Merits and shortcomings of the Proxy Advisory industry: a critical analysis of the EU regulatory framework.

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To my parents Alberto and Marina, for their unrelenting support throughout the years. To my grandparents, for teaching me that education and compassion are the pillars of personal growth.

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1. Introduction

Nowadays we cannot imagine the global equity market without the prominent role filled by Institutional Investors. They are the fabric of corporations' ownership structure, holding some 78% of US public equities and 58% of EU ones.

Throughout the years Institutional Investors have been faced with increasing Stewardship responsibilities and obligations to vote. Together with the internationalization of held portfolios, hence growing information cost, these changes gave prominence to Proxy Advisors, specialized information agents focused on evaluating items subject to shareholders' vote.

This work aims at providing an overview of the EU proxy advisory industry, starting from the historical reasons for their blossoming to the current regulatory framework. A critical assessment of the present and proposed legislation in both EU and US is provided, as well as a case study. The TIM case focuses on the Proxy Advisors' role in facilitating shareholder activism in an Italian public company context.

Overall, this investigation finds out that Proxy Advisors are necessary economic actors that greatly ameliorate the Corporate Governance field by reducing information costs, fostering active participation and easing collective action of sparse shareholders.

At the same time, one aspect of the industry (i.e. conflicts of interest arising from parallel services) is still cause for concern. It is not unlikely that regulators shall intervene in that matter due to antitrust and unfair competition considerations.

As many other professionals of the field advocate, the Author too calls for a more stringent industry self-regulation that tackles the issue rather than leave such prerogative to regulators. Should that be the case, resources best used elsewhere would be consumed and the resulting loss of confidence in the PA industry could have repercussions in the equity markets.

1.1 - What are Proxy Advisors

In the Revised EU Shareholder Rights Directive (SRD)[1], a proxy advisor is defined as "a legal person that analyses, on a professional and commercial basis, the corporate disclosure and, where relevant, other information of listed companies with a view to informing investors' voting decisions by providing research, advice or voting recommendations that relate to the exercise of voting rights."

Proxy advisors firms provide Institutional Investors with research, data, and recommendations on management and shareholder proxy proposals that are voted on at a company's annual and exceptional meetings.

Bianconi (2015) recognizes Proxy Advisors' role in supporting Institutional Investors' informed voting choices based on the analysis of documents made available by the issuer, application of their own voting policies and the identification of problems regarding listed companies' governance compared to international best practice.[2]

Verdam (2006) also identifies that Proxy Advisors assist Institutional Investors with the votes casting logistic when tasked to vote on their behalf in accordance to their instructions.[3]

1.2 - The major PA firms in EU

In the US, Belinfanti (2008) estimated that ISS held around 61% of the Proxy Advising market, Glass Lewis around 36% and other proxy advisors the remaining 3%.[4]

While extensive research in this matter has not been conducted, in its Discussion Paper the European Securities and Markets Authority "ESMA" (2012) recognizes how the European Proxy Advising market is led by ISS. Another important European player nowadays is Glass

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[1] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement OJ L132/1 [hereinafter Revised EU Shareholder Rights Directive]

[2] Bruno, Sabrina, and Fabio Bianconi. "Say on pay in Italian general meetings: Results and future perspectives." (2015)

[3] Verdam, Albert. "An exploration of the role of proxy advisors in proxy voting." (2006)

[4] Belinfanti, Tamara C. "The proxy advisory and corporate governance industry: the case for increased oversight and control." *Stan. JL Bus. & Fin.* 14 (2008): 384.

Lewis, especially after its acquisition of the German PA firm IVOX in 2015[5][6].
ESMA also notes how in Europe there are numerous local PA firms due to the different Corporate Governance systems each reflecting each Member State's specific circumstances and EU Institutional Investors' inclination to buy voting recommendations from multiple providers at the same time.

Institutional Shareholder Services, "ISS" (US): It is owned by the private equity firm Genstar Capital and has over 900 employees. ISS services more than 1900 clients managing an estimated $26 trillion in assets.
ISS covers about 42'000 Meetings of 20'000 companies annually[7].
ISS also provides Governance advisory services through its fully owned ISS Corporate service, Inc.
The subsidiary ISS-Ethix focuses on environmental, social and governance "ESG" consultancy.

Glass Lewis (US): It is a portfolio company of the Ontario Teachers' Pension Plan Board and Alberta Investment Management Corp. and has more than 360 employees. Covering about 20'000 annually, Glass Lewis services more than 1300 clients managing $35 trillion in assets.[8]
In 2015 Glass Lewis acquired IVOX, the leading proxy advisory firm in Germany.

Expert Corporate Governance Services, "ECGS" (EU, Switzerland and Australia): ECGS is a partnership of local Proxy Advisor firms. It comprises of Proxinvest (France), DSW (Germany), Frontis Governance (Italy), Ethos (Switzerland), Manifest (UK), Shareholder

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[5] European Securities and Markets Authority. "An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options." (2012)
[6] Glass Lewis Website - Glass Lewis Acquires IVOX, Leading German Proxy Advisor. [online] Available at: http://www.glasslewis.com/glass-lewis-acquires-ivox-leading-german-proxy-advisor
[7] ISS Website. [online] Available at: https://www.issgovernance.com/ [Accessed 28 Mar. 2018].
[8] Glass Lewis Website. [online] Available at: http://www.glasslewis.com/ [Accessed 28 Mar. 2018].

Support (The Netherlands), Corporance (Spain) and SIRIS (Australia).
As an international network of various local Proxy Advisors, ECGS has a great expertise of the national frameworks in which firms operate[9].

2. - The reasons of Proxy Advising and its influence on Corporate Governance

We are able to identify two main drives that explain the prominent position of Proxy Advising in the contemporary Corporate Governance panorama: an increasing governmental regulation aimed at fostering engagement and some economic reasons arising from those obligations.

2.1 - The regulatory requirements of Institutional Investors

In the past Institutional Investors tended to follow the so-called "Wall Street Rule" (Klöhn and Schwarz, 2012), namely letting the board almost self-regulate itself and choosing the "exit" (i.e. selling their shares) as a means to express dissatisfaction.[10]
This approach implies that shareholders have their paramount right in the transferability of their shares and they should not take an active role in corporate affairs.
As a Heinen and Scharfbillig (2015) note in their study: "despite the beneficial impact of voting, historically there has been scant interest of many investors to actively participate at the AGM and prepare an informed voting decision".[11]
However, in light of the evidence of shareholder involvement's positive influence in value creation and of the explosion of corporate scandals, more recently we have witnessed a global shift toward a more engaged approach to Corporate Governance.

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[9] ECGS Website. [online] Available at: www.ecgs.net/node [Accessed 28 Mar. 2018].
[10] Klöhn, Lars, and Philip Schwarz. "The regulation of proxy advisors." *Capital Markets Law Journal 8, no. 1* (2012): 90-107.
[11] Heinen, Vanda and Mario Scharfbillig. "Do foreign proxy advisors export corporate governance views? Differences in coverage, recommendations and influence on voting outcome between foreign and domestic proxy advisors." (2015)

2.1.1 Obligation to vote at general Meetings

The first step legislators took is the introduction of the compulsory voting requirements for Institutional Investors on a "comply or explain" basis.

If the degree of shareholders' engagement varies from jurisdiction to jurisdiction, the baseline duty to vote arises from the sources of Law we are now going to examine.

USA

In light of the wide-spread use of the Wall-Street Rule as well as the explosion of corporate scandals[12], in 2003 the Securities and Exchange Commission emitted a final ruling (IA-2106) under the Investment Advisers Act of 1940 (adopting new rule 206(4)-6 and amending rule 204-2) , requiring Institutional Investors to "exercise voting authority over client proxies in the best interests of clients, to disclose information about the policies and procedures followed and to maintain certain records relating to proxy voting"

That is because mutual funds owe a fiduciary duty of "utmost good faith and full, fair disclosure" to their clients.

From this rules we can observe that when Institutional Investors in the USA exercise the voting rights for the shares they hold in trust, they have to do so abiding due diligence and transparency requirements. Institutional Investors have to disclose how those rights are exercised and how the pronouncements were formulated.

UK

In the UK, the Financial Reporting Council Stewardship Code (2012) advocates for a clear policy on voting and disclosure of voting activity.

The 5th principle expressly states that "Institutional investors should be willing to act collectively with other investors through formal and informal groups", disclosing the policy for collective engagement.

