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25 June 2012

Dear Sirs,

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

INTRODUCTION

The Quoted Companies Alliance is the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The Quoted Companies Alliance Corporate Governance Committee has examined your proposals and advised on this response. A list of committee members is at Appendix A.

RESPONSE

We welcome the opportunity to respond to this consultation on the proxy advisory industry. Given that the constituency we represent is small and mid-size quoted companies, we strongly support anything that will encourage and facilitate investment into this often marginalised sector of the market.

Small and mid-size quoted companies are very keen to attract investment and support from active and engaged shareholders. However, we are concerned that voting advice given by proxy advisory firms is often too rigid and does not take into consideration the specific circumstances which apply to small and mid-size quoted companies. Small and mid-size quoted companies are different to the larger and more heavily capitalised companies comprising FTSE 100 and FTSE 250. Accordingly, small and mid-size quoted companies must apply different the corporate governance practices and this has been reflected by the principles of the UK Corporate Governance Code (the **"Code"**) being applied down to the small and mid-size quoted sector through our Corporate Governance Guidelines for Smaller Quoted Companies[1] (September 2010) (the **"QCA Code"**).

Just as a "one-size-fits-all" is inappropriate in the context of corporate governance codes, we are concerned that the application of such an approach to voting advice will undermine the basic concept of comply or explain and encouraging a "tick box" mentality. We firmly believe that it is for companies to set out a sensible analysis of reasoned governance decisions and for the investment community to form views on the application of best practice through the direct circumstances applicable to each company.

To move away from reasoned analysis to box ticking and criticism of companies for failing a box tick analysis would not benefit small and mid-size quoted companies, the investment community or European

[1] http://www.theqca.com/shop/guides/26706/corporate-governance-guidelines-for-smaller-quoted-companies-september-2010.thtml

economic recovery. It is likely to make investment into small and mid-size quoted companies less attractive at a time when business growth should be encouraged. Investment into small and mid-size quoted companies is a key engine for new European economic growth. Appendix B to this response sets out certain information regarding the contribution of our sector to the economy of the United Kingdom which we expect is replicated by our contemporaries across Europe.

In our recent QCA/BDO Small and Mid-Cap Sentiment Index[2], 47% of companies and advisors are unable to determine whether proxy voting agencies play a positive or negative role in corporate governance. 33% of companies and advisors feel that the proxy voting firms play a negative role, while 20% of companies and advisors feel they play positive role on companies' governance. We also found in this survey that companies are generally satisfied with their engagement with their investors. As such proxy voting agencies should not be doing anything to upset or distort this relationship.

Correlation between proxy advice and investor voting behaviour

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?

The high correlation is partly due to the influence of proxy advisers but also other factors. Most important is the growing influence of established best practice, not least in the United Kingdom expressed through the UK Corporate Governance Code and our own QCA Code. For commercial reasons, proxy advisers need to take account of this best practice and the challenges to each company faces when applying corporate governance in a meaningful manner with a focus on the quality of explanations.

Whilst correlation is easy to demonstrate, cause and effect is harder to identify. Where correlation is caused by investors blindly following proxy advice, we believe that there is an issue; where investors' decisions are made as a result of other factors, notably engaging with the company and making informed decisions, which happen to correlate with the recommendation made by the proxy adviser, there is less of an issue. The advisers' influence is less appropriate in the former situation.

Investor responsibilities

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

Where investors do not have sufficient resource to carry out their stewardship responsibilities and over rely on proxy advice, there is a cause for concern. However, perhaps the solution to the problem should be targeted at encouraging stewardship responsibilities to be effectively carried out by owners. Proxy advisers are merely an agent of the owners or the owners' agents. Requiring asset owners and asset managers to explain how they use proxy advice and other services provided by the proxy agents will shed some light on how they manage their responsibilities. This would ensure that their agents were acting in a transparent manner in accordance with the stewardship responsibilities of investors and would represent a very useful step.

We also believe that proxy advisers should be encouraged to demonstrate their accountability to their clients. At the moment many decisions are effectively delegated to them by many investors, but they have no responsibility, as owners, for the consequences of their actions.

Conflicts of interest

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

[2] http://bdoqcasentimentindex.co.uk/

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

The most apparent conflict is that the leading proxy adviser also provides a consultancy service to companies on corporate governance. Notwithstanding claims of appropriate information barriers, this could be perceived to represent a serious conflict risk.

