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ESMA – European Securities and Markets Authority
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Re: Discussion Paper -- An Overview of the Proxy Advisory Industry

To the European Securities and Markets Authority:

We are writing on behalf of Sodali, an international corporate governance consultancy and service provider to companies in continental Europe, Latin America and developing markets (www.sodali.com). Sodali is recognized as a leading authority on the global mechanics of cross-border share voting [1]. We support many listed companies around the world in the management of their relations with shareholders and the financial markets, including the conduct of shareholder meetings and the solicitation of proxies from institutional investors [2]. Our role requires us to be in continuous contact with the proxy advisory industry. In furtherance of our mission of "aligning interests," we have taken a constructive approach to working with proxy advisors and we have assisted many clients in resolving the types of problems outlined in the Discussion Paper. Accordingly, we are pleased to submit these comments for consideration by ESMA.

By way of introduction, we refer to two statements in our July 19, 2011 letter commenting on the European Commission's second Green Paper:

With respect to Proxy Advisory Firms we told the Commission: "*We recommend that proxy advisory firms should be held to the same standards of governance and transparency as listed companies. We support a code of conduct for proxy advisors, including full disclosure of conflicts of interest. Such a code should be initiated by the firms themselves together with their institutional investor clients with oversight by the Commission. We do not think that the Commission can effectively regulate the "analytical methods" or the quality of the recommendations published by proxy advisors. However, the Commission should examine whether the institutional investors who purchase advice and services from proxy advisory firms are effectively fulfilling their fiduciary duties by doing so.*"

[1] During the summer of 2011 Sodali was retained by the Council of Institutional Investors (CII) to work on a two-part project relating to international proxy voting: (1) a survey of CII members about current cross-border voting practices, concerns and obstacles; and (2) preparation of a practical guide to educate CII members about the mechanics of cross-border voting, how to use the process more efficiently and how to overcome obstacles and improve results: http://www.sodali.com/wp-content/uploads/C.0027.pdf

[2] http://www.sodali.com/transactions/

With respect to regulation by the European Union, rule-making by member states, standard-setting by non-governmental organizations, or self-administration by the private sector, we stated: "*We support a tiered governance framework in which governance principles are established at the EU level, implemented through the laws and regulations of member states and administered by the boards of individual companies with oversight by their owners*."

We continue to hold these views, which are reflected in the discussion that follows.

General Concerns and Observations:

We begin with questions 8 through 12, which deal with matters of policy and regulation. One of our primary concerns about the Discussion Paper is that its focus is too narrow. We believe that many of the problems associated with Proxy Advisory Firms (PAFs) are rooted in the underlying dysfunctionality of cross-border proxy voting systems and practices. A piecemeal approach limited to the role of PAFs cannot fully address these basic problems. We urge ESMA to embrace a broader investigation of the problems of cross-border voting in coordination with other regulators, in particular the United States Securities and Exchange Commission, with non-governmental organizations and governance associations such as European Issuers and the International Corporate Governance Network, and with private sector groups that are already devoting time, expertise and resources to the search for ways to improve the global cross-border voting process.

Second, we are concerned that the Discussion Paper addresses PAFs collectively, while in fact there are distinct differences between non-U.S. firms and the two dominant U.S. firms, ISS and Glass-Lewis (which are also distinctly different from each other). It is important to remember that PAFs were originally a U.S. invention. Their business model and characteristics reflect the highly detailed rules-based system of governance in the U.S. that mandates strict compliance and relies on legal liability as the primary enforcement tool. From this system arises the highly schematic, compliance-based, box-ticking approach that is poorly suited to the principles-based, comply-or explain governance system that prevails in countries outside the U.S. Strict compliance is not an effective means to evaluate the quality of individual companies' business and governance decisions and their explanations for variance from best practice. The U.S. square peg does not fit into the European round hole.

Third, we are concerned that the Discussion Paper cannot adequately address important differences in the local laws and regulations of EU member States, particularly as they relate to disclosure and shareholder rights. We have found that when local legal requirements are at odds with the policies of PAFs, issuers face an uphill battle making detailed explanations to PAFs and shareholders.

Fourth, we are concerned that the Discussion Paper does not address the need to bring transparency to the activities of less visible third parties in the ownership chain that separates issuers from beneficial owners. PAFs are just one of many agents that stand between issuers and ultimate investors, but because they are on the front line and their decisions are public, their role is subject to direct scrutiny. Other intermediaries, including trustees, asset managers, global custodians, subcustodians and intermediary service providers, play equally important roles that deserve comparable scrutiny and oversight.

Fifth, we are concerned that the Discussion Paper does not address the lack of regulatory parity between issuers and institutional investors. The duties, conflicts and conduct of financial services firms, whose investment divisions are often the employers of PAFs, are inseparably linked to the conduct of PAFs. Stewardship codes are an important first step in the effort to achieve parity in the regulation of institutional investors, to bring their internal governance up to the standards they impose on issuers and to ensure that their conduct serves the interests of the beneficial owners whose capital has been entrusted to them for investment. More needs to be done to achieve parity in the oversight of institutional investors and their agents and to protect the interests of the beneficial owners they represent.

