding the information that the company is required to disclose, either in the internal corporate sphere (shareholders' right to be informed) or outward (duties of transparency towards the market); information, for that reason *voluntary*, which is usually of a *selective* nature.

b) Dialogue with proxy advisors as part of the issuer's strategy of communication of selective market information

Contact between proxy advisors and issuers must also be considered from the point of view of the issuer's communication beyond its circle of shareholders. Not only in the context of the *duties* of transparency required under the securities markets regulations (based on the investor's protection and on the confidence in the proper functioning of the market), but also in the context of what has been considered a market of *voluntary* information. Thus it is possible that, as a matter of corporate reputation or other considerations, the issuer is interested in disseminating *non-binding information* to institutional investors, significant shareholders, financial analysts and, more recently, proxy advisors. When the holding of the general meeting is approaching, directors usually address (directly or through proxy solicitors) a reduced circle of individuals with the purpose of presenting some evidence on the proposals for resolutions to the general meeting. In the case of cross-border shareholding, proxy advisors are considered the bridge that enables corporations to reach the real owners of the issuers' capital, or at least as a way of diffusing certain information to be used for the later exercise of voting rights.

Starting from the utility of providing certain information to proxy advisors, the question arises as to what extent such informational asymmetry does not

52 M.T. Martínez Martínez, El derecho de información del accionista en la sociedad anónima (1999), pp. 36 and 37 and *Idem* 'Derecho de información del accionista e instrumentos y obligaciones de información de la sociedad', in: Derecho de Sociedades Anónimas Cotizadas, (F. Rodríguez Artigas *et al.* eds.) (2006) 329, 360.

undermine the reliance on the capital markets. It is clear that the provision of these *informational advantages* by the board is to be framed in the concrete and strict limits set by corporate and securities regulations[53]. General limits in this area are to be mentioned the director's duty of confidentiality (art. 232 LSC under Spanish law), the equal treatment principle among shareholders (art. 514 LSC under Spanish Law), and the prohibition of disclosure of inside information (arts. 225 and ff. TRLMV-Texto Refundido de la Ley del Mercado de Valores and RD 1333/2005 on November 11, 2005, under Spanish Law)[54].

Apart from the fact that the proxy advisor could be a shareholder himself, the information that he receives from the issuer must clearly be subject to the mentioned limitations and, additionally, to the recommendations on informative meetings with financial analysts and other professionals of the stock exchange. In this sense, it would not be difficult to consider proxy advisors as *similar* to financial analysts (in the terms of art. 6.1 German *Kodex*[55]) or as *professional securities market participants* in the sense of the CNMV's recommendations[56]. But in any case, the particular connection between proxy advisors and the exercise of shareholders' rights, especially the right to vote, draws

53 A. Roncero Sánchez, 'La estrategia de comunicación permanente con inversores institucionales, entidades depositarias y asesores de voto como responsabilidad del consejo', 21 Cuadernos de Derecho para ingenieros (2013) 179, pp. 193 to 195.

54 With respect to German Law, see C. Wilde, 'Informationrechte und Informationspflichten im Gefüge der Gesellschaftsorgane', Vol. 27, Is. 3 ZGR (1998) 423, 460; H. Fleischer, 'Investors Relations und informationelle Gleichbehandlung in Aktien-, Korzern- und Kapitalmarktrecht', Vol. 38, Is. 4 ZGR, (2009) 505, pp. 521 and 522.

55 Given the fact that § 53 a AktG and § 131.4 AktG, both inspired by the equal treatment principle, do not apply with respect to the information previously supplied to third parties different from the shareholders, the principle 6.1 of the *Deutscher Corporate Governance Kodex* (former principle 6.3), whose observance is subject to the "comply or explain" principle, requires the board of directors to immediately provide to shareholders *all* information already supplied to financial analysts or similar. According to the German *Kodex*, good corporate governance practice would then be the achievement of *full* informational equality among shareholders and third parties with respect to all the information supplied, not only regarding the information that may have a significant effect on the price of a stock (as it is required by the rules on market abuse). See T. Baums ed., Bericht der Regierungskommission Corporate Governance. Unternehmensführung, Unternehmenskontrolle, Modernisierung des Aktienrechts (2001), pp. 169 and 170; C. Seibt, 'Finanzanalysten im Blickfeld von Aktien- und Kapitalmarktrecht', vol. 35, Is. 3–4 ZGR (2006) 501, pp. 518 to 520; H. Fleischer, 'Investors Relations und informationelle Gleichbehandlung in Aktien-, Korzern- und Kapitalmarktrecht', Vol. 38, Is. 4 ZGR, (2009) 505, 521; Regierungskomission, 'Deutscher Corporate Governance Kodex (in der Fassung vom 13. Mai 2013 mit Beschlüssen aus der Plenarsitzung vom 13. Mai 2013)', p. 13.

56 Next to principle 6.1 German Kodex are the 'Recomendaciones sobre reuniones informativas con analistas, inversores institucionales y otros profesionales del mercado de valores' released by the Spanish CNMV, on December 22, 2005. On the one hand, they

a distinctive line. In that sense, the impact on the internal corporate field resultant from the activity of proxy advisors should not remain unnoticed. Extended to shareholders, it is likely to influence, either directly or indirectly, their position, which enables us to bring up at this point the equal treatment principle among shareholders with regard to the exercise of their rights (article. 514 LSC under Spanish Law). This is especially important if proxy advisors are taken into consideration as potential channels of *indirect* communication with shareholders. Such contacts are obviously not to replace or to reduce the efforts to promote direct communication between the company and its investors. They should not slow down the progress toward the possibility that the issuer knows the identity of their beneficial owners either. Note that, among other reasons, the services provided by proxy advisors are limited to the proposals of resolutions to the general meeting, while the communication strategy with shareholders has a more extensive scope[57].

For this purpose, without being, in general, either shareholders or their agents, it seems that proxy advisors are an *extension* of the shareholders, rather than, of the beneficial owners. This situation qualifies proxy advisors as a sort of *tertium genus* between a shareholder and a representative thereof, different from any other advisors or analysts. So, although the information is put through the professional's sieve and the possible use the consultant could make of it for other purposes, the truth is that what is transmitted to the proxy advisor probably ends up embedding its voting recommendations, either explicitly or implicitly, and through them, would be taken into consideration by institutional investors when making a decision on how to vote. In fact, such a gathering of information is made in the interests of the shareholders or, at any rate, for the subsequent exercise of voting rights. Some proxy advisors have stated that their customers expect them to engage in contacts with the issuer, as they do not conceive that the adviser cannot provide a specific voting recommendation because of a lack of information.

While there is no legal basis under company law to hold a proxy advisor's right to be informed by the issuer, as there is no corporate link between them, the equal treatment principle among shareholders could be applied in this field. Note that those shareholders who request proxy advisory services would get issuer's information both based on their shareholding (exercise of shareholders' rights) or through the proxy advisor; this first hypothesis being frankly difficult to manage in a cross-border securities holding situation. Anyway, information obtained by any of these means would be aimed at the subsequent exercise of voting rights which may be conceived by the issuer.

do not extend to one-on-one meetings and, on the other hand, beyond analysts, they affect to significant shareholders or rating agencies.

57 EFAMA, Reply to the ESMA Discussion Paper, June 2012, p. 3.

This being so, and provided the equal treatment principle among shareholders is referred not only to the *nominee shareholders*, but also to the *beneficial owners* (which is irrelevant to this extent insofar as the former turns out to be an extension of the latter toward the issuer), it could be argued that the information which is voluntarily diffused to a proxy advisor is information voluntarily diffused to a shareholder[58]. The difficulties, however, of assessing the equal positions among the recipients of the information must be recognized. On the one hand, the investors advised by the proxy advisor could be many and heterogeneous. On the other hand, and above all, their real identity would remain a probable unknown. But, whenever there are doubts, and so long as the information is provided by the company regarding subsequent exercise of voting rights, the equal treatment principle among shareholders should prevail.

V. Strategies for future regulation on proxy advisors

1. Prior considerations: lack of regulation on proxy advice

Despite the increased attention paid in recent years to proxy advisors, it is usually noted that the proxy advisory industry is a field where a regulatory vacuum reigns, as there is no structure, either national or supranational, specifically designed to regulate its activity and the proxy advisor as such. So, once this a lack of regulation has been noted, it has been suggested that certain rules of conduct contained in the securities market regulation may be applicable to them.

The SEC has warned that, depending on the services rendered, proxy advisors may be actually subject to United States federal regulation from two perspectives[59]. On the one hand, they may be subject to federal Proxy Rules, as proxy advice could be considered "proxy solicitation", as it is extensively defined in the Securities Exchange Act 1934[60]. In fact, the Division of Corporation Finance of the SEC has released guidance on the availability and requirements of two exemptions to the federal Proxy Rules that are often relied upon by proxy

58 A similar idea is suggested with respect to buy-side financial analists by T. Drygala, 'A Step Ahead of the Crowd. Zur selektiven Information von Finanzanalysten nach amerikanischem und deutschem Kapitalmarktrecht —Teil II—', 28 WM (2001) 1313, 1322.