The business models of the proxy advisory firms contain significant commercial conflicts of interest. To arrive at a nuanced, bespoke rounded policy and produce a bespoke high-quality analysis is difficult, time consuming and costly. Profitability of proxy advisory businesses depends on their ability to re-sell the same proxy advice to the highest possible number of clients and it is this which, understandably, leads to a focus on large issuers owned by many investors. Accordingly, we are concerned that similar resources and expertise are not then available to small and mid-size quoted companies, thus impacting on the quality of advice. We appreciate the need of proxy advisors to focus their business models in the most effective manner to deliver appropriate profits, but are concerned that small and mid-size quoted companies suffer as a result.

Voting policies and guidelines

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

a. It is important that voting policies take into account local market practices and regulation. However, it is also important that the proxy advisers explain to their clients how they take into account the local corporate governance codes as they develop and interpret their own policy, and also ensure that they interpret their clients' bespoke policies in the way desired. By way of example, the QCA Code have been warmly endorsed by the Financial Reporting Council, the publisher and guardian of the Code but is rarely referred to in the research of proxy voting agencies on small and mid-size quoted companies. We would support initiatives with the relevant regulators and the proxy voting advisor industry to encourage the further promotion of the QCA Code.

   We are aware that at least one proxy advisory firm notes that the UK Corporate Governance Code does not apply to AIM companies, but does not refer to the QCA Code or any other indicator of good practice. We believe that the QCA Code represents a sensible and proportional distillation of the spirit of the Code down to our sector. Any expectation that smaller companies should adhere to the Code is conceptually incorrect and misleading.

b. Proxy advisers should be encouraged to verify the accuracy of their reports with issuers and to correct factual errors. They should provide sufficient time for this to happen. They should not attempt to influence them for commercial gain or otherwise. As importantly, the investor and investee company should be encouraged to participate in regular and direct dialogue with owners. In particular, owners should ensure that their agents are acting in the way that they expect. In this regard the ICGN Model Mandate initiative is an important initiative which is attempting to align better the commercial arrangements between asset owners and their agents in the interests of their beneficiaries.

Voting recommendations

7. **To what extent do you consider that there could be improvement, also as regards to transparency, in:**
   a. **the methodology applied by proxy advisors to provide reliable and independent voting recommendations?**
   b. **the dialogue with issuers when drafting voting recommendations?**
   c. **the standards of skill and experience among proxy advisor staff?**

How the proxy advisor's policy is developed should be clear; any communication that goes beyond fact-checking should be public; the methodology of arriving at a voting decision needs to be explained; the systems of quality control and review of recommendations should be made clear; and the proxy advice firms should, market by market, explain the skills and experience of their staff (we have already noted how the firms' profitability is directly affected by the speed and time that is taken to write the recommendations and the amount that the individual is paid). We further note that the reliance on temporary staff must also have an effect on quality and how this is managed must be transparent.

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

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

Policy options

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

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

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

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

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

We believe that option three is the most appropriate. Given the international nature of proxy advisory firms and most investor activity, a harmonised approach seems most appropriate. In considering any regulatory measures, thought should be given to any impact on competition and increase in barriers to entry in the European proxy advisor markets – competition and diversity is helpful for investor decision-making.

We would also add that the development of stewardship codes for investors provides an additional discipline for both asset owners and their asset managers that should encourage thoughtful voting and greater engagement with investee companies. We would note that notwithstanding our previous point on cost and operational leverage, providing a service that is valued by their investor clients should drive better quality.

We understand that one proxy service provider has a very large market share - anecdotally we have heard reports of it being around 80%. The European competition authorities should consider whether this is healthy for the market and whether remedies such as making the voting process easier in the EU would serve to reduce barriers to entry – and encourage investors to manage their own voting internally - or other solutions such as unbundling the research from voting software platforms, etc.

Preventing proxy advisers from advising both companies and investors on corporate governance and other matters to eliminate this potential conflict of interest should be considered.

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

The Quoted Companies Alliance firmly believes that our member companies benefit from active and engaged shareholders but are frustrated that much of the decision-making about them is sub-contracted to proxy advisory firms who often have very rigid views and voting policies. The nature of corporate governance in small and mid-size quoted companies is very different from that of the largest quoted companies and, as has been reflected in the QCA Code and acknowledged elsewhere, requires an intelligent use of comply or explain.

Any decision of proxy advisers to use their less experienced analysts and spend less time on research for those companies where a more sophisticated understanding is required threatens the concept of comply or explain. This encourages a tick-box mentality towards governance in order to secure the support of the proxy firms. Accordingly, certain investors may become over reliant on the views of advisors in relation to smaller companies. Comply or explain needs to be intelligently applied by all of companies, regulators and the investment community.

