Securing the future of pensions

European Market and Securities Authority (ESMA)

An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options

NAPF Response June 2012

The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1,200 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £800 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure the security and sustainability of UK pensions.

We welcome the opportunity to respond to the ESMA Discussion Paper on the Proxy Advisory Industry and have summarised our views below:

- Proxy advisors provide a service to investors utilising accepted principles of good corporate governance and guidelines devised by the asset owners, their clients and other market participants.
- Given that many investors agree to a common set of good corporate governance practices, it is perhaps not surprising that correlations can be found between proxy advisors' recommendations and shareholder voting outcomes.
- In practice many investors use these services as a form of screening process, highlighting issues worthy of further consideration and assessment by themselves.
- The ultimate voting decision for each resolution at a company meeting is the responsibility of the investor, not the advisory service.
- Proxy advisers are accountable to their clients. Their clients are responsible to the underlying beneficiaries – asset owners / trustees - for how they conduct their voting activities.
- The use of proxy advisors can positively facilitate investors in carrying out their stewardship responsibilities to vote in an informed manner across often highly diversified portfolios.
- It is imperative that the proxy agency's primary obligation remains to their investor clients. Regulation should not seek to conflict with this, any shift to prioritising the interests of issuers over the investor clients would be inappropriate.

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In the interests of transparency, the NAPF has since 2004, been associated with Institutional Shareholder Services (ISS) in the UK through RREV (Research Recommendations and Electronic Voting) in the provision of proxy voting research and advice.

The original joint venture was replaced in 2006 with a policy advisory agreement; the NAPF no longer has a shareholding in RREV and is not involved in the day-to-day management of the business.

Under these arrangements, the NAPF supplies corporate governance policy and policy advice to the ISS UK research team who are responsible for the preparation of proxy voting research and voting recommendations under the RREV brand. The NAPF does not supply specific voting recommendations to RREV or to any of its members and our voting guidelines are developed with active involvement from asset owners and other investor members of the NAPF.

<u>Correlation between proxy advice and investor voting behaviour</u>

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

While there is a directional correlation between the voting recommendations provided by proxy advisors and the actual votes of institutional investors, it is important to note that in the UK at least very few resolutions fail to achieve a majority of votes in favour. This is despite the very difficult business conditions of recent years.

Proxy advisors provide a service to investors, this service – analysis and voting recommendations – utilises accepted principles of good corporate governance and corporate governance guidelines devised by the asset owners or their clients and other market participants – as is the case with ISS who use the *NAPF Corporate Governance Policy and Voting Guidelines* when issuing their proxy voting advice on UK companies.

As many investors agree to a common set of good corporate governance practices, it is perhaps not surprising that correlations can be found between proxy advisors' recommendations and shareholder voting outcomes. It would be a concern if proxy advisors were in their research, consistently interpreting company reports, national corporate governance codes and voluntary policy and voting guidelines in a manner which resulted in recommendations which asset managers and pension funds disagreed with.

2) To what extent:

- **a. do you consider that proxy advisors have a significant influence on voting outcomes?**
- **b. would you consider this influence as appropriate?**

While proxy advisors clearly have an influence over voting, we do not believe they have an overly significant influence over the outcomes.

We would expect investors to utilise a range of research information in assessing a company's AGM resolutions, including that conducted by proxy advisory services. We would expect that such a service would be used in the fashion for which it is intended – advisory – and investors would not rely solely on this recommendation. In practice many investors use these services as a form of screening process, highlighting issues worthy of further consideration and assessment by themselves. Those who have delegated to the proxy advisors expect them either to apply their, the client's, policy or the proxy firm's policy with little discretion.

Importantly, the ultimate voting decision for each resolution at a company meeting is the responsibility of the investor, not the advisory service.

In the UK, Principle 1 of the FRC's Stewardship Code states that institutional investors that make use of proxy voting and other advisory services should disclose how they are used. We believe that this is an eminently sensible approach.

An example of such a disclosure by UK asset manager Aviva Investors is below:

> *We subscribe to a number of proxy advisory services (see principle 6). These provide research and opinions on the state of a company's governance practices that enable us to check our own assessments. However, our voting is not determined by the recommendations of any of the proxy advisory services (except where this has been specifically agreed with our clients in certain circumstances).*
>
> *In making voting decisions, we use governance and other research from a number of sources. These include the Association of British Insurers (ABI) IVIS service, PIRC, Manifest, RiskMetrics and GMI. For SRI research we subscribe to EIRIS, Maplecroft and Vigeo. We use research for data analysis only and we do not automatically follow any voting recommendations. We believe that subscribing to a wide range of research gives us a better and more objective overview of the governance arrangements at companies and enables us to check our own assessments.*

The main instances where proxy advisors have a more significant influence on voting outcomes is in relation to overseas investors – specifically those from the US – however, these largely represent a minority shareholding in EU companies and as such their influence is not overly significant.

<u>Investor responsibilities</u>

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

Proxy advisers are accountable to their clients. Their clients are responsible to the underlying beneficiaries – asset owners / trustees - for how they conduct their voting activities.

Providing the relationship between proxy advisor and client is suitably transparent there is little risk in a shifting of the investor responsibility. In actual fact, the use of proxy advisors can positively facilitate investors in carrying out their stewardship responsibilities to vote in an informed manner across what may often be highly diversified portfolios. Few institutional investors have the appetite or resources to undertake such work entirely themselves, and it would in addition be less efficient and more costly ultimately for the owners and beneficiaries of the investments being managed.