The 6th principle of the Code states that Institutional investors should "seek to vote all shares held" and not "automatically support the board. They should publicly disclose any

[12] U.S. Securities and Exchange Commission "Final Rule: Proxy Voting by Investment Advisers; Release No. IA-2106." (2003) [online] Available at: https://www.sec.gov/rules/final/ia-2106.htm.

voting record.
This code of best practices is particularly relevant in our investigation if we think of the case of ECGS, as the company states that “its proxy voting services are contributing to the satisfaction of the principles set out by the Stewardship Code. As a European partnership with clients on a pan European scale, ECGS considers that the principles of the code should also apply to institutional investors outside the UK.”

EU

Similarly, in the EU managers of UCITS (Undertakings for Collective Investment in Transferable Securities, namely harmonized European mutual funds) are subject to similar requirements.[13]

As stated in the Commission Directive 2010/43/EU, “Management companies should be requested to adopt, apply and maintain an effective and adequate strategy for the exercise of voting rights attached to the financial instruments held by the UCITS they manage”.

With regard to disclosure, management companies should make “information related to the strategy and its application should be freely available to investors”.

The Directive goes more into detail about the strategies for exercising voting rights in Article 21, suggesting to “(a) monitor relevant corporate events; (b) ensure that the exercise of voting rights is in accordance with the investment objectives and policy of the relevant UCITS; (c) preventing or managing any conflicts of interest arising from the exercise of voting rights.”

[13] Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organizational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company OJ L176/42

2.1.2 - Mandatory "Say on Pay" (SOP)

In all the jurisdiction we examine, shareholders have a right to express an **advisory** or **binding** vote regarding executive compensation, comprising a remuneration policy and a remuneration report.

The **remuneration policy** is voted ex-ante and explains what mechanisms set the compensation, the **remuneration report** is voted ex-post and regards the previous year salaries.

ISS, Glass Lewis and other local actors go to great lengths to provide a recommendation on the proposed compensation plan. Their analysis mainly consists of a qualitative assessment of the compensation structure and the accompanying disclosure, and a quantitative assessment following a pay-for-performance approach (making use of in-depth stock performance and peer-group assessment).[14][15]

Research has shown that the "say on pay" may not be useful in reducing executive remuneration (Armstrong, Gow, and Larcker 2013; Conyon and Sadler, 2010)[16][17], however it has some advantages: Iliev and Vitanova (2015) note how "Say on Pay" mechanism are linked to an higher director support, consistent with improved dialogue between shareholders and the board[18]; Ferri and Maber (2013) observe that "Say on Pay" may reduce egregious practices.[19]

We are now going to examine how this principle is implemented in US, UK and Europe.

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[14] ISS Website – Evaluating Pay for Performance: ISS' Quantitative and Qualitative Approach. [online] Available at: http://www.glasslewis.com/ [Accessed 6 Apr. 2018].

[15] Glass Lewis Website – Understanding our Compensation Analysis. [online] Available at: http://www.glasslewis.com/ [Accessed 6 Apr. 2018].

[16] Armstrong, Christopher S., Ian D. Gow, and David F. Larcker. "The efficacy of shareholder voting: Evidence from equity compensation plans." *Journal of Accounting Research 51, no. 5* (2013): 909-950

[17] Conyon, Martin, and Graham Sadler. "Shareholder voting and directors' remuneration report legislation: Say on pay in the UK." *Corporate Governance: An International Review 18, no. 4* (2010): 296-312.

[18] Iliev, Peter, and Svetla Vitanova. "The Effect of the Say-on-Pay in the US." (2015)

[19] Ferri, Fabrizio, and David A. Maber. "Say on pay votes and CEO compensation: Evidence from the UK." *Review of Finance 17, no. 2* (2013): 527-563.

USA

Advisory “Say on Pay” for top executives’ compensation was made universal for public companies by section 951 of the Dodd-Frank Act (2010)[20]. Companies with more than $75 million in public equity float are required to hold an **advisory** vote not less frequently than once every three years.

UK

In the UK three provision bring the **binding** “Say on Pay” into effect: The Companies Act 2006 (Strategic Report and Directors' Report) Regulations (2013), the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations (2013) and the Enterprise and Regulatory Reform Act (2013).

Section 79 of the latter dictates that directors of quoted companies must have their remuneration policy approved by shareholders by ordinary resolution at least every three years. Moreover, all payments made to directors must be consistent with the policy or must be explicitly approved by shareholders.

UE

If historically there has been differences in Member States’ legislation regarding “Say on Pay”, the European framework is moving toward a harmonization on the matter following the Revised Shareholder Rights Directive (2017), coming into effect in 2019.

Article 9a, Comma 1 of the Directive states: “Member States shall ensure that companies establish a remuneration policy as regards directors and that shareholders have the right to vote on the remuneration policy at the general meeting.”

The resolution must be considered as *de facto* **binding**.

That is because under Comma 2 of Article 9a, Member States “shall ensure that the vote by the shareholders at the general meeting on the remuneration policy is binding”.

Even though Comma 3 of the Article proposes an advisory vote, in that case companies shall pay remuneration to their directors “only in accordance with a remuneration policy that

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[20] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o) [Bluebook R. 12.4]

has been approved by the general meeting."

As Bruno (2015) observes, if the remuneration has not been approved by shareholders, a company cannot pay its directors. And since payments not agreed by shareholders cannot be authorized, directors are forced to submit an amended policy in the next general meeting for shareholders' approval. Thus, Bruno deems the juridical nature of the resolution as **de facto binding**[21].

2.2 - The economic rationale of Proxy advising

As we have discussed in 2.1, regulatory requirements dictate that Institutional Investors have obligations to vote, to disclose the process for which such voting decisions were reached and to hold a binding or advisory vote on executive remuneration plans.

Leaving aside for a moment ethical consideration regarding the fiduciary duties to beneficiaries, from a strictly economical point of view these duties put Institutional Investors in front of a "**Downs Paradox**". Namely, for a rational actor, the expected benefits of voting outweigh the costs of casting an informed vote.

This happens for a variety of reasons. For instance, Investors holding a highly diversified, international portfolio might bear enormous information gathering costs (Klöhn and Schwarz, 2012).[22]

Another cause are the **free-riding problems** as examined in Game Theory. Herman (1988) notes that even if a collective monitoring would leave every investor better off, there is a stalemate situation for which no actor will take any action because the others will benefit freely from the efforts undertaken.[23]

We are going to analyze how the use of proxy advising helps Institutional Investors mitigating these problems in order to meet their obligations.

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21 See *supra* note 2

22 See *supra* note 10

23 Herman, Edward S., and Louis Lowenstein. "The efficiency effects of hostile takeovers." *Knights, Raiders and Targets* 211 (1988).

2.2.1 - Cost-effectiveness argument

Many scholars have identified information gathering cost effectiveness as the historical economic rationale that drove the emergence and consolidation of Proxy Advisors in the field of Corporate Governance.

Eritmur, Ferri and Oesch (2013) suggest that PAs' key economical role is processing a substantial amount of information on behalf of institutional investors, hence reducing their cost of making informed voting decisions[24]. PAs indeed help investors identifying voting choices consistent with their preferences by evaluating every item at the Meetings following internal guidelines or guidelines provided by the client. (Choi, Fisch and Kahan; 2009) [25]

As per ISS[26] and Glass Lewis[27] Guidelines, advice given by Proxy Advisors includes, but is not limited to, General Meeting topics such as:

Board of Directors: Director Elections, Board Independence, Discharge of Directors, Board Structure, Composition of Committees, Election procedures.

Transparency and integrity in Financial Reporting: Accounts and Reports, Allocation of Dividends, Appointment of Auditors.

Capital structure: Share issuance, Increase/Reduction in Authorized Capital, Preferred Stock, Debt issuance.

Compensation: Executive and Non-executive director compensation, Say on Pay voting recommendations, Remuneration policies (Peer Analysis, Short-term and Long-term incentives, Fixed and Variable salary, Equity-Based Plans).

Other items: Amendments to the Articles of Association, Restructuring, Mergers and Acquisitions, Mandatory Takeover Bid Waivers, Reincorporation proposals, Expansion of

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[24] Ertimur, Yonca, Fabrizio Ferri, and David Oesch. "Shareholder votes and proxy advisors: Evidence from say on pay." *Journal of Accounting Research* 51, no. 5 (2013): 951-996.

[25] Choi, Stephen, Jill Fisch, and Marcel Kahan. "The power of proxy advisors: Myth or reality." *Emory LJ 59* (2009): 869.