With economic growth of paramount importance to policymakers in Europe, we believe that well governed companies, over the longer term, are more likely successfully to develop, providing economic benefits, including but not limited to returns for shareholders. Accordingly, it is important to the small and mid-size quoted sector that investors do not sub-contract their analysis of smaller companies to companies that are currently not providing a proper service to them, as to do so would represent an abdication of stewardship responsibilities.

We firmly believe that analysis of the QCA Code and the equivalent European guidelines for small and mid-size quoted companies should be the basis for research by the proxy advisors and all investors on companies in the small and mid-size quoted sector. Furthermore, it is important that proxy advisors are able to demonstrate that they are providing research on smaller companies of comparable quality to that which they produce for larger companies.

If you would like to discuss this in more detail, we would be pleased to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

APPENDIX A

The Quoted Companies Alliance Corporate Governance Committee

Edward Beale	Western Selection Plc
Tim Bird	Field Fisher Waterhouse
Dan Burns	McguireWoods
Anthony Carey	Mazars LLP
Richard Chin	Oriel Securities Limited
Louis Cooper	Crowe Clark Whitehill LLP
Madeleine Cordes	Capita Registrars Ltd
Edward Craft	Wedlake Bell LLP
Kate Elsdon	PricewaterhouseCoopers LLP
Nicola Evans	Hogan Lovells International LLP
David Fuller	CLS Holdings PLC
Clive Garston	DAC Beachcroft LLP
Tim Goodman	Hermes Equity Ownership Services
Nick Graves	Burges Salmon
David Isherwood	BDO LLP
Kate Jalbert	The Quoted Companies Alliance
Colin Jones	UHY Hacker Young
Dalia Joseph	Oriel Securities Limited
Derek Marsh	China Food Company PLC
Claire Noyce	Hybridan LLP
James Parkes	CMS Cameron McKenna LLP
Anita Skipper	Aviva Investors
Julie Stanbrook	Hogan Lovells International LLP
Jacques Sultan	The Quoted Companies Alliance
Eugenia Unanyants-Jackson	F&C Investments
Melanie Wadsworth	Faegre Baker Daniels LLP
Tim Ward	The Quoted Companies Alliance
Cliff Weight	MM & K Limited

APPENDIX B

THE QUOTED COMPANIES ALLIANCE (QCA)

An independent organisation funded by its members, the Quoted Companies Alliance champions the interests of small and mid-size quoted companies, their advisors and investors. It was founded in 1992, originally known as CISCO.

The Quoted Companies Alliance is governed by an elected Executive Committee, and undertakes its work through a number of highly focussed, multi-disciplinary committees and working groups of members who concentrate on specific areas of concern, in particular:

- taxation
- legislation affecting small and mid-cap quoted companies
- corporate governance
- employee share schemes
- trading, settlement and custody of shares
- structure and regulation of stock markets for small and mid-cap quoted companies;
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from various standard-setters

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents quoted companies in fourteen European countries.

Quoted Companies Alliance's Aims and Objectives

The Quoted Companies Alliance works for small and mid-cap quoted companies in the United Kingdom and Europe to promote and maintain vibrant, healthy and liquid capital markets. Its principal objectives are:

Campaigning the Government, Brussels and other regulators to reduce the costing and time consuming burden of regulation, which falls disproportionately on smaller quoted companies

Promoting the smaller quoted company sector and taking steps to increase investor interest and improve shareholder liquidity for companies in it.

Educating companies in the sector about best practice in areas such as corporate governance and investor relations.

Providing a forum for small and mid-cap quoted company directors to network and discuss solutions to topical issues with their peer group, sector professionals and influential City figures.

Small and mid-cap quoted companies' contribute considerably to the UK economy:

- There are approximately 2,000 small and mid-cap quoted companies
- They represent around 85% of all quoted companies in the UK
- They employ approximately 1 million people, representing around 4% of total private sector employment
- Every 5% growth in the small and mid-cap quoted company sector could reduce UK unemployment by a further 50,000
- They generate:
    - corporation tax payable of £560 million per annum
    - income tax paid of £3 billion per annum
    - social security paid (employers' NIC) of £3 billion per annum
    - employees' national insurance contribution paid of £2 billion per annum

The tax figures exclude business rates, VAT and other indirect taxes.

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