59 SEC, 'Concept Release on the U.S. Proxy System', Release No. 34-62495 (July 14, 2010), pp.107 to 110.

60 Also in Germany the *Deutscher Anwaltverein* has proposed to apply to proxy advisors the German proxy rules contained in § 135 Abs. 2 AktG. See. DAV, Stellungnahme des Deutschen Anwaltvereins zum Grünbuch der EU-Kommission vom 5. April 2011: Europäischer Corporate Governance-Rahmen KOM(2011) 164/3, p. 13.

advisory firms [contained in Exchange Act Rules 14a-2 (b) (1) and 14a-2 (b) (3)][61]. On the other hand, which is probably more transcendent, the SEC considers that proxy advisors are included in the concept of "investment adviser" contained in the Investment Advisers Act 1940. To reach such a conclusion, the SEC relies on a wide interpretation of such a concept in Section 202 (a) (11)[62]. However, this does not mean that proxy advisors are subject to the full legal regime applicable to investment advisers, but to a sort of *special regime* formed by some general provisions applying to investment advisers (precisely because most of the provisions are to be applied to investment advice, with specific features that are not met by the advisory services provided by proxy advisors). The particularities of investment advisors' activity and the rules applied to SEC registration, including prohibition and exemption rules, applied to them, lead to the fact that SEC registration and supervision over proxy advisors could only occur on a voluntary basis.

In addition to the fiduciary duties required of every investment adviser, registered or not, whenever proxy advisors are registered as investment advisers, a number of additional duties as well as the supervision and inspection by the Office of Compliance Inspections and Examinations of the SEC come over them[63]. For this reason, it has been suggested that probably one of the most effective measures on proxy advisory would be to generally extend the SEC supervisory jurisdiction over them, and not just over those who voluntarily decide to be registered[64]. Precisely, the SEC launched its Concept Release in July 2010 in order to find evidence for future intervention on proxy advisors. Those conclusions are not yet known[65]. Most recently, in December 2013, the

61 Division of Investment Management and Division of Corporation Finance (SEC), 'Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms', Staff Legal Bulletin No. 20 (IM/CF), June 2014.

62 See SEC, 'Concept Release on the U.S. Proxy System', Release No. 34-62495 (July 14, 2010), pp.109 to 114.

63 Among other additional obligations, a registered investment adviser is also required to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of material non-public information (§ 204A Investment Advisers Act 1940). The SEC's Office of Compliance Inspections and Examinations monitors the operations and conducts examinations of registered investment advisers, including proxy advisory firms. U.S. Government Accountability Office (GAO), 'Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting', GAO-07-765, 10 (2007), p. 13.

64 Center on Executive Compensation, 'A Call for Change in the Proxy Advisory in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight', January 2011, p. 68.

65 Although the period for comments was expired, the last reply is dated September 2013.

SEC hosted a roundtable about proxy advisory firms[66]. The subsequent publication, in June 2014, by the Divisions of Investment Management and Corporate Finance of the SEC of their guidance on proxy voting responsibilities of investment advisers and availability of exemptions from the Proxy Rules for proxy advisory firms, raises the question whether the SEC will go forward or not.

In our opinion, as the Canadian CSA has warned regarding the Canadian regulation, it does not seem that registration as an investment adviser and proxy solicitation rules are the proper regulatory framework to address proxy advisors' regulation[67]. Thus, in contrast to the SEC's position, the Canadian supervisory authority has highlighted the difficulties of conceiving proxy voting advice as investment advice, as it does not consist, in fact, in advising on the purchase or sale of securities, but of the exercise of the shareholders' rights attached to the securities already held by investors. Indeed, the same could be concluded under existing Spanish law, as proxy advice could not be considered as a form of advice on "investment strategies" [art. 141TRLMV and art. 5.1 g) RD 217/2008]. Besides, certain standards of conduct under market abuse regulation are not applicable to proxy advisors, as these rules are confined to the field of investment recommendations (art. 229 TRLMV and art. 10 RD 1333/2005, 11 November 11, 2005, on market abuse).

2. *Policy options: regulation versus code of conduct*

The SEC's Concept Release on proxy advisors in July 2010 showed that the absence of regulation, either at the national or supranational level, on proxy advice and on proxy advisors as such, is not the result of an immovable decision, as the question of possible regulatory intervention has been raised recently.

Along with the initiatives in the USA (SEC) and in Canada (CSA), one of the examples at the EU level is the Discussion Paper released by ESMA in 2012 and its Final Report on February 19, 2013. Among the four options considered in its Discussion Paper (No EU-level action at this stage; encouraging Member States and/or industry to develop standards; quasi-binding EU-level regulatory instruments and binding EU-level legislative instruments) ESMA ended up concluding that the best solution at this moment in time is to promote a

66 Information about the *Proxy Advisory Services Roundtable* on December 5, 2013, is available at, http://www.sec.gov/news/otherwebcasts/2013/proxy-advisory-services-roundtable-120513.shtml.

67 See Canadian Securities Administrators (CSA), 'Consultation Paper 25-401 – Potential Regulation of Proxy Advisory Firms' (2012), at 6, 7, 15 and 16.

self-regulation code of conduct drafted by a committee, independent from ESMA, composed entirely (or, at least mostly) of representatives of the proxy advisory sector. In order to initiate this process, ESMA proposed a set of guiding principles focused on, basically, two fundamental aspects related to the activity of proxy advisors: first, the identification, disclosure and handling of conflicts of interest and, second, the transparency to ensure the accuracy and reliability of the voting recommendations. Perhaps aware of the inefficiency of such a solution, ESMA does not reject adopting more severe measures in the future, since its stated intention is to review the development of the code of conduct by 2015 and to reconsider, if necessary, its position, if no progress has been made by that time. The code of conduct on the proxy advisory industry was developed in March 2014. Its impact will be evaluated by ESMA at the end of 2015, once it has reviewed the responses to the Call for Evidence launched in June 2015. In parallel, art. 3 i of the proposal for an EU Directive amending the Shareholder Rights Directive includes measures seeking more transparency among proxy advisors on the methodologies they use to prepare their voting recommendations and on how they manage conflicts of interest[68]. We will deep into these recent developments on the subject in the next sections.

Regardless of whom should be entrusted with the elaboration of the code (either national authorities or the industry itself as proposed by ESMA) or whom should be targeted (either proxy advisors or those who are linked with them), the fact is that most of the authorities and institutions that have being dealing with the question prefer self-regulation rather than undertaking regulatory measures[69]. The problem is that past experiences in relation to other service providers whose industries were also characterized by a lack of regulation and high market concentration, and whose activity raised problems comparable to those raised by the proxy advisory industry (external auditors, remuneration consultants, financial analysts and rating agencies), revitalise the debate on whether to act similarly or not with regard to proxy advisors.

In this context, although self-regulation is, at least for now, advisable for ESMA because the proxy advisory is an embryonic market whose impact is at this stage unknown, and there is no evidence of market failures, in our opinion the experience of other service providers should support a normative

68 See note 33.

69 Such is, for example, the case of the position held by the Spanish Group of Experts sponsored by the CNMV regarding the ESMA Discussion Paper, of the UK Department of Industry and Innovation & Skills or of the German *Deutsches Aktieninstitut*. See also the Proposals for codes of conduct for institutional investors and for proxy advisors, respectively, elaborated by the Millstein Center for Corporate Governance and Perfomance, (Yale School of Management), 'Voting Integrity: Practices For Investors And The Global Proxy Advisory Industry, (2009)'.

intervention as necessary before it is too late, for example as a preventive instrument to avoid feared market failures[70]. Trusting free growth and development of the industry is, in our opinion, naive, especially when there is already evidence of cases in which the existence of ethical codes has not prevented some practices of dubious legality subsequently inspected by supervisory authorities (to whose authority certain proxy advisors are subject on a voluntary basis)[71].

Ultimately, a positive valuation of the role of proxy advisors should lead to the regulatory recognition of their existence and to the regulation of their activity, so that the problems associated with them are neutralized and the positive aspects in relation to their activity in the corporate governance of listed companies are encouraged. Requiring duties for proxy advisors with legal consequences resulting from their non-observance would help to achieve this objective. And they should be implemented immediately. Note that the recognition of a greater scope for the shareholders' decision-making power on aspects such as the binding say on pay, which is beeing discussed presently, is likely to result in a disproportionate increase of proxy advisors' power of influence[72].

It has been stated that the potential regulatory treatment of proxy advisors should begin to affect aspects such as the existence of conflicts of interest or the disclosure of voting guidelines[73]. But it has also been highlighted that such regulation would not necessarily be comprised of measures only directly aimed at proxy advisors, but also at other individuals, which indirectly would affect the first. In this context we should mention the duties of institutional investors to report on the use of proxy advisory services. This would provide legal backing to what is already voluntarily observed in some areas subject to the "comply or explain" principle (UK Stewardship Code) and which seems to

70 See the Speech of Commissioner Gallagher before the Corporate Directors Forum 2013 in San Diego available at: http://www.sec.gov/News/Speech/Detail/Speech/1365171492142#.UhXt0BvIZ48.

