CORPORATE GOVERNANCE

Pass-through Voting

Granting a voice to the investor community in the passive investment space

Produced in collaboration with

Firebrand research

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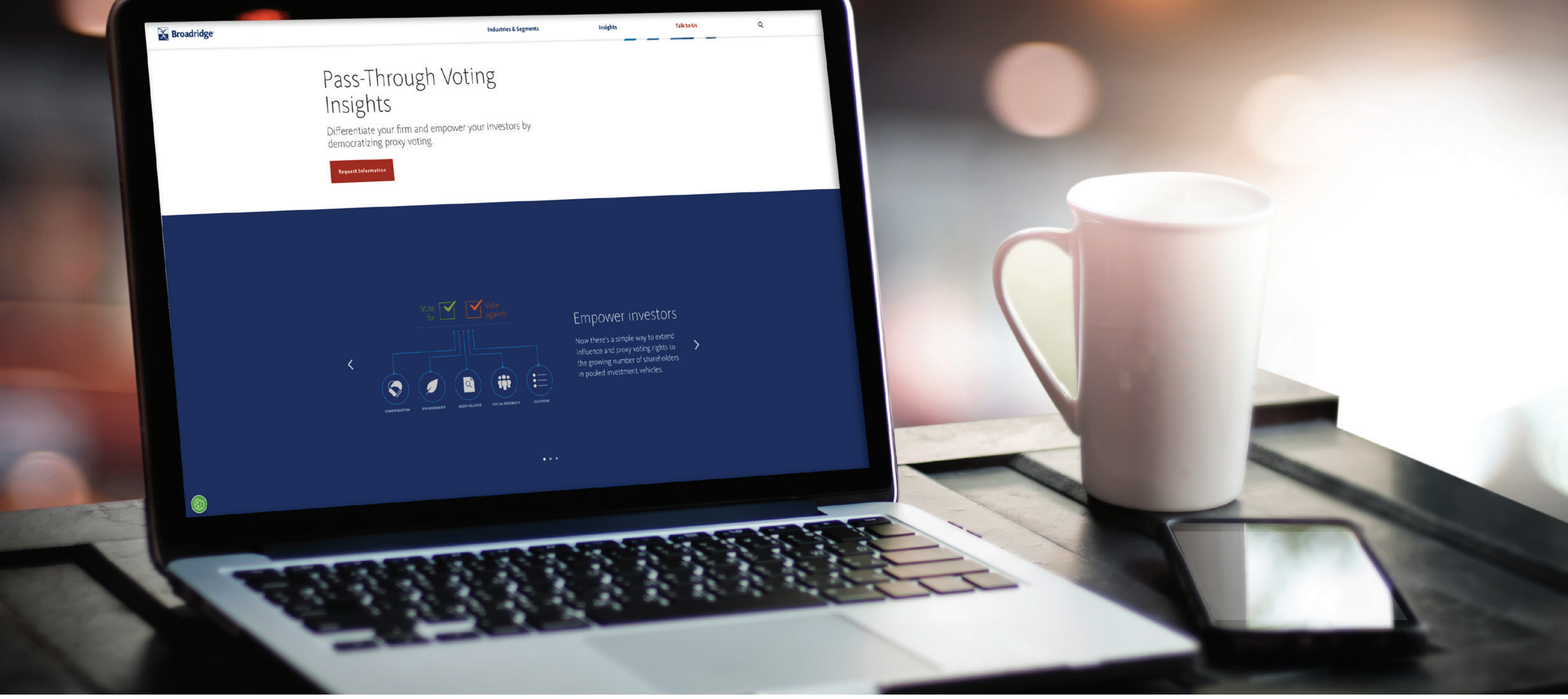


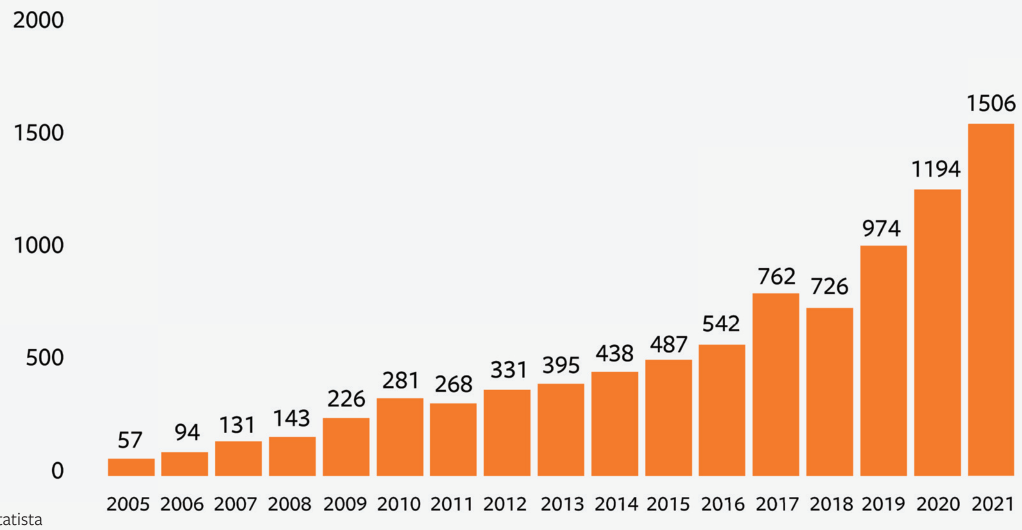
WHAT IS PASS-THROUGH VOTING?