Conflicts of interest

4) To what extent do you consider proxy advisors:
   a. to be subject to conflicts of interest in practice?
   b. have in place appropriate conflict mitigation measures?
   c. to be sufficiently transparent regarding conflicts of interest they face?

There is clearly the potential for conflicts of interest to occur with regards to proxy voting firms – as there is along the entire investment chain. To counter this, we believe that proxy advisors should explicitly disclose any conflicts along with their procedures for managing them on their website.

Importantly, we would welcome more specific disclosure around conflicts, rather than general disclosure that conflicts exist. But we would suggest that this should be done on a case-by-case basis, rather than formulaically, in order to avoid boilerplate disclosures.

> For example, if Proxy Adviser A provides voting recommendations on Company B, and Company B is also a client of Proxy Adviser A; this specific conflict should be disclosed. This is as opposed to a broad disclosure that Proxy Adviser A experiences conflicts of this nature from time to time. We would also expect that such disclosures are made readily available to the necessary stakeholders, as opposed to being 'fine print' disclosures.

5) If you consider there are conflicts of interest within proxy advisors which have not been appropriately mitigated:
   a. which conflicts of interest are most important?
   b. do you consider that these conflicts lead to impaired advice?

We have no further comments to make.

Voting policies and guidelines

6) To what extent and how do you consider that there could be improvement:
   a. for taking into account local market conditions in voting policies?
   b. **on dialogue between proxy advisors and third parties (issuers and investors) on the development of voting policies and guidelines?**

a. It is important that voting policies take into account local market practices and regulation. The only international standards of any standing are those of the OECD which are set at a very high level and tend to form a key building block of any policy.

   With regards to the UK, the NAPF supplies corporate governance policy and policy advice to the ISS UK research team who are responsible for the preparation of proxy voting research and voting recommendations under the RREV brand. The NAPF does not supply specific voting recommendations to RREV or to any of its members and our voting guidelines are developed with active involvement from asset owners and other investor members of the NAPF.

b. There is always scope for improved dialogue. Proxy advisory services should seek to develop their policies through outreach to all market participants; however, in practice only a few issuers and investors take time to comment on policies as they are being formulated. The issues tend only to come out on a case by case basis at the time of AGMs.

Voting recommendations

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

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

   b. the dialogue with issuers when drafting voting recommendations?

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

We believe that proxy advisors should be transparent about the methodology and guidelines they are utilising to determine their recommendations. Given the wide scope for interpreting policy and the need to do so given widely differing company circumstances, it is essential the proxy advisers have discretion when applying policy. In this context we welcome the European Commission's initiative to improve the quality of explanation offered by issuers for non-compliance with their local Code or Policy.

It also makes sense for companies to be given a window to respond and correct any factual errors or provide a concise explanation which can be included within the report to investors. However, this should not be seen as an opportunity to negotiate a favourable voting recommendation – that must be a judgement call by the proxy agency. It is imperative that the proxy agency's primary obligation remains to their investor clients. It is to their clients that they owe their first duty; ensuring information is provided in sufficient time for votes to be informed and thus executed in an appropriate manner. Regulation should not seek to conflict with this, any shift to prioritising the interests of issuers over the investor clients would be inappropriate.

We do not feel there are any issues of concern with regards to the standards or skills and experience among proxy advisor staff. This is a commercial issue for which the market for proxy advisory services should drive.

Policy options

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

Option 1 - We do not believe that there is a need for EU-level action at this time. We are not aware of any evidence to indicate the inappropriate use of proxy advisors that might warrant regulatory intervention. We are not in favour of EU wide legislation with regards to proxy advisors. It is important to remember that regulating organisations such as proxy voting agencies will add to their importance and confirm their role in the system.

In considering any regulatory measures, thought should be given to any impact on competition and increase in barriers to entry in the European proxy advisor markets – competition and diversity is helpful for investor decision-making.

Should it be felt that regulatory action is necessary, we would be most supportive of *Option three: Quasi-binding EU-level regulatory instruments*. This is for the reason that we see merit in a disclosure regime with the imposition of disclosure requirements in certain key areas such as with regard to resources applied, their approach to dialogue with issuers, and their policy with regard to conflicts of interest.

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

In our view, an approach such as that adopted in the UK through the Stewardship Code is an appropriate mechanism to improve stewardship, engagement, and transparency by all market participants. The Code, while aimed primarily at asset managers, seeks signatories from throughout the investment chain, including asset owners and service providers -signatories to the Code include ISS, Manifest, Glass Lewis and PIRC.

In addition, as described above, Principle 1 of the Code states that institutional investors that make use of proxy voting and other advisory services should disclose how they are used. This creates transparency about the level of reliance or not an investor places on the proxy advisory services recommendations.

We believe that this approach is the best way forward and expect the Code to continue to evolve to reflect expected best practice.

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

N/A

11) What would be the potential impact of policy intervention on proxy advisors, for example, as regards:
  - **a. barriers to entry and competition;**
  - **b. inducing a risk of shifting the investor responsibility and weakening the owner's prerogatives; and/or**
  - **c. any other areas?**

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

We believe this question is best left to others to answer.

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

We believe that the use of proxy advisors is primarily the responsibility of investors. Investors chose the services they purchase, often the guidelines that are used and in what manner they utilise the information, analysis and recommendations provided.

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22 June 2012