71 It has been the case of certain practices regarding a former ISS' employee. See SEC Release N.3611/May 23, 2013. Administrative Proceeding File N.3-15313 (May 2013).

72 Among others, it has also been suggested by L. Strine, 'Toward a true corporate republic: A traditionalist Response To Bebchuk's Solution For Improving Corporate America', 119 *Harv. L. Rev.* (2005–2006) 1759, p. 1765; Perdices Huetos, 'Las agencias de calificación crediticia y los proxy advisors', 9 Cuadernos de Derecho para ingenieros (2011)143, 151; E. Dubois, 'Shareholders' General Meetings and the Role of Proxy Advisors in France and Japan', 4 Kyushu Journal of International Legal Studies (2011) 56, 96; H. Fleischer, 'Zur Rolle und Regulierung von Stimmrechtsberatern (Proxy Advisors) im deutschen und europäischen Aktien- un Kapitalmarktrecht', 1–2 AG (2012) 2, pp. 4 and 5.

73 See Fleischer, 'Zur Rolle und Regulierung von Stimmrechtsberatern (Proxy Advisors) im deutschen und europäischen Aktien- un Kapitalmarktrecht', 1–2 AG (2012) 2, 11.

act as a *disincentive* to automatically follow what the advisor has recommended[74]. In the same vein it has been suggested that this possible regulation is to be inspired by that of other operators, such as rating agencies and financial analysts, among others[75], though properly adapted to the characteristics of proxy advisory activity[76].

In any case, it does not mean, necessarily, that proxy advisors and their activity must be entirely regulated, but only those aspects which are required to protect the reliance on the proper functioning of the market and the trust laid by institutional investors on the consultant's uprightness and professionalism. Hence, in our opinion, a conciliatory option would be to strike a balance between those aspects that should be subject to regulation (in order to provide a minimum of legal certainty in the market and to prevent future market failures) and those which are to be entrusted to market governance practices.

Before going through our proposals on what must be subject to mandatory regulation, we consider it convenient to start reviewing the recent developments on the subject, both from the self-regulation side and from the regulatory side. As we have mentioned before, two relevant steps have been undertaken during 2014 in the core of the dichotomy between self-regulation and mandatory regulation on proxy advisors. Among other aspects, they both focus on transparency, albeit from the different approach which is inherent to their nature (self-regulation and binding measures), as well as from the different context to which they are ascribed. We refer particularly to the 'Best Practice Principles for Providers of Shareholder Voting Research & Analysis' and to the proposal for a revised Shareholder Rights Directive. It has to be noted that both of them start from a positive assessment on the role that could be played by proxy advisors as a tool serving institutional investors, especially in case of cross-border shareholdings. Precisely, they try, at least on a theoretical level, to dissipate the doubts around the proxy advisory industry with the purpose of enhancing trust on its functioning, and therefore, of fomenting its positive role.

74 Fleischer, 'Zur Rolle und Regulierung von Stimmrechtsberatern (Proxy Advisors) im deutschen und europäischen Aktien- un Kapitalmarktrecht', 1–2 AG (2012) 2, 10.

75 T. Belinfanti, 'The Proxy Advisory and Corporate Governance Industry: the Case for Increased Oversight and Control', Stan. J. L. Bus & Fin. (2008–2009), 384, pp. 431 to 436; Fleischer, 'Zur Rolle und Regulierung von Stimmrechtsberatern (Proxy Advisors) im deutschen und europäischen Aktien- un Kapitalmarktrecht', 1–2 AG (2012) 2, 7, the latter warning that the parallelism with financial analysts has some time been drawn by the French AMF, as it is the case in the *Mansion* Report. See recommendation n/ 11 in the 'Rapport pour l'amélioration de l'exercice des droits de vote des actionnaires en France', September 2005 (*Mainson* Report).

76 It has been also warned by the See Canadian Securities Administrators (CSA), 'Consultation Paper 25-401 – Potential Regulation of Proxy Advisory Firms' (2012), p. 17.

Although we will focus on those two steps in the next section, it should also be noted that on April 30, 2015, the Canadian Securities Administrators published the 'National Policy 25-201 Guidance for Proxy Advisory Firms'[77], designed to promote transparency with regard to conflicts of interests, determination of voting recommendations, development of proxy voting guidelines and communications with clients, market participants, other stakeholders, the media and the public. It consists of a set of recommendations for good practices by proxy advisory firms which are, therefore, non-mandatory.

3. Recent developments on the proxy advisory field

a) The 'Best Practice Principles for Providers of Shareholder Voting Research & Analysis'

Following ESMA recommendation of elaborating a code of conduct for and by the proxy advisory industry, the Best Practice Principles for Providers of Shareholder Voting Research & Analysis was released in March 2014. It was drafted by a working group (BPPG) formed by representatives of the industry members (the Signatories)[78] under the independent chairmanship of Prof. Dr. Zetzsche, whose commission was to provide advice and coordination, not interfering in the decision making. Before releasing the definitive version, the committee sought feedback of the initial draft proposals by launching a public consultation in 2013[79].

The stated purpose of the Best Practice Principles (BPP) is to help clients and stakeholders understand the nature and character of the services provided by proxy advisors, the standard of conduct on which the rendering of these services is based and how proxy advisors interact with other market participants (like issuers or the media). It comprises three Principles and their Guidance on three main topics that have been at the heart of the discussion surrounding the industry: quality of services; conflicts of interests and com-

77 See https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150430_25-201-proxy-advisory.htm.

78 BPP's charter signatories are Glass, Lewis & Co., Institutional Shareholder Services Inc., IVOX GmbH, Manifest Information Services Ltd, PIRC Ltd and Proxinvest.

79 See the instructive 'Report of the Chairman of the Best Practice Principles Group Developing the Best Practice Principles for Shareholder Voting Research & Analysis', Prof. Dr. Zetzsche, which comprises the following documents issued by the committee (annexed to the report): I. The 'Best Practice Principles for Providers of Shareholder Voting Research & Analysis' discussed in the report, II. The consultation document distributed by the Committee to stakeholders in fall 2013, and III. The Feedback Statement on the Consultation. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436066. We are following this document in this section.

munication with issuers and the public. In the introduction to the Principles, the BPPG notes that they are designed to facilitate transparency and to assist the rendering of service to clients. In this part of the code, it is marked how positive it could be for investors the role played by proxy advisors, as regards access to information and administration tools that support them in the discharge of their responsibilities. However, it is warned that the ultimate responsibility for the decision making on the exercise of voting rights lies with institutional investors.

First, on service quality, Signatories provide services that are delivered in accordance with agreed client specifications. Signatories should have and publicly disclose their research methodology and, if applicable, "house" voting policies. Signatories should have and disclose a written research methodology that comprises the following essential features: the general approach that leads to the generation of research; the information sources used; the extent to which local conditions and customs are taken into account; the extent to which custom or house voting policies or guidelines may be applied; and, the systems and controls deployed to reasonably ensure the reliability of the use of information in the research process, and the limitations thereof. The comment on this Principle in the report of the Chairman focus on the adherence to local standards, where it is marked that divergence between local standards and the country-specific guidelines of a Signatory does and should exist. Anyway, diverging from local standards without recognition or a contextual explanation is not considered best practice.

Second, on conflicts of interest management, Signatories should have and publicly disclose a conflicts-of-interest policy that details their procedures for addressing potential or actual conflicts-of-interest that may arise in connection with the provision of services. For that purpose, Signatories should organize their firms with special regard to potential conflicts and to implement measures to mitigate such conflicts. The code includes a list of measures, such as information barriers. Conflict management and mitigation procedures should include one or more of them: (i) transparent policies and procedures, (ii) code of ethics, (iii) division of labour, (iv) employee recusal, (v) fire walls/ IT systems and controls (vi) information barriers and ring-fencing (vii) independent oversight committees (vii) physical employee separation or (ix) separate reporting streams. Second, the fact that a Signatory advises investors and issuers simultaneously should be publicly disclosed. Unfortunately, it does not mean that proxy advisors should disclose to their clients the specific relation with other parts that could give rise to a conflict of interest, since this Principle is to be fulfilled by just reporting on the *possibility* that it exists. As evidence, according to the Statement released by one of the Signatories, it does still exist the practice (usual before the publication of the BPP) of incorporating a *boilerplate* in any communication with the customer-investor warning him of the

mere *possibility* of the existence of links with the issuer, without providing specific data whether or not it is in fact the case[80]. The CSA 'National Policy 25-201 Guidance for Proxy Advisory Firms' seems to move in the same vein. For this reason, we consider that no big changes are to be expected from this second Principle.