[26] ISS Website – Current Voting Policies 2018 [online] Available at: https://www.issgovernance.com/policy-gateway/voting-policies/ [Accessed 8 Apr. 2018].

[27] Glass Lewis Website – Policy Guidelines Available at: http://www.glasslewis.com/guidelines [Accessed 8 Apr. 2018].

Business Activities, Related Party Transactions, Antitakeover Mechanism.
"ESG" Environmental, Social and Governance Issues and **Shareholder Initiatives.**

2.2.2 - Facilitating Shareholder Activism argument

Before proceeding to analyze the crucial role that proxy advisors have in enabling Shareholder Activism, we will briefly discuss this trending phenomenon in Europe.[28]

What is shareholder activism?

Low (2004) defines Shareholder Activism as "the exercise and enforcement of rights by minority shareholders with the objective of enhancing shareholder value over the long term".[29] It is a concept related to the Stewardship responsibilities as expressed in the Revised EU Shareholder Rights Directive 2017, the UK FRC Code of 2012 and the American Investor Stewardship Group's Principles[30].

Cloyd (2015) breaks down Shareholder Activism in a spectrum, depending on the significance of the desired change and the assertiveness of the investor activity. [31]

Hedge fund activism: It is the case of an investor, usually a hedge fund or a party aligned with it, that seeks to significantly change a company's strategy.

In USA in the 1980s they mostly engaged in "corporate raiding", namely obtaining a large block of the company's shares and engage in a proxy contest for the control of the board. After achieving that, complacent directors would pass resolution to strip the company of its assets, chop it up in different entities to sell or any other action aimed at paying off the initial investment of the fund.

After the widespread adoption of legal countermeasures to avoid this phenomenon such as

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[28] CMS Law Website - Publication: Shareholder Activism: A European Perspective. (2018) [online] Available at: https://cms.law/en/INT/Publication/Shareholder-Activism-A-European-Perspective.
[29] Low, Chee Keong. "A road map for corporate governance in East Asia." *Stud. Int'l Fin. Econ. & Tech. L. 7* (2004): 377.
[30] Investor Stewardship Group Website - Principles [online] Available at: https://isgframework.org/ [Accessed 10 Apr. 2018].
[31] Cloyd, Mary Ann. "Shareholder Activism: Who, What, When, and How?" (2015) [online] Available at: https://corpgov.law.harvard.edu/2015/04/07/shareholder-activism-who-what-when-and-how

poison pills, golden parachutes, increase of debt levels in the balance sheet and staggered boards, the role of hedge fund investors changed. Moreover, they have been steadily establishing an active presence in the European equity market .

As Fronda (2016) notes, they still pursue an assertive approach to influence a company's strategy, but they are more focused on finding a new executive management, curbing operational inefficiencies, advocating for financial restructuring and reviewing the acquisition policy.[32]

"Vote No" campaigns: It is the case when an investor or a coalition of investors urges shareholder to withhold their votes from one or more of the board-nominated director candidates. This type of campaign aims at compelling the voluntary withdrawal of a director, especially if it is not incumbent, or to express shareholders' dissent. If the level of negative votes is significant enough, a director may be replaced during her subsequent term. Ertimur, Ferri, and Muslu (2011) also noted that this type of campaign results with a reduction in future executive pay.[33]

Shareholder Proposal: In every jurisdiction we examine, shareholders can sponsor proposals to be included in a general meeting.

There is a difference, however, between USA on the one side and UK and Europe on the other (except the Netherlands): in the former shareholders' proposals are **advisory** while in the latter they are **binding**. We also should notice that in UK as well as in Italy shareholders have the power to dismiss directors with an ordinary resolution, therefore their proposals usually carry a great degree of influence.[34]

Below is a table of the statutory share requirements for requisitioning Meeting of shareholders and submitting shareholder proposals.

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[32] Fronda, Aaran. "The rebranding of corporate raiders." (2018) [online] Available at: https://www.worldfinance.com/strategy/the-rebranding-of-corporate-raiders

[33] Ertimur, Yonca, Fabrizio Ferri, and Volkan Muslu. "Shareholder activism and CEO pay." *The Review of Financial Studies 24, no. 2* (2010): 535-592.

[34] UK Companies Act (2006) Section 168, Italian Civil Code, Article. 2383 comma 3

Country	EGM	Shareholder Proposal - Resolution Integration of the Agenda	Source of Law
USA	10%	1% or $2000 market value	§ 240.14a-8 Shareholder proposals.
UK	5%	5% or 100 voting members with avg. contribution of >£100.	Companies Act 2006*
Germany	5%	5% or €500’000 nominal value	German Stock Corporation Act 1965*
France	0.5%-5%	5%	French Commercial Code*
Italy	5%	2.5%	Italian Civil Code, Article 2367* Legislative Decree 58/1998, art. 126-bis*
The Netherlands	10%	0.33% (Advisory)	Book 2 of the Dutch Civil Code*
Spain	5%	3%	Capital Companies Act 2010*
Portugal	5%	2%	Portuguese Commercial Code*

*They were influenced by the Shareholder Rights Directive 2007/36/EC and by its amendment coming from Directive (EU) 2017/828. Regarding the UK, it is uncertain whether the SRD amendments will be implemented depending on the timing of the Brexit.

One of the main merits of Proxy Advisors is that of facilitating collective action. As Malenko and Shen (2016) notice, shareholders coordinate themselves over aligned recommendations.[35] Since Proxy Advisors elaborate their public general recommendations following internal guidelines, those reports are a starting point for a meaningful dialogue between shareholders. For instance, Investors may be more willing to vote an item (including **Shareholder proposals**) once a *super partes* analysis of it has been conducted.

[35] Malenko, Nadya, and Yao Shen. "The role of proxy advisory firms: Evidence from a regression-discontinuity design." *The Review of Financial Studies* 29, no. 12 (2016): 3394-3427.

From both the arguments 2.2.1 and 2.2.2 discussed, we can also identify the Proxy Advisors' role in facilitating cross border shareholding. That is because beside functioning as information and coordination agents, Proxy Advisors consider local regulation in their analysis and translate all the relevant information in English.[36] For example, Heinen and Scharfbillig (2015)[37] note how PAs carry out a "paraphrasing function" of the dualistic system typical of Germany, Italy and the Netherlands to foreign investors.

2.3 - The effect of Proxy advisors' recommendation on shareholders' vote

To better understand the relevance of Proxy Advisors in the contemporary Corporate Governance panorama, we should investigate the vastity of their client base as well as the impact of their recommendation on the shareholders' voting decisions.
Many regression studies have been carried out on the matter, especially regarding ISS's impact on the voting decisions of Institutional Investors. Hitz and Lehmann (2014) note how the influence is even more pronounced for firms with high free float and low voting turnout.[38]

Study	ISS influences shareholder votes by
Bethel and Gillian (2002)	13.6-20.6 %
Cai, Garner and Walkling (2009)	19 %
Malenko and Shen (2016)	25 %
Holstein (2008)	30 %
Rose (2007)	> 33 %
Choi, Fisch and Kahan (2010)	6-10 % *

[36] See *supra* note *5* p. 10
[37] See *supra* note 11
[38] Hitz, Joerg-Markus and Lehmann, Nico. "Empirical Evidence on the Role of Proxy Advisors in European Capital Markets " (2014). European Accounting Review, Forthcoming. [online] Available at https://ssrn.com/abstract=2624653

The Choi, Fisch and Kahan's study (2010) is particularly relevant because it distinguishes correlation from causality. Indeed, they note that rather than just the ISS' advice itself, also the underlying factors of a Meeting Item may swindle the vote of shareholders.[39]

Even with their prudent approach, isolating the merits of the issue put to vote from the bare recommendation, they find out an appreciable influence of 6-10% on Investors' voting.

That is not surprising since many publications such as the SEC Roundtable of 2003[40], the OECD document of 2009[41] and the ESMA report of 2012 have repeatedly pointed out the increasing impact of Proxy Advising in the Corporate Governance field.

In the EU the debate regarding Proxy Advisors' power has gone beyond the scholar circles, as the Revised Shareholders' Rights Directive tackles the issue in the amended Articles of Directive 2007/36/EC.[42]

Article 3g and 3i, regarding the engagement of Institutional Investors and transparency of asset managers respectively, dictate any service from Proxy Advisor to be disclosed, Article 3j sets the transparency requirements of Proxy Advisors.