Finally, based on our experience working with issuers and PAFs, we note that disputes arise primarily in the following situations: (i) where there is disagreement about the reasoning, logic, or conclusions in a PAF analysis; (ii) where a PAF includes erroneous factual data about a company or selects inappropriate peers; (iii) where a PAF makes a negative vote recommendation; (iv) where the solicitation is contested, as in an election contest, or where there is a dissident solicitation campaign in opposition to a management proposal. We do not think a formal EU-level regulatory solution to items (i), (ii) and (iii) would be practical. However, we recommend that ESMA consider implementing guidelines that will increase the time and strengthen the incentives for issuers and PAFs to engage in dialogue and thereby resolve disputes privately without regulatory intervention. ESMA should also consider the implementation of guidelines requiring PAFs to publish in a timely manner any written statements submitted by issuers in opposition to PAFs' analyses or vote recommendations. With respect to item (iv), contested solicitations, we believe that ESMA should go further and consider the adoption of a formal rule mandating that PAFs may not issue voting recommendations in cases where there is a proxy contest. The rule would have to define "proxy contest" so as to include only bona fide contested solicitations and dissident campaigns, thereby avoiding manipulation or abuse of the proxy advisory process. We believe that a properly administered neutrality mandate -- permitting PAFs to assemble data and conduct a detailed analysis of both sides in a bona fide contested solicitation, but prohibiting a vote recommendation – would benefit issuers, dissidents and PAFs by compelling shareholders to make their voting decisions on the merits in cases where their votes have the greatest impact.

Recommendations:

Based on these concerns and observations, we make the following policy recommendations:
As we indicated in our introductory comments, we believe that a tiered approach to regulation and private sector action makes the most sense to increase the transparency of PAFs, to ensure their accuracy, independence, neutrality and reliability and to promote effective dialogue with issuers.

1. We recommend that an EU Directive, comparable to the Shareholder Rights Directive of 2007, should address the underlying issues that relate to the conduct of institutional investors and financial services companies in the EU. The Directive should set forth principles that will serve as the basis for a Code of Governance and Responsibility for Institutional Investors. The Code should address the following issues:
   - The governance of institutional investors.
   - Their fiduciary duty to beneficial owners, customers and clients, including a clear legal definition of the "ultimate owner."
   - Their standards of business conduct and ethics, including conflicts of interest, self-dealing and risk controls.
   - The fulfillment of their stewardship role, engagement with issuers and the exercise of voting rights.
   - Guidelines for the delegation of these duties to custodians, agents and other intermediaries in the investment chain.
   - Guidelines governing the conduct of PAFs, including (i) a requirement to publish written statements by issuers relating to PAFs' analyses and vote recommendations; and (ii) a neutrality mandate prohibiting the issuance of vote recommendations in certain bona fide contested solicitations.
   - Transparency and disclosure of all matters covered by the Code.

2. As was the case with the Shareholder Rights Directive, EU member states should implement the directive in accordance with local law, thereby requiring institutional investors subject to their jurisdiction to adopt such a Code of Governance and Responsibility.

3. PAFs should develop a Code of Conduct governing the proxy advisory industry that (i) deals with the issues in the Discussion Paper and (ii) defines and enforces the role of PAFs in fulfilling their delegated responsibilities under their institutional clients' Codes of Governance and Responsibility.

Comments and answers to specific questions.

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

2) To what extent:
a) do you consider that proxy advisors have a significant influence on voting outcomes?
b) would you consider this influence as appropriate?

Given that shareholders who choose to vote rather than abstain have only two choices – *For* or *Against* – a high degree of "correlation" with the advice of proxy advisors is inevitable. The more important question is one of causality. To date we have seen no convincing evidence that voting decisions are being made by shareholders based solely on the advice of proxy advisors without regard to the merits. Given that investors are not likely to admit to such a practice, we think causality will be very difficult to establish.
We are strongly opposed to any efforts by PAFs to directly influence the voting decisions of their clients or beneficial owners. The PAFs' role is to objectively analyze and make recommendations based either on the basis of their disclosed policies or their interpretation of the merits. By contrast, it is the responsibility of each investment manager to make voting decisions that are in line with the risk profile and investment strategy of the portfolio and the economic interests of the beneficial owners they represent. That level of analysis is generally beyond the capacity of proxy advisors and should not be delegated to them without full disclosure.

Proxy advisors' recommendations unquestionably have a significant influence on vote outcomes. This is particularly true for "routine" proposals where there is little reason for investors to look deeper than the PAF analyses and voting recommendations. The more difficult question is whether the influence of PAFs is equally great in votes that involve controversial proposals, contested elections and transactions with economic and strategic consequences. The answer is unclear because convincing statistics are unavailable. Many investors with large equity portfolios, particularly those that use indexing and other passive investment strategies, are known to use proxy advisors primarily as a screening device to highlight non-routine voting decisions that require close attention. For these extraordinary cases the investors usually conduct additional analysis and make their voting decisions on the merits. In some cases, proxy advisors are acting in the capacity of an agent and voting in line with preset policies established by investor clients.