In fact, the disclosure of the specific conflict is only contemplated as a secondary measure. Thus, in the guidance supporting Principle Two it is also marked that if a Signatory becomes aware of a material conflict of interest that cannot be effectively managed, the Signatory should disclose the conflict to the relevant client(s) without undue delay before or at the same time the service is delivered, *subject to contractual arrangements*. Note that it would not be *before* the provision of the service, as we consider it necessary and as it was pointed out by EFAMA when responding to the BPPG's consultation launched in 2013[81], but at the time of the delivery of the service. Anyway, the fact of being *subject to contractual agreements* introduces a tinge of uncertainty on whether such a disclosure would be made in any case. This reference to a possible agreement on this matter was not included in the initial draft submitted to public consultation.

Third, on communications policy, Signatories should have and publicly disclose their policy (or policies) for communication with issuers, shareholder proponents, other stakeholders, media and the public. According to the Chairman's Report, as a general principle, it is best practice to communicate with issuers and shareholder proponents about policies and governance matters prior to the release of the meeting agenda. Communication should be ongoing throughout the year, with the exception of the proxy season. This limitation does not extend to communication regarding alleged factual errors or omissions (which may happen on both sides Signatories and issuers).

Seeking the flexibility that supports innovation and value creation (as declared by the Chairman of the Group), both the Principles and the Guidance on their application are subject to the "comply or explain principle". It means that the Principles are subject to Signatory discretion, since Signatories could deviate from them, provided they explain the reason for such a deviation and the alternative measures undertaken. To that extend, Signatories to the Principles should publish a link to their Statement of Compliance with the Best Practice Principles, via the BPPG's independent website. The BPPG will develop a comparative framework to facilitate assessment for how each Signatory has

80 See ISS Compliance Statement, on June 10, 2014, p. 19, available at http://bppgrp.info/wp-content/uploads/2014/06/BPP-ISS-ComplianceStatement-1406010.pdf.

81 See 'EFAMA Reply to the public consultation on best practice principles for governance research providers', p. 9, available at http://bppgrp.info/wp-content/uploads/2014/01/EFAMA-BPP-GRP-Consultation-Response-2013.pdf.

implemented the Principles and related Guidance. It is expected to be completed in the fourth quarter of 2015.

Nonetheless, the Chairman has declared that there are three key areas where Signatory discretion is not possible at all: (1) investors interests should always prevail, (2) under no circumstances should proxy advisors engage in proxy solicitation and (3) Signatories must have public policies regarding their research methodologies; disclosure and management of conflicts of interest; and communication with parties other than clients, in which they explain their approach to the Principles and Guidance provided in the Principles. In our opinion, the first commitment must include the way to deal with conflicts of interests, which must be handled by imposing disclosure duties to clients prior to rendering the service, as we discuss in the next section. No flexibility is admissible in this regard. Unfortunately, the second Principle is aim at this aspect, and therefore, is subject to the flexibility inherent to a "comply or explain" approach. Besides, as we have pointed out, the Best Practice seems to give priority to other measures such as *Chinese walls* rather than transparency.

The BPPG will undertake a formal biennial review of the Principles, which will include a review of the results of ESMA's independent review of the Principles and other market developments. In fact, ESMA is seeking evidence on the impact of the Best Practice Principle for proxy advisors by launching its Call for Evidence in June 2015. ESMA will consider all comments received by 27 July 2015 and will publish the final results of its review at the end of 2015[82].

b) The revision of the Shareholder Rights Directive

The 2012 Action Plan on European company law and corporate governance, put forward by the European Commission to the Parliament, included an initiative to improve the rules governing proxy advisors on transparency and conflicts of interest, possibly in the context of the revision of the Shareholders' Rights Directive, which, in turn, would be focused on the disclosure of voting and engagement policies as well as voting records by institutional investors[83]. Indeed, in April 2014 the European Commission announced a

82 See ESMA, 'Call for Evidence Impact of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis'. During the proofreading stage of this article, results of the consultation were published. See ESMA Final Report at www.esma.europa.eu.

83 See 'Communication from the Commission to the European Parliament, the council, the European Economic and Social Committee and the Committee of the Regions Action Plan: European Company Law and Corporate Governance – A modern legal framework for more engaged shareholders and sustainable companies', on December 12, 2012, COM/2012/0740 final.

package of measures to improve the corporate governance of companies listed on Europe's stock exchanges[84]. It was launched with the purpose of contributing to the competitiveness and long-term sustainability of these companies and included the revision of the Shareholder Rights Directive, a Recommendation on corporate governance reporting and a proposal for a Directive on single-member private limited liability companies.

As regards the revision of the Shareholder Rights Directive, it tackles certain corporate governance shortcomings relating to the behavior of companies and their boards, shareholders (institutional investors and asset managers), intermediaries and proxy advisors. Consultations and extensive informal meetings had shown the Commission problems in the area of corporate governance of listed EU companies. Among others, we should mention the doubts that came up on the reliability of the advice of proxy advisors, due to insufficient transparency on the methodology used or to possible conflicts of interest[85]. For that reason, art. 3 i of the proposal for an EU Directive amending the Shareholder Rights Directive includes measures seeking more transparency among proxy advisors on the methodologies they use to prepare their voting recommendations and on how they manage conflicts of interest. Proxy advisors are required by this proposed article to publicly disclose certain key information related to the preparation of their voting recommendations and, to their clients and the listed companies concerned information on any actual or potential conflict of interest or business relationships that may influence the preparation of the voting recommendations.

First, on methodologies, Proxy advisors shall on an annual basis publicly disclose all of the following information in relation to the preparation of their voting recommendations: (a) the essential features of the methodologies and models they apply; (b) the main information sources they use; (c) whether and, if so, how they take national market, legal and regulatory conditions into account; (d) whether they have dialogues with the companies which are the object of their voting recommendations, and, if so, the extent and nature thereof; (e) the total number of staff involved in the preparation of the voting recommendations; (f) the total number of voting recommendations provided

84 See the section Corporate Governance: European Commission optimizes environment for companies, on the European Commission, The EU Single Market website. In this section we are following the information it provides.

85 See Commission Staff Working Document Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council on amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement and Commission Recommendation on the quality of corporate governance reporting ('comply or explain'). SWD/2014/0127 final, pp. 32 to 34.

in the last year. The information shall be published on their website and remain available for at least three years from the day of publication.

Second, on conflicts of interests, Member States shall ensure that proxy advisors identify and disclose without undue delay to their clients and the company concerned any actual or potential conflict of interest or business relationships that may influence the preparation of the voting recommendations and the actions they have undertaken to eliminate or mitigate the actual or potential conflict of interest.

Assuming that proxy advisors play an important role with regard to shareholder engagement, the proposed article is aimed at ensuring reliable and high quality recommendations (based on a thorough analysis of all the information that is available to them) and to enhance trust in the services rendered by proxy advisors. In fact, the Commission believes that undertaking this measure would help shareholders and investors have more and better information to take their decisions and to defend their interests.

The implementation of binding transparency requirements were preferred among all options considered: no policy change, recommendation on transparency, implementing binding transparency requirements or introducing a detailed regulatory framework. According to the Impact Assessment accompanying the proposal, requiring disclosure on methodology and management of potential conflicts of interest would put additional pressure on proxy advisors to establish adequate procedures on these aspects. In the Commission's view, binding transparency requirements would be more effective than soft law (recommendation on transparency), while avoiding inflexible and disproportionate charges linked to a detailed regulatory framework. According to the Commission, the last would submit proxy advisors to specific rules regarding the treatment of conflicts of interest and methodological requirements to ensure that they act in the best interests of their clients. In addition, it would also include measures on authorization or registration and supervision by competent authorities. As we will discuss in the next section, register and monitoring mechanisms and the disclosure of specific conflicts of interests prior to the provision of advice are the crucial aspects relating to proxy advisors that, in our opinion, should be subject to mandatory regulation. We do not consider it would put disproportionate charges to proxy advisors. Being an intermediate step, it does not mean a regulatory framework covering all aspects of proxy advisors' regime. Note that not all the ways to deal with conflicts of interests are equally incisive on proxy advisors. Also, the submission to authorization and the registration by supervisory authorities cannot be seen as equivalent measures. Therefore, we do not think that all these measures should be analyzed under the same policy option, as it has been the Commission's approach.

Despite the Commission's statement against the implementation of specific rules regarding the treatment of conflicts of interests, art. 3 i *apparently* proposes a given way to handle with them: disclosure on the conflicts of interests or on any business relationships that may influence the preparation of the voting recommendations. Unfortunately, the statements in the Impact Assessment together with the complementary duty to disclose the actions undertaken by proxy advisors to eliminate or mitigate the actual or potential conflict of interest, makes it probable that such a first requirement will be fulfilled by just incorporating *boilerplate* language in the terms we have mentioned before. Besides, it is clear that this complementary duty introduces flexibility on how to deal with conflicts of interests.

As stated in the Citizens' summary regarding the package of measures on the modernization of corporate governance, there is a need that the measures proposed in the amendment of the Shareholders Rights Directive (included those aimed at proxy advisors) are taken from a EU level. Insofar as the EU market in shares of listed EU companies has to a large extent become international (listed companies have an increasing proportion of foreign shareholders and institutional investors, asset managers and proxy advisors carry out activities of international nature), only European measures can guarantee a level playing field with a comparable level of transparency and protection for investors and the effective exercise of shareholder rights across borders. As the Commission has stated, there are currently around ten proxy advisory firms (with two main actors sharing most of the market) active in the EU that would be potentially affected by these measures.