2.4 - Case: The role of Proxy Advisors in the Telecom Italia Case

The Telecom Italia (TIM) case is relevant for our analysis of Proxy Advisors, as it shows in practice an example of "facilitating shareholder activism". From the case we will see that TIM has been plagued by a conflict between controlling and minority shareholders, and how only a coordinated action of investors solved the impasse.

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[39] *Ibid*

[40] US Securities and Exchange Commission. "Proxy Advisory Roundtable" (2003) [online] transcript available at: https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt

[41] OECD. "Corporate Governance and the Financial Crisis. Conclusions and emerging good practices to enhance implementation of the Principles." (2009)

[42] See *supra* note 1

The Actors:

Telecom Italia S.p.A., also operating under the name TIM S.p.A. (TIM) It is an Italian telecommunications company which provides telephony services, mobile services, and DSL data services. Tim has a Market Capitalization of €17.41 billion as of April 15, 2018.[43]

Elliott Management Corporation (Elliott) Regarded as the largest activist fund in the world[44], it administers two multi-strategy funds which combined have $ 34 billion of assets under management. On March 14, 2018, Elliott disclosed a 5.74% stake in TIM, along with plans to **replace six directors**, push for a separation of TIM's fixed-line network, end the company's dual class structure, and eliminate Vivendi's conflict of interest. On April 9, Elliott raised its stake in TIM to 8.848% of ordinary share capital.[45]

Vivendi SA (Vivendi) It is a French media conglomerate which conducts operations ranging from music to film and telecommunications. Vivendi started to build its stake in TIM in 2015 and is currently *de-facto* controlling TIM with 23.943% of common shares (18% economic stake due to non-voting saving shares).[46]

Proxy Advisors: Institutional Shareholders Services (ISS), Glass Lewis and Frontis Governance have been following closely the Vivendi-Elliott diatribe, ultimately ratifying their advice to shareholders of voting in favor of Elliott's proposals.[47]

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[43]Reuters - Telecom Italia SpA [online] Available at: https://www.reuters.com/finance/stocks/overview/TLIT.MI [Accessed 15 Apr. 2018].
[44] Stewart, Emily (2017). "Elliott Management: What is it, and who is behind it?" [online] Available at: www.abc.net.au/news/2017-06-05/what-does-elliott-management-want-from-bhp/8584824
[45] TIM Website – Significant Shareholders [online] Available at: http://www.telecomitalia.com/tit/en/investors/shareholders/significant_shareholdings.html [Accessed 15 Apr. 2018].
[46] *Ibid*
[47] Festa, Carlo. "I «proxy advisor» schierano i fondi dalla parte di Singer" *Il Sole 24 Ore* 10 April 2018

Key Developments:

December 4, 2015: Vivendi gets four seats on TIM's board.

May 4, 2017: Vivendi appoints 10 out of 15 directors at TIM.[48]

March 14, 2018: Elliott discloses a 5.74% stake in TIM. On the same date it requested an integration of the AGM agenda with the proposal for replacement of six directors drawn from Vivendi slate of 2017.[49]

March 16, 2018: Elliott sent a letter to other Telecom Italia shareholders calling for a "truly independent" board to improve governance, stating that "poor stewardship under the Vivendi-controlled board has resulted in deeply troubling corporate governance issues, a valuation discount and strategic failures". Elliott nominates a slate with six candidates for the 15-member board to be voted at the AGM of 24 April.[50]

March 22, 2018: Eight TIM directors resign, the removal of five of them had been requested, other two were drawn from the Vivendi slate. These resignations triggered a new election under the *Voto di Lista* election system, therefore the board of directors decided to call for an extraordinary shareholder meeting on May 4 for this purpose.
The board thus did not supplement the agenda for the April 24 AGM with Elliott proposals regarding the replacement of six directors.[51]

March 27, 2018: TIM statutory auditors decide to include Elliott's proposals (removal of directors and nomination of a new slate) on April 24 shareholder meeting's agenda.[52]

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[48] Olivieri, Antonella. "Telecom: Vivendi strappa la maggioranza in assemblea" *Il Sole 24 Ore* 4 May 2017
[49] Olivieri, Antonella. "Telecom, Elliott chiede la revoca di 6 consiglieri in quota Vivendi" *Il Sole 24 Ore* 15 March 2018
[50] Transforming TIM – Letter to Shareholders [online] Available at: https://www.transformingtim.com/shareholder-information/letters/
[51] Olivieri, Antonella. "Telecom, si dimettono in otto e decade il Cda. Reggenza a Bernabé. Elliott: da Vivendi atto cinico ed egoistico" *Il Sole 24 Ore* 22 March 2018
[52] Olivieri, Antonella. "Telecom, i sindaci si riservano di mettere ai voti la lista Elliott" *Il Sole 24 Ore* 24 March 2018

April 5, 2018: Vivendi submitted its slate of candidates for the board renewal scheduled for May 4. The slate contains ten members and includes most of the directors who resigned on March 22.[53]

April 9, 2018: TIM challenges at the Tribunale di Milano the statutory auditors' decision of including Elliott's proposals in the 24 April AGM.[54]

April 11, 2018: Italian government controlled Cassa Depositi e Prestiti (CDP) discloses a 4.26% stake in TIM.[55]

April 23, 2018: The Tribunale di Milano upholds TIM appeal. Elliot proposal is removed from the agenda.[56]

May 4, 2018: The Election under the *Voto di Lista* system is held. The slate of ten Board members proposed by Elliot wins 49.8% of the votes. Vivendi places five Board members with 47.18% of the votes.[57]

Elliott's critique on Vivendi's "reign of value destruction"[58]

First and foremost is the profound and persistent share price underperformance despite improving fundamentals. The value of TIM's ordinary share fell 35% from December 4, 2015 (Vivendi nominees joining TIM Board) to March 14, 2018 (Elliott disclosing a 5.74% stake in TIM and its proposal of replacing six Board members).
Another critique is to the "obsolete capital structure" of the company, which includes non-

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[53] TIM Website – Press releases - "Vivendi has filed the slate for the renewal of the Board of Directors" [online] Available at: http://www.telecomitalia.com/tit/en/archivio/media/comunicati-stampa/telecom-italia/corporate/economico-finanziario/2018/CS-LISTA-VIVENDI-CdA-Maggio-2018.html
[54] Olivieri, Antonella. "Vivendi-Elliott: su Tim la sfida si sposta in Tribunale" *Il Sole 24 Ore* 13 April 2018
[55] Corriere delle Comunicazioni – "Lo Stato italiano più forte in Tim, CDP in campo con il 4,26%" [online] Available at: https://www.corrierecomunicazioni.it/telco/lo-stato-italiano-piu-forte-in-tim-cdp-entra-con-il-426/
[56] Redazione Economia. "Tim, il tribunale accoglie il ricorso. Borsa, giù la Juve e Fiera alle stelle*." Il Corriere della Sera* 23 April 2018
[57] Rossitto, Simona. "Tim, Elliott vince e apre al dialogo con Vivendi. Conti verso la presidenza." *Il Sole 24 Ore* 4 May 2018
58 See *supra* note 56

voting saving shares. Eliot believes that a fully independent Board can take action to grant all the shares the same voting and economic rights. Even though it declared to be in favor of the conversion, Vivendi blocked the saving to ordinary shares conversion at the TIM's AGM of December 2015 and has since failed to provide a new plan to do so. Elliott believes it happened "to further protect its own interests at expense of minority shareholders". Elliott also criticizes the limited progress on Structural Transformations. The Board is in favor of a partial sale or separate listing of NetCo (TIM's fixed line network) but it is committed to own it outright. Elliott is in favor of maintaining a stake in NetCo but pushes for widening its share register to create value for TIM shareholders. Moreover, Elliott is encouraging the new Board to consider selling part of Sparkle (TIM's international wholesale business), using proceeds to reduce leverage at TIM and reintroducing a dividend. Finally, there are huge concerns regarding Governance Failings and Conflict of Interest. Elliott identified such as of Related Party transactions (TIM's advertising contract with Vivendi's subsidiaries Havas); nomination of an executive and a formally independent Director with ties to Bollore Group (controlling shareholder of Vivendi); European Commission detection of horizontal, vertical and conglomerate effects caused by Vivendi's simultaneous *de facto* control of TIM and significant stake in Mediaset, possibly breaking the Gasparri law of media antitrust rule; payment of severance package of €25 million to former CEO Flavio Cattaneo despite Board of Auditors expressing a negative opinion on the compensation package; and strained relationship between Vivendi and Italian regulators.