Retail and institutional investor appetite for investment funds has grown as the variety and volume of these offerings has increased over time. Collective investment vehicles in Europe, for example, have evolved as regulatory regimes and industry innovation have shaped the sector, including Undertakings for the Collective Investment in Transferable Securities (UCITS) funds, Alternative Investment Funds (AIFs) and exchange-traded funds (ETFs), to name just a few.

The growth story within the European ETF market (highlighted by the statistics from Statista in the diagram below) is proof that the future direction of travel for the industry is much more toward these fund vehicles than pure equities. While investors in equities have always been able to vote proxies, the funds sector traditionally has not offered the same level of engagement opportunity to its growing investor community. However, this is gradually changing with the advent of pass-through voting.

Total AUM of ETFs listed in Europe

(in U.S. $ billions)



Source: Statista

KEY TAKEAWAYS

- Pass-through voting capabilities could be a differentiator: With so many investors focused on governance as part of the ESG agenda, firms that fail to meet industry demand could fall behind their competition. If large players such as BlackRock have moved in this direction, the rest of the market is likely to follow.

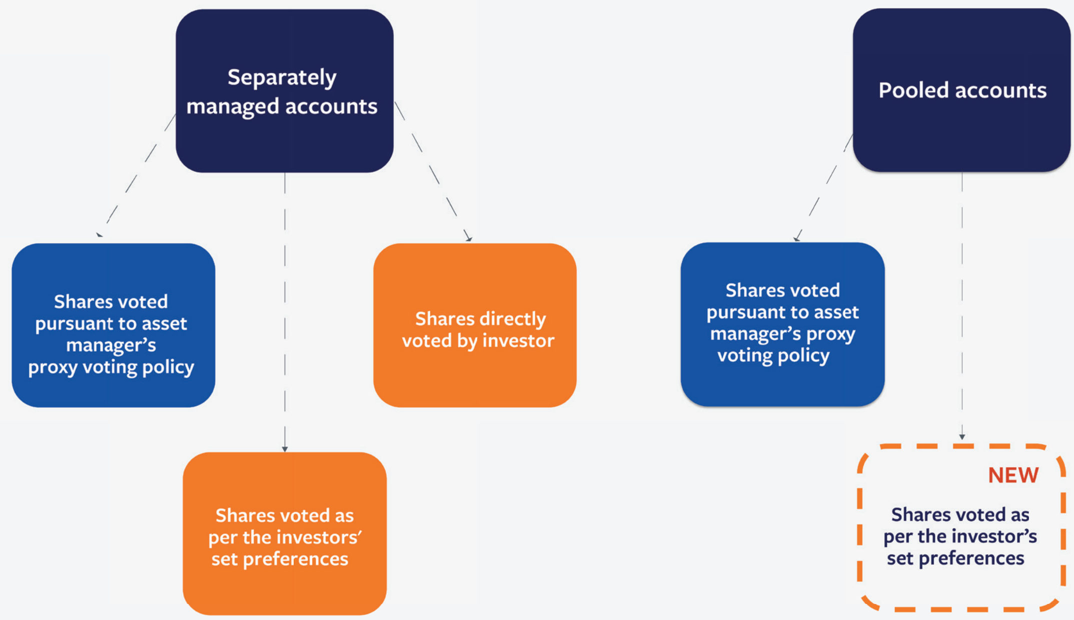
- Regulatory changes are likely to drive forward more end investor engagement: The priorities of regulators across the globe reflect the need to ensure shareholder democracy is maintained in spite of the changing investment product dynamics. As investment vehicles such as ETFs become more prevalent throughout the world markets, there will likely be much more regulatory scrutiny of governance processes related to these assets.

- Pass-through voting gives a voice to all shareholders: Rather than relying solely on overburdened investment stewardship teams' decisions, pass-through voting provides a valuable input for these teams and allows all investors to weigh in on important decisions.