Now, the last statement brings up the discussion on the extraterritorial application of EU law. Indeed, the application of EU Law to US market players has always represented a real 'battleground'. As a general principle, Public International Law prevents States from exercising their sovereign rights in the territory of another State without its consent. However, there are some areas in which this principle might experience exceptions or modulations. We refer to Data Protection and Intellectual Property Law, Environmental Law, Competition Law and, of course, the Law of the Treaties (regarding, for example, human rights).

This extension of EU Law is based on the "effects doctrine" or objective territorial principle. According to this doctrine, EU Laws are applicable to foreign firms when their behavior or transactions produce a direct, immediate, substantial and foreseeable effect within the EU[86]. The doctrine was first

86 For further analysis on this topic see, among others, C. Otero García-Castrillón, 'El alcance extraterritorial del derecho de la competencia y su utilización como medida comercial', 212, Gaceta Jurídica de la Unión Europea y de la Competencia (2001), pp. 34–56 and J. Scott, 'Extraterritoriality and Territorial Extension in EU Law, 62 (1) American Journal of Comparative Law, (2014), pp. 87–125.

embraced in the Court of First Instance (CFI) judgment in the *Gencor Lonrho* case[87], when stating that the application of the Merger Regulation to a merger between companies outside EU territory was justified under Public International Law, since it was foreseeable that the proposed concentration would have an immediate and substantial effect in the Community. It has been stated that the "effects doctrine" enables EU to protect its competition interests when co-operation is not possible or has failed immediate and substantial[88].

Anyway, despite its admission, the extraterritorial application of EU Law on those fields (such as Protection Data and Intellectual Property Law, Environmental Law, Competition Law) still shows the complexity of this issue both in theory and in practice, which brings up topics for discussion[89]. Given the state of development of the proxy advisory market, the importance of the areas where this extraterritorial application does take place, its exceptional nature and the fact that such application is not completely free from controversy, it is hard to believe, at least at this moment in time, that there will be a territorial extension to US market players of the EU rules on proxy advisors. At any rate, they do have an influence on how voting rights are exercised in Europe. It does not seem to be substantial enough but, the "effects doctrine" appears as a possibility which obviously requires further discussion in the future.

4. Specific aspects of the activity of proxy advisors that must be subject to mandatory regulation

a) Approach

In our opinion, there are a number of specific aspects of the activity of proxy advisors to be subject to immediate legal regulation and, therefore, which should not be left to self-regulation, namely: the way to deal with conflicts of interest and the establishment of supervision and control mechanisms to ensure the informational transparency as a securities market's basic principle. Along with those, should be added measures to increase competition which, in turn, would enable alleviating the risk of conflict of interest when delivering

87 Case T-102/96 *Gencor* [1999]. Judgment of the Court of First Instance (Fifth Chamber, extended composition) of 25 March 1999.

88 L. Davison and D. Johnson, The EU's Evolving Stance on the International Dimension of Competition Policy: A Critical Commentary, 37 (5) Intereconomics, 2002, p. 244.

89 As evidence, this question has been recently discussed in the international Conference in Vigo (Spain) on June 18/19, 2015 entitled 'The Extraterritorial Application of EU Law', organized by the Spanish Association of Professors of International Law and International Relations (AEPDIRI).

services both to investors and to issuers[90].This would lead to better distribution of customers from both sides of the corporate relationship. In addition, a *side effect* would be better distribution of the workload among consultants, thereby increasing the time that could be spent on the underlying analysis for each portfolio advised. So, the more players operating in the market, the better the allocation of customers demanding proxy advisory services will be. It would enable proxy advisors to perform further analysis of the concrete situation of the issuer and, especially, to customize that analysis in relation to the profile of the customer and its aggregate portfolio.

An issue discussed in the context of possible regulation (direct or indirect) on proxy advisors is whether such regulation (or in general any intervention, binding or not, in the proxy advisory market) must be undertaken from a national or international perspective. Clearly, the globalization of markets would advise a regulatory approach through international instruments. But apart from that, from Europe, it would be advisable to undertake a supranational perspective[91] (either by Regulations or Directives) to ensure a minimum level of enforcement and a certain degree of effectiveness, as has been the case of other service providers such as rating agencies and financial analysts, whose services are also of a certain cross-border scope.

However, taking into account the nationality of the majority of proxy advisors and their customers, only the securities (which are sometimes underlying if the investment has been made on ADS) referring to foreign (European) issuers can establish a link with Europe, limiting greatly the potential of such regulations. Merely the expansion of some US consultants through branches or subsidiaries in Europe to provide services to European investors and the fact that some proxy advisors are European, could ensure a certain level of effectiveness for such regulations. And in the same way, it should also be taken into account in this context the fact that some European institutional investors with largely internationalized portfolios are opting for the advice of those US proxy advisors who, as pioneers and market leaders, are able to offer globalized coverage of general meetings, not only with respect to their current investments[92], but

90 On the various conflicts of interests affecting some US proxy advisors, see U.S. Government Accountability Office (GAO), 'Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting', GAO-07-765, 10 (2007), pp. 9 to 12, and Center on Executive Compensation, 'A Call for Change in the Proxy Advisory in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight', January 2011, pp. 42 to 54.

91 Also, E. Dubois, 'Shareholders' General Meetings and the Role of Proxy Advisors in France and Japan', 4 Kyushu Journal of International Legal Studies (2011) 56, 105.

92 U.S. Government Accountability Office (GAO), 'Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting', GAO-07-765, 10 (2007), pp. 13 y 14.

also with respect to future investment decisions regarding other markets. That is probably the reason why some proxy advisors have joined under ECGS to offer wider service to their customers[93]. As we have pointed out in the precedent section, probably not much can be done from Europe at the existing level of development and the geographical concentration of the proxy advisory industry. The scope of possible US policy intervention and the subsequent monitoring of proxy advisors by the SEC are thus remarkable.

b) Control over the activity of proxy advisors: register and monitoring mechanisms

In the context of discussions regarding the role of proxy advisors, the need or convenience of submitting their activity to the supervisory market authorities, whether domestic (the SEC in the United States, the *BaFin* in Germany or the CNMV in Spain or other supervisory authorities created *ad hoc*[94]), or supranational (similar to the rating agencies' register with ESMA) has been stated. This ranges from measures such as the submission of the advisory activity to prior authorization, to other less incisive measures, such as requiring registration with supervisory bodies, combined with other monitoring mechanisms (for example, disclosure requirements).

While the submission of proxy advisory activity to prior authorization would enable the establishment of certain requirements of the service provider designed to ensure professionalism and high qualification, it is disproportionate to conceive the proxy advice as a reserved activity subject to prior authorization and subsequent continuous monitoring[95]. Besides, the establishment and subsequent accreditation of certain requirements both from the proxy advisor and its staff in charge of carrying out the preliminary analysis and of issuing voting recommendations would be complicated. Precisely for this

93 Expert Corporate Governance Service (ECGS), formerly known as European Corporate Governance Service, is integrated by Ethos (Switzerland), Frontis Governance (Italy), Shareholder Support (Holland), Proxinvest (France), Deutsche Schutzvereinigung für Wertpapierbesitz (DSW) in Deutschland and Groupe Investissement Responsable Inc. (Canada). Depending on the issuers' nationality, the preparation of the voting recommendations is distributed among these partners, who apply a uniform voting policy. The voting recommendations are then gathered by the *managing partner* (at present, *Proxinvest*) and delivered to the customer. For further information see http://www.ecgs.org/.

94 T. Belinfanti, 'The Proxy Advisory and Corporate Governance Industry: the Case for Increased Oversight and Control', Stan. J. L. Bus & Fin. (2008–2009) 384, especially pp. 436 and 437.

95 T. Baums, 'Zur Deregulierung des Depotstimmrechts,' ILF, Working Paper Series, n/67/2009, p. 12.

reason, the debate has been focused mainly on the requirement of registration of the business of proxy advice.

Not existing insurmountable obstacles to voluntary proxy advisors' registration (as happens in fact), there is no consensus on the convenience of making it mandatory, which would be set up as a requirement for the exercise of proxy advisory activity. In fact, among those who have dealt with the study and analysis of proxy advisors, there is a majority position contrary, for the moment, to a registration requirement. Such a position is based primarily on the bureaucracy linked to the registration and monitoring by supervisory authorities, considered as additional barrier to entering into the (for the moment) highly concentrated market[96]. Contrarily interpreted, most of these positions do not rule out that the proxy advisory activity should be subject to supervision, but only question the choice of the most appropriate moment for it. Thus, among those who openly reject a registration requirement, some highlight that it may be appropriate at a later time, as an early obligation to register could backfire[97]. Among those who support a registration requirement, some propose it as the following step after a previous self-regulatory attempt[98].