Moreover, Elliott's proposals are believed to be in line with the outgoing Italian Industry Minister Carlo Calenda's strategy of "protecting the network as an asset of national importance” and “defending public interests”.[59] Minister Calenda also called Vivendi an “awful” investor.[60] The CDP indeed voted in favor of the Elliott slate.[61]

TIM’s response:[62]

TIM presented its own recovery plan for the next three years that include a resumption of dividend payments and a reduction in the company’s leverage. The CEO Amos Genish also stated that forcing Telecom Italia to float its network would antagonize bondholders. Finally, he stated that the moves TIM made were made as part of “a or a long-term plan to benefit Telecom Italia, Italy and the health of the market”.

The role of Proxy Advisors in TIM’s proxy fight

As we can observe in the ownership structure of TIM, in order to implement the slate advocated by Elliot Management the minority Institutional Shareholders needed to cast a coordinated vote.

Type of Shares	Voting Power	Share Issued
Common Equity	1	15,203,122,583
Saving Shares	0	6,027,791,699

Ownership of Common Equity	N. of Shares	% of Class
Vivendi SA	3,640,109,990	23.94
Elliott Management Corp.	1,345,124,573	8.85

[59]Reuters Staff. “Elliott's plan for Telecom Italia in line with government's strategy – minister” *Reuters* 21 March 2018 [online] Available at: https://www.reuters.com/article/italy-telecom-italia/elliotts-plan-for-telecom-italia-in-line-with-governments-strategy-minister-idUSI6N1QR00R
[60] Landini, Francesca. “Italian minister calls Vivendi 'awful' investor in Telecom Italia” [online] Available at: https://www.reuters.com/article/us-telecom-italia-vivendi-minister/italian-minister-calls-vivendi-awful-investor-in-telecom-italia-idUSKBN1HN0L6
[61] See *supra* note 63
[62] Fildes, Nic. “Telecom Italia chief rolls up sleeves for fight with Elliott” *Financial Times* 8 March 2018

Cassa Depositi e Prestiti S.p.A.	648,000,000	4.62
Norges Bank Investment Management	392,240,552	2.58
Northern Cross LLC	390,360,432	2.57
Canada Pension Plan Investment Board	362,121,000	2.38
Brandes Investment Partners LP	306,829,395	2.02
The Vanguard Group, Inc.	282,894,720	1.86
BlackRock Fund Advisors	199,591,560	1.31
BlackRock Investment Management LLC	195,672,910	1.29
Caixabank Asset Management SGIIC SA	191,842,452	1.26
Telecom Italia SpA	163,754,388	1.08
Majedie Asset Management Ltd.	114,659,019	0.75
Invesco Asset Management Ltd.	110,459,891	0.73
E. de Rothschild Asset Management SA	107,823,614	0.71
Dimensional Fund Advisors LP	88,420,609	0.58
BlackRock Advisors (UK) Ltd.	70,751,818	0.47
CAPFI DELEN Asset Management SA	65,790,600	0.43
Exane Asset Management SA	65,635,952	0.43
Metropole Gestion SA	63,890,000	0.42
APG Asset Management NV	61,881,484	0.41

Data from FactSet Academic, accessed April 16, 2018

Elliot management mounted a Shareholder campaign consisting of Letters, Press releases, Presentations and website that was picked up and analyzed by many constituencies.
ISS, Glass Lewis and Frontis Governance engaged in dialogue with TIM to understand its position with regard to dissident proposals, and with Elliot Management to understand the rationale of those proposals.
All the three Proxy Advisor firms have issued the recommendation of supporting Elliot proposals of substituting six directors, rather than go to elections the 4th of May, 2018 with the *Voto di Lista* procedure.[63]
ISS stated that "Vivendi appears to be more a liability than an asset for TIM", citing the "declining relationship with the Italian government, the ever-present conflict of interest, and the fact that having a media company as de-facto controlling shareholder has apparently restricted TIM's strategic alternatives". These issues all "make a case for supporting Elliott's nominees".[64]
Similarly, Glass Lewis approves Elliott's plan to "functionally evict those directors clearly serving Vivendi's interests and replace them with new, independent candidates bringing experience and expertise plainly germane to Telecom Italia's operational scope and strategy".[65]

On May 4 the General Meeting of TIM took place. 67,15% of ordinary shares were represented. The slate proposed by Elliott was voted by 49.84% of the recorded shares (33.47% of the capital), winning ten seats on the Board while the Vivendi slate was voted by the 47.18% (31.68% of the capital), obtaining five seats on the Board.[66] In favor of Elliott

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[63] See *supra* note 53
[64]Navarro Gonzalez, Marc. "ISS Says Telecom Italia Investors Should Back Elliott" Morningstar 9 April 2018 [online] Available at: https://www.morningstar.com/news/dow-jones/TDJNDN_201804095305/iss-says-telecom-italia-investors-should-back-elliott.print.html
[65] Reuters Staff. "Proxy adviser Glass Lewis tells Telecom Italia investors to back Elliott's proposals" *Reuters* 8 April 2018 [online] Available at: https://www.reuters.com/article/us-telecomitalia-vivendi-elliott-glassle/proxy-adviser-glass-lewis-tells-telecom-italia-investors-to-back-elliotts-proposals-idUSKBN1HF097
[66] Rendiconto Sintetico Votazioni 4 maggio – TIM Website [online] Available at: http://www.telecomitalia.com/content/dam/telecomitalia/it/archivio/documenti/Investitori/AGM_e_assemblee/2018/Rendiconto_sintetico_delle_votazioni_04_05_2018.pdf

were most small shareholders, the CDP, Vanguard, BlackRock, State Street, funds historically linked to Assogestioni, Svm and Asati.
Vivendi gained the support of the French financial groups, the Caisse des Depots et Consignations, Bdl Capital Management and Norges Bank. [67]

Proxy Advisors played a prominent role in propagating the instances raised by Elliott open letter to shareholders.
Firstly, PAs included their dialogue with the proponent and the issuer in the voting recommendation, serving a useful "double-checking" role.
Most importantly, they served as facilitators of collective action.
At the beginning of the diatribe, Assogestioni did not present a slate after ISS, Glass Lewis and Frontis Governance expressed a negative opinion on Vivendi's one in order to do not disperse the collective efforts. The most striking PAs' result was that of reuniting sparse shareholders, even "passive" ones, towards a common goal. Indeed Vivendi, notwithstanding the critiques, could count on the backing of a compact block of shareholders in terms of stock held and national interests (French financial groups, Caisse des Depots et Consignations).[68]

Without the recommendations of PAs, overcoming a majority shareholder holding alone 23.94% of the capital would have been arduous. Even with all the support expressed by other constituencies, Elliott slate won by a thin margin. This case is exemplary of how Proxy advisors can facilitate the convergence of minority shareholders actions, hence ameliorating Corporate Governance with a democratic process of confrontation.

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[67] Festa, Carlo. "Assemblea Telecom, i grandi fondi decisivi: Blackrock con Elliott, Norges con Vivendi" [online] Available at: http://carlofesta.blog.ilsole24ore.com/2018/05/05/assemblea-telecom-i-grandi-fondi-decisivi-blackstone-con-elliott-norges-con-vivendi/
[68] *Ibid*

3. - How the "Best Practice Principles for Providers of Shareholder Voting Research & Analysis" answered the critical issues of proxy advising

This work focuses on the EU regulatory steps regarding the proxy advising industry, but will provide an overview on the US situation as well in its final considerations.
After having analyzed the rationale for the use of proxy advisory services, we are going to analyze the problems associated with this practice and divide the issues in three areas corresponding to the ground covered by each Principle and assess to what extent they were solved by such industry self-regulation. The conclusions about the current and the possible future regulatory framework will follow in Chapter 4.