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 advisors fill a market need. Their services enable institutional investors to manage high volume voting mechanics while avoiding burdensome and expensive case-by-case analysis of every proxy statement, many of which involve only routine matters. It is not surprising that reliance on proxy advisory services has increased. Whether this reliance involves a "shifting of investor responsibility and weakening of the [beneficial] owner's prerogatives" is a question that can be answered only by the institutional investors themselves. We have heard many expressions of concern that inappropriate delegation of voting power has occurred or that investment managers have failed to fulfill their fiduciary duty to beneficial owners. We share that concern. Despite its importance, the issue does not exist in a vacuum and should be considered in the context of the inefficiencies, opaqueness and lack of accountability that afflict the entire cross-border voting process. ESMA should consider the role of proxy advisors in the context of global proxy voting reform. Regulatory attention is needed to deal with the full array of complex problems that arise from the daisy chain of agents, intermediaries and advisors, many of whom currently operate without regulatory oversight.

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 the conflicts of interest they face?***

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

- ***a) which conflicts of interest are the most important?***
- ***b) do you consider that these conflicts lead to impaired advice?***

We agree that PAFs, like other members of the community of financial service providers, are subject to many conflicts of interest. The typ es and extent of conflicts and levels of transparency vary among the different proxy advisors. Our advice to the proxy advisory industry would be to collaborate on the development of an industry code of ethics and business conduct and to agree to full transparency in the disclosure and resolution of all conflicts of interest. We believe this approach would be an effective basis for the establishment of principles at the EU level and enforcement by the member states or through private action by issuers, institutional investors and beneficial owners whose

interests are affected. The proxy advisory industry itself might consider whether it would be well served by establishing an independent enforcement mechanism, possibly through the appointment of an industry ombudsman.

In our view, the most critical conflicts of interest are those that compromise the neutrality, objectivity and independence of the proxy advisor's analysis and vote recommendations. A few hypothetical cases might include the following situations: (i) where fees paid by an issuer to a proxy advisor for consulting services compromise the rigor of the voting analysis and lead to a vote recommendation favorable to the issuer; (ii) where a proxy advisor adopts a voting policy imposed by an institutional investor that conflicts with the independent analysis and recommendation of the proxy advisor; (iii) where an institutional investor that provides asset management services to an issuer pressures the proxy advisor to issue a favorable vote recommendation. We have seen no evidence of such practices, but the lack of clear standards and transparency creates uncertainty about the potential for conflicts and undermines confidence in the integrity of the entire proxy advisory industry.

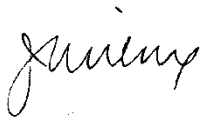
6) To what extent and how do you consider that there could be improvement:
a) for taking into account local market conditions in voting policies?
b) on dialogue between proxy advisors and third parties (issuers and investors) on the development of voting policies and guidelines?

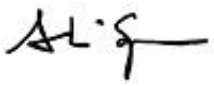
In recent years we have seen improvement in efforts by proxy advisors to make reference to local market conditions, legal requirements and business practices in their analysis of governance practices and matters subject to shareholder approval. Pressure for customized analysis and vote recommendations has come primarily from issuers. They rightly object to standardized policy-based analyses that ignore business contingencies and produce recommendations that they characterize as "one-size-fits-all," "cookie-cutter," and "box-ticking." In the wake of the financial crisis and with the development of stewardship codes, pressure for customized analysis is also beginning to come from institutional investors, particularly those who recognize that corporate governance is integral to a company's risk profile and financial performance. As demand for in-depth analysis increases, proxy advisory firms will be compelled to rely less on policy and more on the type of company-specific analytics they now use for proxy contests and extraordinary proposals.

We have also seen improvement in dialogue among issuers, proxy advisors and institutional investors, although much more needs to be done. Issuers that wish to communicate and engage in dialogue with their shareholders face significant obstacles in certain markets, particularly the United States, while the comply-or-explain governance regime in the EU formally endorses such dialogue. As the European Commission's second Green Paper reveals, issuers must do more to upgrade the quality of their

"explanations" of governance decisions. We also believe that issuers should accept their primary responsibility for managing shareholders' expectations and for initiating dialogue with them on governance and proxy voting matters. At the same time, however, proxy advisory firms must be more transparent about their analyses and voting decisions and more available for dialogue with issuers. Finally, institutional investors must be willing to engage in direct dialogue with issuers about matters of governance and share voting. Dialogue is effective only when all parties are transparent and willing to engage. In our work on behalf of corporate clients, we have been greatly encouraged by the willingness of all these parties to engage in constructive dialogue. However, the success of these efforts will be limited so long as the cross-border proxy voting system remains opaque and inefficient.

Respectfully submitted,





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