Investors in funds have been obliged to rely on their asset managers to vote in their best interests for some time. Institutional investors that wanted to incorporate specific voting policies for their investments have had to ask their asset managers to create a dedicated fund committed to voting in line with those policies. However, with the introduction of pass-through voting, some large asset managers have now opted to allow their institutional and, in some cases, retail clients more of a direct voice in the proxy process.

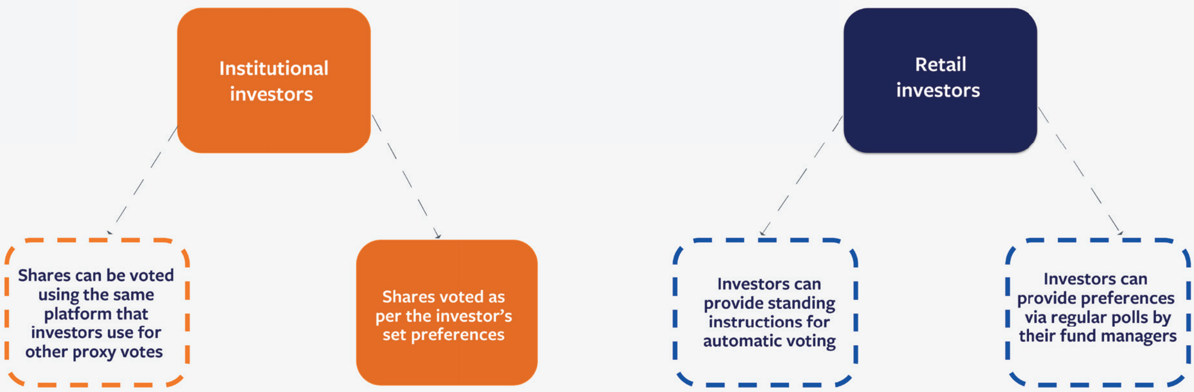
The adoption of pass-through voting enables individual and institutional investors to influence how the funds vote on key issues without the requirement to create a new fund even if the asset manager is the legal beneficial owner of the underlying securities in UCITS fund or ETF. As shown in the diagram below, investors in investment funds can now have shares voted as per their chosen policy or preferences via the pass-through voting process. This voting can be in alignment with their own choices or with those of their designated proxy advisor policies.

The voting options



The process for institutional investor voting is not exactly the same as that offered to retail clients as it must be tailored to each investor type. The diagram below highlights the options Broadridge provides for its clients to facilitate pass-through voting. Asset managers are able to split the vote in portfolio companies proportionally according to the investor's holdings relative to other investors. Institutional investors have the option of using their existing voting platform to vote the proxies for the underlying portfolio companies in investment funds. Retail investors, on the other hand, have two options for voting. They can provide their asset manager with voting instructions on any individual equities held by the fund for pre-determined meetings via established standing voting preferences. Alternatively, asset managers can poll these retail investors to capture vote preferences and give directional input for the asset manager voting on an ongoing basis.

The pass-through process for retail versus institutional investors



DRIVERS FOR PASS-THROUGH VOTING

There are numerous drivers for asset managers to consider when adopting pass-through voting for their clients, including the increasing prevalence of environmental, social and governance (ESG) investment strategies. Individual investors have become much more focused on the G in ESG over recent years as demonstrated by the increase in shareholder engagement around topics such as 'say on pay,' board diversity and sustainable investing. The governance aspect of ESG is perceived by many to be where the most impact can be made by individual shareholders on corporate entities.

From a fund governance perspective, pass-through voting improves the democracy of shareholder voting in the investment funds space as it allows asset managers to more accurately reflect the views of their clients when voting proxies. Arguably, it allows these firms to benefit from more external inputs when voting and it reduces the potential for both conscious and unconscious bias in the investment stewardship team's decision-making. Moreover, it is in line with the goal of improved transparency in corporate governance, which is an essential component of the ESG agenda.

The governance and oversight burden on investment stewardship teams continues to increase as more industry focus is directed toward the voting process and volumes increase. These teams at the largest fund managers within the investment funds universe range in size from 10 to 40, which places a lot of pressure on these individuals to scrutinise and make decisions without external input. As of mid-July 2022, there were 813 shareholder proposal filings in the Russell 3000 Index and 642 in the S&P 500, according to ESGauge. Providing these teams with more directional input from end investors could significantly ease concerns about governance missteps at the firm level.

One of the greatest drivers for change in governance processes will be the investors themselves. ESG developments aside, the amplification of the retail investor voice via social channels such as Reddit and Twitter has been noticeable over the last few years. The investor community, both institutional and retail, is beginning to demand much more of a say in the direction of their investments.