3.1 - From ESMA call for evidence to the Principles

The European Securities and Markets Authority (ESMA) is a European Union financial regulatory institution and Supervisory Authority. Its mission is "to enhance investor protection and promote stable and orderly financial market". ESMA achieves its mission and objectives through four activities: assessing risks to investors, markets and financial stability; completing a single rulebook for EU financial markets; promoting supervisory convergence; directly supervising specific financial entities.[69]

In light of a growing prominence of the Proxy Advisory industry in Europe, after a lengthy fact-finding work in 2012, ESMA published the Discussion Paper "An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options" in order to gain evidence on possible market failures related to the activities of Proxy Advisors and to discuss to which extent EU-level intervention might be appropriate.[70]

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[69] European Securities and Markets Authority Website. [online] Available at: https://www.esma.europa.eu/about-esma/who-we-are
[70] See *supra* note 5 p. 5

After having received feedbacks from Proxy Advisor firms, investors and issuers, ESMA published its Final Report on the Proxy Advisory Industry having found no evidence of a market failure requiring regulatory intervention. However, it expressed some concerns regarding **conflicts of interest management** and the **transparency of PA analysis** that would benefit from an improved clarity from the industry.
ESMA therefore advocated for “the establishment of an EU Code of Conduct that will assist in improving understanding amongst issuers and investors of the proxy advisors’ role, allowing them to better focus on fostering effective and robust corporate governance, thereby contributing to investor protection and efficient markets.” [71]

Following the publication of the ESMA Final Report, several industry members formed the Best Practice Principles Group (BPPG) to develop a set of Best Practice Principles for Providers of Shareholder Voting Research &Analysis (Principles) which countersigners (signatories) should adopt on a comply-or-explain basis. Each Principle is accompanied by a Guidance that recommends how to apply it.[72]
Published in 2014, the signatories comprised Glass Lewis, ISS, IVOX, Manifest, PIRC and Proxinvest.
Principle One: Service Quality states that “Signatories provide services that are delivered in accordance with agreed client specifications.” and “Signatories should have and publicly disclose their research methodology and, if applicable, *house* voting policies.”
Principle Two: Conflict-of-Interest Management recites that “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.”
Lastly, Principle Three: Communications Policy declares that “Signatories should have and

[71] European Securities and Markets Authority. ““Final Report – Feedback statement on the consultation regarding the role of the proxy advisory industry,” (2013)
[72] Best Practice Principles Group. “Best Practice Principles for Providers of Shareholder Voting Research & Analysis.” (2014) [online] Available at: https://bppgrp.info/wp-content/uploads/2014/03/BPP-ShareholderVoting-Research-2014.pdf

publicly disclose their policy (or policies) for communication with issuers, shareholder proponents, other stakeholders, media and the public."

In 2017, BPPG announced a review of the Principles in order to improve them also to address the transparency requirement of Proxy Advisors outlined in the amendments to the revised EU Shareholder Rights Directive 2007/36/EC.[73]

It can be evinced from the public consultations that while the first and third Principle are welcomed and followed, there are huge concerns regarding the effectiveness of Principle Two in managing conflict of interest, concerns so strong that led Frontis Governance[74], Ethos Foundation[75], and possibly many other PA firm not to undersign such Principles.

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[73] Best Practice Principles Group Website. "BPP Group announces Principles Review, Independent Chairman" (2017) [online] Available at: https://bppgrp.info/principles-review-independent-chairman

[74] Carbonara, Sergio. "2017 Review of the Best Practice Principles for Governance Research Providers." (2017) [online] Available at: https://bppgrp.info/wp-content/uploads/2018/01/Frontis-Governance-1.pdf

[75] Kaufmann, Vincent and Yola Biedermann. "2017 Review of the Best Practice Principles for Governance Research Providers." (2017) [online] Available at: https://bppgrp.info/wp-content/uploads/2018/01/Ethos.pdf

3.2 - Quality of the Service area

3.2.1 - One -size-fits-all argument

Many detractors of Proxy Advisors argue that these firms apply a one-size-fits-all approach and do not sufficiently consider local market conditions, such as business practices and regulatory regimes.[76]

That is the belief, for instance, of Heinen and Scharfbillig (2015)[77]. With a regression study they pointed out how voting recommendations of proxy advisors do not completely overlap and how they differ stronger between foreign (ISS) and domestic Germany (IVOX, at the time not a subsidiary of Glass Lewis) service providers. Furthermore, they provide an example of "culture clash" with the case of Mr. Mayrhuber at Lufthansa.

Mr. Mayrhuber, former CEO of the company, left the management board in 2010 and ran for the chair of the supervisory board in 2013. ISS recommended voting against his candidature on the basis of its internal guidelines indicating a suggested cooling-off period of five years, in contrast with the German corporate Governance Codex that requires only two years.[78] Lufthansa subsequently criticized ISS for "not understanding the German dualistic corporate governance system".[79]

3.2.2 - Sub-par standards of the recommendation argument

Other scholars, such as Klöhn and Schwartz (2015), criticize the quality of Proxy Advisors' recommendations claiming that investors entrust PAs with forming voting advice that cannot be reliably monitored and reviewed for quality.[80] They note that if the recommendations could be scrutinized in a consistent fashion, investors would not need PAs' services to begin with.

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[76] See *supra* note 5 p.23
[77] See *supra* note 11
[78] Maushagen, Peter and Marilyn Gerlach. "Mayrhuber named Lufthansa chairman after stormy AGM." *Reuters* 7 May 2013 [online] Available at: https://www.reuters.com/article/us-lufthansa-board/mayrhuber-named-lufthansa-chairman-after-stormy-agm-idUSBRE9460PC20130507
[79] See *supra* note 11
[80] See *supra* note 10

This may lead to situations in which advisors have an incentive to maximize their own profit at the expense of their customers, namely not exercising due care in establishing the recommendations. Indeed, PAs are not legally responsible for the analysis provided to clients. Klöhn and Schwartz conclude by pointing out that an investor cannot use the threat of exit as a useful retaliation for PA negligence as it would incur in huge switching costs (new service evaluation, adaptation to new format and transferal of voting rights).
Another apprehension in this matter is the wide spread use of temporary staff due to the highly concentrated and seasonal nature of the AGM season, namely in Spring.[81] Even if it is true that temporary staff may be trained and given simple tasks, they still make up a significant part of the workforce. For instance, in 2015 22% percent of ISS workforce was temporary staff. This figure is even higher for firms such as Proxinvest (42%) and IVIS (45%).[82]

3.2.3 - Principle One: Service Quality

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.

The Guidance of Principle One regards best practices on aspects such as Responsibility to Clients, Quality of Research, Voting Policies (Shareholder and Signatory), Employee Qualification & Training, Timeliness, Complaints & Feedback Management and Client & Supplier Understanding and Client Disclosure Facilitation.[83]

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[81] See *supra* note 5 p.25
[82] European Securities and Markets Authority. "Report. Follow-up on the development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis" (2015) pp.12-13
[83] See *supra* note 72 p. 12-15

Responsibility to Clients: Providing services in accordance to agreed specifications is the signatories' primary responsibility. Clients are the ultimate and legitimate judges of the quality of shareholder voting research and analysis.

Quality of Research: Shareholder voting research should be relevant, accurate and reviewed by appropriate personnel prior to publication.

For instance, signatories ought to demonstrate the substantial standard of quality of their advice by providing a record of the sources of data used and ensuring adequate verification of their research with the implementation of Issuer fact-checking and Four-eyes principle (i.e. reports reviewed by an appropriate second person such as a senior analyst or management).

Research Methodology: Signatories should disclose their general approach to research, the information source used, to which extent local conditions and customs are taken into account and the quality control systems deployed.

Voting Policies or Guidelines

Shareholder Policies: Signatories may provide services based on clients' own *custom* policies or *in-house* benchmark policies. Shareholders may integrate such researches in their own assessment and decision-making process.

Signatory Policies: Signatories' benchmark policies, developed following high level Corporate Governance principles such as the ones proposed by the OECD[84], should be publicly available. Signatories ought to explain how local standards, guidelines and market practices were considered when developing such policies. ESG and Sustainability considerations in the guidelines are to be disclosed as well.

Each signatory will have its own public approach to guidelines development and review that should include inputs from various constituencies. Signatories should explain how their policies are updated and how feedbacks are incorporated in the process.

Employee Qualification & Training: Signatories' employees should have the education, skills, competence and experience appropriate for their positions.

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[84] OECD "G20/OECD Principles of Corporate Governance" (2015) [online] Available at: http://dx.doi.org/10.1787/9789264236882-en

Timeliness: Signatories have a responsibility to provide clients with timely services, subject to the availability of information from issuers, shareholder proponents or others.

Complaints & Feedback Management: Signatories should disclose their approach for managing complaints, feedback and comments about their services.

Client & Supplier Understanding: Signatories ought to notify clients of the potential limitations in their services, due, e.g., to the lack of public data, missing documents and disclosures or reliance on third parties beyond their control.

Signatories should provide a framework that enables them to fulfill their due-diligence requirements, possibly including site visits, interaction with research teams, information on quality controls and qualifications of the staff.

Client Disclosure Facilitation: Institutional Investors may be subject to disclosure requirements of any use of shareholder voting research. That is the case, for instance, of European Investors.[85] Signatories should be willing to assist clients with relevant material relating to the discharge of stewardship responsibilities.