Considering, on the one hand, the role played by proxy advice in the process leading to the determination of how to vote at listed companies' general meetings and, on the other hand, the transparency as a basic securities market's principle, the registration and supervision of proxy advisors is, in our opinion, imminently necessary. The subsequent additional obligations of proxy advisors (the duty itself to register as a prerequisite for the proxy advisory business, transparency requirements, the duties to prevent and to deal with conflicts of interest, etc.) that might complement registration and its possible disincentive effect on the entrance of new agents into the highly concentrated market are not decisive enough to justify the contrary at this stage. There is no doubt that the registration of proxy advisors, with the consequent disclosure of certain identifying features of the service provider, and their submission to supervision, would contribute to generating trust and transparency in the markets. Note that the advice would then be rendered by supervised entities. Note also that the advisory vote ends up being part of the process leading to the voting-decision making and through it, to the formation of the corpora-

96 See, for all, EFAMA, Reply to the ESMA Discussion Paper An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options', June 2012, p.7.

97 DAV, Stellungnahme des Deutschen Anwaltvereins zum Grünbuch der EU-Kommission vom 5. April 2011: Europäischer Corporate Governance-Rahmen KOM (2011) 164/3, 2011, p.12; H. Fleischer, 'Zur Rolle und Regulierung von Stimmrechtsberatern (*Proxy Advisors*) im deutschen und europäischen Aktien- un Kapitalmarktrecht', 1–2 AG (2012) 2, 9.

98 G. Bachmann, 'Der "Europäische Corporate Governance-Rahmen" – Zum Grünbuch 2011 der Europäischen Kommission-', en 28 WM (2011) 1301, 1307.

tion's decision through the general meeting resolutions. Precisely for this reason, and to the extent that voting recommendations are likely to affect the markets which the advice refer to, it would be desirable that such registration (and subsequent monitoring) would be held by the supervisory authorities of those markets for which proxy advisors offer advice. This could include not only the issuer's home market (for example, registration with the CNMV in relation to a Spanish listed company), but also those in which its shares are trading or admitted for trading (for example, registration with a foreign authority in relation to a Spanish company whose shares were admitted for trading in its market). However, the cross-border nature of an activity that is provided by national companies that actually do not operate in the markets where such supervisory authorities are competent makes difficult the factual setting up of a measure whose need is theoretically obvious. Hence, along with the supervisory authority regarding their nationality, we appreciate, as more practicable, the submission of proxy advisors to supervisory authorities of the markets where their branches or subsidiaries have been established for advisory service.

Registration should also be accompanied by duties with regard to the existence of conflicts of interest and the need for market transparency, whose compliance should be subject to the control of the supervisory authorities. We will deal with the former more thoroughly in the next section. Regarding the latter, disclosure duties would ensure the accuracy and reliability of proxy advisors' voting recommendations. Improvement and clarification of the criteria taken into consideration by the proxy advisor when making voting recommendations have been proposed in this regard. Such measures would enable the investor to choose the proxy advisor with the voting policies most aligned with his interests[99]. Also, the board members or the proponent shareholders would have adequate guidance on how to justify their proposals for resolutions when based on criteria not entirely aligned with those applied by, at least, the principal advisors. While it has the reverse risk that board members would simply adapt their proposals to the proxy advisor's criteria, instead of making efforts to propose and justify what is in the best interests of the company[100], we

99 S. Choi, J. Fisch, M. Kahan, 'Director elections and the role of proxy advisors', 82 Southem California Law Review (2009) 649, pp. 651, 696 and 697 e *Idem* 'The power of proxy advisors myth or reality?', 59 Emory Law Journal (2009) 869, pp. 883 and 884.

100 Some proxy advisors do not disclose any voting guidelines on their websites and justify this in the circumstance of basing their recommendations on the voting policies previously drafted by their customers, by themselves or in collaboration with the proxy advisor. Nonetheless, in the latter case it usually leads to the application of the standards drafted by public institutions selected by the customer such as the BVI – Bundesverband Investment und Asset Management e. V. – or the ICGN-International Corporate Governance Network –.This enables proxy advisors to point out (and even

consider that transparency in methodology and criteria is necessary in any case. This in general lines, since the underlying methodology and analysis are part of commercial confidentiality.

Secondly, similar to proposals by the SEC regarding art. 936 Dodd-Frank Act in relation to credit rating agencies[101], in this context of transparency it is also convenient to impose disclosure duties regarding the training and experience of proxy advisors' analysts. It would keep the competent supervisory authorities informed on the level of qualification of those involved in the analysis and the issuance of voting recommendations by a particular proxy advisor, which may ultimately increase the level of qualification of the proxy advisor's staff.

c) Provision of parallel services and dealing with conflicts of interest: prohibition (general or particular) versus transparency

Along with registration and monitoring by supervisory authorities, the treatment to be given to conflict of interest situations that proxy advisors may encounter are prominent in the debate on the regulation of the proxy advisory industry. Although the potentially conflicting situations may be different, the proposals for future regulation or intervention on the proxy advice have been mainly focused on how to deal with the potential conflict arising from the parallel provision of advice on corporate governance to issuers and on proxy voting to investors, respectively.

In particular, in the current state of concentration of the industry, it is likely that the proxy advisor ends up issuing a voting recommendation on how to vote with respect to the proposals the consultant has assisted to draft. In the belief that proxy advisors will not "act against their own acts", the members of the board are likely to have the temptation (and even, at times, the pressure) to consider proxy advisors as their perfect *allies* to ensure a satisfactory level of support of their proposals at the general meeting. In fact, this situation has been assimilated to the one of "creating a test and selling the answers"[102].

to justify) that the voting recommendations made regarding the same general meeting are not necessarily the same. This applies, for example, to customers of the German IVOX.

101 We agree in this point with the recommendation III set by the *Institute sur la Gouvernance d'organisations privées et publiques* (IGOPP) in 'Le rôle préoccupant des agences de conseil en vote ("proxy advisors"): quelques recommandations de politiques', (June 2013), p.23. Available at http://igopp.org/wp-content/uploads/2014/04/pp_rolepreoccupantconseilllersvote-pp7_fr.pdf.

102 See D. Starman, 'A Proxy Adviser's Two Sides', in *The Washington Post*, January 23, 2006.

Entering into two-sided business relations gives rise to the risk of placing the proxy advisor in a delicate situation, being obliged, at least morally, to be faithful to its partners. If taken to its logical conclusion, to recommend the board a proposal and to advise a shareholder (institutional investor) to vote against, could be seen by the issuer as a sort of *betrayal*. Similarly, to recommend the investor, as a gesture of loyalty to the company, to cast the vote for the proposal, when it is not in the best interests of the client-investor, would be inconsistent to the good faith over all contractual relations. In extreme cases, the vote for the board's proposals could be raised by the proxy advisors as a "sure result", provided the issuer promises to hire their services in the future. Thus from the proxy advisor's point of view, it could be used as a *decoy* to offer service to issuers.

Being clear that such a conflict must be avoided, the various proposals achieve this objective in varying ways. The discussion focuses on the analysis of the practical effectiveness of the different instruments that could be set up to deal with this issue. The different possibilities that arise are basically: a) the prohibition, either general or particular, of providing parallel services, b) the obligation to establish *Chinese walls* between the two types of services, and c) transparency requirements in relation to conflicts of interest.

Obviously, the more drastic and effective measure in this regard is to ban the parallel provision of advisory services to issuers and to shareholders, so that every advisor is allowed to render services just to one part of the corporate relationship. Then the conflict of interest would not exist. This could be done in two ways, either by prohibiting the general provision of advisory services to another part of the relationship when it is already rendered to one part, no matter the identity of the customers (general prohibition) or by prohibiting the parallel service only when, regarding the identity of the customers involved, this may result in a specified conflict situation, in the sense of acting in the interests of one part to the detriment of the another (particular prohibition).

In any case, the conflict of interest does not come from the fact that the advisor renders simultaneous or parallel services to any issuer, but with respect to the *same issuer* whose general meeting proposals for resolution are to be analysed in the course of the service provided to investors (or with respect to companies linked to that issuer). It seems that the provision of advice on corporate governance matters could be of utility for proxy advisory activity in the sense of enabling a better understanding of the good governance practices and, above all, of the possible perspective undertaken by the board when proposing the resolutions to the general meeting, as well as certain local peculiarities. Considerations of this type, together with the limitation of business opportunities of an absolute prohibition on providing advisory services on corporate gov-

ernance to issuers, whoever they may be, lead to the rejection of a disproportionate *general prohibition* measure.

But even in consenting to the general provision of services to *both sides* (issuers and investors), the most effective way to struggle with the negative effects of a possible conflict of interest is to impede it through abstentions or prohibitions of action in providing both services *on the same listed company.* It could be set up from the side of proxy advisors or from the side of their clients. In fact, a look at the current or proposed regulation for other service providers suggests the ban of provision of corporate governance advice and of proxy advice on the *same issuer*[103]. That would not mean that the advisory service on corporate governance to issuers is *in all cases* incompatible with the proxy voting advice to investors, but only when both services refer to the *same issuer* (particular prohibition).