THE REGULATORY PUSH

The regulatory focus on ESG across the globe includes improving investor engagement and transparency, which is why regulations such as the updated Shareholder Rights Directive (SRD II) have been implemented in regions such as Europe. Governance practices are also under review in nearly every major market, for example, the Monetary Authority of Singapore updated its code of corporate governance at the start of 2023 to reflect exchange rule changes related to director tenure and compensation. Furthermore, there are specific regulatory proposals in play that directly relate to pass-through voting processes in other countries such as the U.S.

In May 2022, a US senator introduced a new bill intended to rein in the power of the largest investment advisers over corporate governance in the passive investment space. The Investor Democracy is Expected (INDEX) Act promotes the use of practices that allow end investors to vote on shareholder decisions, such as pass-through voting. If enacted, this law would require investment advisers of passively managed funds holding more than 1% of a company's shares to vote a proportionate number of those shares in accordance with voting instructions received from end investors.

The regulatory focus on the G in ESG sits alongside the more specific goals of regulators such as the European Commission to foster more robust capital markets via encouraging greater retail investor activity. To this end, European regulators have crafted a framework under the Capital Markets Union (CMU) that is targeted at improving retail investor engagement.

The UK's Financial Conduct Authority (FCA) has indicated that effective investor stewardship is a key priority for the regulator and it is a core part of its ESG Strategy. It is working with the Financial Reporting Council (FRC), the Pensions Regulator (TPR), the Department for Work and Pensions (DWP) and other government bodies to reduce the barriers to effective asset owner voting implementation for UK pension funds. Its work follows the recommendations of the Taskforce on Pension Scheme Voting Implementation's (TPSVI) report, which was published in September 2021.

The TPSVI recommended that the FCA take further actions to review asset manager voting practices and disclosures, which resulted in the FCA's establishment of a Vote Reporting Group in late 2022. The group is currently drafting proposals to "better equip asset owners to hold asset managers to account on their voting activity," according to the FCA's director of ESG. This will include further disclosure requirements for asset managers but may also include recommendations for the adoption of pass-through voting market practices.

THE CONTINUED RISE OF PASSIVE INVESTMENT

Passive investment strategies aren't disappearing any time soon. The investor preference for these funds is no doubt linked to their long-term investment horizons, which is in keeping with the goals of pension funds in particular. They have grown significantly in the U.S. market, and even in Europe these strategies are beginning to increase in adoption despite some headwinds.

In 2021, inflows into BlackRock's European-domiciled iShares ETFs jumped by a third from U.S. $60 billion the previous year to U.S. $80 billion. Certain countries have seen more growth than others, for example, Germany has witnessed significant growth in ETFs due to the uptake of ETF savings plans offered by newer online platforms and mobile investment applications. The number of these plans increased from 500,000 in June 2017 to just under five million at the end of March 2022, according to data from extraETF.

The CMU plan includes reducing some of the barriers to the adoption of these passive investment strategies across the European region, which may spur further growth. ESMA (European Securities and Markets Authority) has been measuring the costs and performance of EU retail investment products over recent years and has been placing pressure on national regulators to come into greater alignment around reducing the costs for UCITS funds and ETFs.

NEXT STEPS

The increased appetite for pass-through voting processes that better enable investor engagement and the fact that several of the largest asset managers in the market such as BlackRock, Charles Schwab and Vanguard have adopted such a model indicates that other firms are likely to move in this direction. The competitive disadvantage of failing to meet client demand for a greater voice in the investment funds space should not be ignored. However, any such move needs to be considered carefully as it means existing capabilities and paperwork need to be reviewed and processes adapted.

THINGS FOR ASSET MANAGERS TO BEAR IN MIND

Asset managers who consider adding pass-through voting capabilities to their client offerings should remember several things:

- Investor education is a key component for success, especially for the retail investor segment.
- Their fiduciary duties to vote in the best interests of their funds when structuring voting options. These options should be consistent with the goals of the fund and be clear and concise for the end investors to vote upon.
- The voting demographics may need to be monitored to ensure that key votes are not swayed by a small group of investors. Managers may wish to review votes during the submission process for retail investor voting to ensure governance and oversight standards are maintained, which is likely to be a regulatory and industry concern moving forward.
- Required updates to existing fund documentation may be needed to ensure that account changes to the voting process, especially in areas such as delegation of voting authority, are documented accordingly.
- Asset managers should also review their regulatory disclosures related to governance processes and investor voting transparency as these may need to be amended.

CONTACT BROADRIDGE

To engage in further industry dialogue relating to the Capital Markets Union, Shareholder Rights Directive II, Environmental, Social and Governance and shareholder communications, or for more information about Broadridge's proxy management, shareholder disclosure and corporate governance services, please contact:

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