3.2.4 - Compliance with Principle One and Assessment

The one-size-fits-all all and possibly sub-par quality of recommendation arguments have surely been useful to point out some of the critical issues of Proxy Advising. However, those problem have been positively addressed thanks to the development and acceptance of an industry standard of transparency of the research process.

3.3 - Conflicts of Interest area

The major issue of the Proxy Advising is the existence of a substantial conflict of interest (COI) that shadows over the entire industry.

We can identify three types of COIs in the proxy advising industry: the business, the personal and the organizational kind.

[85] Revised EU Shareholder Rights Directive, *supra* note 1, art. 3g at 1b

The **business** COI arises when there is an Issuer-Client influence, such when PA firms provide corporate ratings or other consultancy services to issuers and at the same time offer proxy research and advice to institutional clients with respect to those issuers. It may also be an Investor-Client influence if an Investor client of the firm is also shareholder proponent or dissident shareholder in meetings analyzed by the Proxy Advisory firm.
The **personal** type concerns whether PA employees (or their close relatives) have significant ties to or a substantial economic stake in a public company under analysis.
Finally, the **organizational** sort arises from the ownership structure of PA firms. It regards how a PA firm acts with respect to a person of interest (i.e. a director or executive of its parent company) or concerning the analysis of companies in which its parent organizations have a significant economic stake.

As Mr. Carbonara, proprietor of Frontis Governance, states: "the best way to manage any conflicts of interest is to avoid them".[86] While some conflicts cannot be totally evaded but only managed, virtually all Proxy Advisors but one eliminated the business-type of conflict by deciding not to provide advisory services to either issuers or shareholders proponents,[87][88][89]whereas ISS does not provide such services only to the latter.[90]

3.3.1 - Outstanding Conflicts of Interest

The most controversial and foremost COI in the industry regards ISS, fully owning ISS Corporate Solutions (ICS), that advises directors and officers of stock companies.[91] Klöhn

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[86] See *supra* note 74
[87] Glass Lewis Statement of Compliance (2018) [online] Available at: http://www.glasslewis.com/wp-content/uploads/2018/02/GL-Compliance-Statement-2018.pdf
[88] Proxinvest Compliance Statement (2015) [online] Available at: http://www.proxinvest.fr/wp-content/uploads/2015/07/Proxinvest_Compliance_Statement_BPP_2015.pdf
[89] ECGS "Answer to the ESMA questionnaire for proxy advisers" (2012) [online] Available at: https://www.esma.europa.eu/file/10586/download?token=2H47Sl_9
[90] ISS Compliance Statement (2017) [online] Available at: https://www.issgovernance.com/file/duediligence/best-practices-principles-iss-compliance-statement-april-2017-update.pdf
[91] ISS Corporate Solutions Website [online] Available at: https://www.isscorporatesolutions.com

and Schwartz (2012) suggest that ISS may not give impartial recommendations on aspects such as executive compensation to shareholders when the Board of the company sought the advice of ICS[92]. But the implications of ISS owning ICS are more far-reaching than just an impaired advice, which, per se, would already be cause for concern.

First, as Mr. Kaufmann and Mrs. Biedermann of the Ethos Foundation note in their response to BPPG consultations, parallel consulting services are negatively perceived by the market and impair the credibility of the Proxy Advising profession in its entirety. Moreover, Ethos claimed to "have been informed by some issuers that one proxy firm strongly recommended an analyzed company to use the consulting services proposed by its firm in order to gain a "yes" vote".[93]

Mr. Carbonara notes how allowing a PA firm to provide advisory services to issuers distorts competition.[94] As almost all Proxy Advisors avoid this type of conflict by self-regulating not to provide any advisory services, any PA firm who does so may gain a huge competitive advantage. That is because it could adopt aggressive commercial strategies reducing the price of proxy researches thanks to another stream of revenues coming from the issuers. If investors are surely interested in the quality of an analysis, the pricing factor is still a crucial aspect when choosing a Proxy advisory service provider. This is especially true for the investors that perceive the voting as just matter of compliance.

This practice may constitute an abuse of a dominant position.

3.3.2 - Principle Two: 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.

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[92] See *supra* note 10
[93] See *supra* note 75
[94] See *supra* note 74

The Guidance of Principle Two illustrates how signatories should address conflicts of interests treating aspects such as Conflicts-of-Interest Policy, Possible Conflicts for Consideration, Conflict Management & Mitigation and Conflict Disclosure.[95]

Conflicts-of-Interest Policy: Signatories should disclose their conflict-of-interest policy that explains the existence of potential material conflicts, how such conflicts are divulged to clients, how employees are trained in the operation of the policy and how conflicts will be managed.

Possible Conflicts for Consideration: Signatories should consider conflicts arising from, but not limited to, ownership structure, employee activities, investor-client influence, issuer-client influence, influence of other clients.

Conflict Management & Mitigation:

The Guidance suggests that conflicts should be mitigated with procedures such as Transparent policies, Code of Ethics, division of labor, employee recusals, fire walls, information barriers, independent oversight committees, physical employee separation and separate reporting stream.

3.3.3 - Compliance with Principle Two and Assessment

Formally signatories Proxy Advisors broadly comply with Principle.[96] The true question to ask ought to be: should a Business-sort COI (i.e. parallel advisory service to issuers) be considered as a simple conflict or as an incompatible mandate?[97]

Most of the measures for addressing possible conflicts seem adequate. The disclosure in of potential conflicts of the personal type in the reports is common practice in proxy research industry. Similarly, PA recur to employee recusals when necessary.

With regard to the organizational sort of COI, ISS and Glass Lewis have strict and

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[95] See *supra* note 72 pp.16-17

[96] See *supra* note 82 p.41

[97] e.g. an auditor keeping the books of an audited company.

transparent policies when interacting with issuers somehow tied to their owners, either via persons of interest or via ownership structure. [98][99]

Periodically acknowledged and reviewed Code of Honors for employees are enforced thoroughly, even though there have been incidents in the past such as the case of Brian Bennett. A former employee of ISS, he testified to have leaked information about how clients voted on corporate matters to employees of Georgeson employees who were seeking a competitive edge.[100]

The true concern comes from the system of “Chinese Walls” that separates ISS and its subsidiary ICS. ISS claims that there are strict firewalls that prevent information flows to and from ICS and Proxy Research teams. The identities of ICS clients are confidential, and issuers cannot disclose to ISS that they have purchased ICS services per contractual obligation. A whistleblower hotline was set up to collect evidences of misbehaviors in this matter.[101]

As sound as these measures might appear, there are many doubts on their efficacy.

Ethos and Frontis Governance point out that analyst can easily identify listed companies using researcher’s advisory services.[102][103] Most importantly, all these issues could be avoided in the first place should ISS decide to spin-off its subsidiary ICS.

As ESMA and many other players in the industry note[104], this issue is still cause for concern and therefore Principle Two is not efficacious. If the Principle recognized parallel advisory services as an incompatible activity with the proxy research, it would probably be more efficient.

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[98] See *supra* note 87
[99] See *supra* note 88
[100] Nate, Raymond “Ex-proxy adviser employee says he leaked information in return for sports, concert tickets” Reuters 27 February 2018 [online] Available at: https://www.reuters.com/article/us-usa-fraud-georgeson/ex-proxy-adviser-employee-says-he-leaked-information-in-return-for-sports-concert-tickets-idUSKCN1GB33Z
[101] See *supra* note 90
[102] See *supra* note 74
[103] See *supra* note 75
[104] See *supra* note 82

3.4 - Constituencies Engagement area

3.4.1 - Weakening of Investor responsibilities argument

One of the main debates arising from the discussion about Proxy Advisors regards their role with respect to investor responsibilities.

Shareholders bear risk with their investment and are entitled to certain rights such as the one to vote. In the case of Institutional Investors, they are also subject to stewardship responsibilities.

This is a delicate issue to address: if on the one hand PAs may facilitate shareholders in exercising their rights, on the other some scholars believe that the over reliance on their advice may weaken the very prerogatives of investors.

For instance, Verdam (2006) notes how the excessive reliance on proxy advisors may hinder the accountability of institutional investors with regard to their position as shareholders, as it is an external advisor to guide the direction of their voting behavior.

Belinfanti (2009) notes how Proxy Advisors may influence firms' value without participating in their development. The Stewardship principles in every jurisdiction are indeed based on the premise that Investors bear the financial risk of companies' underperformance. Belinfanti also points out that Institutional Investors may adhere to following PAs recommendations rather than the one of the Board. Without entering on the merits of the advices of either part, this phenomenon could falter the dialogue between issuers and shareholders.