One of the drawbacks of such a special or particular prohibition would be that it could end up limiting the (already reduced) choice among proxy advisers by institutional investors, as they could not receive services from whom is already advising the companies in which they have invested. However, from the point of view of the competitive situation in the market, such a measure could lead to the need for new proxy advisors. In any case, such effects not being immediate, it would be complex to put the measure in practice at this stage. First of all, until the rise of new players, the investor would have to receive *scattered* advice from the few advisors currently operating in the market. In addition, its effective implementation requires the comparison between the investors' investment portfolios and the list of proxy advisors' corporate clients. And possibly the prohibition should also extend to other issuers linked to the one advised on corporate governance (for example, a company in the same group). Furthermore, as is evident, this measure would require the prior identification of the proxy adviser's customers from the side of listed companies, which clashes with the establishment of the *Chinese walls* used as barriers by some advisers to neutralize such conflicts of interest.

Thus, the establishment of *Chinese walls* between both types of advisory services is an alternative measure to the general or particular prohibition of

103 That is the case, among others, of credit rating agencies (art. 6.2 in connection with Appendix I, Section B, number 4 of the EU Regulation n/ 1060/2009), of statutory auditors of public-interests (art. 10.3 of the proposal for a regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest, Document COM (2011) 779 final 2011/0359 (COD) Brussels, 30.11.2011) and of the consultants on remuneration of directors of listed companies (9.2 Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, Document {SEC (2009) 580} {SEC (2009) 581} Brussels, 30.4.2009 C (2009) 3177).

the parallel provision of advisory services. Applied to proxy advisors, it means that two different sections or departments of the entity, completely independent from each other, are in charge of each service. Such separation and isolation of activities precisely pursues that the proxy advisor is unaware that he is advising on proposals to a general meeting that he has helped to draft. The most drastic types of *Chinese walls* would even lead to the setting up of two separate legal entities for the provision of services to issuers and to investors, respectively. Indeed, among the measures of this type that some proxy advisors have self-imposed, is to be mentioned the one applied by ISS, with an entity, *Institutional Shareholder Services, Inc.,* in charge of advising investors and another one, *ISS Corporate Services, Inc.*, responsible for advising corporations (which is nevertheless a subsidiary of the first). Thus, in the case of ISS, only its Legal/Compliance Department knows the identity of the clients from both sides and, therefore, can report on it to the institutional investors *who request it*. Note that, as we have already announced and we discuss below, we consider it must be reported *before* providing the service and *regardless* of there is a previous request from the client.

In our opinion, in an industry with few professionals it is probably not too difficult to identify whether the advice of a team of advisers belonging to the same proxy advisory entity is underlying the discussed proposals. The writing style itself or some formal elements of the wording of the proposed resolutions may be key elements in this regard. In any case, if nothing prevents two completely separate entities from contacting, the less difficult it would be when it comes from business units of the same company or from entities belonging to the same group. To this is also added the effort itself which, nevertheless, the consultant could perform to avoid ending up offering contradictory advice from both sides. Hence, transparency measures have also been considered, as an additional measure in cases where *Chinese walls* do not seem to be effective enough or directly as an alternative to it. It consists in disclosing investors the links with the issuers prior to the provision of proxy advisory service. Beyond that, if the situation which could give rise to a conflict of interest exists once the proxy advisor has been hired, the consultant should report on it as soon as possible.

Actually, probably a more effective solution than the establishment of *Chinese walls*, and less drastic than the particular prohibition of parallel services, is the transparency on conflicts of interest. In response to some market practices, it appears that this cannot be considered satisfactorily fulfilled through the practice of incorporating a *boilerplate* in any communication with the customer-investor warning him of the mere *possibility* of the existence of links with the issuer, without providing specific data whether or not it is in fact the case. The correct application of the measure would require the identification of the specific terms of the contractual or business relationship with the issuer (or whoever

could generate the conflict situation). Indeed, it could extend up to the need of reporting even the fees received for the provision of other services[104] or the shareholding percentages source of the existence of the conflict[105]. This is in line with the guidelines of the Division of Corporate Finance of the SEC. Regarding the application of proxy solicitation rules to proxy advisors, the Division has considered that the communication of conflicts of interest must enable the customer to understand the nature and extent of the significant relationship or interest, including the measures taken to mitigate its effects, and provide sufficient information to assess the reliability and objectivity of the voting recommendations. As has been noted with respect to proxy solicitation rules, this communication should not be subject to prior request[106], as sometimes happens in practice. This must also be the purpose of the general duty to disclose conflicts of interest of proxy advisors which we support with a wider application. Note that the guidelines of Corporate Finance of the SEC just interpret the existing US federal law on a specific issue (the exemptions to Proxy Rules). As we have already noted, the Best Practice Principles for Providers of Shareholder Voting Research & Analysis contemplates the disclosure of the specific conflict as a secondary measure, when other measures are not effective enough. On the contrary, we consider that it must be put in the first place. Beyond that, it has been pointed out that it is complicated to set *Chinese walls* and to impose disclosure duties simultaneously in practice, since it is difficult to provide customers with information which is supposed not to be known by the reporter as an effect of the implementation of the *Chinese walls*[107]. In our opinion, this statement is to be made relativize. Such is the case when the information is to be disclosed to the public in general, but not necessarily if just the clients have access to such data. If the proxy advisor adopts organisational structures so that only one of its Departments (such as ISS's Legal/Compliance Department) knows the identity of the clients from both sides, the client from any side should be led first to this Department.

So, the customer being aware of the contractual or corporate links between the issuer (or individuals linked or interested therein) and the advisor or his

104 H. Fleischer, 'Zur Rolle und Regulierung von Stimmrechtsberatern (*Proxy Advisors*) im deutschen und europäischen Aktien- un Kapitalmarktrecht', 1–2 AG (2012) 2, 8.

105 Meridian Compensation Partners, LLC, 'SEC Staff Issues Guidance on Investment Advisers and on Proxy Advisors', vol. 5 Is. 10 Meridian Client Update, July 3, 2014, p. 7. Available at: http://www.meridiancp.com/.

106 Division of Investment Management and Division of Corporation Finance (SEC), 'Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms', Staff Legal Bulletin No. 20 (IM/CF), June 2014, in particular, responses to questions 12 and 13.

107 A. Perdices Huetos, 'Las agencias de calificación crediticia y los *proxy advisors*', 9 Cuadernos de Derecho para ingenieros (2011) 143, p. 154.

circle, it would be up to the customer to assess whether such a situation is likely to affect the impartiality of proxy advice. In this regard, the duties of institutional investors toward their beneficiaries could be strengthened in a similar line as has been included in the UK Stewardship Code which, at a self-regulation level, requires duties to report on the use of proxy advisors and their voting recommendations. Now, this could wield an added pressure on institutional investors, precisely when they hire the proxy advisor to alleviate the fulfilment of their duties in connection with the exercise of voting rights[108]. Small institutional investors appear to be the most vulnerable in this regard, especially for not having enough resources to properly asses these aspects. Generally, the large institutional investors will have, first, their own voting guidelines to be applied by the advisor and, second, a team that could supervise *a posteriori* (and at short notice) the voting recommendations. To some institutional investors, the fact that the advisor applies voting policies previously disclosed or, above all, the ones drafted by or for the customers, reduces the negative effects of a possible conflict of interest. In such a case, institutional investors' managers assure that the subsequent review of what has been recommended by the proxy advisor helps them to eliminate all doubts of partiality. However, in our opinion, to the extent that such guidelines are developed in general terms, there will always be a certain level of discretion in their application, where the effects of the conflict of interest could arise. Note also the tight deadlines (sometimes a couple of days) in which they have to review the recommendations regarding hundreds of general meetings; time intervals rarely attributed by institutional investors to a delay caused by proxy advisors in issuing voting recommendations, but to corporate regulations that establish a short period of time to cast votes. Anyway, the combination with other measures to ensure the reputation and professional qualification of proxy advisors and their staff (like register and monitoring mechanisms) could calm that pressure somewhat.

At times, institutional investors demand the services of a second proxy advisor, to contrast the previous analysis, or simply to increase the effect of "insurance against criticism" they provide[109], especially in relation to those proposals that could be controversial for the institutional investor. But, the fact that, in practice, some institutional investors decide to hire the services of two proxy advisors does not seem to be a solution. Given the current stage of concentration of the industry, it is likely that a new conflict of interest with regard to

108 T. Belinfanti, Response to SEC Concept Release, October 20, 2010, p. 4.

109 L. Strine, 'The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face', 30 Delaware Journal of Corporations Law, (2005), p. 688 and J. Carney, 'Why Should you be worried about Proxy Advisory Firms?', in *NetNet*, October 26, 2010, available at http://www.cnbc.com/id/39795662.

other issuers in the institutional investor's portfolio arises. A likely increase of the cost, among other reasons, makes it not desirable as a solution to avoid conflict of interests.

Hence, we prefer the imposition of transparency duties to the establishment of *Chinese walls*. Nevertheless, it seems that the latter are prevailing in relation to other advisers, such as investment advisers as regards possible conflicts of interest among their customers, and it has been implemented by a well-known proxy advisor on a voluntary basis. But, it must be noted that the regulation ends up imposing transparency duties to investment advisers as a secondary measure if the *Chinese walls* – which could be considered as less strict – are insufficient (art. 195 TRLMV and arts. 44 to 47 RD 217/2008 under Spanish Law). Doubts about whether they really work with regard to proxy advisors do not seem to be dissipated, not only in relation to the situation arising from the provision of parallel services both to issuers and to investors (where the consultant is likely to feel *forced* to avoid ending up offering contradictory advice from both sides, as we have already marked), but also in relation to advisory services rendered to an investor on which another investor-customer might have an interest. This assumption is not to be belied by the fact that a study has concluded that such measures implemented by a particular proxy advisor to deal with conflicts of interest are adequate[110]. It should be noticed that the study was commissioned by the same proxy advisor analyzed.

In any case, in our opinion it is convenient to set up a duty for proxy advisors to disclose the existence of, not only this, but also other types of conflicts of interest (proxy advisor's shareholding in the issuers under analysis, etc.)[111]. Given the difficulties and limited effectiveness of imposing them from Europe, most proxy advisors (at least, those covering most of the market) being subject to US jurisdiction, an immediate action to achieve a similar objective, at least in relation to the provision of parallel services, is that the listed issuers disclose the information on the use of proxy advisory service by its inclusion, for example, in the annual corporate governance report[112].

Apart from that, the provision of parallel services regarding the same issuer could, apparently, cause problems of disclosure of inside information that

110 We refer to the letter issued by *Sullivan & Cromwell* on 29th November 2007, which ISS discloses at its website under the following link: http://www.issgovernance.com/files/ISS_Corporate_Services_Conflict_Policy_Review_Project.pdf.

111 U. Schneider and H. Anziger, 'Institutionelle Stimmrechtsberatung und Stimmrechtsvertretung – A quiet guru's enormous clout', 10 NZG (2007) 88, p. 95 and 96.

112 PwC, 'Proxy advisors, ¿qué impacto tienen en las sociedades cotizadas españolas?, (May 2013), p. 6. Available at: www.pwc.es/es_ES/es/publicaciones/gestion-empresarial/assets/proxy-advisors.pdf.

should be taken into consideration when facing future regulation on proxy advisors. Among the measures aimed at the prevention of disclosure of inside information among the various business units of the proxy advisor delivering parallel services, some types of *Chinese walls*, required with respect to investment services companies (art. 229 TRLMV under Spanish Law) could be considered. In any case, it needs to be pointed out that they would be implemented, not in order to make the proxy advisor unaware of the identity of the customers from both sides (as they are in practice implemented), but in order to avoid the transfer to the proxy advisory service of the information received from the issuer when providing advice on corporate governance.

However, in the case of proxy advisors it seems to be convenient to provide for these situations a different treatment from that established for the situations generated with regard to investment advisers or credit rating agencies. Note that a better understanding of the issuer would enable the proxy advisor to provide more accurate voting recommendations to the specific issuer's circumstances. In fact, one of the striking problems relating to the activities of proxy advisors is precisely the lack of knowledge of the peculiarities of local markets and jurisdictions and the specific circumstances of the issuer analyzed. In any case, when issuing its voting recommendations, the proxy advisor must observe the limits imposed by the rules on the prohibition of disclosing inside information and should be obliged to previously disclose, to those recruiting professional services, the links with the issuer or with the institutional investors, respectively.

VI. Conclusions

Regardless of the fact that proxy advisors could be considered investment advisers under some jurisdictions, and therefore subject to registration requirements and duties aimed at investment advisors, any jurisdiction contemplates a specific regime on proxy advisors.

The lack of evidence of massive market failures is not an obstacle that prevents an intervention in the activity of proxy advisors in certain aspects related to their business that require immediate regulatory treatment. These are, basically, the duties to register with a supervising authority as a requirement for the provision of proxy advice and to properly deal with conflicts of interest (in our opinion, by requiring disclosure to the customers in advance of hiring proxy advisor's services). Regarding the first duty, registration by the supervisory authorities of the markets for which the proxy advisory services are offered would be desirable. Transparency as a core securities market principle requires public disclosure of those who are taking part in the process leading to the determination of how to exercise voting rights in relation to issuers oper-

ating in the markets in which these supervisory authorities are competent. In addition to the interests that listed companies may have in their identification, investors must be able to know who is involved in the process leading to the voting-decision making and, through it, to the formation of the corporation's decisions through the general meeting resolutions. Now, being aware of the difficulties of the application of such a measure, we consider that the registration should be mandatory at least by the supervisory authorities of the market where the proxy advisor is established, which extends to the markets where its branches or subsidiaries have been established.

Among the options that have been raised in relation to the ways to deal with conflicts of interest resulting from the parallel provision of advisory services to issuers and to investors, in our view transparency is preferable. Actually, prohibiting the provision of parallel services is the most effective of all possible solutions, because in that way the existence of the conflict itself is prevented, though this is not the most desirable. Note that this could result in a disproportionate and excessive limitation of proxy advisor's possibilities of business (particularly if it is a general prohibition) or that its setting up in practice could be complex (especially in the case of a particular or special prohibition). Therefore, whenever a simultaneous provision of advice exists, and in the event that a conflict occurs, we understand that the best way to deal with it is transparency. Thus, once the investors have been warned of what is connecting the adviser to the issuer, he would be given the opportunity to assess whether the provision of the service in such conditions is likely to affect the impartiality and usefulness of the advice and thus, he would be given the opportunity to decide whether to hire the professional services of the adviser. And for the same reason, from the perspective of the advisory services on corporate governance to listed companies, the proxy advisor should act in the same way.

Given the current level and geographical market area of development of the proxy advisory industry, with a significant concentration of advisers and clients in the United States, the biggest impact on their activity would be achieved from US regulation. In any case, some measures could be also undertaken to this effect from Europe, in particular at a supranational level. Note that some US proxy advisors are operating in Europe through European networks of branches and subsidiaries; that there are also some European proxy advisors and that the European clients of the biggest US proxy advisors are European institutional investors with largely internationalized portfolios seeking a comprehensive coverage of all the general meetings regarding issuers whose securities are included in their portfolios. Moreover, such measures would not necessarily be aimed at certain aspects related to the activity of proxy advisors (*direct measures* such as dealing with conflicts of interest, policy voting disclosure, registration requirements and supervision, etc.), but also at individuals who relate to them, as listed companies or institutional

investors (*indirect measures* such as duties to report on the use made of the services of proxy advisors). Precisely these indirect measures offer greater possibilities of effectiveness from Europe.

In any case, the establishment of measures that would directly affect institutional investors would ultimately increase the obligations already imposed on them by their regulatory framework in relation to the exercise of voting rights, which might be undesirable. For this reason, we consider, in a similar vein, that the direct measures applied on proxy advisors should not excessively affect those who relate to proxy advisors, especially their institutional investor-customers. Thus, banning the issuance of voting recommendations regarding the same issuer already advised on corporate governance, but allowing the delivery of a parallel service in other cases, is likely to end up forcing the institutional investor to request the services of several proxy advisors. Imagine that among the proxy advisor's customers from the listed companies side appear one or more issuers in whom the institutional investor has invested. In addition to a likely increase in the cost, such a measure would be difficult to apply. Among other reasons, it would involve the handling of different voting platforms with respect to each proxy advisor. This is unless all the information and recommendations from the various proxy advisors could be concentrated in a single platform. In any case, regardless of the likely increase of the cost, this dispersion of the analysis and the issuance of voting recommendations among different proxy advisors would impede a *comprehensive assessment* of the institutional investor's overall portfolio.

The guidelines released in June 2014 by the Divisions of Investment Management and of Corporate Finance of the SEC rest on some ideas close to the ones raised here. Also the proposal for a Directive by the European Commission in the context of the revision of the Shareholder Rights Directive (art. 3 i) moves in a similar vein. Despite the narrow scope of the first (limited to very specific cases), which by the way are just interpretation and application criteria on existing US federal law, and the confinement of the second to the Shareholder rights' Directive (with a limited scope), they constitute small steps in the right direction.

The Best Practice Principles for Providers of Shareholder Voting Research & Analysis also moves in the same vein, but, in our opinion, there are some specific aspects that cannot be left to self-regulation. The protection of the reliance on the proper functioning of the market and the trust laid by institutional investors on the consultant's uprightness and professionalism requires the approach raised here. It does not seem that the application of the Best Practices Principles will change the situation as regards conflicts of interests. No flexibility is admissible in this regard. Unfortunately, the second Principle is subject to the flexibility inherent in a 'comply or explain' approach. Besides,

as we have pointed out, it seems to give priority to other measures such as *Chinese walls* rather than transparency. Anyway, the fact of being *subject to contractual agreements* introduces a tinge of uncertainty on whether such a disclosure would be made in any case. As evidence, proxy advisors behave the same way after the publication of the Principles and we do not believe that *boilerplate* language that such a relationship or interest may or may not exist is a satisfactory solution.