All these issues are exacerbated by the fact that the bulk of PA clients bundled the reports subscription including the end-to-end vote casting service, sometimes with the automatic voting following the general recommendation.[105]

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[105] Belinfanti observes this client behavior from the 2008 annual report of MSCI (previous owner of ISS). The same client behavior is described in the following annual reports up to 2013. From 2014 onwards, ISS has been owned by private equities firms, therefore we do not have public data on the matter available. Similarly, from the "Glass Lewis Response to ESMA Call for Evidence – Impact of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis" we can see that just 20% of their clients uses custom policies, another 15% of clients automatically vote following the Glass Lewis benchmark

While a stimulating debate, rather than an issue of proxy advising, the investor responsibilities discussion should mainly relate to investors and their duty of diligence and care in exercising their rights. As ISS states: "ISS provides information, analysis and voting recommendations, not voting decisions. As a general matter, the ultimate voting decision for each resolution at a company meeting remains the responsibility of the client."[106]

The response of ECGS to the ESMA Discussion paper seems the most appropriate to the weakening investors responsibilities criticism:

"Regulators might like to remind institutional investors that they keep the fiduciary duties attached to the exercise of the voting rights in the only interest of investors and that a careful vote is required for the most sizeable lines of their portfolios. But the regulators should also reckon that relying upon the proxy adviser only is the reasonable solution for a documented voting of the shares of large index portfolios including a very large number of companies."

The rationale behind Principle Three is that fostering communications between al parties involved in the investment process may strengthen the prerogatives of investors.

3.4.2 - Principle Three: Communications Policy

Signatories should have and publicly disclose their policy (or policies) for communication with issuers, shareholder proponents, other stakeholders, media and the public.

The Guidance of Principle Three illustrates how signatories should approach communication with said constituencies.[107]

Dialogue with Issuers, Shareholder Proponents & Other Stakeholders: Signatories should disclose the policy for discoursing with them. Signatories should disclose in their research reports the nature and the outcome of that dialogue.

The policy should cover issues such as the circumstances under which dialogue can occur, how signatories verify the information used in their analysis, how issuers can review

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policies while the rest uses other tailored in-house policies such as the ESG, faith-based or Taft-Hartley (pro-labor) policies. [online] Available at: http://www.glasslewis.com/glass-lewis-response-to-esma-call-for-evidence/

[106] See *supra* note 90

[107] See *supra* note 72 pp. 18-19

research reports, what are the procedures for avoiding the receipt of privileged information and how to manage them if received, how signatories communicate during the voting period (from the release of the agenda until the general meeting) and what steps are taken to protect signatories and their employees from undue pressure arising from the delivery of the service.

Dialogue with Media & the Public: Signatories reserve the right to respond to general media enquiries about the nature of their services and about the companies or issues they cover. Signatories should disclose policies for communication with the media and the public that specify, at minimum, which employees are permitted to make comments to the media and the directions regarding the publication of recommendations on any particular resolution.

Signatories should always observe the laws regarding libel, slander, market abuse, insider trading and distribution of privileged information.

3.4.3 - Compliance with Principle Three and Assessment

All signatories broadly comply with Principle Three. The procedures of dialogue engagement, media inquiries and the persons responsible communication are clearly stated. An important aspect of the Principle, linked with the *Facilitating Shareholder Activism argument* of 2.2.2, is the Proxy Advisors' stance towards the "public recommendation". Signatories may indeed respond to media inquiries and even divulge research reports. ISS do so when it is helpful "to clarify confusion in the market as to the contents of a particular report".[108] Glass Lewis may distribute special reports on key issues such as Say-on-Pay or Shareholder Proposals.[109] Voting recommendation of Proxinvest are made publicly available two days before the General Meeting. [110]

As we will see in 3.4.4, Proxy Advisors' dialogue with Issuer, dissident shareholder and

[108] See *supra* note 87
[109] See *supra* note 88
[110] See *supra* note 92

media contributed to shape the outcome of the Telecom Italia Case.
Overall, Principle Three sets a clear framework of communication which can be beneficial to the societal debate on the best practice of Corporate Governance.

4 - Thesis conclusions. From Soft Law to Hard Law: Prospect for the future of the Proxy Advising Industry

The first thing to consider before drawing up any conclusion are the hard-law rules stemming from the Article 3j on the Transparency of proxy advisors of the Revised EU Shareholders Rights Directive, effective from 10 June 2019.
Comma 1 of the Article states that “Member States shall ensure that proxy advisors publicly disclose reference to a **code of conduct** which they apply and report on the application of that code of conduct.”
Comma 2 of the Article declares that: “Member States shall ensure that, in order to adequately inform their clients about the accuracy and reliability of their activities, proxy advisors publicly disclose on an annual basis at least all of the following **information** in relation to the preparation of their research, advice and voting recommendations:
(a) the essential features of the methodologies and models they apply;
(b) the main information sources they use;
(c) the procedures put in place to ensure quality of the research, advice and voting recommendations and qualifications of the staff involved;
(d) whether and, if so, how they take national market, legal, regulatory and company-specific conditions into account;
(e) the essential features of the voting policies they apply for each market;
(f) whether they have dialogues with the companies which are the object of their research, advice or voting recommendations and with the stakeholders of the company, and, if so, the extent and nature thereof;
(g) the policy regarding the prevention and management of potential conflicts of interests.
Finally, Comma 3 states that “Member States shall ensure that proxy advisors identify and disclose without delay to their clients any actual or potential **conflicts of interests** or

business relationships that may influence the preparation of their research, advice or voting recommendations and the actions they have undertaken to eliminate, mitigate or manage the actual or potential conflicts of interests."

Interestingly, also the US are taking a similar approach for regulating the proxy advisory industry. On December 21, 2017, the House of Representatives passed the "Corporate Governance Reform and Transparency Act of 2017" and referred it to the Committee on Banking, Housing and Urban Affairs of the US Senate, where it is currently under discussion.[111]

The Bill includes parts concerning:

Registration of Proxy Advisory Firms: PAs have an obligation to register with the SEC, which will make publicly available all documents and information received.

Registration Procedures – Required information: Proxy Advisors shall disclose: procedures and methodologies used in developing proxy voting recommendations, Code of Ethics, Details of any potential or actual conflict of interest (arising from the ownership structure of the firm and from the consulting services for corporate issuers) and policies to manage conflict of interest.

SEC powers to: "censure, place limitations on the activities, functions, or operations of, suspend, or revoke the registration of any registered proxy advisory firm if necessary for the protection of investors and in the public interest".

Reliability of Proxy Advisory Firm Services: PAs shall produce recommendations based on accurate and current information, provide a draft recommendation to issuers to receive meaningful comments and employ an ombudsman that receives and seeks to resolve complaints about the accuracy of voting information.

Conflict of Interest: The SEC may issue final rules to prohibit, or require the disclosure of, any COI relating to the offering of proxy advisory services. Conflicts include the provisioning of advisory service to issuers, business relationship, ownership interests and any other personal and financial interests between the registered Proxy Advisor and its

[111] Corporate Governance Reform and Transparency Act of 2017, H.R. 4015, 115th Cong. (2017)

client or company analyzed.

Prohibited Conduct: The SEC shall prohibit any unfair, coercive or abusive practice such as conditioning a voting recommendation or departing from the systematic methodologies based on whether an issuer, or an affiliate thereof, purchases another service or product from the proxy firm.

Annual report publication that includes: the number of shareholder proposal review, the number of recommendations made and number of recommendation where the proponent received services from the proxy advisory firm.

While still in the legislative process, the US might adopt rules akin to the ones arising from the Revised Shareholder Directive.

Therefore, the Proxy Advisor industry should continue following the BPPG Principles as they have proven partly successful in mitigating the outstanding issues and are compliant with the requirements of the Directive. At the same time, the industry as a whole should stick together to dismiss any doubts of purposeful conflicts of interest. This means that all PA firms should sign a reviewed set of Principles that bars advisory activity to issuers parallel to the proxy research. ISS should spin off its subsidiary ICS in order to achieve such a goal and not to incur in further antitrust scrutiny from either European or US regulators. That would be a commendable act as no public resources would be wasted trying to solve a problem that could have been easily avoided in the first place. Furthermore, a more authoritative self-regulation of the industry might foster a "race to the top" towards best practices arising from healthy competition rather than from governmental intervention.

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